
Session 3

Accounting Issues related to Financial Management

IPF

CIPFA

PUBLIC SECTOR ACCOUNTING

Chamber of Control, Georgia

7 January 2002

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Why is accounting important to auditors?

- The accounting issues for auditors
- The purposes of accounting
- Public accountability
- Forms of accounting
- Deciding on the best accounting system for 'you'!

We regard auditing as an accountancy rather than a legal discipline. Auditors are not magistrates

Accounting

Good accounting essential for:

- Budgetary control
- Management control
- Performance measurement
- Providing a discipline with intellectual rigour about the way accounts are kept

Without these effective audit is not possible and
'control' is spurious

Accounting

Good accounting raises difficult issues and auditors should have a view: e.g.

What is meant by:

- Capital, revenue, assets, liabilities, depreciation, the balance sheet?

What do we mean by:

- Accountability, performance, valuation, control, audit?

Who are and what are the responsibilities of:

- Accountants, managers, controllers, auditors?

The purposes of accounting (1)

Auditors should also have views on the purposes of accounting, e.g. about:

- Public accountability, including information to Parliament and its control processes
- Information to stakeholders – essential in a democracy
- Demonstrating that revenues have been properly collected and accounted for
- Showing that assets and liabilities have been properly valued and accounted for

Revenues and assets do go ‘missing’!

The purposes of accounting (2)

Auditors should also want the accounting system to be consistent 'year on year' and to ensure that:

- There is a comprehensive reporting of activity
- Managers do properly control the activities of the state/organisation they are responsible for
- There is accurate preparation of budgets

Without these purposes being satisfied there cannot be a thorough and independent audit

The purposes of accounting (3)

Therefore auditors need to ask: For what purpose are transactions recorded?

- Is it just to identify expenditure against the budget (but was the budget properly prepared in the first place?) and to complete the chart of accounts?
- Who specifies the form and detail of the chart of accounts and for what reason?
- Who uses the information in the chart of accounts and for what purpose? - Do you?
- Is there any other record or analysis and is it consistent with the published chart of accounts?

The purposes of accounting (4)

We see accounting as a creative and dynamic instrument able to:

- Facilitate control of the direction of the organisation
- Manage the efficiency and effectiveness of the organisation
- Assess the reliability of the budget
- Demonstrate how resources have been used
- Inform all interested stakeholders

Do you see accounting in the same way?

The purposes of accounting (5)

To facilitate good accounting the auditor should recognise that:

- The substance of accounting is much more than completing the chart of accounts
- Successful management depends upon good quality and timely financial information
- Efficient and effective public services depend on good management which in turn depends on good accounting

Therefore the auditor should be concerned with far more than control: good accounting is essential to efficiency and effectiveness.

Public accountability (1)

Accounting is a key factor in public accountability: it should demonstrate:

- That the law and the budget have been complied with
- That proper records have been maintained
- That the organisation has achieved the performance standards set for it
- The accountability of management

The audit role is to provide confidence through independent certification and assessment

Public accountability (2)

Inefficiency in revenue collection is a major public sector problem. Accounting can provide evidence of failure to:

- Levy appropriate taxes
- Construct a proper tax base
- Collect taxes due
- Levy appropriate charges
- Collect appropriate charges

The auditor should ensure the accounting system provides this evidence.

Public accountability (3)

Accounting system should demonstrate that assets are properly accounted for, but this is a major weakness of public sector accounting because usually Governments do not know:

- What assets they have
- What they are worth
- Whether they are being used properly
- If they are being properly maintained

Does the auditor know the answers? How can he without a good accounting system?

Public accountability (4)

Accounting system should demonstrate that liabilities are properly accounted for, but:

Greater problems with liabilities because:

- Political/legislative promises not recorded, yet make calls on future revenues
- Perceived cost is current expenditure (which may be minimal)
- Future liabilities may be difficult to identify and value (e.g. environmental and pension)

How will the auditor deal with such issues? How can he quantify them without a good accounting system?

