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► **To cite this version:**

Évelyne Lande, Sébastien Rocher. Prerequisites for applying accrual accounting in the public sector. *Public Money and Management*, 2011, 31 (3), pp.219-222. 10.1080/09540962.2011.573241 . hal-02480846

HAL Id: hal-02480846

<https://hal.science/hal-02480846v1>

Submitted on 27 Jun 2024

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Prerequisites for applying accrual accounting in the public sector

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Many countries have become involved in the reform of their accounting system and apply or are going to apply accrual accounting. This article presents the elements to be considered to apply accrual accounting in the public sector. In a first time, the material, cultural and organizational elements that should be taken into account then, in a second time, the still pending normative and conceptual elements.

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Accrual-based accounting is common practice in the private sector, and has been used to some extent in the public sector since the beginning of the 1990s (Lüder and Jones, 2003; Pina and Torres, 2003; Torres, 2004; Christensen, 2007; FEE, 2007; IFAC, 2007). However, full accrual accounting, as used in the private sector, is rare in the public sector. Several different forms of accrual accounting are in use in the public sector—see table 1.

Table 1. Different forms of accounting in the public sector.

	Cash-basis accounting	Modified cash-basis accounting	Modified accrual-basis accounting	Accrual-basis accounting
Operation recognised	Only expenditure and revenue are recognised	Recognition of assets is limited to certain monetary assets and liabilities	Most tangible assets are recognised but only some intangible assets and certain provisions are recognised	All assets and liabilities are recognised
Time of recognition	Recognition based on the collection or the disbursement	Recognition based on the collection or the disbursement	Recognition in the period based on the operative event	Recognition in the period based on the operative event

Under a modified cash-basis system of accounting, recognition of assets and liabilities is limited to certain monetary items and investments made plus loans taken out or redeemed in the year. Under a modified-accrual-basis system, receivables and payables are recognised in addition to monetary assets and liabilities. These first two levels mainly concern financial items. Under an accrual-basis system in the public sector, most tangible assets are recognised but only some intangible assets and certain provisions are recognised. There is thus a double degree of complexity between cash accounting and accrual accounting related to a different presentation of information (in the balance sheet, the income statement, the appendix) and to the date of recognition of accounting events.

In addition, a large number of studies carried out on governmental accounting systems are based on declarative assertions, which can introduce interpretation biases. Indeed, some respondents could estimate that they are in accrual basis accounting while at the same time:

- they do not record certain long term engagements such as the provisions for retirement; the loans financing the public goods bought in leasing; the fixed assets financed within the framework of PPP;
- they recognize the incomes (in particular non exchange revenues such as taxes) on a cash basis accounting.

Thus, governmental accounting systems classification is often in contradiction with the examination of the financial documents. Another hypothesis is that some technical issues are not specifically dealt with in the context of the public sector. Then, **this leads to the main questions of this article: what are the prerequisites to apply accrual-basis accounting in the public sector?**

One can wonder if such divergences do not come from the loss of focus on the necessary preconditions to fill before wanting to implement a new accrual basis accounting system: firstly, definition of the objectives attached to the implementation of this reform, the existence of a favorable cultural, material and organisational environment and secondly, the capacity to overcome related technical and conceptual difficulties.

1. The need for a favorable cultural, material and organisational environment

According to Lüder (2002), different stimuli (financial scandals, international pressures...) are at the origin of the reform of governmental accounting systems, allowing the improvement of financial information and decision-making process. The reform of the accounting system is thus not seen as an end but as a means to increase public accountability.

