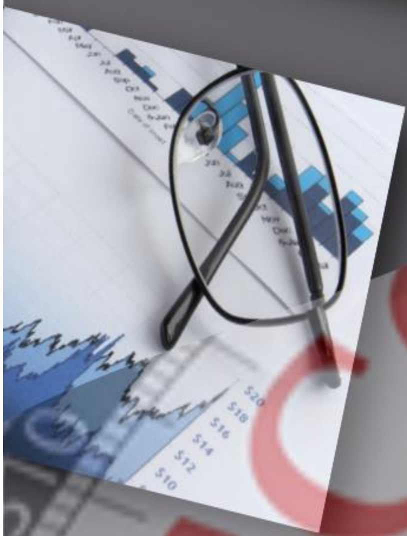

Government Accounting System in Developed and Developing Countries

– A Comparative Analysis

Committee on Public Finance and Government Accounting

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

GOVERNMENT ACCOUNTING SYSTEM IN DEVELOPED AND DEVELOPING COUNTRIES – A COMPARATIVE ANALYSIS

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E-mail : cpf_ga@icai.in

Website : www.icai.org

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Foreword

Government Accounting is primarily concerned with the recognition, measurement and reporting of transactions undertaken by governmental entities. Government Accounting is different in many respects from business and Commercial Accounting. Governmental entities have operating objective and philosophies different from those of their business counterparts. This makes it desirable to treat government accounting as a separate branch of accounting.

Currently, many developing countries and countries in transition are in the process of improving their capacity to better understand Government Accounting issues. This, in turn, leads to a growing awareness among a wide array of stakeholders of the usefulness of improving Government Accounting to socio-economic development of nations. Effective Government Accounting requires not only a sound policy/legal/regulatory framework, but also qualified human resources, as well-trained and motivated accounting personnel are a basic requirement for ensuring effective use of resources.

Government financial information is used by a wide range of stakeholders, all of whom have an interest in the financial health and management of public resources. Financial information should be transparent in order to effectively hold government accountable for its use of public funds. It should also provide a basis for evaluating the current financial position and past performance for decision-making purposes.

I compliment CA. Prafulla P. Chhajed, Chairman and CA. Manu Agrawal, Vice Chairman for conceptualizing and bringing out this Study Report.

I am sure that this research would enrich the readers and be immensely helpful and beneficial to various stakeholders, members of the profession and other interested readers.

New Delhi **CA. M. Devaraja Reddy**

President, ICAI

Preface

In order to achieve socio-economic goals, developed and developing countries require public sector institutional capacity for setting and implementing public policy, which in turn necessitates government accounting system. The social value of government accounting system therefore lies in its contribution to development goals, including poverty reduction. An emphasis on assuring financial integrity and a shift to accruals can make Public Sector more useful in government accounting system in developed and developing countries.

In developed countries, government accounting is considered as an integral part and a successful aspect of public sector reforms. In developing countries, besides being a tool for government financial management modernisation, accounting is regarded as a weapon against fraud and waste in government. The aim of this research is to study a comparative analysis of Developed and Developing countries in Public Sector Government Accounting.

The International Consortium on Governmental Financial Management (ICGFM) has a strategic focus on improving Public Financial Management (PFM) in developing and emerging countries. PFM improvements include the support of International Public Sector Accounting Standards which have set a direction for the evolution of public accounting and reporting. ICGFM accomplishes this mission as a consortium of international organizations and practitioners with global government experience.

The objective of this handbook is to give the readers a bird's eye view of the change in Government Accounting System. I appreciate **CA. Jitin Asudani** for visualizing and bringing out this study report.

I wish to express my deep gratitude to CA. M. Devaraja Reddy, President, ICAI, CA. Nilesh Shivji Vikamsey, Vice President, ICAI and CA. Manu Agrawal, Vice Chairman, CPF&GA for their guidance and encouragement for the initiatives of the committee. I must also thank all members of the Committee for their untiring efforts in supporting the committee's activities.

New Delhi

CA. Prafulla P. Chhajed
Chairman, CPF&GA

Acknowledgement

Over years, the focus of public finance has changed dramatically. At one time it was strictly about what the term proclaimed—how governments should raise money to finance public activity. The new public finance at the time had to deal with the interplay between national and local public finance, including what activities should be conducted at the national level and what at the local level. It was clear that national public goods, for instance, ought to be provided at the national level and that responsibility for redistributive taxation also must lie there.

Developing countries have been challenged to adopt all elements of the Cash Basis IPSAS issued in 2003. This Compilation Guide will assist these countries in their efforts to implement IPSAS requirements in a more orderly manner. Transparent accrual-based financial statements help government to demonstrate, and users to evaluate, accountability for the use of public funds.

The Committee on Public Finance & Government Accounting, ICAI is happy to express its gratitude to everyone who supported it in bringing out this research. We are thankful for their inspiring guidance, and constructive sharing of their true and illuminating views on a number of issues related to the research.

New Delhi

CA. Prafulla P. Chhajed
Chairman, CPF&GA

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CHAPTER 1
CONCEPTUAL FRAMEWORK

1. Introduction to government accounting

Accounting is commonly understood as the process of recording, analyzing, classifying, summarizing communicating and interpreting financial information. When such exercise, is undertaken by government, it known as government accounting.

The difference between private and government system of accounting arises mainly because of the environment of accounting system. Whilst the government entities have the primary responsibility of fiscal accountability, in private sector, the main goal of entities is profit maximization. Also, the usage of the results of accounting processes of government differs significantly from the use thereof in the private sector. On the basis of its accounts, the government determines the shape of its monetary and fiscal policies.

