ACCRUAL ACCOUNTING SEES A CLEARER PICTURE

Most accounting professionals regard the accrual basis as the best way to present a government’s financial picture. Despite widespread adoption, there are still many cash-basis holdouts – and even some reversals. George W. Russell talks to global experts about the pros and cons of both systems.
If you happen to be in the United States this month and pass through West Liberty, Iowa, don’t miss the Muscatine County Fair, which opens on 16 July. Locals flock to the annual three-day event with its cattle shows, rodeo and stalls selling corn dogs and cotton candy.

For accountants, this city of 3,300 people – a three-hour drive west of Chicago, along Interstate 88 through northern Illinois and across the Mississippi River – has another, lesser-known draw: it is the site of a counter-intuitive public-sector financial reporting approach.

Last month, West Liberty’s council voted to report the city’s finances on a cash basis instead of an accrual basis, a move generally considered by many global accounting thought leaders as the opposite of making progress.

Cash basis accounting records financial transactions when income is received and expenses are paid. It is easy to learn and carry out and requires no special accounting skills. West Liberty’s City Clerk, Missy Carter, said it would give municipal employees “a more common and clear method” of looking at the finances.

Accrual basis recognizes as income what a government or public-sector entity has earned or is entitled to receive, even before payment is received, and recognizes as an expense what it is obliged to pay, when billed or contractually liable, even before payment is made.

The International Federation of Accountants, backed by the Big Four firms, is at the vanguard of a push to establish accrual basis accounting as an international standard for governments and public-sector entities, which, they say, makes it harder for budgeters to mask long-term obligations.

Accrual accounting, says Jean-Louis Rouvet, Global Public Finance and Accounting Leader at PricewaterhouseCoopers in Paris, acts as a “catalyst to improve accountability, transparency and public finance management.”

Warren Allen, IFAC’s President, also supports what he sees as accrual accounting’s greater clarity. “When governments adopt accrual accounting, it just revolutionizes the process of governance,” he says. “I see the benefits of that so clearly.”

The main vehicle for reform is the IFAC-supported International Public Sector Accounting Standards Board, which issues the International Public Sector Accounting Standards for use by public sector entities around the world in the preparation of financial statements.

So far, according to PwC data, the world’s governments are roughly evenly split between cash-based and accrual-based systems. However, Rouvet and his team expect 37 more countries to switch to accrual between now and 2018.

Malaysia’s federal government will be moving to accrual in 2015, followed by the country’s state governments the following year. Nigeria, Costa Rica and Guatemala are among countries currently converting.

Confounding categories
Cash accounting has been the primary method used in the public sector for many years and remains in place for many governments. However, an increasing number of governments are now using accrual-based accounting frameworks.

Others follow hybrid approaches that can be classified as either modified cash accounting or modified accrual accounting. As a result, government accounting practices can be classified into four categories.

• Cash accounting: Cash payments and receipts are recorded as they occur.
• Modified cash accounting: Cash receipts and disbursements committed in the budget year are recorded and reported until a specified period after year-end.
• Modified accrual accounting: Accrual accounting is used but certain classes of assets (e.g. fixed assets) or liabilities are not recognized.
• Accrual accounting: Transactions and economic events are recorded and reported when they occur, regardless of when cash transactions occur.

In Hong Kong, the government presents both cash-based and accrual-based consolidated accounts each year, with reconciliation statements. “The accrual-based accounts present more information on the overall financial performance and position...
of the government,” says Ricky Chui, Assistant Director of Accounting Services of the government and a fellow of the Hong Kong Institute of CPAs.

Cash accounting is, in general, used to report on the General Revenue Account as well as the funds established under the Public Finance Ordinance (such as the Capital Works Reserve Fund and the Innovation and Technology Fund), while the accrual-based accounts are prepared to consolidate the financial performance and position of the other funds, government business enterprises, and statutory bodies. (See Hong Kong accounts: simple vs. thorough on page 25.)

