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## Performance Budgeting—Is Accrual Accounting Required?

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**Abstract**

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper reviews the role of accounting in budget system reform from the perspective of emerging economies who wish to adopt the OECD's performance budgeting reforms. While many OECD countries, pursuing the reforms associated with the New Public Management, have moved their accounting systems from a cash to an accrual basis, this paper argues that given the costs involved, such a move is perhaps only worthwhile in the context of adopting much wider public sector management reforms. Moreover, while recognizing that accrual accounting does support public expenditure management best practices, it is also argued that many of the objectives of performance-oriented budgeting can be attained by less than full accrual accounting, and that unless certain preconditions are met it is safer for countries to remain with, and improve, their cash-based accounting systems. For those countries with sound enough cash-based systems the paper describes a possible phased approach to the introduction of accruals, as well as the parallel stages of adopting the new international GFSM 2001 reporting requirements.

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## I. INTRODUCTION

Emerging economies, as well as some of those in transition, have looked to member countries of the Organization for Economic Cooperation and Development (OECD) as models for reforming their public expenditure management (PEM) systems. In these countries there has been a continued stress on more complete accounting information and the need to reform these accounting systems. Accordingly, emerging economies have sought to replicate the accounting reforms in the more advanced OECD countries—usually in moving government accounting from cash to an accruals basis.<sup>2</sup> Despite the fact that this conversion has only been achieved in a handful of OECD countries, it is recognized that others have had to modify their pure cash-based systems to a modified accrual systems to accommodate accrual based reports.<sup>3</sup> Accrual-based reporting has received considerably more attention with the recent change in international Government Finance Statistics (GFS) reporting standards recommending adding accrual information to existing cash data, and reporting cash data consistent with an accruals basis.<sup>4</sup>

Often emerging economies have too eagerly accepted this reorientation, and have overlooked a number of important issues. This paper examines one of the more important of these issues: specifically, the need to recognize the relationship between reforming the government's accounting system and wider budget system reforms.<sup>5</sup> First, it is argued that moving to an accrual accounting system, given the costs involved, is perhaps only worthwhile in the context of adopting wider public sector management reforms. Second, since the reform process inevitably takes time, it should be planned in a phased way, and the paper describes possible stages in moving to accrual accounting. Third, recognizing that many countries are constrained from moving in this direction in the near future, the paper examines some intermediate solutions for gaining some of the benefits afforded by accrual accounting in cash-based systems. Fourth, while agreeing that accrual accounting systems are more comprehensive, and provide a wealth of financial information, it is important at the same time not to overstate their case. The requirements of budget management typically will require supplementary information. Last, the paper reviews the approach of countries in adopting the new accrual-based GFS reporting requirements. While agreeing it will be possible from a reporting viewpoint to meet most of these new requirements without adopting full accruals, it is also suggested that from a budget management viewpoint, and for in-year reports, this will be extremely difficult without such a move. The paper describes the possible stages of adopting the new international reporting requirements paralleling the move to accrual-based accounting.

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<sup>2</sup> Currently about half of all OECD member countries have adopted accruals to some degree. There are great variations, however, on the extent of this movement: some at agency and ministry level financial reporting; some to whole of government financial reporting; and some others to budgeting. See OECD (2002).

<sup>3</sup> Such as those required by the Maastricht criteria.

<sup>4</sup> It should be noted that the IMF's standards for the reporting of GFS emphasizes accrual concepts as a statistics standard and not an accounting standard, whose design is for macroeconomic analysis of fiscal data. See IMF (2001).

<sup>5</sup> Diamond (2002).

## II. THE MOVE FROM CASH TO ACCRUAL ACCOUNTING

In understanding the attraction of accrual over cash accounting it is best to first clarify the differences between the two systems of accounting. The most important distinction is the so-called *basis of accounting*. This describes the fundamental measurement rules instructing accountants on when to register or “recognize” the effects of an entity’s transactions, i.e., based on the timing of registering the transaction’s effects. In the accrual system, recognition occurs with the exchange of liabilities/assets, usually before the cash flow, which is closer to measuring the economic impact of the transaction.<sup>6</sup> In contrast, the cash basis, used in most traditional budget systems, is perhaps the simplest and records outlays and receipts only when they involve cash transactions. This simplicity has various advantages, but also disadvantages (see Box 1).

### Box 1. Pros and Cons of Cash-Based Accounting

Pros:

- Easily comprehended by users
- Allows judgment on compliance with budget appropriations, traditionally cash-based
- Simple to implement, this ease of compilation, facilitates reports being timely, reliable, and comparable.
- Costs are low due to the lower level of accounting skills required.

Cons:

- Limited scope, not good at showing the impact of transactions resulting in cash flows outside the current reporting period.
- Cannot meet the demands for information on assets and liabilities, and impact of current consumption of the stock of assets held by government, transactions in kind, and arrears.
- Focuses solely on cash flows and ignores other resource flows which may also affect government’s ability to provide goods and services now and in the future (e.g., accumulated borrowings and other liabilities).
- Limits accountability to use of cash, ignores accountability for management of assets and liabilities.

Source: IFAC (1998).

Despite its simplicity, in practice, often many problems are encountered by countries using cash accounts. Typically, however, many of these problems do not arise from the accounting system as such, but rather its abuse. It is often claimed that cash accounting is more objective than accrual accounting, since the recognition and measurement of assets and liabilities, rather than just cash, requires a greater measure of judgment and hence there is greater room for manipulation. However, experience has shown that cash accounts also require judgment—for example, whether transactions are on or off budget, or in the timing in which they are recorded or recognized in the government accounts. Also, the strength of cash

<sup>6</sup> Chan (1998, pp. 362ff).

accounting as a constitutional safeguard in that the legislature must approve all monies spent and collected can also be its principal weakness in countries with governance problems where there is political pressure to hide rather than reveal. Box 2 gives only a few illustrations of “creative accounting” in a cash-based system. All of these distortions could be avoided by return to legitimate uses of these accounting operations.

Apart from such distortions, there are legitimate limitations and drawbacks to cash accounting, which could only be resolved by ubiquitous “memoranda items.” To the extent that during a particular year not all purchases for goods and services are paid for and not all revenues are collected implies there are carryovers in the form of payables (a liability) and receivables (an asset) that should be reported in the balance sheet at year’s end. However, there is no full balance sheet in a cash system. Thus apart from the problem of identifying arrears, there are a number of financial transactions like on-lending operations, government loans to enterprises, etc., which are difficult to capture in cash accounts since the only ledger balance carried forward is the cash balance.<sup>7</sup> The other parts of the ledger balances, in particular financial assets and liabilities, cannot be “carried forward” in the formal accounts as opening balances in the new fiscal year. The accrual basis accounts for these inter-period effects, and in so doing takes a more comprehensive view in measuring the government’s assets and liabilities.

Not surprisingly, adopting an accrual basis comes with the price of introducing considerably more complexity into the accounting process. For example, accrual accounting requires decisions on which assets and liabilities to include and which to exclude—and there is usually considerable subjectivity in applying the recognition criteria. For example, whether a contingent liability is to be recognized in the accounts or whether it is recorded off the balance sheet.<sup>8</sup> There is, thus, latitude in deciding the degree of accrual to be used, i.e., in determining the range of assets and liabilities to be included. Also, the recognition of revenues can be quite elastic: should it be cash and current financial resources; or does it include noncurrent financial resources? Can a government recognize revenues as soon as it acquires a legal claim the moment a taxable transaction takes place, or should it be treated like a business and only recognize revenues until they are “earned” or received? To avoid too much subjectivity, such questions must be answered by well-defined government accounting standards.

