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ARGUMENTS FOR INTRODUCING ACCRUAL BASED ACCOUNTING IN THE PUBLIC SECTOR

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Abstract: From a long time, accounting for public entities has been on a cash basis, with no change until the '80s when it was considered appropriate that these should move closer to commercial accounting principles practiced in the private sector. Demands for better accountability by governments and by public sector managers are being heard around the world as the public realizes that living on credit is not sustainable for individuals and the same principle applies to governments. The paper highlights the main characteristics of accrual accounting, arguments and counter-arguments on this reform and particular aspects of Public Accountancy reform in Romania through introduction of accounting-based accrual, in order to facilitate better planning, financial management and decision making in government as well as an accepted way of measuring the economy, efficiency and effectiveness of public policies.

1. Introduction

Over the last decades, governance of the public sector has been affected by some transformation, like as deregulation, decentralization, replacement of input control by output control, management by results, assignment of responsibilities, and the introduction of private sector management techniques. These reforms are often referred to as New Public Management (NPM). Its main aim is to create an environment in which the public demand reforms the way governments manage their activities, and fulfil their responsibilities without leaving a huge burden on future generations. NPM is focused on efficiency, as governments around the world are being asked to do more with less and to be fully accountable to the community for resources entrusted to them. **Accounting plays a crucial role in NPM developments** as the means by which measurements are made, achievements are documented, and negotiations take place. A number of European Union countries have adopted and developed new ways of working, which have changed how central and local governments serve their communities and have often resulted in improved performance. Accountability structures, accounting rules, reporting schemes, have seen significant changes. These changes have meant that finance professionals have had to re-examine and modify their traditional ways of assessing achievement.

2. Accrual versus Cash Accounting

The public sector accounting is based on two thinking ways, cash accounting, and accrual accounting. The most known accounting schools acknowledge these two trends as a paradigm and as some contestable ideologies at the same time, since in the history of accounting there have been periods when one or the other dominated clearly.

The cash accounting model was initially considered more appropriate for the public sector; its emphasis was on compliance with rules and regulations. The main characteristic is that it makes little or no reference to the liabilities that an organisation

will be required to meet in the future, nor does it recognise the benefits that will be obtained from purchased assets over a period of time. Financial statements give limited information to financial managers and decision makers. In practice, most countries still using cash accounting to produce periodical balance sheet information.

Accrual accounting is an accounting methodology under which transactions are recognized as the underlying economic events occur, regardless of the timing of the related cash receipts and payments. Following this methodology, revenues are recognized when income is earned, and expenses are recognized when liabilities are incurred or resources consumed. This contrasts with the cash accounting under which revenues and expenditures are recognized when cash is received/paid. Through accrual accounting we can maximize the effects of the process of competition enabling public management efficiency so that this should be achieved with minimal costs for the society. It records flows when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled, according to accrual-basis principle in ESA 95 (European System of Accounts: 1.57 Time of recording), an internationally compatible accounting framework for a systematic and detailed description of a total economy, its components and its relations with other total economies. For the public entities, The Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) issues International Public Sector Accounting Standards (IPSAS).

▪ ***Advantages of Accrual Based Accounting***

Passing to accrual accounting system is not a purpose in itself but rather a change of mentality regarding the budgetary process, by passing from a rigid situation of cashed incomes and paid expenses to a situation where the emphasis is on achievements and forecasts.

Financial Position. Accrual accounting provides information on an entity's financial position and current assets and liabilities, based on the balance sheet. Public entities need this information to: make decisions about the feasibility of financing the provided services; plan the future funding requirements of asset maintenance and replacement; plan the repayment of existing liabilities and, thus, manage their cash position and financing requirements. Accrual accounting highlights the impact of financing decisions on net assets/equity, leading entities to take a longer term view when making financing decisions.

Financial Performance. Accrual accounting provides information on revenues and expenses, including the impact of transactions where cash has not yet been received/paid. Knowing revenues is essential for assessing the impact of taxation on the government's fiscal position and the need for borrowing in the long term. Knowing expenses is necessary to assess revenue requirements, the sustainability of existing programs, and the likely cost of proposed activities and services. The income statement helps governments to focus on management by results as well as management of resources, which become more useful because performance can be measured more reliably when full costs for a period are taken into account.

Cash Flows. Moving to an accrual basis of accounting does not mean the abandonment of cash accounting, cash management being an integral element of accrual-based financial management framework. It is required the production of a full statement of cash flows in order to separately identify cash receipts and payments associated with operating, investing, and financing activities. Modern accrual-based systems have functionalities to support cash-based accounting and reporting. Accrual accounting provides comprehensive information on current and certain projected cash

flows, including those associated with accounts and receivables, leading to better cash management and assisting in preparation of more accurate cash budgets.