It is thus necessary that a prior reflection emerges among decision makers on the nature of the financial information they need and the objectives attached to it. To some extent, in most cases, with the implementation of accrual accounting, it is necessary to redefine the philosophy of public management and the administrative culture because of the introduction of a public management directed towards more performance (efficiency, effectiveness, economy of the public expenditure). Accounting reform requires a shift in the philosophy and culture of the public sector, bringing it closer to the private sector, as well as commitment at all levels of the organisations concerned. The change to accrual-basis accounting leads to the presentation of budgets in accordance with the same principles, requiring changes in the practice and knowledge of users. Accrual-basis accounting plays a limited role when the budget is drawn up on the basis of collections and disbursements during the fiscal year

(Hepworth 2003; Paulsson, 2006). Implementation of accrual-basis accounting in the public sector must thus be associated with budget management centred on future obligations.

Once this first eminently strategic and political stage is engaged, the reform of the accounting and controlling systems and an evolution of the work tasks and missions of the actors can take place. This second stage leads to the redefinition of the organisational framework in which the accounting reform will fit.

Lastly, the last stage can be engaged, that of the evaluation of available technical and human means to make the reform successful: staff training; technical skills to acquire; conceptual issues to deal with... As Cohen et al. (2007, p. 94) observe in connection with the introduction of accrual-basis accounting in many OECD countries, obstacles to the modernisation of accounting systems include the lack of training resources combined with the limited technical competence of professionals, the absence of motivation and incentives for the change to accrual accounting, the inadequacy of human and IT resources to introduce accrual accounting and use financial statements so produced in a reliable and pertinent manner, and insufficient support from the accounting and audit professions. Similarly, Hepworth (2003, p. 39) notes the need for adequate expertise, in particular for supervisory bodies and external auditors, to ensure that financial statements are true and fair and that the principles of accrual accounting are properly applied, making for an improvement in the quality of accounting information. Auditors and supervisors must thus be aware of the risks inherent in accrual accounting. Cohen et al. (2007) also stress that the benefits of adoption of accrual-basis accounting appear limited when it is not associated with a broader reform of public administration (Christiaens, 2001).

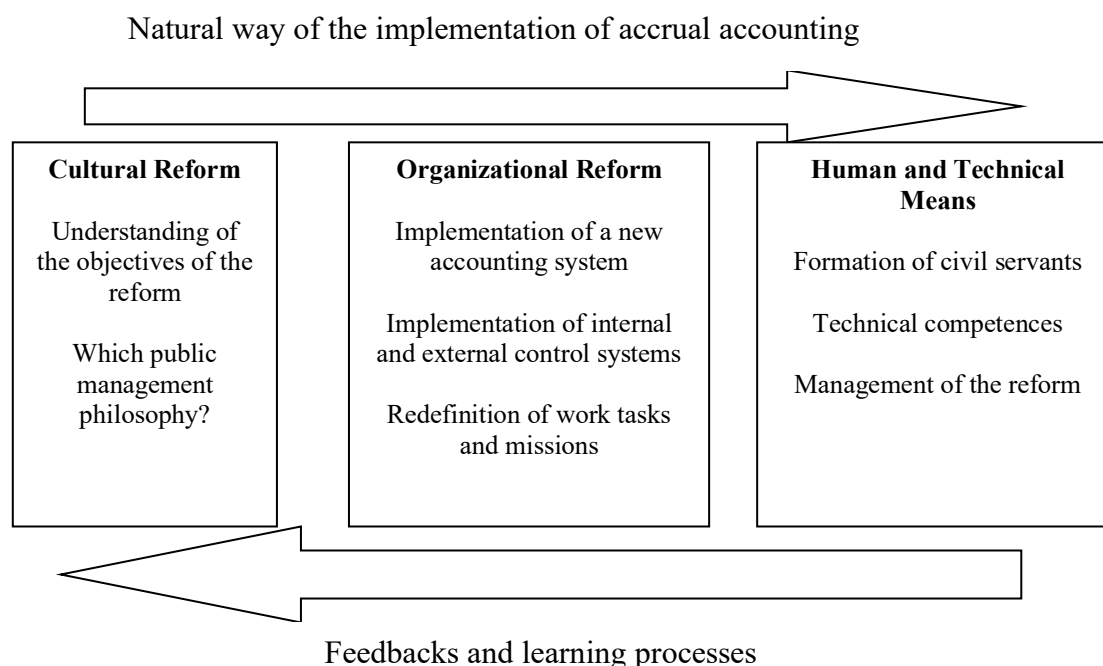


Figure 1: The different stages of accrual-basis accounting reform implementation.