Officials have pointed out that there is no universal definition of “modified cash accounting” and “modified accrual accounting” and such accounts may still be regarded as prepared in accordance with the cash or accrual basis.

Other differences abound: In its 2013 report, Towards a new era in government accounting reports, PwC considers the U.S. as an adherent of the accrual basis method.

Former U.S. congressman Joseph DioGuardi, an American Institute of CPAs member, begs to differ. “The U.S. federal government operates under a modified cash basis system of accounting for financial reporting, which means that it does not use the same Generally Accepted Accounting Principles used in the private sector by publicly traded companies.”

DioGuardi is Founder and President of Truth in Government, a 25-year-old watchdog organization in Washington, D.C. that promotes reform of budgeting, accounting, financial management and reporting practices.

“Accrual accounting is considered a better way to measure a large and complex entity’s financial condition and the results of its operations, not only in financial terms but in an economic sense,” he says.

“The U.S. does not use the accrual basis of accounting for calculating its annual budget deficits and the resulting national debt,” DioGuardi told the Journal of Government...
Financial Management this year, adding that actuaries estimated federal pension and health insurance liabilities and obligations at more than US$40 trillion in 2013, well above the official estimate of US$16.7 trillion.

He argues that the use of accrual accounting can also be used more broadly as a measure of overall fiscal responsibility, citing the Sovereign Fiscal Responsibility Index co-published by Stanford University’s Stanford Institute for Economic Policy Research in 2011 and The Comeback America Initiative.

“While countries, which use accrual accounting for their budgets and financial reports, such as Australia and New Zealand, are ranked No. 1 and No. 2 respectively, the U.S. is ranked a dismal No. 28 – just ahead of near-bankrupt Greece at No. 34,” he says.

New Zealand is regarded as the poster child of accrual accounting. “New Zealand probably comes closest to managing assets as a company would, and in some respects going even further,” Ian Ball, Chairman of the Chartered Institute of Public Finance and Accountancy, recently told The Economist. “It not only uses the accrual method but also updates its financial statements each month.”

New Zealand’s transition was no walk in the park, an IFAC report noted in 1994: “The successful implementation of these reforms demanded considerable effort at both strategic and operational levels and led to fundamental and extensive changes in the management of public-sector operations.”

Accrual accounting can also cost more, which was one factor that influenced the West Liberty city council. The state-mandated annual audit of the city’s finances would be cheaper under the cash accounting method, saving taxpayers US$24,000 this year, Carter, the City Clerk, pointed out.

Rouvet at PwC acknowledges there is no easy path to an accrual accounting system. “The transition to accrual accounting is much more than an accounting exercise; it is a transformation of the finance function,” he says. “It requires a change of mindset.”

Malaysia, for example, took a step-by-step approach, first switching to cash-based IPSAS in 2005, a decade before the adoption of full-accrual IPSAS. “Adopting the cash-basis IPSAS was beneficial in creating some discipline around our procedures and was a positive transitional step,” Devantri Kaur, Director of Accrual Accounting at the Accountant General’s Office in Putrajaya, told IFAC researchers.

**Teething troubles**

The accrual-basis method has its detractors, who say it can be more easily manipulated than the cash-basis method. “One tool particularly favoured to gain earnings… is accrual accounting,” James Spellman, Adjunct Professor at George Washington University Graduate School of Political Management in Washington, D.C. wrote in the Financial Times. “[Chief financial officers] are able to inflate income, grow receivables faster than sales, and keep the books open beyond a fiscal year’s last day to surreptitiously capture more revenue.”

Proponents readily acknowledge that accrual accounting will not magically stamp out fraud. “Fraud is possible with any accounting system,” says DioGuardi of Truth in Government. “Accrual accounting may not stop fraud, but it will report the financial condition of an entity more accurately.”

Other experts point to difficulties sometimes encountered in mastering accrual-basis accounting. “Accrual accounting is more complex than cash accounting,” says Müller-Marqués Berger, who is also a member of the IPSASB and the IFAC Public Sector Steering Committee.