A government accounting system normally has eight main components:

- Documents providing evidence of transactions
- Bank accounts through which payments and receipts are handled
- Accounting records (cash book, ledgers etc.)
- Procedures and controls
- A means of aggregation of accounting data
- Internal accounting reports
- External accounting reports (financial statements)
- Staff

Sub-systems of a government accounting system are as follows:

- General ledger (a system of classified ledger accounts allowing all revenues and expenditures to be sorted into appropriate categories)
- Cash book
- Payroll

- Payables
- Receivables
- Assets and liabilities including cash management

2. Purpose and objective

The aim of government accounting is to reflect transactions and other economic events involving the receipt, spending, transfer, usability and disposition of assets and liabilities. Broadly, the purpose of government accounting is:

- To carry out the financial business of government in a timely, efficient and reliable manner (e.g. to make payments, settle liabilities, collect sums due, buy and sell assets etc.) subject to necessary financial controls.
- To keep systematic, easily accessible accounting and documentary records as evidence of past transactions and current financial status, so that detailed transactions can be identified and traced and all aggregates can be conveniently broken down into their constituent parts.
- To provide periodic financial statements, containing appropriately classified financial information, as a basis for (a) stewardship and accountability and (b) decision-making.
- To maintain financial records suitable for budgetary control, internal control and the needs of auditors.
- To provide means for effective management of government assets, liabilities, expenditures and revenues.

3. Bases of accounting

There are four main bases of government accounting:

- cash basis
- modified cash basis
- full accruals basis
- modified accruals basis

The basis of accounting determines the extent of information that an accounting system can collect and therefore report. For instance, a pure, cash-based system

can only report on cash balances and cash flows (inward and outward). But cash payment or receipt is usually only a small element in the history of a transaction.
(Detailed implications of various bases of accounting have been discussed in following chapters)

4. Government budgeting

The budgetary cycle lies at the heart of any public financial management system, proceeding in stages from budget formulation, approval and execution, to audit and performance assessment and evaluation.

While a move toward the accrual basis is clear on the accounting side, there seems to be less appetite for accrual budgeting. The common reason given is that accrual budgeting is viewed as too complex and that politicians are unwilling to change given their understanding of, and familiarity with, cash budgeting systems.

As with cash based accounting, cash budgets include only the current period's expected cash receipts and payments, while accrual budgeting provides better insight for decision-making by taking the long-term impact of government policies into consideration. The reasoning is exactly the same as for accrual accounting.

The ability to compare budgets against actual results is also important for accountability purposes. Such comparisons are difficult, however, when accounting and budget documents are prepared according to different financial reporting bases.

5. International Public Sector Accounting Standards (IPSAS)

The IPSAS Board (IPSASB) is an independent standard-setting body working under the auspices of the International Federation of Accountants (IFAC). The IPSAS Board publishes IPSAS, which governs the recognition, measurement, presentation and disclosure requirements in relation to transactions and events in general purpose financial statements

When developing IPSAS, the IPSASB uses the International Financial Reporting Standards (IFRS), as developed by the International Accounting Standards Board

(IASB), as a starting point. Each IFRS is reviewed with respect to its relevance for the public sector and adapted to the unique needs of the public sector, where necessary.

As the IPSASB has no formal power, the adoption of the IPSAS in local, state/regional and central governments is voluntary. The global drive to modernize government accounting looks set to continue in the coming years and is supported by international organizations such as the European Commission, Interpol, NATO, OECD and the United Nations. All these influential international organizations promote sound financial management and accountability, and choose to use IPSAS themselves.

IPSASs (cash or accrual) are gaining acceptance all over the world. The countries which have either adopted IPSAS or have undertaken the process to do so include: Afghanistan, Albania, Argentina, Bangladesh, China, Cyprus, East Timor, France, Gambia, Ghana, Hungary, Indonesia, Israel, Jamaica, Macedonia, Maldives and Malaysia.

In the globalised scenario, there is an increasing trend of seamless transfer of funds across countries. Financial statements which are prepared in accordance with the local standards of a country would not be decipherable for the majority of the international investors interested in the accounts of the country. Adoption of a uniform global standard would ensure readability of the financial statements to the international investors. In other words, adoption of cash IPSAS would increase the acceptability of accounts, internationally. Further, the adoption of the IPSAS by all countries would enable comparability of the financial statements of all the countries.

While this chapter discusses the basic concepts of accounting, the subsequent chapters delve and discuss in detail, various bases of accounting being followed in select developed and developing jurisdictions, their respective implications and setting the stage for adoption of better method of government accounting in developing nations like India.

CHAPTER 2
INTERNATIONAL EXPERIENCE

1. Background

The previous chapter provided a conceptual framework and introduction to government accounting. This chapter discusses the spectrum of government accounting practices being followed across the globe.

2. Diversity in government accounting practices

There is great diversity in government accounting practices worldwide. Classification in one of the four categories of government accounting practices requires judgment and is inevitably somewhat subjective.

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, while others still follow hybrid approaches that can be classified as either modified cash accounting or modified accrual accounting.

A study conducted by IMF revealed that by 2009 only a few countries had successfully implemented a full accrual accounting framework. Other countries, ranging from transition economies in Europe to developing countries in the Middle East, were considering such a move and are increasingly expressing an interest in receiving technical advice on various aspects of undertaking such a major reform.

In 2013, PwC conducted a study of government account practices of around 140 countries. Over half (54%) of the countries surveyed reported that they follow the cash or modified cash basis of accounting, while only 46% follow the accrual or modified accrual basis.

3. Accrual accounting is mostly used in developed economies

In OECD countries, accrual accounting is generally well established and stable, with certain exceptions noted here. Moreover, several OECD countries, currently following cash or modified bases of accounting, indicate that they expect to implement full accrual accounting over the next five years.

Similarly, in Europe, government finance statistics (GFS) provide the basis for fiscal monitoring. Governments must report under the so-called ESA (European System of Accounts) rules, a macroeconomic accounting framework based on accrual principles. A number of countries have developed their own public sector accounting standards, based on national standards or IFRS, adapting these rules to the public sector environment and seeking inspiration in IPSAS as they deem appropriate.