However, in practice, most of the time the priority is given to the human and financial means to mobilize because of the huge number of civil servants concerned, the important cost of the reform and also because these aspects are the most visible ones. But such a focus on the last stage of the reform tend to minimize the importance on the one hand of the origin of the

reform (stage 1, improvement of management) and on the other hand of the organisational aspects (stage 2). It leads to consider the reform as an end in itself and not a means of action.

Finally, according to the Federation of European Accountants (FEE, 2003, p. 6), the main risks associated with a change to accrual-basis accounting in the public sector are that the principles of the system may be applied without proper understanding of its purposes and that the dynamic, evolutionary nature of the process of change may not be properly apprehended. One could also add the risk of incomplete accrual accounting standards for the public sector which leads to a partial application of the accrual accounting principles.

2. The need to deal with unresolved technical and conceptual issues

The introduction of accrual-basis accounting in the public sector raises a wide variety of technical and conceptual issues (see for example Pallot, 1992; Wynne, 2003; Carlin, 2005; Christensen, 2007). Without attempting any exhaustive study of the difficulties associated with the recognition of accounting events under accrual-basis accounting, we will focus on four of these: recognition of tangible fixed assets, recognition of intangible fixed assets, recognition of the obligations of the State and recognition of taxes, a form of revenue specific to the public sector.

2.1 Recognition of tangible fixed assets

In the private sector, investment in fixed assets is justified by a single objective, which is the generation of future economic benefits for the company and its shareholders. The accounting recognition of these assets as a component of the company's business is thus unarguable, the only issues being the methods used for recognition and write-downs, the subject of much debate. In the public sector, in contrast, investments in roads, education, defence, security, the administration of justice, and so on are not motivated by the search for future economic benefits, the goal being rather to achieve a given level of public service. Roads, schools, historical buildings, museums, libraries and the collections they contain, military buildings, etc., do not generate future economic benefits for the state (unless it is supposed that the public services rendered contribute to the education, health, mobility and security of citizens and users and, indirectly, to the power, growth and economic influence of the country).

The International Public Sector Accounting Standards Board (IPSASB) has thus adapted the private sector concept of assets to the public sector, with IPSAS 1 stating that "*Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.*" This definition differs from that applicable in the private sector only by the addition of "*or service potential*".

Yet it would appear that not all public property satisfies this definition, in particular as regards control and the fact that the benefits do not necessarily flow to the entity, i.e., the state, but rather to citizens and users (e.g., forests, nature reserves and churches).

This being the case, should such types of property be recognised as assets of the state or a local authority or region? This definition appears to conflate an entity (the state) with society as a whole. This makes it unclear what purpose the recognition of assets is to serve. Is it to recognise all property generating economic benefits or service potential for society as a whole? If so, how (and why) should a monetary value be attributed to property whose social value is, by definition, not economic? Should a municipality recognise a church, roads, footpaths, its water supply networks, war memorials and so forth, and, if so, how are they to be valued: on the basis of historic cost; historic cost adjusted for inflation; replacement value;

present value of future maintenance; or some other measure altogether? And how are depreciation and impairments to be dealt with? This question of the recognition of impairment is important, because if the government or a local authority fails to spend the necessary amounts on maintenance and if the asset concerned deteriorates more quickly than expected, it would seem necessary to recognise this difference in the entity's accounts to avoid passing the cost on to a future generation. The question also applies to hospitals: is it really useful to recognise the value of a hospital when annual maintenance costs are a better guide to the required public healthcare appropriations? Similar considerations apply to central government. What is the point, for example, of recognising the value of military fixed assets (buildings, vehicles, weapons, etc.) or stocks of ammunition, light equipment, or uniforms? What methods and what durations should apply for the recognition of any impairments?