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<sup>7</sup> Even government debt has to be recorded through subsidiary registers, and balances carried forward. The formal cash accounts carry forward only one balance—the cash balance.

<sup>8</sup> Also, for example, generally accepted accounting principles leave investment in human capital off the balance sheet along with projected receipts, the tax base or the power to tax, as assets.

<b>Box 2. “Creative Accounting” in a Cash-Based System</b>	
<b>1. Suspense accounts</b>	
<p><i>Legitimate use:</i> A suspense account can be viewed as an account in transit that can be of three kinds: expenditure accounts, revenue accounts, and other receipt and payment accounts (financing items). Such accounts are used for expenditure when an invoice or payment order may not have sufficient information to determine where the expenditure should be posted (which budget account the expenditure should be debited from). When the invoice is paid, this is a mechanism for correcting a misclassification. If the invoice is not paid (though the good was delivered), the amount is recorded in a suspense account until further information is obtained. When the information is available, the expenditure is regularized, i.e., taken from the suspense account and placed in the correct budget account.</p>	<p><i>Typical problem:</i> No additional information is obtained; the amount remains at the end of the year, and may never be regularized. If bills are paid and the affected budget and account heads have not been debited, they show an unspent balance in the budget. This is a way the spending agency can in effect exceed its budget. If bills are not paid, arrears arise. Hence this mechanism can be used generally to circumvent expenditure controls. Another problem is where the central bank acting on the behalf of the government makes payments but delays the adjustment in the government’s books, by utilizing such accounts. Consolidation, particularly of budgetary and extrabudgetary accounts, is made more difficult.</p>
<b>2. Advance or imprest accounts</b>	
<p><i>Legitimate use:</i> A means of financing recoverable expenditures. Amounts are advanced for specific purposes (e.g., travel, salary advances to government officers for embassies in other countries, to contractors, to support work being undertaken, etc.) for which the final total is not known until after the cost is incurred. The understanding is that once known costs will be recovered and accounted for against the appropriate head. Since contingencies are not seen in advance, advance accounts are sometimes used for this purpose, again with the understanding that at year-end they will be cleared under the appropriation for contingencies. Usually it is anticipated that the advance amount will be small, but often due to time lags and late submission of payment vouchers, advances can often accumulate for a period of months beyond the close of the accounting period.</p>	<p><i>Typical problem:</i> Same as suspense accounts. Even if advance monies are repaid to the budget, a distortion is introduced: a good is acquired in one period but payment is recorded in the next period. In this way the economic impact felt in one period only affects the fiscal position in another. When spending agencies are concerned about insufficient budget provision, there is an incentive to leave such expenses as advances, and use these accounts as a contingency fund, i.e., nonclearance at end year.</p>

3. Clearing accounts	
<p><i>Legitimate use:</i> Accounts to which sums due to various agents (for service rendered to government) can be charged temporarily, like suspense accounts, awaiting funds to be cleared. The understanding is that these charges have to be cleared to appropriate account heads before the close of the financial year, i.e., there is an assumption that the provision for such expenditure exists under the relevant vote.</p>	<p><i>Typical problem:</i> Many items booked under these accounts are regular expenditure payments with no hope of being cleared in the short run due to cash constraints. These items should be recognized and paid either through contingencies or by obtaining a supplementary vote. Often this is not done, and hence these items become arrears. Also, this is an avenue for recording “irregular” expenditures.</p>
4. Trading accounts	
<p><i>Legitimate use:</i> Operated on a commercial basis using the treasury as a banker. Typically used for departments providing a service to another department or individuals with the intention of recovering the cost of such services (e.g., research facility, printing shop, works department, motor pool, etc.).</p>	<p><i>Typical problem:</i> In principle a good practice, since each department has a recording mechanism for its dealings with another. However, can be abused in the same way as clearing accounts, with recording of irregular expenditure not covered by appropriations.</p>
5. Deposit accounts	
<p><i>Legitimate use:</i> Deposit of monies, which are neither revenue nor capital receipts of the government. The interest accruing on such deposits is credited to revenue. For example, the government may collect insurance premium on behalf of its employees, and deposit these amounts in such accounts awaiting transfer to the insurance companies. A subset of such accounts is used for reimbursement (e.g., customs holds monies while goods are cleared).</p>	<p><i>Typical problem:</i> In a situation of cash shortage there is the temptation to use such deposits for other purposes, or delay reimbursement. A highly illegal use of these accounts is to circumvent the lapse of appropriation at the end of the fiscal year, by debiting the government main account and crediting a deposit account, to allow subsequent expenditure.</p>

Spending recognition is, of course, critical for budget management. The budget spending process goes through distinct stages: after the budget is approved and appropriations determined, government agencies make commitments against these appropriations, goods are received and verified, at which point the obligation to pay is usually recognized, the payment order is issued, and then eventually cashed and the government's account is debited. From an economic viewpoint it is often argued that a liability should be recognized at the commitment stage, when the government first takes command of resources, rather than at the verification stage. However, not all commitments are the same. Some like wages are converted into cash with minimal time lags, others like investment spending associated with large-scale multiyear projects involve considerable time lags between the commitment and cash outlay. Further, it is necessary to recognize that not all commitments will be fulfilled, since not all contracts



will be honored and cash payment eventually made. As a result, the verification stage tends to be preferred for recognition purposes as the point when the liability is reliably created.<sup>9</sup> The budget manager, however, will have to follow all stages of the spending process. Although, the speed of commitments made, and the goods received and verified, are important for planning future cash needs, the difference between outstanding payments orders due for payment and those overdue for payment is also very important. Thus, regardless of the basis of accounting, whether it be cash or accrual, sound budget management requires attention to be paid to accrual concepts, such as payables and contingent liabilities, and not just cash flows.

### **III. DIFFERENT ACCOUNTING MODELS FIT DIFFERENT MANAGEMENT NEEDS**

As previously argued, accounting needs should not be divorced from management needs. Cash accounting has some advantages from a management viewpoint—especially for the central agencies of the Ministry of Finance (MOF)—when the principal objective is to enforce compliance with the annual budget law. The primary requirement from this viewpoint is to prepare end-year accounts that show the relationship between the amounts approved in the budget for detailed items of spending and the actual spending that has taken place on those items. Traditional budget systems are thus more focused on inputs and the costs of those inputs, and cash accounting serves this orientation quite adequately.

As budget systems have evolved to meet stabilization requirements, they have had to accommodate adjustments to the approved budget that may be required during the financial year due to unforeseen changed economic circumstances. Recognizing that government spending decisions have an impact on the economy before cash payments are made, in turn highlights the economic impact of budget expenditures, and the need to monitor the different stages of spending. This has led to demands for noncash information—for example, commitments that had been made, commitments coming due, and the amount of outstanding obligations still to be met in cash. Thus cash accounting and reporting have been supplemented by what may be termed modified cash accounting. While there is no authoritative definition for the latter, the term is used here only to signify cash accounting with some supplementary accrual information. These procedures are typically not regarded as long-term solutions—but rather as ad hoc and selective, arising from particular emerging problems, and avoiding the rigor of a well-constructed overall accounting framework.