In United States ("US"), the Governmental Accounting System is designed, *inter alia*, to present fairly and with full disclosure the financial position and results of financial operations of the governmental units in conformity with generally accepted accounting principles, which are based on accrual/modified accrual system of accounting. So far as US budget is concerned, now US is moving away from a strict cash budget towards a blend of cash and accrual concepts.

In France, the development of accrual accounting was a strong priority for the French Ministry of Finance. This priority and the context in which it was to be applied was established by the new budgetary rules established by the Constitutional Bylaw 2001. Accrual accounting aimed to bring out a change that involves performance-oriented management, globalised allocations, managers' responsibility and accountability, and long-term management. However, French Government has decided to adopt 'dual' system which led to:

- A cash-based approach for the budget i.e, the recording of payments received and expenditures authorised or paid by a public accountant.
- An accrual-based approach for accounting, although currently only receipts are recorded on this basis.

The dual system thus combines the elements of cash-based accounting (budget accounts) and accrual accounting (financial accounts), although these were still not fully in place, particularly for accrual accounting. The aim of the French Government was that the accrual based general government accounts should be prepared from

1st January 2005 while maintaining the conventional budget presentation in terms of receipts and payments on cash basis.

New Zealand has been at the forefront of government accounting developments, having implemented accrual accounts two decades ago, the central government is now moving from IFRS for the public sector to IPSAS. New Zealand now publishes Government accounts similar to those of private sector companies. These accounts, which are independently audited, encourage governments to focus on the longer-term consequences of policies.

Following are the benefits realized by New Zealand from the accrual accounting reforms:

- Improved cash management.
- Better planning of savings as accrual system lead to elimination of idle cash balances.
- Better accounting for and management of accounts receivables.
- Better management of assets.
- Ensuring recovery of cost for services provided.

Sterck*et al*. (2006) have stated that only a few countries, like Australia, New Zealand and United Kingdom, have introduced full accrual basis in both systems. Most countries that have earlier adopted accrual basis in their financial systems, still keep cash and commitments bases in the budget preparation and reporting. These authors and also Yamamoto (2006) stressed that the main reason for this situation is the general thinking that the preparation of accrual-based budgets may be a risk for budgetary discipline. The study of Carlin (2005) shows that, while full accrual basis was largely adopted by the budget funded agencies, most counties still apply modified cash basis, sometimes with additional accrual data, at the local and central government entities.

An E&Y study of 19 European entities in 2010 revealed that most governments were preparing to shift to accrual based accounting. The study notes, "*The long-running debate among European government entities over whether to move public sector* *accounting from a cash- to an accrual-based system is over. Our survey of 19 government entities across 17 European countries suggests that over half of local and national governments which have yet to transition have already converted to accrual accounting. For others, the key question seems to be, when will we convert rather than, will we convert?"*

In this context, consideration has been given to public sector accounting standards in the context of the budget surveillance mechanism and fiscal motoring. While the ESA rules are not designed for entry-level accounting, the European Commission recognizes the need for uniform and comparable accrual-based accounting practices for all sectors of general government to ensure the quality of the information on which the ESA data is based.

Recently, the International Monetary Fund noted that in 2014, China's State Council approved the Accrual Government Comprehensive Financial Reporting Reform Plan in 2014. As part of the plan's implementation, the Ministry of Finance (MOF) published a package of accounting and financial reporting guidelines, including the Government Accounting Basic Standard, Government Financial Reporting Regulations, and the General Budget Accounting Regulation. The issuance of these critical documents marks the start of a substantial transformation China is making towards adopting accrual accounting. With over 15,000 budget entities in central government, and hundreds of thousands in local government, good government accounting is obviously very important in China. From a fiscal risk point of view, local government is perhaps the most important, as they have borrowed extensively through informal mechanisms in the past decade.

4. Cash accounting is mostly used in developing economies

Cletus O. Akenbor[1]and Tennyson Oghoghomeh[2] argue that cash basis of accounting does not significantly promote effective financial reporting of public sector entities in

[1] Department of Accounting and Finance, Federal University, Otuke, Bayelsa State, Nigeria
[2] Department of Accounting, Finance and Banking, Delta State University, Asaba, Nigeria

Nigeria. Consequently, the authors recommended the adoption of accrual basis of accounting in public sector entitles in Nigeria as it significantly promotes effective financial reporting of public sector entitles in Nigeria.

A World Bank study of Bangladesh's government accounting system revealed usage of cash based accounting. The report noted that application of international standards will strengthen decision-making, management and accountability, and ultimately development reforms in Bangladesh. Report recommendations included the adoption of IPSAS, with a gradual transition from cash basis to accrual basis standards; attention to summary tables of outstanding accounting and auditing issues; the adoption of new International Standards on Auditing in addition to existing international standards; the elaboration of a comprehensive Public Financial Management reform program; the improvement of accounting and auditing skills through better recruitment and training practices; and the preparation of an indicators-based public financial management survey to monitor progress.