2.2 Recognition of intangible assets

Accrual-basis accounting in the public sector often occults the problem of accounting for intangible items because of the difficulty of identifying and valuing them, and determining the informative value of such recognition. No standard has been published on intangible assets by the IPSASB yet. For the intangible assets common with the private sector, it seems possible to extent the rules to the public sector. But what about the intangible assets which are only meet in the public sector: how to recognise the sovereign rights of the States in accounting? Do they meet the definition of intangible assets? Is it possible to evaluate them? Is it appropriate?

According to IAS 38, an intangible asset is “an identifiable nonmonetary asset without physical substance”. About the recognition of an item as an intangible asset, it “requires an entity to demonstrate that the item meets the definition of an intangible asset and the recognition criteria. An asset meets the identifiability criterion in the definition of an intangible asset when it is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations”.

Because the definition of assets adopted by the IPSASB mentions that they are “resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity”, it seems possible to extent this definition to intangible assets and advance that they also represent a potential of service.

About the recognition of intangible assets, in agreement with IAS 38, “an intangible asset shall be recognised if, and only if, it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and the cost of the asset can be measured reliably.

This last condition results in distinguishing two categories of intangible assets in the public sector, at the State level, on the particular aspects of the sovereign rights of the State. The first relates to the intangible assets for which a reliable evaluation of their value is possible, starting from the actualization of the future advantages economic that they induce. It is in particular the case of:

- the rights of a State on the use of the public domain such as the privative use of the pavements by coffee terraces or newspaper kiosks, the privative use of the public highway by transportation companies (taxis...), or exploitation of machines and hangar located on the public domain (on harbour for example);

- the rights of a State on the exploitation of the public domain, like the right to extract and dispose of natural resources, its right to grant a franchise for the operation of a place of interest (a tourist site for example), the exploitation of the shores of the sea, the exploitation of the Hertzian waves, the right to use the driving force of water...

For the whole of these rights it is possible to evaluate the economic advantages because they give place to the payment of a royalty which represents the counterpart of the special advantages granted to the occupant.

The second category of intangible assets relates to those for which a reliable evaluation is not possible. Thus, the right to raise taxes for a State or a local government, the possession and the use of many economic and statistical data bases or public marks are not easily appraisable with reliability.

2.3 Recognition of the State's obligations

The research of the recording of the whole of the rights of a State must be accompanied, in parallel, with the recognition of its obligations. But the question of the unreliability of the evaluation of the rights of a State is also found for its obligations. Indeed, how to record:

- the State's obligations as the "insurer of last resort" of the biggest infrastructures such as the nuclear power stations or dam for example, but also of the financial markets or terrorism;
- the State's obligations of education for all, safety, or its obligations on public services continuity?

Admittedly, these elements answer the definition of liabilities, namely "the obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential" (IPSAS 1), but the impossibility of evaluating them with a sufficient reliability limits the possibilities of recognizing them in the accounts of the State.

2.4 Recognition of taxes

Nor are there any generally accepted principles for the treatment of taxes in public-sector accounting.

Whereas under cash-basis accounting taxes are recognised on collection, under pure accrual-basis accounting, tax revenues should be recognised when the economic transaction giving rise to taxation takes place. This is the position defended by the IPSASB in IPSAS 23 "Revenue from Non-Exchange Transactions". A non-exchange transaction is one in which an entity obtains an asset of a certain value or a certain sum of money from another entity without directly giving an asset or service of equivalent value in exchange. Tax revenues fall within the scope of this definition since the taxpayer transfers financial resources to the state without directly receiving any consideration of equivalent value. In their primary capacity as citizens, taxpayers naturally benefit from the public services which taxes finance, but these services are not rendered to tax payers in proportion to the amounts they pay in.