Public accountability (5)

Is everything accounted for?

Financial reporting should be comprehensive, i.e. should cover all activity, but does it:

- Include all funds of the government that the government controls, including trading
- Define what is meant by 'control'
- Match the budget in terms of coverage
- Include 'off-balance sheet' activity
- Include defence and other 'private funds'?

The accounting system should cover everything.

Equally the audit report should be comprehensive.

Good accounting allows managers to manage!

Does managerial freedom exist and can the manager be held accountable?

- Are there clear objectives and performance targets?
- Is the manager able to reallocate resources?
- Is the control at a detailed or higher level?

The accounting system should support managerial needs.

The auditor should be satisfied managerial needs are met.
Without that how can the auditor conduct an efficiency and effectiveness audit?

Good accounting facilitates preparation of budgets!

Budget is usually the most important document, but:

- Often a legal document only
- Based on inputs not outputs
- Frequently requires illogical detail
- Sometimes unrealistic - is a political agenda
- Does not reflect financial reality because budget and accounts not linked

Budget should be based on actual financial position. What is the point in the auditor checking payments against the budget if the budget is unrealistic?

Good accounting facilitates independent audit

Audit extends beyond checking the numbers and the authority to spend: it can only be effective if the accounting system :

- Is reliable
- Provides appropriate analyses
- Is comprehensive, and
- Corresponds to management responsibilities

The forms of accounting-which type of accounting system is best?

Two forms of accounting:

- Cash
- Accrual

Most Governments account on a cash basis; sometimes with elements of accruals (often in subsidiary organisations)

Where accounting is cash based there is often inconsistent recording from year to year

Cash accounting (1)

Benefits:

- Records cash flows
- Easy to understand and record
- Facilitates link with taxation
- Facilitates Parliamentary control

Cash accounting (2)

Problems:

- Easy to manipulate
- Provides no information about assets or liabilities
- Provides no information about creditors or debtors
- May not separate capital from revenue
- Not necessarily comprehensive
- Little use to management other than as cash control

Accrual accounting

Benefits:

- Covers assets/liabilities/debtors/creditors
- Clear separation of capital and revenue
- Facilitates managerial control
- Encourages development of vfm approaches
- Facilitates more effective audit
- Requires comprehensive accounting
- Can be measured against a set of standards

Accrual accounting

Problems:

- Requires use of sophisticated skills
- Requires considerable use of judgements
- Therefore, also capable of manipulation
- Accounts and budgets should be on same basis
- Makes Parliamentary control more difficult
- Should require change in management approach

Accrual accounting

Requires new thinking about e.g.

- Costs of capital
- Cash flow
- Valuation and use of assets
- Valuation and level of liabilities
- Balance sheets and the information displayed

Should expose 'hard decisions'

Cash v accrual accounting

Overall accrual far better system but requires:

- Extensive preparation
- Availability of accounting skills in Government
- Willingness to change the management style and to use the information produced
- Use of computerised information systems
- Significant change to chart of accounts
- Audit and long run Parliamentary support

Should accrual accounting be adopted?

The pressure is adopt: however very unwise unless:

- There is a cultural acceptance to 'obey the rules'
- There is no systemic corruption
- The cash system is already robust
- There are no major management problems such as a lack of a comprehensive budget
- A willingness exists to make 'hard' decisions
- A technical capability is available
- A recognition that the change will take time

Should accrual accounting be adopted?

If these conditions do not exist, risks are:

- Will not be understood
- Will not as a result be properly implemented and maintained
- Benefits from better management will not occur
- The areas of judgement will be manipulated
- Consequently, potential loss of control

The auditor should ensure realism about the issues!

Accounting in public finance - summary

- Essential element in public accountability and good governance, hence
- Vital for a successful democracy
- Accounting reform goes with budgeting, Parliamentary & management reform
- Ensure cash accounting is sound before reform
- To adopt accrual accounting needs far more than technical knowledge

The audit interest is to secure a good accounting system!