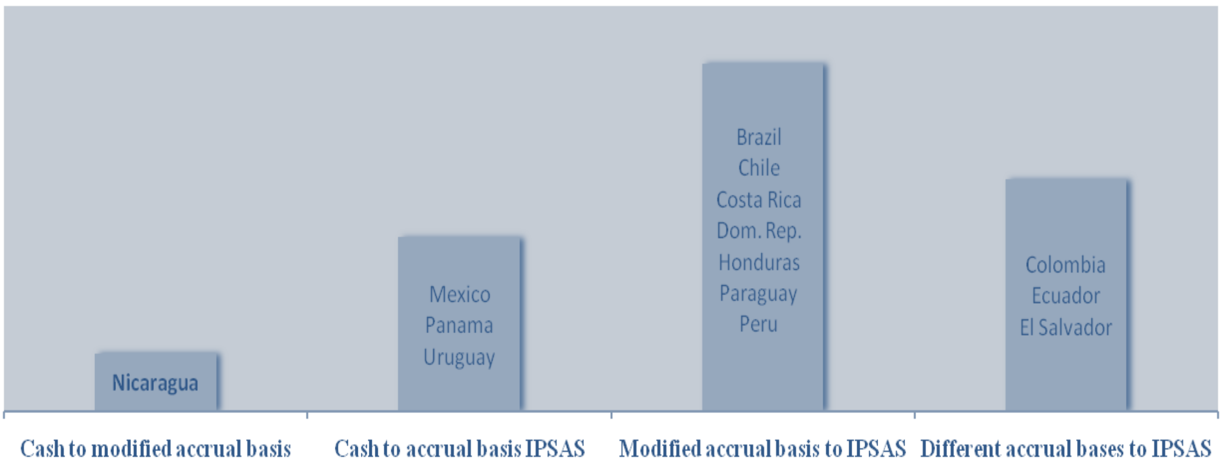
Similarly, a study of other SAARC nations like Nepal, Pakistan and Srilanka also indicate that governments of such countries are using cash-based accounting system. These countries have yet to implement accrual based accounting system and adopt IPSASs for the purpose of financial reporting. However, the awareness of the benefits of accrual based accounting system and efficient public sector reporting system is increasing day by day in the governments of SAARC nations. Some countries have even chalked out plans for introduction of modified accrual accounting, while the others are slowly moving from cash-basis to accrual basis of accounting.

The accounting system prevailing in India and the states is essentially cash based. The preparation of government accounts in India is governed by the Government Accounting Rules, 1990 framed under Article 150 of the Constitution of India. As per the Government Accounting Rules, 1990, the accounts are to be kept on cash basis.

In India, the accounting policies followed by Government entities are outlined in the Government Accounting Rules (GAR) and the General Financial Rules (GFR). These set out the guidelines to be followed by the government entities accounting for any receipt or expense or receipt.

In view of the above, it can be inferred that different countries (both developed and developing) are following different bases of accounting. Similarly, in different parts of Latin America different methods of accounting are followed. The diagram below depicts different methods of accounting being followed by different countries in Latin America.

Government accounting practices in Latin America



5. Reasons for variance in practices

Government accounting refers to a government's financial information systems and financial disclosure practices. Its state of development results from the interaction between the supply of and demand for government financial accountability and transparency. Since it is costly everywhere to produce and disseminate information, governments in all types of political systems lack the economic incentives to do so.

However, some political systems exert a greater demand for government accountability and transparency than others; for example, representative democracies are more demanding than authoritarian and totalitarian political systems. In a democracy, the government is obliged to be more responsive to information demands placed upon it. This would be the case in developed countries and developing countries alike. However, the opportunity cost of resources used in improving government financial information is higher in developing countries than in developed countries.

Therefore, even if governments in democratic developing countries are willing to undertake government accounting reform, they may be unable to afford it; governments in non-democratic developing countries are both reluctant to undertake and unable to afford government accounting reforms.

6. Need for reforms

Developing countries

Literature review and stakeholder interaction under the project revealed that in governments of developing countries, the producers of accounting information are rarely qualified accountants. Therefore, few have experience of accrual accounting. But they usually belong to a separate cadre allowing for training and the acquisition of specialist accounting skills. In some countries, those who supervise the accounting process are not themselves trained in accounting. Accounts are kept for a wide variety of administrative entities: ministries, departments, taxing authorities and spending units (including for instance hospitals, research centres, colleges, schools, police stations, and defence establishments).

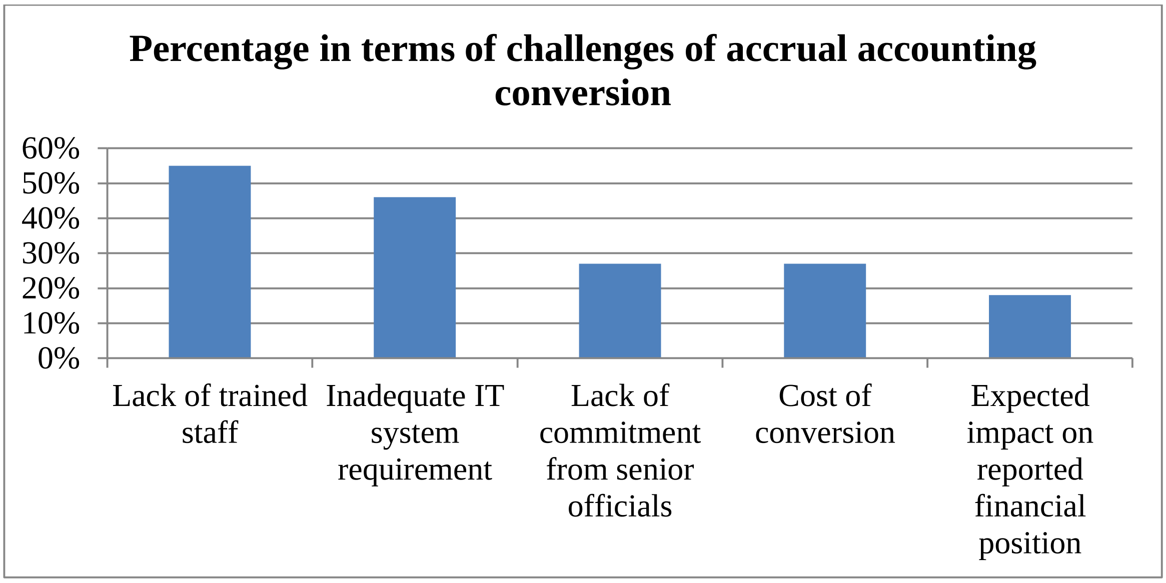
Developed countries

In the aftermath of the global economic crisis, concerns about accountability, transparency and sustainability have surged back to the top of the political agenda in European economies. A new appreciation is emerging that the public sector needs a robust and uniform set of accounting standards to bring greater stability to the global economic system, and greater accountability and efficiency to govern

7. Transition from cash based to accrual-based government accounting

A transition to accrual based-accounting requires a significant commitment of resources in terms of time, effort and money. It also depends on specialized skills and a general shift in the mindsets of people at all levels of governments. In addition, IT systems need to be upgraded or new systems put in place in order to support the transition. Commitment from governments and regulatory agencies is essential in order to secure necessary resources and promote buy-in.