With assured compliance and improved mechanisms to ensure macroeconomic stabilization objectives, in the last thirty years OECD governments have turned to focus on efficiency and effectiveness objectives.<sup>10</sup> In this environment accrual accounting had certain attractions. It was not that there was no need for cash accounting and reporting, but rather that the accrual information was viewed as offering many advantages. It was recognized that an accruals system can and must generate cash information, so that it is equally able to address short-term effects of fiscal policy. At the same time, an accrual system recognizes a financial flow,

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<sup>9</sup> Hence, on an accrual basis, the recording of flows should occur when economic value is exchanged or transferred (economic transactions), or created, extinguished, or transformed (other economic flows).

<sup>10</sup> See OECD (1994, 1995).

which does not result in cash flows—e.g., depreciation, transfer, write-off of physical assets, and accrued interest—which were necessary to consider from an efficiency viewpoint, representing the full costs of providing government services, and which also allowed a wider assessment of government operations. The major advantages claimed are:

- Improved resource allocation

A common problem of cash accounting is a lack of good information on full costs of providing services. In measuring the latter, the cost of utilizing capital assets paid for in prior years (i.e., depreciation costs) was frequently ignored. Perhaps more important, where fixed asset values are based on current costs, the depreciation amount can also provide an indication of the future expenditure required to replace the existing assets at the end of their useful lives and so maintain current activity levels. It is also often difficult for the government to evaluate capital purchase proposals under cash accounting systems. This is because neither the government nor the agency has good information about what assets are owned by agencies, and hence cannot judge whether there is any scope to finance a new asset by liquidating some existing assets. While this information can be recorded in subsidiary ledgers, it is an important focus in accrual accounting systems. Similarly, with accrual accounts the pensions of public servants are included as an expense and the additional liability is shown on the balance sheet. This can be important information where the annual cash outlays are significantly different from the accruing liabilities. In particular, where the accruing liabilities significantly exceed cash payments, this could have implications for the sustainability of the non-pay-as-you-earn (non-PAYE) pension arrangements, in addition to raising broader issues about intergenerational equity. In its ability to provide more comprehensive information on the costs of operations, accrual accounting allows decision makers to make better resource allocation choices.

- Strengthened accountability

Enhanced accountability for managers arises when they become responsible not only for cash inflows and outflows, but also the assets and liabilities they manage. A side product of the availability of accrual information is greater precision in determining management performance. With the introduction of accrual accounting, agencies would need to specify clearly their performance in service provision vis-à-vis full resource costs in delivering the service since the more precise specification of performance determines the financial and nonfinancial information required to manage government and its spending agencies. One of the problems in existing cash accounting regimes is the attempt to measure agency performance, without considering whether the agency involved can be held accountable for those results. Accrual accounting could improve the accountability in the use of public resources because under this method of accounting, agencies only account for those public resources for which the government wants to hold them accountable. Thus it is possible, for example, that resources administered by agencies on behalf of the central government not to be reported on departmental financial statements.

- Enhanced transparency on total resource costs of government activities

Accrual accounting also has more general benefits in providing a greater range of financial information on the operations of government that has the potential of enhancing transparency

and improving fiscal responsibility. Governments generally have significant assets and liabilities, and disclosure of this information is an essential element of fiscal transparency and accountability. Apart from cash flows, accrual accounting framework requires a full statement of assets and liabilities and revenues and expenses. Most importantly, these are integrally linked with each other—the difference between revenues and expenses directly affects the net assets position, and movements in cash balances are reconciled to results of operations and movements in other assets and liabilities. This complete picture provides key information for macro-fiscal management and also serves as a powerful tool for strategic planning and financial management. Noncash transactions, left out of cash accounting but with an obvious economic impact, would be routinely and systematically reported under such a framework. This would include transactions such as off-set arrangements, creation and settlement of liabilities, including payments due, the assumption or settlement of debts of state-owned enterprises, and off-budget funding by donors. In this way, the true cost of government operations would become transparent.

- More comprehensive view of government's impact on the economy

Similarly, because of the integrated nature of accrual accounts, differences between above- and below-the-line information in fiscal reports can be eliminated, or significantly reduced. The cash flow statement should clearly show the reconciliation between the net cash flow to the change in the cash and bank balances as reported on the balance sheet, thus reducing the unexplained differences between above- and below-the-line data on fiscal reports needed for fiscal management. Moreover, the integrated framework, it is argued, can also improve the quality of cash flow data. By classifying the flows as being related to operating, investing, and financial activities, the cash impact of these government activities is better quantified and easier to track by being viewed in an interrelated manner. For example, just as in the private sector, it is easier to see whether operating activities are generating a surplus or at least breaking even, whether operating surpluses are being ploughed back into investments, and whether sales proceeds from investing activities are being utilized to retire debt or pay for operating activities.

#### **IV. ACCRUAL ACCOUNTING AS A COMPONENT OF WIDER BUDGET SYSTEM REFORMS**

It has been emphasized that the change in the accounting system should follow rather than lead more general budget system reform. Indeed, to gain the full benefits of the change in the accounting system, indicated above, will require parallel changes in the PEM system.<sup>11</sup> It is evident from the above description of the benefits to be derived from accrual accounting that these can be wide-ranging. For example, in terms of compliance, politicians potentially could increase their control over all resources from accrual reporting on a whole of government basis. Similarly, the central policy-making agencies would have more comprehensive and meaningful data to assist in the development of policies, to judge their sustainability in the longer term, and to undertake more comprehensive financial analysis of government operations. Specifically, a major area where accrual accounting is useful is in the

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<sup>11</sup> "As reporting is but one aspect of the whole management cycle (planning, short-term budgeting, implementation, performance monitoring and reporting), it is a truism that management planning and budgeting in the public sector should be undertaken using the same basis of accounting to ensure the benefits of reforms are achieved," (see Mellor, 1996, pp. 78–81).

management of assets, particularly nonfinancial assets and liabilities. However, arguably the main benefits are to be seen at the operational level where managers will have more complete information to make decisions and to have their accountability and performance assessed in a more comprehensive and consistent way.<sup>12</sup>

This key accountability relationship is the basis of the new performance budgeting model found in some more advanced OECD countries, based on five main elements:

- a clear ex ante specification of the performance expected of each agency head;
- devolution of decision-making authority to give agency heads the degree of managerial autonomy they need to achieve the tasks assigned to them;
- incentives and sanctions to encourage agency heads to act in the government's interests;
- a clear performance assessment process involving ex post reporting of actual performance against the initial specification; and
- agreed ex ante arrangements for the collection of all the information required to assess performance.

Different countries have adopted their own interpretation of these elements. In the New Zealand case this accountability model rests on two important distinctions, the first is between *the purchase and ownership interests*. In the public sector the government is typically both the owner of institutions and the purchaser of services from these institutions on behalf of its citizens. The information derived from accrual accounting makes this tension more explicit and forces the government to consider the trade-off between its ownership and purchase interests and to settle on a price for the use of its assets. The second is the distinction drawn between *outputs and outcomes*. Accountability implies that departments should only be held accountable for those things they can deliver. Outcomes tend to be influenced by many factors, only a few of which are under the control of the agency head. In this way, the New Zealand model divides accountabilities, so that the departmental head is responsible for producing the outputs agreed with the minister for the price agreed, and the minister is responsible for the choice of outputs and, by implication, for their impact on the community (i.e., the outcomes).<sup>13</sup>

Needless to say, the implications of this reorientation in delineating performance are far-reaching, namely:

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<sup>12</sup> Hood (1991,1995), described the New Public Management as centrally involving, first, a lessening or removing of difference between the public and private sector, and, second, seeking a shift in emphasis from process accountability to accountability in terms of results.