Reporting and Budgeting. Any reform is considered successful only when it brings about changes in the behaviour of the people the reform is targeted toward. Accrual reporting objective is to provide understandable, relevant, reliable and comparable information, useful to a wide range of users in making economic decisions. It incorporates non-cash information, such as revaluations, write-offs, consumption of assets through depreciation, pension liabilities. Financial reports have to rely on the budget and show any differences between the actual results and the budget, as well as any changes during the term. Sometimes the budget is financially much more important than the financial statements.

The accrual accounting is promoted by the majority of European public administrations. The European Council has been supporting this methodology with the International Federation of Accountants, undertaking the task to update and improve the EU accounting system in line with recent developments, which focus on accuracy and transparency. Supplement cash accounting with accruals is shared and encouraged by international bodies (EU, International Monetary Fund, World Bank, European Central Bank and OECD).

▪ ***Disadvantages and risks associated with adopting Accrual Based Accounting***

The main disadvantages are **very high costs** and **increased complexity of the financial statements** produced. Costs are related to: identifying and valuing existing assets; developing accounting policies; establishing accounting systems, including the purchase of software and pilot testing them; developing necessary skills and providing financial information training for preparers and users. Other disadvantages: (a) it is designed to measure profit, a largely meaningless concept in the public sector; (b) maintenance of public assets is more important than providing information on their value; (c) it takes budgetary control away from finance staff, as they decide when cash is paid, but non-financial managers and suppliers decide when invoices are issued; and (d) given its complexity, requires greater professional judgment by both the preparers and the auditors of government accounts. Comparatively, cash-based accounting is simpler and more objective.

The potential risks of transition to accruals shouldn't be underestimated.

Risks associated with adopting IPSAS. The way accounting standards might be applied can lead to a number of potential risks which could seriously undermine the validity of the financial reports that are produced. IPSAS could be applied with no real understanding of the issues that are raised or the general accounting principles in IPSAS might not be properly addressed.

Risks associated with the budgeting process. In the public sector the budget is often seen as a key document, as it determines the allocation of resources between the public and private sectors, determines fiscal policy and the distribution of the taxation burden, allocates public resources between the different expenditure programs and may also provide the legal authority for expenditure. Where the budget remains framed on a cash basis and the accounts are maintained on an accrual basis, this could make the process of financial management and expenditure control much more difficult, because of the systematic adjustments that have to be made.

Other associated risks: (a) Political pressure may cause decisions to be made about the accounting treatment of transactions in order to remove or minimise political criticism; this problem is accentuated as the dividing line between public sector and private sector transactions becomes increasingly blurred; (b) The

principles based approach leaves too much unfettered discretion to governments which the external auditor may be unable to prevent occurring and for which the Parliamentary process provides an inadequate check; and (c) Financial statements may be less readily understood than those prepared under the cash basis, therefore it is important that the user has solid grounding in the principles of 'assets', 'liabilities', 'income' and 'expenditure'.

The experience of OECD countries is that the implementation of accrual accounting is not easy. There are increasing doubts over whether the change to accrual accounting by governments is worth the costs and the additional risks involved. The countries which decide to pass from cash accounting to accrual accounting are warned by IFAC to analyze the validity and the benefits expected from this reform, based on conditions, priorities and local characteristics. Also, Fédération des Experts Comptables Européens (FEE) issued a paper outlining the risks involved and explaining the essential pre-conditions for the successful implementation of accrual accounting.

If accrual accounting succeeded in reaching its goals, still remains an open question. To find an answer, Andy Wynne has made researches regarding the effects of accounting reform in a few countries (United Kingdom, Australia, New Zealand). Author reviews several studies made by governmental or independent entities, academics, specialists holding high position in government departments, also expressing his personal opinions. Wynne's conclusion is that the accruals' benefits are to be questioned, mainly in terms of 'cost-benefits' comparative approach: lack of wealth for financial reporting, increased complexity of the financial statements, no positive impact on decision making, complexity and incomprehensibility of information, lack of contribution to improve public services. Bottom-of-line, **substantial costs and risks are not justifiable.**

3. Introducing accrual based accounting in public sector in Romania

The reform of the Romanian accounting system circumscribes to the reform as a whole of the national economy, and, particularly, of the public entities management. Improving public accounting aimed to become a reference tool for decision making by managers, to ensure the preparation of financial statements that disclose the true financial position and performance of the government business enterprise, and to reflect the financial credibility of the public sector in its economic relation with investors, in order to support sustainable development of the country.