However, the transition from cash based accounting to accrual-based accounting is subject to a number of challenges – lack of trained staff, inadequate IT system requirements, lack of commitment from senior officials, cost of conversion and expected impact on reported financial position. The graph depicted below shows the response of survey respondents (in PwC Survey undertaken in 2013) about various challenges in accrual accounting conversion, for example, 55% of the respondents believe that there is dearth of trained staff in order to cope with new accrual system of accounting. Similarly, around 45% of the respondents believe that inadequate IT system is a hurdle in transitioning from cash system of accounting to accrual system of accounting. Around 28% of the respondents believe that lack of commitments from senior government officials and cost of conversion are hampering this transitioning. Around 18% of the respondents are conscious about (unintended) impact on reporting of financial information once accrual based accounting is adopted.



Despite all the challenges, the biggest move to accrual based government accounting is expected in Africa (+ 11 countries), though the trend toward accrual accounting is also evident in other parts of the world, with accounting reforms in process or planned in Asia, including the Middle East (+ 10), and Latin America (+8).The move to accrual accounting typically begins with an intermediate objective of complying with the cash-basis IPSAS as part of a gradual, or step-by-step, approach to adopting an accrual accounting framework and, in many cases, accrual IPSAS.

For developing countries like India, accrual system to the point of recognizing and reporting infrastructure assets and heritage assets could only help up to a particular level. It is only appropriate to accrue assets and liabilities to the extent that benefits exceed costs. Recognition and accurate measurement of current financial resources and current liabilities could be the starting point of any accrual accounting project. This gradual symmetrical approach takes into account cost considerations, the need to accumulate experience, secure political support, and build systems and human resource capacity.

8. Average time period required for transition to accrual accounting

Most of the countries, which have moved to accrual accounting, have taken a period of 7-10 years for the transition. New Zealand, which has the most well developed and documented transition process, took nearly 7 years to come to a full accrual accounting stage. Canada is a country similar to India in terms of the federal structure and complexity, and it took about 8 years to complete the transition. Considering the size and complexity in India it is estimated that the transition process may take about 10-12 years. However, India has the advantage of learning from the experiences of other countries such as New Zealand, UK, USA and Canada.

9. Publication of government financial statements

The usefulness of financial statements depends on the timeliness of the information provided to the end users including the change-makers. Timeliness will depend upon the procedures and systems in place to collect, process and analyze the relevant financial information. Further, the financial information loses its relevance if it is published after avoidable delay.

Thus, publishing annual financial statements within a reasonable period (say six months) of the reporting date would seem to be a minimum requirement in terms of timeliness. Delay in reporting financial information should also be looked in the light of current reporting practices and bearing in mind the relative limitations of cash-based financial reports currently produced by many governments.

According to the PwC Survey(undertaken in 2013), 23% of the countries surveyed publish their annual financial statements beyond 6 months and around 14% of the countries do not make their government financial information available to the public at all.

Given that cash-based accounting system is still prevalent in a number of jurisdictions, further delay in reporting the financial information may lead to futile financial information.

Also, if an easier cash-accounting approach has led to a delayed financial reporting by almost one-fourth of the nations, once accrual-based accounting is in place, this figure is likely to shoot up.

Therefore, when these governments move to accrual accounting sooner or later, enhanced processes and change management programmes will be required to ensure an efficient, time closing process. Stakeholders during the study also validated such observations.

While this chapter explained the international experience in terms of following different accounting practices, need for accounting reforms and publication of financial information; the next chapter will discuss the implications of various bases of accounting.

CHAPTER 3

BASES OF ACCOUNTING AND IMPLICATIONS

1. Background

The earlier chapters discussed the concept of government accounting in detail. Further, a comparative study of different accounting systems being followed in select countries across the world is also undertaken.

This chapter intends to discuss various bases of accounting, in detail. In addition, an attempt has been made to compare them by discussing in brief, their respective impacts (both positive and negative) basis available literature and stakeholders' consultations.

2. Spectrum of government accounting practices

As discussed in earlier chapter, government accounting practices are generally divided into four categories, moving from the least to the most sophisticated side of the spectrum: cash accounting, modified cash accounting, modified accrual accounting, and accrual accounting.

Cameralistic/ Cash Accounting	Modified cash accounting	Modified accrual accounting	Accrual accounting
Transactions and other events are recognized only when there is a cash inflow or outflow.	Transactions and other events are recognized on cash basis during the year. In addition, unpaid accounts and/ or receivables are also taken into account by keeping the book open for a specified period after the year's end.	Transactions and other events are recognized on accrual basis, but certain classes of assets or liabilities are not recognized.	Transactions and other events are recorded and recognized when they actually occur, regardless of when they are settled.

The following sections are divided into two (broad) heads of cash accounting and accrual accounting.

2.1. Cash basis of accounting

The cash basis measures cash flows at the time those flows actually take place. The modified cash basis allows a short period of time after the year-end for settling liabilities of the year just ended (and treats this expenditure as occurring in the year just ended).