<sup>13</sup> Schick (1996).

- performance needs to be specified and reported on a basis which encourages good purchase and ownership performance;
- departments need greater managerial autonomy and freedom from tight input controls so that they can determine their own production mix; and
- changes may be needed to the range of incentives and sanctions facing departmental managers.

To enjoy the full benefits to be derived from the adoption of accrual accounting will also require some fundamental changes to public sector managerial and personnel arrangements, to strengthen accountability relationships. These requirements have quite fundamental consequences for traditional PEM systems. Under accrual accounting, *reporting requirements* for government are basically the same as for the private sector, with three main reports provided by an accounting system—statement of financial position, operating statement, and statement of cash flows—supplemented by a number of other reports: statements of objectives, service performance, commitments, contingent liabilities, and accounting practices. Logically, the budgetary process should be consistent with the ex post reporting format.<sup>14</sup>

Carried to its logical conclusion, there are two main *budgetary implications* of accrual accounting. First, ex ante and ex post performance information should be harmonized. Agencies should move both their ex post reporting and ex ante budgetary documentation onto an accrual basis. This would require agencies to prepare prospective financial statements as well as prospective service performance (output) information for inclusion in the estimates. Second, the major budgetary constraint placed on agencies—the appropriation process—must also be in a format that is consistent with the performance system. The appropriation process under an accrual budgetary regime could appropriate for:

- the purchase of goods and services (i.e., outputs) from agencies, other government-owned entities, and private sector entities;<sup>15</sup>
- capital injections to increase the government's net asset holding in a department or agency; and
- other payments of benefits and grants.

Of course, having an accrual-based, performance-oriented PEM system does not necessarily imply accrual appropriations. It is conceivable that performance projections can be

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<sup>14</sup> The use of accrual appropriations is now a feature of the Australian “accrual output budgeting” approach. For a description of the general outlines of the system, see, for example, Australia, Department of Finance and Administration (1999).

<sup>15</sup> Ideally, the appropriation for output purchases should be made on the basis of a contestable market price, i.e., agencies should be invited to quote prices for the provision of the goods and services the government is contemplating buying from them that would be compared to alternative quotations from private sector suppliers where available. In practice, this is likely to occur only in exceptional cases.

established on an accrual basis, the cash requirements assessed, and accordingly appropriations made for the cash required for the period.<sup>16</sup> This approach, however, could result in dual, and potentially conflicting, performance objectives: on the one hand, accrual performance against accrual expectations, and, on the other, compliance with cash appropriations. In this way the appropriation process would determine, rather than reflect, the criteria for agency performance. Moreover, focusing on cash would again fail to give the legislature effective control over the true consumption of resources and negate one of the great advantages of moving to an accrual system.

Most important, the resource costs and the degree of management skills required should not be underestimated. The move to an accrual-based PEM system has implications for all aspects of the PEM system. *Accounting for agency activities* is probably best decentralized to the agencies, the central accounting functions of the MOF would then focus on: the provision of bookkeeping for payments/receipts of the core central government functions; the consolidation of departmental information; the promulgation of accounting policies for the government; and the production of financial reports at the government level. Alongside the decentralization of the accounting function there may also be a case for *delegation of asset management*. The government's investment of capital assets in agencies is usually significant. To improve the performance of capital assets, it could be argued an agency should have the freedom to sell and buy these assets so far as not to increase the government's total investment in the agency. This is because it is difficult to measure the performance of agencies if they do not have the delegated authority to deliver that performance. With this delegated authority, internal control and audit would also need to be decentralized (albeit with central oversight). Similarly, *audit and finance regulations* will most likely need amending. Agencies will provide new sets of financial statements under the accrual accounting system. The impact on the audit procedure needs to be carefully examined in the implementation process. Significant revisions are likely to be required in financial regulations to provide for accrual accounting policies and procedures; departmental reporting requirements and formats; and management of departmental assets and bank accounts. Last, but far from insignificant, there will be a need to *upgrade computer and human resource capacities*. Accrual accounting is more complicated than cash accounting, and will require a heavier investment in computerization and skilled labor.

The latter change, that to *public sector personnel policies*, is perhaps the most profound and revolutionary. At the same time as the above changes will create demands for skilled labor, the fact that agencies are turning over to a mode of operating that has more in common with that in the private sector means that there will be greater opportunities for labor mobility between the sectors—especially in managerial and other skills, such as accounting. The new reforms not only present such possibilities, but also actually provide the incentives to exploit them. For example, if agency heads are to be held much more tightly accountable for the performance of their departments, they will become much more interested in the quality of the staff assigned to assist them in this task. They are likely to want to have the major say in deciding all key appointments, and they may also want a freer hand in dismissing

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<sup>16</sup> The approach of the recent French reforms; see France, Ministère de l'Economie, des Finances et de l'Industrie (2001).

nonperforming staff. This could lead, and in some OECD countries has led, to fundamental changes in public sector employment arrangements.

## V. THE PRECONDITIONS FOR THE MOVE TO ACCRUAL

From the above description of the benefits derived from moving to an accrual-based system, it is not difficult to appreciate why advocates of PEM best practices have tended to include accrual accounting systems as an essential element.<sup>17</sup> However, this does not imply advocating its universal application. Because accrual accounting is difficult to divorce from other elements of wider, and more fundamental, budget system reforms, is the reason why, despite its obvious advantages, it is unlikely to be readily adopted by governments.

First, and foremost, for a large number of developing and less-developed transitional countries the move to accrual accounting is of dubious relevance. Until basic compliance with the rule of law is established, and some basic controls are in place to allow government spending to be adjusted to ensure some reasonable level of fiscal stability, the move from a centralized traditional budget management model to a more decentralized model has inherent dangers, and is perhaps to be discouraged. For countries with governance problems, the complexity of accrual accounting can be readily employed to hide and distort. Accrual accounting thus lends itself to creative accounting even more than cash-based systems. For many of these countries, it must be recognized that their administrative capacity may not be at a sufficiently high level either to undertake the major reforms implied or apply the required skills to make them work. Given the higher level of required skills, when such countries find cash accounting difficult, the move to accrual should not be encouraged. Ironically, while the most urgent needs to improve accounting are in countries where a cash or modified cash basis is used—accruals can only be considered a long-term option.

Second, even more advanced middle-income countries may also find the costs and challenges of introducing accrual accounting too great. Not only is its introduction a challenge, but also gaining understanding of the full implications of the new performance regime usually accompanied by such a move will be difficult. Although government financial reports in an accrual regime may look the same as private sector financial reports, their analysis is different and this difference must be accommodated in the decision-making process. The most meaningful method of displaying the data in financial statements, and the required reporting requirements, will have to be decided. It should be noted that the Government Financial Statistics Manual 2001 (GFSM 2001) prescribed a consistent framework for this purpose (see below). Much preparatory work will be required to launch the new accounting system. Information bases will need to be built up, and this will take time and money. A great amount of training will be required for those preparing and using the new information. Complete and consistent accounting standards and practices will need to be formulated. In sum, the investment required in introducing an accrual system, and in reforming the budget management system to gain the full benefits from this investment, may be too onerous for many middle-income countries.