The difficulty is to decide when tax revenue is to be recognised, and thus what operative event is to be considered. Several kinds of operative event (or taxable event) can be identified:

- a primary operative event, such as the period worked or the payment of the salary due for that period;
- a secondary operative event, such as the declaration of amounts serving as the base for

taxation;

- a tertiary operative event, which may correspond to the calculation of tax due or notification of tax to be paid;
- finally, collection of the sum (or non-payment if the debtor is insolvent).

Of course, all or some of these events may be simultaneous in some cases, in particular when tax is levied at source. However, the greater the lapse of time between the primary operative event and collection, the more complex the system used to estimate revenue will have to be to ensure an acceptable margin of error and thus the necessary degree of reliability. According to the Conceptual Framework, *“To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.”* Unreliable information can thus never be relevant. The method of taxation (at source or on declaration) can thus lead to the adoption of accounting options that make the application of accrual-basis accounting more or less easy, or to the selection of operative events well downstream from the primary event.

It is, however, difficult, if not impossible, to determine at what moment the taxable event takes place and to estimate the amount accurately and reliably. For some forms of taxation, the timing of declarations is such that the revenue due to the state in a given fiscal year can be estimated in full before the close of accounts, or recognition in the fiscal year is simply a matter of the date of collection. In such cases, recognition in the financial statements for the fiscal year they pertain to does not raise any difficulties. Many other forms of taxation, however, including personal income tax (except when levied at source) and taxation of corporate profit, allow reliable assessment only in the period following the occurrence of the taxable event. The timing of the declaration of taxable transactions (the basis for reliable assessment) means that there is a gap between the occurrence of the event giving rise to the state’s claim and the determination of the amount of this claim. Moreover, in some exceptional cases revenues can only be reliably measured after a long lapse of time. An example would be the assessment of duty due on an estate comprising antiquities and works of art, which may require the advice of a number of specialists and be extended over several fiscal years. Criteria for identification are thus not satisfied until payment is made or due.

In some cases, then, the requirement of reliable measurement may lead to recognition of revenue in years subsequent to that in which they should otherwise theoretically be attached. The criterion adopted could be, for example, the declaration of the taxable base or the issue of an executory act by the tax authority.

In this context, most states and local government authorities either record tax revenue when it is collected, in which case they apply a cash-basis system even if their financial statements are presented in accordance with the conventions of accrual-basis accounting, or they recognize revenue when the tax is imposed, which is then the operative event.

The dilemma consists in the choice between the primary operative event with its attendant uncertainties and the secondary operative event allowing more accurate estimation of the amounts recognised but raising the risk of failure to apply the principles of accrual-basis accounting. Must there really be only one date for the recognition of accounting events, that of the primary operative event, as the IPSASB currently maintains?

There would appear to be a need for comparative studies at international level considering methods for public-sector recognition of taxation in more detail.

Conclusion

The implementation of a new accounting system on the basis of accrual-basis accounting requires consideration of implementation costs and the purposes it serves. In accordance with Christensen (2007, p. 51), “*much has been written about accrual accounting applied in a public-sector context yet much is unknown. The gap between what we might know and what we don’t know about accrual accounting is greatest when considering the managerial impact of the change from cash to accrual in the general government sector*”.

Moreover, as Wynne (2003, p. 18) points out, countries adopting or planning to adopt accrual-basis accounting must either adopt international standards, or invent new practices, or ignore the problem. Christiaens (2001) notes this divergence in Flemish municipalities. Similarly, the Federation of European Accountants (FEE, 2003, p. 6) stresses the current limits of international standards and expresses concern that the absence of standards in sensitive areas is not the subject of discussion. According to Hepworth (2003, p. 38), the absence of standards on sensitive points such as debt may lead some governments to define politically motivated national standards designed to present information in the most attractive possible light. Few years earlier, Pallot (1992) insisted on the need of a conceptual framework in the public sector.

Maybe could such questions give the European countries an opportunity to come together under the aegis of the European Union to review these issues jointly and adopt pragmatic, consistent solutions.

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