Cameralistic/cash-based accounting has been the mainstream accounting and financial information system in the government sector of several countries for many years, with some governments using and preferring this method.

Arguments for adoption of cash accounting

- Easy to learn and carry out. It requires care, but no special accounting skills.
- Well-adapted to the needs of budgetary control. Strict budget control can be exercised by comparing sums authorized with those actually spent.
- Easy to understand and verify.
- A statutory requirement in many countries.

Arguments against adoption of cash accounting

Although cash accounting is easy to learn and carry out, and the system also is well-adapted to the needs of budgetary control, it fails to capture information on concerning liabilities, the future benefits for assets, accountability and decision-making; and consequently, presents a very short-term view of public finances in primary financial reports.

For instance, a purchase transaction might go through the following stages, each of which could generate accounting information:

- Commitment of funds
- Issue of purchase order for the supply of goods
- Receipt of the goods and of the invoice claiming payment
- Payment of invoice
- De-commitment of excess funds committed

Pure cash accounting does not provide useful information for managing payables and receivables but is restricted to only that lag of transaction which involves cash inflow and outflow.

The lack of complete, reliable and timely information about the financial obligations weakens the debtor government's ability and incentive to discharge its responsibility, consequently, affecting the credibility of the government. Conversely, lack of complete and timely information about non-cash financial resources/ revenues – investments, taxes, receivables, etc., hampers the government's collection effort, and reduces its ability to convert these resources into cash to invest in public functions.

Further, the objectives of financial statements are to provide information that is useful to a wide range of users in making and evaluating decisions about the allocation of resources, and to demonstrate the accountability of the entity for the resources entrusted to it. Cash accounting system fails to achieve this objective. The inability to match financial assets and liabilities in terms of amounts and timing is a fundamental cause of liquidity and solvency problems, which can become full-blown financial crises.

Moreover, a cash accounting undermines the objectives of promoting government's financial transparency as this system lacks transparency, and has an adverse long-term economic impact on financial performance, financial position and cash flows.

An opaque financial reporting practice may present the illusion of positive financial results in the short-term, at the expense of longer-term fiscal stability.

In most governments, the cash basis of accounting is used in conjunction with the commitment basis for budgetary control purposes. Under the commitment basis, expected expenditures are first entered into the accounting system as commitments (also defined as 'obligations'). Authorized expenditure ('the available budget') is reduced by commitments which have not been liquidated (i.e, not been followed by a cash payment). However, when the cash payment occurs, the sum committed is extinguished.

2.2. Accrual basis of accounting

The full accrual basis records expenditures and revenues when they become due (i.e., in many cases before the associated cash flows take place). It records assets and liabilities, and is therefore associated with the production of balance sheets. In other words, transactions and other events are recognized when they occur, meaning they are recorded in the accounting records and recognized in the financial statements of the periods to which they relate. It is also associated with providing depreciation on assets with finite lives.

The modified accrual method is similar to the full accruals basis, but it is simpler because it does not involve the capitalisation of fixed assets (nor the provision of depreciation of fixed assets).Transactions and other events are recognized on an accrual basis, but certain classes of assets or liabilities are not recognized. A typical example is the expensing of all non-financial assets at the time of purchase.

An accrual accounting system provides a comprehensive view of government's assets and liabilities, and of its financial performance and cash flows for an accounting period. It provides a systematic method of recording and managing sums due, something which many governments badly lack.

Arguments for adoption of accrual accounting

- Accrual accounting standards reflect the long-term economic impact of political decisions in the financial statements.

- Accrual accounting generates reliable information on the full range of assets and liabilities.
- Accrual accounting can generate comprehensive financial information about government e.g. a loan which is written off has no impact on a cash-based statement, but under accrual accounting it diminishes net worth.
- Accrual accounting provides adequate information on the full costs of operation, thus supporting decision-making, e.g. decisions either to place sub-contracts with private sector contractors or to carry out the work in-house.

- By introducing accrual accounting, governments demonstrate their desire to achieve greater transparency and accountability.
- Accrual accounting will lead to improvements in the quality of financial data, which can be used in the context of a wider finance function to assess performance and influence resource allocation and other strategic decisions.
- The conversion to accrual accounting provides an opportunity to rethink the transactional process flow, build accounting capacity and reduce the overall cost of public administration.

Arguments against adoption of accrual accounting

According to E&Y's study, which was validated by stakeholder consultation under the project, the cost of accounting reforms is identified as the most common reason governments cite for not adopting accrual accounting. This poses an interesting contrast to the most common justification given for choosing accrual accounting: to improve cost awareness and efficiency. The associated implication is that quality has high costs, but it also has the potential to provide greater efficiency gains overall.

Although, the accrual basis of accounting has its own merits and demerits, the full benefits of implementing accrual accounting can be captured as part of a wider finance reform, serving as a catalyst to provide high-quality financial information. Even more importantly, it aids in improving operational and service performance, and in contributing to the long-term sustainability of public finances. Also, this will increase the credibility of the government and public entities and buy-in from relevant stakeholders. This is important from India's perspective as well, which is already witnessing huge push for reforms in financial sector.

3. Benefits of efficient government accounting

It is not widely recognized that a sound government accounting system is an important part of a country's institutional infrastructure. Rather, government accounting is commonly perceived as a bureaucratic function. To make matters worse, like the foundation of a house or the sewer lines under the street, the accounting system as a critical institutional infrastructure is often invisible until it fails: when public money is lost and wasted, when taxes are not collected, or when employees are not paid on time.

Better accounting systems can quite readily lead to improvements in a government's financial management. However, the accounting system's contribution to the achievement of higher-order goals, such as poverty reduction, is necessarily indirect and long-term. So it is difficult to see its social benefits.

Furthermore, in poor countries, government accounting reform poses a moral dilemma. Because of its costs, such reforms compete with food for the hungry, medicine for the sick, and clean water for urban slum dwellers. In such an environment, how can one justify spending money to improve the way a government keeps its accounts and produces annual financial reports?