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<sup>17</sup> The central role of accounting in the modernization of public sector management is discussed critically in Lapsley (1999). See also Guthrie 1998.

Third, one should not exaggerate the benefits of accrual accounting for middle-income countries. It is all too easy to overstate the case for accrual accounting by underestimating the substantial costs involved in its introduction and maintenance. Without adopting the fully fledged performance budgeting system, based on a decentralized modern agency model of budget management described above, the main benefits are likely to be at an agency or departmental level, not the aggregate level (see Box 3). But if this is not in place then there are other mechanisms—albeit not so comprehensive—that can be substituted at the agency level to send the correct signals to managers. This can be achieved through changes in cash budgeting and accounting systems without moving to an accrual-based system.

### **Box 3. Usefulness of Accrual Accounting for Government Entities**

- Facilitate assessment of program performance by showing the full cost of programs
- Facilitate assessment of financial position by showing all resources and obligations
- Enhance the accountability of management for their performance
- Act as a spur to better management performance due to increased transparency
- Provide a wider range of information needed for decision making
- Enable more effective use to be made of a given level of resources
- Provide a more effective basis for decisions about such matters as user charging, identifying savings options to finance high priority objectives, and workplace bargaining.

One example is the introduction of a capital charge. As indicated above, in traditional budget systems based on cash accounting a typical weakness is poor asset management. A major change would be the consideration of the total investment in assets and the recognition that such investment has an opportunity cost which can be captured in management decision making by the introduction of a capital charge. Capital charging would thus aim at internalizing the full costs of the delivery of goods and services, and recognizing the wider opportunity cost of the capital held by agencies. This could generate a number of efficiency benefits: facilitate the assessment of competitiveness of public delivery; enhance transparency in costing of public outputs; provide a basis for introducing user payments; and provide incentives for agencies to identify and dispose of underutilized or surplus assets.<sup>18</sup> Alternative models for such a capital charge are shown in Box 4. Other possibilities for introducing more realistic costing in agency outputs are the imputation of various overheads, such as workers compensation and pension costs (as recently introduced in the U.S. federal government).<sup>19</sup> Thus within the cash system it is possible to make departments pay for

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<sup>18</sup> In Australia some states have had a number of years of experience operating capital charging regimes. See the discussion in Robinson (1998). Also Heald and Dowdall (1999).

<sup>19</sup> As indicated previously, there is a wider question about how national pay-as-you-go pension schemes are treated under accrual accounting, which is alternately a question of defining a liability under accrual accounting. Present practice requires us to treat future public service pension costs as a liability and thus recognize the emerging expense, but not future national pension costs. Thus GFSM 2001 recognizes only liabilities for



common services (e.g., accommodation, transportation) through internal charging and/or through the commercialization of the service provider.

It is also possible to introduce elements of performance budgeting in a cash accounting system by developing performance information. For example, each agency could be required to identify the linkages between financial and nonfinancial inputs to their production of goods and services and, in turn, the outcomes that they have. This process may not necessarily mean that agencies have to identify all the outputs of their production process; this will come later as managers gain more experience in measuring performance. Although fraught with difficulty, the linking of inputs to program outcomes is predominantly the responsibility of the relevant ministry. The aim should be to clarify suitable performance indicators and the development of an information system to support them. Subsequently, a process should be progressively introduced for publicly releasing performance information. Ultimately, this will entail all agencies releasing, prior to the budget, a full set of programs, associated outcomes, and clear linkages to inputs and performance indicators. The main incentive for managers to improve their performance will come when funding to their budgets are affected by poor performance data. A system of performance agreements could enforce this, with built-in incentives to reward good managers. A stage further would be to introduce performance-based pay, whereby employees could enter workplace agreements with management whereby performance bonuses are paid for an agreed level of performance. All such initiatives in introducing performance-based budget management could take place under a cash accounting regime.

<b>Box 4. The Design of the Capital Use Charge</b>	
<p><b>1. Net Assets:</b> charge determined on total assets controlled by agencies less liability under their control.</p>	<p><i>Pros:</i></p> <ul style="list-style-type: none"> <li>• Uses basic information available in accrual accounting, and consistent valuation principles applied</li> <li>• Identifies total cost of capital</li> <li>• Allows fair comparison between public and private providers</li> <li>• Gives agencies an appreciation of their cost of capital</li> </ul> <p><i>Cons:</i></p> <ul style="list-style-type: none"> <li>• Relies heavily on the valuation base, usually not well developed in cash accounting regimes</li> </ul>
<p><b>2. Capital Flow:</b> charge is levied on funds committed to new capital expenditure, net of asset sales.</p>	<p><i>Pros:</i></p> <ul style="list-style-type: none"> <li>• Ease of implementation</li> <li>• Can be linked with appraisal of capital projects</li> </ul> <p><i>Cons:</i></p> <ul style="list-style-type: none"> <li>• Only covers flow of new capital expenditure and cannot adequately accommodate management of capital stock</li> <li>• Cannot provide managers with information on full capital cost of outputs</li> </ul>
<p><b>3. Debt Assignment:</b> debt is assigned to agencies based on the proportion of assets they control, and charge is applied to agencies' proportion of the debt.</p>	<p><i>Pros:</i></p> <ul style="list-style-type: none"> <li>• Provides incentives to reduce debt</li> </ul> <p><i>Cons:</i></p> <ul style="list-style-type: none"> <li>• Agencies asset base may not be debt funded, therefore underestimates capital use</li> <li>• New capital funded from nondebt sources not captured</li> </ul>
<p><b>4. Debt Equity:</b> assign debt and equity to agencies and charge agencies interest on their proportion of debt and in addition a capital charge to the residual government equity after deducting the debt allocated to them.</p>	<p><i>Pros:</i></p> <ul style="list-style-type: none"> <li>• Encourages focus on all assets and provides for full costing of outputs</li> <li>• More in line with private sector practice</li> <li>• Identifies the separate debt and equity elements of the asset base</li> </ul> <p><i>Cons:</i></p> <ul style="list-style-type: none"> <li>• More sophisticated and requires substantial management skills and complementary information systems.</li> </ul>

Finally, it should be further emphasized that accrual accounting supports good PEM but does not replace it.<sup>20</sup> Essentially, in moving from cash-based to accrual-based accounting requires a change in recognition of a transaction. As indicated previously, in the cash system a transaction is recognized when cash is received or paid, and the financial result for a period is

<sup>20</sup> As succinctly put: "accruals is not a "magic bullet" for improving the performance of the public sector. It is simply a tool for getting better information about the true cost of government. It needs to be used effectively and in tandem with a number of other management reforms in order to achieve the desired improvement in decision-making in government." (OECD, 2002, p. 11.)

measured as the difference between cash received and cash disbursed. The accrual basis recognizes the transaction as adding or subtracting to the government net worth, i.e., the point at which obligations are exchanged and liabilities are recognized. In terms of PEM which views the spending process as a series of stages—from appropriation, to commitment, to delivery verified, payment order prepared, and payment order executed—this means transactions are recorded near the verification stage. However, a good manager will be interested in all stages of the spending process, and will wish to monitor all stages—indeed, good expenditure control starts with good commitment control. The internal accounting of transactions should therefore be able to record all stages of the spending process, not just at the verification (or recognition of the obligation to pay) or the payment stage. Introducing accrual accounting may make this task easier but will not replace the necessity for it.