As an example of such an illusion, he cites a public-sector issue concerning fair value measurement of debt with 30 to 40 years of maturity leading to a face value well below nominal value. “This leads to a much more favourable debt-to-gross-domestic-product ratio, which should not be seen as an invitation for further borrowings.”

Experts say that to convert fully to accrual-based IPSAS requires a large amount...
Partner with KPMG in Vancouver and Global Chair of the firm’s Public Sector Accounting
Standards Sub-Committee.

Johnston, a CPA Canada member, says
conversion requires a deep knowledge of
the accounting standards used. “We use
this knowledge to perform a gap analysis,
initially at a high level and then through
a deep-dive approach,” he says. “Our gap
analysis shows us the key areas the project
must focus on to be a success.”

He says a resulting impact analysis can
resolve the issues across information tech-
nology systems, business and reporting
impacts and the human capital and change
management requirements.

Back in Iowa, Carter, the City Clerk, be-
lieves the cash accounting system is all about
visibility. “If you’re on a cash basis, it gives
you a real-time picture of where we are at, so
it’s much more transparent for all of you and
the public to see,” she told council members.

The people of West Liberty, as they nibble
on their cotton candy this month, might well
be wondering that if, in search of a clearer
snapshot, their city council has obscured the
broader financial picture.

HONG KONG ACCOUNTS: SIMPLE VS. THOROUGH

Hong Kong has wrestled with the question of how to present its accounts for decades.

In an interview with A Plus last year, former Hong Kong Institute of CPAs chief executive and registrar Winnie Cheung recalled being invited by the government in the 1990s to look at whether the government accounts should be changed from cash basis to accrual basis.

“In the end we decided not to at the time,” she said. “Because 1997 was coming and if you suddenly change the government’s accounting there might be suspicion - were the British using it to take money away or something?”

The topic was revisited early in the 2000s with the appointment of a Task Force on Review of Government’s Financial Reporting Policy.

After a public consultation showed broad support for a transition, the government decided to prepare a set of accrual-based consolidated financial statements – in addition to the statutorily required cash-based accounts – from the 2002-03 financial year.

Cash-based accounts are prepared according to the statutory reporting requirements laid down in the Audit Ordinance and the Government Lotteries Ordinance. “The accounts serve mainly to demonstrate that public money has been paid within the limits and aims approved by the legislature,” says Ricky Chui, the Hong Kong government’s Assistant Director of Accounting Services and a fellow of the Institute.

Chui says cash-based accounts show the sources and disposition of cash resources. “They show the cash required to finance the activities, the cash raised to meet those requirements and the cash resources available.”

These accounts, he adds, provide information to show that government spending has been made in accordance with the purposes and the limits approved by the legislature for the year as set out in the Public Finance Ordinance and the Appropriation Ordinance.

The principles underlying the cash basis of accounting are simple to understand and operate, Chui says. “They are considered to be more objective – compared with the accrual basis – since there is no need to exercise subjective judgment or to arrive at estimation, for instance, on the valuation of other assets and liabilities to be included in the accounts.”

The accrual-based accounts present more information on the overall financial performance and position of the government. In addition to the government entities covered in the cash-based accounts, the accrual-based accounts also include the Exchange Fund, the Hong Kong Housing Authority, government business enterprises such as MTR Corporation and the Trading Funds, as well as other government funds such as the Quality Education Fund and the Beat Drugs Fund.

The factors in favour of accrual accounting, says Chui, include:

• Enhancement of financial transparency by presenting more comprehensive statements on revenue, expenditure, assets and liabilities for better accountability to the public;
• Provision of fuller costing and management information on delivery of public services to facilitate resources management and performance evaluation.

Chui says the government will, from time to time, review accounting policies and introduce improvements, if they are considered appropriate, for the preparation of both cash-based and accrual-based accounts, “having regard to the requirements of any relevant legislation, international accounting standards, including International Public Sector Accounting Standards, and the appropriateness and applicability of these standards vis-à-vis the local situation as well as the cost and-benefit considerations.”