This moral predicament is resolved by the social benefits of government accounting. Government accounting itself does not reduce poverty. Government accounting contributes to a country's socioeconomic development through its effect on public financial management and accountability. Effective government accounting makes it possible to manage the government's finances smoothly and provides audit trails to prevent and detect financial misconduct. In the light of the pervasiveness and severity of government corruption in many developing countries, financial integrity assurance is a critically important function of their government accounting systems. Only ethical and competent public management can efficiently and effectively implement programs to reduce poverty reduction and achieve other socioeconomic goals.

Thus, it takes a certain amount of foresight and insight to make investments in government accounting reform - the foresight to anticipate the consequences of bad or no accounting and the insight to link accounting to government performance and eventually the achievement of societal goals.

Government accounting can contribute to a country's socioeconomic development by providing information to public managers and those who hold them accountable for performance of the fundamental functions of the state. As a support function, accounting does not have value of its own, and does not decide the allocation of resources. However, once these decisions are made, the accounting system performs the critical function of following the money.

As such, accounting and its allied functions - including information system design, internal control, pre- and post-audit, revenue administration, and public expenditure management - ensure that resources are used for their intended purposes. If the purpose is socio-economic development, accounting can help meet this goal by ensuring legal and contractual compliance, facilitating financial management, and promoting transparency and accountability.

As a result, in order to ensure adequate accounting from such a wide range of entities, a government accounting system has to be:

- Relatively uniform
- Well-documented
- Simple to learn and operate
- Easy to consolidate

Irwin notes that although the budget deficit is much discussed in political debate and economic research, there is no agreement on how it should be measured. There are at least four options, which can be called the cash deficit, the financial deficit, the full-accrual deficit, and the comprehensive deficit. Each is informative, but each has problems of relevance or reliability. Some are more vulnerable to manipulation involving assets and liabilities that are unrecognized in the underlying accounting, others to manipulation involving the mismeasurement of recognized assets and liabilities. Governments should publish all four in a form that reveals their interrelationships.

4. Improving the government's finance function

Accrual accounting is a key driver for increasing capacity and improving quality in the government finance function. It is an essential step toward improved public financial management and decision-making. The government finance function must demonstrate its usefulness by providing insights into business performance and contributing to public value creation.

The finance function is not confined to maintaining accounts and producing financial statements, rather should be concerned with analyzing financial data, assessing the cost of public services and offering practical interpretations on the meaning and relevance of financial information.

By strengthening the planning and forecasting capacity, the finance function stands to increase its relevance in the decision-making process. Individual initiatives can be taken for targeted improvements in asset management, cost accounting, performance measurement or any other aspect of the financial management. However, these are closely interrelated, with data gathered on area often used in, and necessary for subsequent reporting and analysis functions. Thus, a holistic approach is often the best approach for improving the finance function as a whole.

Consequently, fundamental to the development of accrual accounting in developing countries is the ability to identify and measure the government's assets and liabilities. Unless financial integrity is assured, the credibility of government's financial information suffers. Thus, both financial integrity assurance and accurate accrual accounting are accountants' professional contribution to developing countries.

The following chapter will discuss the best accounting practices for India and corresponding accounting reforms required for adoption of such best accounting practices.

CHAPTER 4
ACCOUNTING PRACTICES FOR INDIA

1. Government accounting structure in India

The Government accounting system in India is rule based and follows primarily cash basis of accounting. The preparation of government accounts in India is governed by the Government Accounting Rules, 1990 (GAR) framed under Article 150 of the Constitution of India. Under Article 150 of the Constitution, the accounts of the Union and the States shall be kept in such a form as the President may after consultation with the Comptroller and Auditor General of India (C&AG) prescribe.

C&AG has constituted Government Accounting Standards Advisory Board (GASAB) with the support of Government of India in the backdrop of the new priorities emerging in the Public Finance Management and to keep pace with International trends. The new priorities focus on good governance, fiscal prudence, efficiency & transparency in public spending.

The mission of GASAB is to formulate and recommend Indian Government Accounting Standards (IGASs) with a view to improving standards of governmental accounting and financial reporting that will enhance and strengthen the quality of decision-making and public accountability. GASAB has two-fold mission - improvements in the existing cash basis accounting system, and facilitating an eventual migration to accrual basis accounting.

GASAB develops accounting standards under cash basis known as Indian Government Accounting Standards (IGAS) for the existing accounting system, and standards for accrual basis under the nomenclature of Indian Government Financial Reporting Standards (IGFRS). The latter is essentially to facilitate pilot studies and the on-going applied research on accrual basis accounting in Government.

GASAB has so far developed six IGAS and submitted them to the Government of India for consideration, of which 3 IGAS has already been notified by the Government of India.

IGAS notified by Government of India

1. Guarantees given by Governments: Disclosure Requirements (IGAS 1)
2. Accounting and Classification of Grants-in-aid (IGAS 2)
3. Loans and Advances made by Governments (IGAS 3)

IGAS approved by GASAB and under consideration of Government of India

1. Government Investments in Equity (IGAS 9)
2. Foreign Currency transactions and loss or gain by Exchange rate variations (IGAS 7)
3. Public Debt and Other Liabilities of Governments: Disclosure Requirements (IGAS 10)

In addition, GASAB has so far developed five IGFRS and submitted them to the Government of India for consideration.

1. IGFRS 1 – Presentation of Financial Statements
2. IGFRS 2 – Property, Plant & Equipment
3. IGFRS 3 – Revenue from Government Exchange Transactions
4. IGFRS 4 – Inventories
5. IGFRS 5 – Contingent Liabilities (other than guarantees) and Contingent Assets: Disclosure Requirements

GASAB has also developed a detailed road map and an operational framework for Government of India and various States to migrate to accrual basis accounting. Several other products of GASAB are under various stages of development.