## VI. THE TRANSITION FROM CASH TO ACCRUAL ACCOUNTING

The experience of OECD countries is that the implementation of accrual accounting is not easy; it takes time and requires sustained political commitment. Not surprisingly, it cannot be considered a top priority for most countries. So when should countries attempt to move to accrual accounting? Accepting that the nature and speed of progression is likely to differ among countries, and the transitional steps may be unique to each government, is it possible to delineate the stages in developing government accounting systems? A possible strategy for the reform of accounting systems can be described in the following steps:

### **Stage one:** *Get cash accounting to work well*

This will typically involve a two-pronged approach. First, purge the system of common abuses, and second, supplement the cash accounts with adjustments to improve fiscal reporting.

As suggested previously, some benefits of accrual accounting can be derived by adjusting cash basis to include accrual data. For example, there is a strong argument that accrual accounting does better reflect emerging liabilities such as unfunded public service pensions, but multiyear cash-based expenditure plans equally highlight the problem. Similarly, most cash systems are weak in providing information on payment arrears. A logical step is to add on systems that can generate information on bills payable and bills due for payment. These adaptations of the cash system would lead to the next stage of the accounting system's development—a modified accrual system.

### **Stage two:** *Integrate operating accounts and financial asset and liability accounts—to move to modified accrual*

Integrating asset and liability and operating accounts would represent a significant step forward. It has the advantage of assuring that all transactions are treated in a consistent, self-balancing framework. For example, the practice, say, of financing the recapitalization of banks by issuing government debt to build up a bank's assets, without showing a corresponding deficit above the line, would have been fully reflected in any form of accrual accounts. Although consistency can best be achieved by adopting some form of modified accrual system, an acceptable second-best solution may be to propose an explicit standard for

reporting such transactions, as a memorandum item in the operating accounts of cash basis systems.

An essential element of this adjustment of cash accounts will be to include payables and receivables:

- **Accounts payable.** This will allow for the recording of liabilities that have not resulted in the payment of cash in the current accounting period. It would include goods delivered but not paid for and agreements to pay subsidies and grants to the private sector.
- **Accounts receivable.** This would allow for the recording of revenue earned by the government that has not resulted in the receipt of cash although it is sufficiently close to cash to be reasonably secured. It would include taxation and nontaxation revenue including credit sales of goods and services.

This second stage should be regarded as a reasonable target for developing countries, recognizing that any movement to incorporate accrual concepts will provide more useful information for fiscal policy makers. For any one country it should be possible to identify a series of steps towards modified accrual that would represent a logical transition path. A system based on cash recording and reporting, but with an integrated set of operating and financial asset and liability accounts, would achieve the operational advantages of integration, while not involving the additional complexities of maintaining accounts on an accrual basis. Box 5 indicates some of the steps involved in moving to this stage.

**Stage three:** *Introduce more elements of accrual recording and move to a partial accrual presentation in ex post reporting*

In this stage the additional elements of accrual accounting that could be recognized include:

- *Provisions for employee entitlements*, such as pensions (linked to years of service and leave) as the employee earns them. Such entitlements have been generally shown to be a significant hidden cost of government that result in large unfunded demands on budget resources in future years. Recognition of the buildup in such demands through provisioning provides budget managers with useful early warnings of possible future problems in the cash funding of these entitlements, and enables corrective action to be implemented.
- *Prepayments received by government.* These receipts can range from deposits on the sale of assets to installment payments on the provision of government goods and services. Such receipts can be used to inflate the fiscal result for the current accounting period and consequently understate the fiscal result for future periods. However, since conditions have not been met for their recognition as government revenue, they should not be treated as revenues, but shown as financial transactions affecting assets and accounts receivable.

### **Box 5. Steps Involved in Moving to Modified Accruals**

- Adopt a classification structure that facilitates the recording of revenues, expenses, assets, liabilities, and cash flows (see GFSM 2001 below).
- Ensure the general ledger is based on a double-entry system
- Explore best option for recording and reporting selected assets and liabilities.
- Generate and agree trial balances.
- Establish a process of reconciliation of assets and liabilities in the general ledger with subsidiary records, such as accounts receivable and payable and fixed assets.
- Similarly, reconcile accounts with independent third party information where available (e.g., ledger balances with bank statements)
- Publish statements of contingent liabilities and outstanding commitments as part of budget documentation.
- Establish and train an asset valuation unit, which would develop appropriate valuation methods and value all government financial assets.
- Develop a statement of government financial assets (initially at historic cost, unless market valuation has been established), including investments in all parastatals and liabilities.

- *Interest payable.* Interest on debt can be a significant drain on budget resources and simply recording interest as it is paid may not provide adequate information on future trends in interest payments and whether they will place acceptable demands on budget finances. This is particularly the case with zero coupon bonds. This information would be seen as complementing expenditure control and the level of funds held within the commercial agency banks.

At this stage of the move to accrual accounting, ex post reporting of the budget would include a partial balance sheet with selected financial assets and liabilities, and the adjusted cash flow operating statement would include some items on an accrual basis.

#### **Stage four:** *Recognize nonfinancial assets—final stage for accrual accounting*

This transition from recognizing only financial assets to recognizing both financial and nonfinancial assets greatly complicates the accounting process. This requires consistent valuation practices to be applied to all government nonfinancial assets—many of which are not easily subjected to a market-related assessment of value. Once this task has been completed, depreciation can be charged as an expense for each accounting period, so providing a better indication of the full costs of government operations. This stage, even for the most advanced OECD countries, has not proved easy.

Only at this stage would full accrual ex post reporting be introduced to include:

- operating statement of performance showing how revenues and expenses explain the movement in the net stock of assets;

- balance sheet of financial position for the beginning and end of the accounting period;
- cash flow statement showing cash flows embodied in assets, liabilities, revenues, and expenses clearly distinguishing between operations, investment activities like loans, and advances and the financing of cash flows through the issue of government securities.

**Stage five:** *Move from accrual accounting to accrual accounting and budgeting*

Accrual budgeting should be differentiated from accrual accounting. Only New Zealand, Australia, and Iceland have so far moved to a system where the budget balance is targeted and measured on an accruals basis. Others may report on an accruals basis ex post, but budget (and also report ex post) on a cash basis. While logical consistency in a performance-oriented system would suggest this is required, the difficulties in moving to this final stage are easily appreciated. There are major additions to the information required to accrual budget:

- the information that is included in the cash budgets currently prepared, viz., movements in cash and cash equivalents, the cash being spent on purchase of assets and received for sale of assets, and estimated financing transactions;
- estimated movements in inventories, receivables, payables, employee entitlements, and other liabilities; and
- details of asset depreciation policies.

Accrual budgets would show projected cash flow (as existing budgets), projected revenues, expenses, and operating result in the operating statement; and projected assets, liabilities, and equity in the statement of financial position. Certainly, if achievable it produces economic indicators that are of great importance for fiscal analysis. Moreover, if a government is able to achieve accrual budgeting, it should also have the capacity to carry out some form of accrual monitoring for the whole government, i.e., monitoring the real revenues and expenses and the movements in all assets and liabilities and not just cash.

