INTRODUCTION

Accrual accounting is a method of recording financial transactions where the full characteristics of those transactions are recorded in the period to which they relate. Cash accounting simply records the cash effects of a transaction in the period in which they occur.

BENEFITS OF ACCRUAL ACCOUNTING

Accrual accounting allows Governments to obtain a more realistic picture of their performance in terms of revenues earned and resources consumed in a period. It is more difficult for cash accounting to do this because it only records the cash received and paid in a period regardless of the relevance of that cash movement to the period in question.

Accrual accounting often therefore facilitates better planning, management and decision making as well as providing a means with which to assess financial resilience. Accrual accounting can also facilitate better performance measurement and therefore performance management. Further it can permit more effective comparisons of some aspects of financial performance between different government departments and agencies as well as international comparisons. Comparison between government services for the purposes of competitive tendering as well as pre and post privatisation can also be made more readily if both sets of financial statements are prepared on the same basis. From all this it can be seen that accruals accounting provides tremendous scope for organisations to manage their finances more effectively.

It is for these reasons that many governments in Europe and worldwide have adopted accrual accounting. For example, Denmark, Sweden and Finland have all stated that the move towards accrual accounting has formed a key part of their administrative reforms. Further, the Danish, Dutch, Finnish and UK governments have reported that they have seen accrual accounting as a key part of their drive to greater efficiency. Finally, Denmark and Sweden have reported improved transparency as a key aim of their accrual programme.

It is also why the European Commission has recently completed a project to introduce accrual accounting for its own financial statements which will be prepared on an accruals basis from 2005 onwards. This is
something also that has been encouraged by the European Court of Auditors and the International Federation of Accountants.

It is important to note that the benefits of accrual accounting can only be fully realised and embedded if budgets are also prepared on an accruals basis. Without accrual based budgets, financial managers will not be disposed to manage their key indicators on an accruals basis and thus are less likely to operate a fully accruals based finance function. They are also less likely to exploit the full potential of accrual based financial information as an in-year financial management tool.

Not all the benefits of accrual accounting in terms of good financial management have been realised in the public sector in countries where it has been introduced. Indeed for many there are still a number of barriers to be overcome before accrual accounting can be utilised to its full potential. Amongst the more important factors are the need for a positive political will and real cultural change – issues which have been highlighted in the New Zealand experience. This is particularly relevant to the subject of this paper.

**ACCEPTANCE OF THE BENEFITS**

Until the full potential of using accrual based information is realised, policy makers will not readily accept the benefits of accrual accounting, which, for all its advantages, is less straightforward than cash accounting. They will also want to be convinced of the role accrual accounting can play in the achievement of wider performance goals before they will be fully converted to it. It is thus somewhat of a circular situation.

**ACTING ON THE INFORMATION**

One of the ways in which policy makers can become convinced of the benefits of accrual accounting is if they can see opportunities where they will be able to act on the information that becomes available to them and then see the positive results of those actions. The best way of illustrating this will be to include examples where such decisions have been made in practice and to include, if possible, the benefits that have resulted. These examples will be most readily available where both budgets and financial statements are prepared on an accruals basis.

**PROMOTING AN UNDERSTANDING OF ACCRUAL ACCOUNTING**

Cash-based financial statements are straightforward for the user. Whereas accrual accounting provides more complete information on financial performance and position but can actually make financial statements more difficult for the user to understand particularly for those without accounting skills. Terms such as “assets”, “liabilities”, “income” and “expenses” may not be clear to those who have little prior experience of evaluating accrual-based statements.

Without this level of knowledge politicians will not be in a position to understand, comment and act on accrual statements. This inevitably means that the legislature will not be in a position effectively to hold the executive to account and the executive will not be so able to defend its position robustly. This undermines the functioning of democracy.
There is therefore a need to ensure that politicians have the tools they need to understand financial material prepared on an accrual basis. In order to achieve this, several key steps will need to be taken:

- Briefing for politicians is necessary in order to provide clear expositions of the fundamentals of the accrual concept and the benefits of its use. The information must be appropriately tailored to its audience;
- There must be ongoing communication with politicians;
- The presentation of accrual based information must be as clear as possible, so that the key features of that information can be readily identified;
- Key ratios and performance information should be highlighted;
- There should be a clear reconciliation of budget to accounting information when these are on different bases.

**BRIEFING**

Material will need to focus on both the fundamental differences between cash-based financial reporting and performance information and how such information is reported on the accrual basis. The fundamental principles that will require explanation are as follows.

**Key principles in the recognition of income and expenditure**

It will be important to ensure that users of financial statements understand the fundamental principle of accrual based information, which is that it records when income becomes due and expenditure is incurred rather than when cash leaves or arrives with the organisation. It will be important to ensure that the meaning of ‘due’ and ‘incurred’ is well understood (that it is when goods or services are received rather than when they are ordered or when payment is made and when income has been earned rather than when it is received).

Other principles worthy of explanation will be the consistency and matching principles as well as the principles of materiality and going concern. Also of relevance is the concept of prudence.

It will be important to convey the message that financial statements must be prepared in line with these generally accepted accounting principles and that such principles may not be redefined if they become inconvenient.