As a result of the commitment assumed by the Romanian Government in 2001 to move to accrual accounting, the reform process began in 2002. Ministry of Public Finance has developed the **Strategic Development Plan for Public Finance Management Reform**, one of its components being ***Accrual Accounting and Financial Reporting***. During the transitional stage, for ISPA and SAPARD funds the accounting methodology was based on the principle of accruals; for PHARE funds, the initial methodology was based on cash accounting, later replaced with the accrual accounting methodology. In 2003, it was undertaken for the first time in public sector, a reevaluation of fixed assets, with the objective of recognition their true fair value, followed by a complete reevaluation of all assets by 2007.

Tax claims (e.g. taxes, fees, contributions) began to be recorded in accounting from 1st of January 2003, and from 1st of January 2004 the amortization of fixed assets began to be calculated and recorded applying straight line method, excepting national assets and other exceptional items. In 2005 revenues were recorded only in the moment of collection and expenses when they were made, but without applying the principle of independence of accounting year. Implementation of new accounting rules was experienced in a number of public institutions; in the same time intensive

training sessions were organised for all accountants from public sector. Since **1st of January 2006 accrual accounting became mandatory** for all public entities regardless their subordination and way of finance, involving theoretical and practical application of the accrual accounting principle, as a general accepted one.

The next important stage in implementation of strategic development plan of public entities management is fully **adopting ISPAS** at national level (in the present time the accounting laws took their principles and regulations only partially).

Since 2002, the Romanian Government had to adopt the necessary legal accounting framework for the transition from cash based accounting to accrual based accounting, aiming the compliance with European legislation on the matter of public accounting:

- *The Public Finance Law 500/2002*: mentions for the first time that one of the general accepted principle regarding public accounting is **accrual based principle**, under which flows are recorded when claims and obligations arise;

- *Accounting Law 82/1991* (subsequently modified, last republished in 2008): mentions the public entities accounting obligation to record *claims when they arise, revenues when they are collected, accruals, and payments* (as it was modified by Government Order 70/2004); reformulates the role of public entities accounting in order to ensure the recording of *claims, collected revenues, budget obligations, legal obligations, payments and expenses* (as it was modified by Law 259/2007);

- *Minister of Public Finance Order 1917/2005 for approving the legal requirements concerning the methodological regulations of keeping accounting records in the public entities, the accounts list and the its practical implementing rules* (subsequently modified): establishes the mandatory framework that was necessary in order to introduce and apply the accrual based accounting in the whole public sector, starting with 1st of January 2006.

Being a major component of public entities financial management reform, it's important that the new accounting methodology demonstrates its practical valences for decision making, as soon as possible: (a) **improving statistical reporting** in order to inform government decision-makers, and international and regional economic and financial organisations as well (EU, IMF, OECD); (b) **implementation of a system of responsibilities**, that can be used by the Parliament in order to assess the government performances; and (c) **improving the reporting objectiveness** about how government finances its activities and insures its financial resources, in order to assess its performance related to the costs of public services, its efficiency and achievements.

The problems that occurred during the transition period, and after, were: (a) **high costs associated with the transition and further reform** (e.g. training, IT, opportunity costs, technical development, foreign experts consulting); and (b) **necessary reorganisation of the whole accounting system** (e.g. training in book-keeping, training for using the accounting information system components and the financial reports that it disclosures; adapting the whole accounting information system, related to accounting documents, software, and information flows; adapting the managerial system, related to structure and content of tasks, competences and responsibilities of public entities managers).

Regarding the accounting reform, Romania falls within the European trend, according to a study made by FEE. Our country joined to other 13 which finalised the reform and institutionalized accrual accounting for budgetary and external financial reporting purposes. This wave of change is mentioned in a wider study made by IPSASB. According to this, an increased number of countries intend to adopt ISPAS based on accrual principles or made strategic plans and started to apply them in order to achieve

this goal or even partially adopted IPSAS. Only a few countries aim to adopt the cash based accounting and, then, to move to accruals.

4. Conclusions

Public accounts provide information on budget management and proper and appropriate use of public funds, ensuring for users the possibility of making the best economic decisions. In achieving this requirement is necessary to move from the traditional cash inputs approach, towards outputs and outcomes, respectively accrual based accounting. Arguments are the multiple advantages provided by the financial statements, transparency and accuracy, improved assets and liabilities management and budgeting process, reliable source for decision making, better assessment of programs and related services costs. In Romania, introducing accrual accounting for public sector was part of a wider reform agenda. According to the EU requirements, the whole government accounts passed to accrual accounting system, by adopting new general accepted accounting principles. These principles had to be in compliance with the European rules, and adequate to our country's circumstances and to its public sector. Given the engagements assumed by Romania, started from 2006 for all the public institutions is mandatory to base their accounting on accruals. And because **accounting is changing as the world changes**, reform will continue and the next step is adopting IPSAS.

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