## **VII. THE IMF'S NEW GFS STANDARD FOR FISCAL REPORTING**

With the publication of the new *GFS Manual* in 2001 (GFSM 2001), the IMF has “raised the bar” in terms of the international standards of reporting statistics for general government. The new manual reorients the IMF’s prescribed fiscal reporting system to a format consistent with an accruals basis, harmonizing the GFS with other statistical systems—specifically the 1993 revised System of National Accounts and Balance of Payments (BOP) Manuals. However, because GFSM 2001 is intended to serve a different purpose from SNA, the ways in which the data are recommended to be reported, and most of the balancing items, will be different from the SNA, and also different from the previous cash-based GFS analytical structure. While GFSM 2001 continues to focus on the general government, it also recognizes the usefulness of expanding the coverage of fiscal data to the public sector. Box 6 summarizes the new features of the GFSM 2001.

### Box 6. Key Features of the New GFS (GFSM 2001)

- The revised GFS is strictly harmonized with the 1993 revised System of National Accounts. Therefore it is on a full accrual basis, covering transactions and other economic flows, and provides complete balance sheets.
- Since GFS serves a different purpose from the SNA, the ways in which data are reported, and most of the balancing items, differ from the SNA, and are very different from the previous cash GFS analytical structure.
- The essential structure of *GFSM 2001* is:  
$$\text{Opening balance sheet} + \text{Transactions} + \text{Other economic flows} = \text{Closing balance sheet}$$
- The balance sheet lists all government assets and liabilities, differentiated by type of asset/liability, identifying the accumulated resources available to government for the provision of services and the distribution of those resources by asset type.
- Liabilities measure the constraints placed on government policies as a result of past events. The change between opening and closing balance sheets indicate whether government improved or worsened its position as a result of economic events during the period.
- The classification of type of asset/liability distinguishes financial and nonfinancial assets as major categories, allowing separate investment (in real assets) and financing accounts to be provided.
- A fundamental distinction is made between transactions that affect the net worth of governments—revenues and expenses—and those that do not. A subaccount for revenues and expenses (i.e., an operating account) provides an economic breakdown of these flows as well as (for expenses) a functional classification.
- Other economic flows are all economic events affecting assets and liabilities which are not transactions, e.g., valuation changes, changes to assets from damage or loss due to natural disasters, wars, asset depletion or discovery, and debt write-off.

Source: IMF (2001).

It should also be noted that the GFSM 2001 presentation is similar in many respects to conventional accounting, having an operating (profit/loss) account, balance sheets and cash flow statement. However, it presents data in a form suitable for time series analysis and links all data flows and balance sheet items within an articulated set of accounts. GFSM 2001 also distinguishes clearly between economic flows, which can be influenced by government (“transactions”) from those that occur independently of government decisions (other economic flows). For this reason, GFSM 2001 is much easier to use than normal accounting data for most data analysis purposes.

It can be envisaged that countries converting to the new GFSM 2001 reporting requirements could follow the transition path previously mapped out for the changeover from cash to accrual accounting. Those countries unable to meet the old GFS standards should perhaps not attempt the conversion. However, it is possible to identify countries which are able to meet the old GFS standards that are in the position to begin the typically lengthy process of conversion to the new GFSM 2001. Moreover, many of these countries have a substantial

amount of accrual data allowed for in their national accounting standards, which can be used to move GFS reporting closer to a full accrual basis. For example, many Latin American countries have a partial accrual system, with accounts recorded at the time that the exchange of obligations occurs, with the generation of accounts payables and receivables. In addition, the subordinate agency level is often required to prepare balance sheets covering the assets and liabilities that they control, and depreciation of such assets is also recorded. Usually, the accounting for assets does not include common assets, such as major infrastructure assets (e.g., roads, bridges, and water supply). So for many countries, therefore, it would be opportune to adopt a “cash plus accruals” strategy based on the availability of such accrual-based data, and for some countries a move in this direction would be an important step in strengthening their cash-based systems.

The conversion path to the GFSM 2001 for such countries would then mirror those presented in the previous section of this paper, namely:

**Stage one:**     *Restructure existing cash data*

- Without the need for additional data, the cash transactions would be restructured.

Those relating to the operations of government (i.e., tax and other current revenue, wages and salaries, purchases of goods and services, interest and other current payments) would be included in a cash operating accounting.<sup>21</sup> Purchases of nonfinancial assets would be classified to an investment account and changes in financial assets and liabilities would be shown in a separate financing account.

- Adopt simplifying recognition rules

For revenue recognition, adopt a rule that stays very close to cash realization while recognizing tax revenues as “accrual basis.” In terms of expense categories, do not adopt category No. 22 “use of goods and services” (refer to Box 7) except to distinguish current expenditure from longer-lasting material assets acquisitions. In respect of the latter assets, adopt a 100 percent first year depreciation rule to achieve a better correlation between budget “expenditure” on a cash basis and accrual-based “expense.”<sup>22</sup> At this stage, do not adopt category No. 23, “consumption of fixed capital,” a periodic depreciation of fixed assets.

The advantages of this approach are first the ease at which it can be done. Second, the generation of cash operating account and a separate investment account distinguishes

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<sup>21</sup> There are not too many differences between “old” and “new” GFS classifications for expenses/expenditures and revenues, although since “expense” is conceptually different from “expenditure” this could create confusion. Certainly, when planning a new chart of accounts and designing future information systems it might be expedient to begin by adopting the new classifications.

<sup>22</sup> Expenses are the consumption or loss of future economic benefits resulting in the reduction of assets or increases in liabilities. They contribute to an accrual fiscal indicator. Expenditures are above-the-line cash payments that contribute to a cash fiscal indicator.



government operating activity from its investment programs, which is not done in the current GFS. Third, although the cash operating statement excludes depreciation and may have significant timing problems, it provides a more useful measure of government operations than current GFS aggregates. Fourth, all changes in financial assets and liabilities are included in the financing account, eliminating distortions resulting from, for example, privatization proceeds.

**Stage two:** *Use partial accrual data*

- Accommodate some elements of statement of economic flows

Although other economic flows are typically not recorded in cash systems, these can be derived by subtracting transactions from the total of changes between the opening and closing balance sheets. While admittedly less useful than accrual recording of these flows, at least this will give a measure of the impact of revaluations and other changes in volume on government assets and liabilities which are implicit in the opening and closing balance sheets.

Most “flows” under this category involve revaluation of fixed and financial assets and liabilities at market rates. This can be substantially diluted during the early transition when these flows could be granted recognition only in some (illustrative) cases: write-off of assets (if on the books) due to irretrievable losses; revaluation of financial assets/liabilities due to exchange rate fluctuations; recognition of windfall gains/losses of assets due to natural disasters or unforeseen accretion to wealth through discovery of new mineral assets; permanent transfer of functions to a corporation or quasi-corporation without remuneration assets (i.e., by reclassification), etc.<sup>23</sup>

- Progressive recognition of existing financial and nonfinancial assets

Consolidated government balance sheets covering a substantial proportion of real assets, as well as financial assets and liabilities, could also be provided. A possible transition path is as follows: first priority is financial assets including on-lending, and then easily quantifiable assets (e.g., government building and land). The more difficult assets like infrastructure assets would follow, but this is avoidable for an indefinite period during transition. Only in the next stage would it be necessary to attempt to include mineral resources and other hard-to-define assets like forest wealth, and finally, if at all, heritage assets.