**Elements of accrual based financial statements**

The elements of accrual statements will have to be explained clearly. These are:

- Assets,
- Liabilities,
- Residual Interest,
- Income,
• Expenses,
• Contributions from funders,
• Distributions to funders.

The main point to be made about assets and liabilities is that the term “economic benefits”, which is a core aspect of the definition, includes “service potential” rather than cash inflows and outflows. Explanations will need to be included for these terms, which have a particular meaning in a public sector context.

**Capital vs revenue**

The treatment of property, plant & equipment is one of the areas where the cash and accrual accounting systems clearly diverge and thus will need to be covered in the briefing. Under the cash basis, expenditure on property, plant, & equipment is simply included in the revenue statement when the item is purchased. Under the accrual system the item is first recognised in the balance sheet on purchase and is then depreciated through the revenue statement over the years of its useful life. Beside explanations of these aspects, it will also be useful to include some discussion of the basis of valuation and how ownership is defined.

**Financial reporting**

Some information will be required in order to assist in the understanding of financial statements. This should concentrate on the primary statements and how they interrelate.

**Audit**

Briefing will also be needed to explain the role of the auditor in reporting on accrual-based statements. This will need to outline the nature and meaning of the audit opinion and the grounds on which opinions are qualified - disagreement, limitation of scope, disclaimer. Included in this explanation should be reference to the role of the auditor in ensuring that the statements comply with the relevant accounting standards. The briefing will also need to refer to the fact that the auditor must abide by auditing standards in the conduct of his/her work. Finally, the role of professionals such as valuers and actuaries in providing information essential for accrual-based statements will need to be explained.

There will need to be clarity on the additional duties of the Public Sector auditor who must ensure compliance with regulations and who must often check on the veracity of reports of budget outturns.

**COMMUNICATION**

The New Zealand experience has confirmed that initial communication with politicians overseeing the implementation of accrual accounting is crucial but that it should not end there. Politicians change and new post holders will need to be convinced on an ongoing basis of the value of the use to which accrual based statements can be put. Thus a strong communications strategy is required initially and on an ongoing basis.
Key elements of the communications strategy will need to be determined.

PRESENTATION

Sometimes accrual information can be presented in a way that is difficult for non-accountants to understand.

One way to make accrual information more accessible is to focus on the key elements of accrual financial statements by the production of summary information, which includes comparative figures for previous years. It is also important to present the information in a digestible way, such as by use of graphical presentation as well as narrative explanation.

Advice on how to produce this kind of information can be found in the UK HM Treasury publication, *Reporting to the Board* in the Managing Resources series and there will be other sources of advice that can be considered.

It will be important to direct politicians’ attentions to key ratios and measures that can be derived from the different accrual statements. Some of the ratios and measures that could be of interest to politicians would be as follows:

*Quality of expenditure plans*

- Outturn against budget for current/previous years.

*Indicator of efficiency and effectiveness*

- Debtor and creditor days for current/previous year,
- Ratio of administrative costs to net operating cost for current/previous year,
- Cost per service,
- Ratio of capital invested to expenditure.

*Liquidity*

- Ratio of current assets to current liabilities.

These will vary according to which part of the public sector is being reviewed and the circumstances and imperatives of that sector. For instance, central government in the UK is not permitted to retain significant cash balances whereas many local government bodies have investment portfolios, which they must manage. Thus measures of investment performance will only be relevant to the local government scene in the UK. Some of these and other possible measures to be used are identified in the UK Treasury Booklet, *Analysing Resource Accounts: An Introduction*.
It is important that financial information is not presented separately from information on how well entities have met their key objectives. Therefore accrual-based financial information should be complemented by non-financial performance information which is output and outcome based wherever possible.

**INTERFACE WITH BUDGET**

As mentioned above, if accruals accounting is to be embedded fully, it will be very important for budgeting also to be on an accrual basis.

Unfortunately, however, many budgets are still produced on a cash basis. Under such circumstances the likelihood is that monitoring against budget will be on a cash basis and conversion to accrual will be made after year-end as part of the close-down procedures for producing the financial statements. Under such circumstances consideration should be given to producing a reconciliation between the budget and the financial statements.
APPENDIX: ACCRUAL ACCOUNTING AND POLITICIANS - SOURCES OF ADDITIONAL INFORMATION

IFAC
Implementing Accrual Accounting in Government – The New Zealand Experience
The Modernization of Government Accounting in France
The Government Accounting System in Argentina
Resource Accounting: Framework of Accounting Standard Setting in the UK Central Government Sector
Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities

OECD

Danish Ministry of Finance
Erfaringer med omkostningsbelillinger i staten, September 2005

Treasury Board of Canada

GRC Exchange Website
The GRC Exchange is a new website sharing the latest information about governance in development. Hosted by the Governance Resource Centre (GRC) of the UK Department for International Development (DFID), and compiled by leading international experts, the GRC Exchange provides a focal point for sharing ideas in governance.

Accrual Budgeting and Accounting in Government and its Relevance for developing member countries By S L Athukorala & B Reid

Footnote
The ACCA paper on development of accrual accounting in Northern Ireland is currently in draft and not available.