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<sup>23</sup> Other specific examples are discussed in section 4.49 of GFSM 2001.

<b>Box 7. Stages in Accommodating GFSM 2001 Reporting</b>			
<i>Description of Government Transactions</i>	<i>Stage</i>		
	1	2	3
<b>REVENUE</b>			
11 Taxes			
12 Social contributions			
13 Grants	→		
14 Other revenue			
<b>EXPENSE</b>			
21 Compensation of employees	→		
22 Use of goods and services		→	→
23 Consumption of fixed capital		→	
24 Interest			
25 Subsidies			
26 Grants	→		
27 Social benefits			
28 Other expense			
Net/Gross Operating Balance			
<b>TRANSACTIONS IN NONFINANCIAL ASSETS:</b>			
Net Acquisition of Nonfinancial Assets	→		
311 Fixed assets		→	
312 Change in inventories			
313 Valuables			→
314 Nonproduced assets			
Net Lending/Borrowing			
<b>TRANSACTIONS IN FINANCIAL ASSETS AND LIABILITIES</b>			
32 Net acquisition of financial assets	→		
33 Net incurrence of liabilities			
<b>CHANGE IN NET WORTH RESULTING FROM OTHER ECONOMIC FLOWS:</b>			
41 & 51 Nonfinancial assets			
42 & 52 Financial assets		→	
43 & 53 Liabilities			→
Full accommodations	→		
Partial accommodations	→		

- Begin to replace cash transactions in the operating account by the corresponding accrual transactions.

All liabilities should, of course, be recognized as soon as they arise. Even contingent liabilities (like placed orders for supply) can be accommodated in accounts by opening account heads to capture accounts receivable in revenue and accounts payable in expense. The depreciation cost could also be included as an expense for those assets for which it is available.

In completing this stage, it should be possible to switch over to GFSM 2001 classification structures and a GFSM 2001 compatible chart of accounts and be able to generate new fiscal reports without adopting full accrual accounting. Although the information available will not allow the full implementation of the GFSM 2001 framework, this stage will provide enhanced analytical information. Use of partial accrual data will allow maximum value to be obtained from present accounting systems, and undertaking this work will allow the identification of those areas requiring a modification of accounting standards required for the full GFSM 2001.

**Stage three:** *A progressive move to full accrual data.*

For this stage the introduction of accrual accounting for government cannot be avoided. GFSM 2001 recognizes that the implementation of the fully integrated GFSM 2001 system will take time and will progress according to the circumstances of the country. In particular, it highlights the expectation that ultimately countries will have to revise their accounting systems to an accrual basis, as well as adopt the GFSM 2001 classifications systems.

For the first two stages, indicated above, accrual accounting is not required. GFSM 2001 does admit that since GFS is a statistical reporting system it can differ in important respects from the underlying accounting system of a country from which GFS statistics are derived.<sup>24</sup> Certainly, it is possible to envisage a country operating an accrual accounting system with different national accounting standards, and different coding structures from that of GFSM 2001 classification structure (e.g., Australia). Or alternatively, accepting GFSM 2001 accrual-based system but with very significant dilutions of the accrual concepts.<sup>25</sup> The central point in recommending the migration of cash to accruals is that such a migration would increasingly provide more useful information for fiscal policy formulation, execution, and monitoring. In this way, putting even modified data in the GFSM 2001 framework would be valuable for fiscal policy and analysis. At the same time, it is difficult to see how the full GFSM 2001 statistical reports can be derived from an accounting system, which is not on an

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<sup>24</sup> See IMF (2001, para 1.32, page 5).

<sup>25</sup> For example, depreciating new buildings 100 percent in the first year, so as to reflect the entire "capital cost" as an expenditure in the same fiscal year (as Canada); valuing heritage assets by a token value, etc. Others eliminate the difference between "expense" and "expenditure" by assuming immediate consumption of stocks on purchase, etc.

accrual basis. Moreover, if GFSM 2001 in-year reports for fiscal management purposes are to be generated, rather than historical data, then the integration of GFSM 2001 classifications into the government chart of accounts will be essential.

The implications are clear—if countries are to fully meet the new international fiscal reporting standards they cannot avoid moving to an accrual-based accounting system for government. The issue then, as indicated previously, is to ensure that the correct preconditions exist and that an orderly transition path is formulated and followed.

## VIII. CONCLUSIONS

In examining the need for accrual accounting as an underpinning for introducing budget system reforms, this paper has emphasized a number of points. First, the adoption of accrual accounting should be seen as an integral part of wider budget system reform. It is argued that accounting serves rather than leads budget system reforms, and, therefore, a country's budget system model should determine the government's accounting needs. The converse of this argument also holds: that to be effective, and to derive maximum benefits from accrual accounting, necessitates other features of the budget management system to be in place. In any case, moving to an accrual accounting system typically necessitates parallel changes elsewhere in PEM. Indeed, implementation of an accrual-based system for government accounting, given the costs involved, is perhaps only worthwhile in the context of an overall transformation of public sector management. Accordingly, it is essential to appreciate the full ramifications of implementing accrual accounting.

Second, it should be recognized that budget systems are not created overnight, but have evolved, by passing through distinct stages—from compliance to performance-oriented systems—implying that this transformation has been accompanied by an accommodating evolution in accounting requirements. One can detect this parallel development of accounting requirements, in the move from a cash basis accounting to a modified cash/modified accruals, and then to full accruals. Therefore it appears important to examine the typical path of development of accounting systems, and for countries contemplating the move to learn from the experience of the countries that have followed this path and to better plan the transition process.

Third, as budget management systems have developed they have adopted more comprehensive budget management objectives that have put increased demands on the accounting system. This development should be seen as one of accretion—adding to accounting requirements rather than substituting one accounting system for another. There has been a temptation to engage in a spurious debate on the virtues of cash versus accrual accounting. Since accrual accounting allows the generation of cash accounts, these systems should not be regarded merely as substitutes. Rather the debate should focus on why there is a need for the increased information derived from accrual accounting. Since the introduction of accrual accounting is hardly a costless exercise, it is important to recognize there may be intermediate solutions or alternative ways of gaining some of the benefits afforded by accrual accounting.

Fourth, it must not be forgotten that accounting systems perform two central functions. The first is the need to account for the financial position of the government at a particular point in time, determined by legal requirements, and directed to ensuring accountability for public funds. The second, is the day-to-day recording of transactions, used as a basis for the information systems as an aid to management decision making. These requirements of budget managers usually necessitate more information than the legal financial statements, and on an on-going basis. Regardless of the system of accounting, whether it is cash or accruals, there is usually a need for budget managers to record each stage of the spending process and to be aware of other “off-balance-sheet” items like contingent liabilities. From this viewpoint, while accrual accounting systems are more comprehensive, it is important not overstate their case.

Last, improved fiscal reporting requirements, such as those implied by the new GFSM 2001 standards, cannot be divorced from the parallel reform of the accounting system, which underlies the generation of the basic data. It is possible from a statistical reporting standpoint to view the new accrual-based GFSM 2001 reporting requirements as distinct from accounting requirements. However, to ensure the quality and comprehensiveness of the reports will ultimately necessitate a move to accrual accounting. It is argued that if reports are to be generated within year, and if these reports are to be useful for budget management as distinct from purely statistical purposes, full compliance with GFSM 2001 will require a supporting move to accrual accounting.

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