2. Need for accounting reforms

Twelfth Finance Commission (FC) in its report submitted in November 2004 recommended introduction of accrual accounting in government. In this regard, the FC highlighted that the change over to the accrual based system of accounting will place considerable demands on the accounting personnel in various government organizations, particularly at the lower and middle levels of the accounting hierarchy, consisting of accounts clerks, accountants, assistants, treasury officials and others. The absence of professionalized accounting personnel in the government sector in India has also been commented on by several analysts. Considering the need for qualified and professional accounts staff and training for capacity building particularly in the context of changeover to the accrual based system of accounting, the FC recommend setting up of a National Institute of Public Financial Accountants (NIPFA) by the Government of India and its charter be decided in consultation with the C&AG.

The Government of India accepted its recommendation to move to accrual accounting for the Union and the State Governments, and the roadmap for transition to accrual accounting has been prepared by GASAB. Whilst the roadmap and the operational Framework are meant to serve as implementation guidance, a two-pronged agenda is being followed for implementation of accrual accounting.

First, the ministries and departments at the Union level are taking up pilot studies for knowing their requirements for migration and implementation. Initiatives for migration to accrual accounting are underway by some Ministries and the Ministry of Railways at the Union level. It is important to note that the Ministry of Railways is presently working with the Institute of Chartered Accountants of India (ICAI) and undertaking a pilot study to shift to accrual based accounting. The Department of Posts is also actively considering introduction of accrual accounting.

Second, the State Governments are also being taken on board. Office of the Comptroller and Auditor General of India has taken up the matter with the State Governments for sensitizing them on accrual accounting through seminar-cumworkshop. Many state governments have agreed in principle to introduce accrual accounting. A few of them have constituted their task force for starting pilot study to know the gap between the existing system and the proposed migration and requirements for the same. Pilot studies have already been undertaken or under the aegis of GASAB in various States like Madhya Pradesh, Andhra Pradesh, Haryana, Gujarat and Rajasthan.

In this context, in the year 2001, the Supreme Court of India opined that accounts of the local bodies should be in the accrual format. Based on that, several municipal corporations have adopted the accrual system. As of 2011, 48 urban local bodies in 17 states have switched over to accrual-based accounting. Four states — Gujarat, Karnataka, Kerala and West Bengal have adopted accrual accounting for Panchayati Raj institution.

3. Impact assessment of implementing accrual accounting

It is difficult to undertake an accurate impact assessment exercise before accrual system of accounting is actually implemented. However, countries that have implemented accrual system of accounting have gained from improved governance, better control over assets, increasing buy-in from all stakeholders, and quite simply from availability of more accurate information for decision-making with all stakeholders. There is authentic and accurate information on government position, resulting in better flow of resources in the economy and generally better economic performance riding on more certainty. A couple of illustrations of benefits are:

- United Kingdom has been able to identify a number of idle assets that were hitherto not being put to any gainful use.

- New Zealand had been able to quantify the extent of fines and other charges levied by various departments of the government and follow-up on their collection (the cash-based system of accounting will not be in a position to provide the amount of receivables).

4. Checks and balances and risks involved in accrual accounting

Stakeholders' consultations under the research project revealed that before accrual accounting is implemented, accounting policies that determine principles of recognition, measurement and disclosure need to be defined. These policies will entail that discretion is not applied indiscriminately. Further, the role of Audit also needs to be strengthened to ensure compliance. Since every transaction will have a corresponding entry, Audit will assume a stronger role and responsibility and will ensure checks and balances. The risks involved in accrual accounting can be similar to the risks involved in the present cash accounting system. However, accrual accounting leads to greater transparency in accounts resulting in easier detection of frauds.

5. Way ahead

As suggested by the Twelfth Finance Commission, while the full switch over to accrual accounting is a long-term goal, a beginning is to be made by starting disclosures of financial information that are outside the present reporting framework of government accounting. This is possible within the existing system and needs to be an immediate concern. Simultaneously, preparation for switch over to accrual accounting needs to be planned. This was further corroborated by consultations with stakeholders under the project.

Switch over to accrual accounting would facilitate informed decision-making by the stakeholders and help in assessing long-term financial impacts of the current decisions taken and policies formulated. If imbibed in spirit, it would be helpful in taking fiscally responsible decisions. Politically, it will help governments to be more focused, judicious and rational in resource allocation, as fiscal imprudence leads to fiscal burden in the long run. In brief, accrual accounting would facilitate fiscal transparency and accountability through restraint on fiscal irresponsibility and opportunism. Benefits of such a reform are more qualitative than quantitative.

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ANNEXURES

Annexure –I –Experience of other countries

The following countries have moved over to accrual accounting and accrual budgeting:

i. Australia
ii. New Zealand
iii. The Netherlands (in the process of introducing full accrual budgeting)
iv. Sweden (in the process of introducing full accrual budgeting)
v. Switzerland (in the process of introducing full accrual budgeting)

The following countries have adopted full accrual accounting but follow cash-based budgeting:

i. Canada (While the federal Government adopts cash budgets, several Canadian provinces have adopted accrual budgeting)
ii. Japan
iii. United States
iv. Italy
v. United Kingdom
vi. Portugal (provides additional accrual information along with the budgets)
vii. Azerbaijan
viii. Uzbekistan

The following countries have set in motion the process of moving over to an accrual-based accounting system:

i. France
ii. Fiji Islands
iii. Indonesia
iv. Marshall Islands
v. People's Republic of China
vi. Philippines

vii. Republic of Korea

viii. Sri Lanka

ix. Mongolia

Annexure –II – Stakeholders' consulted

S.No.	Name	Designation&Organisation
1.	Mr. Amol Kulkarni	Senior Policy Analyst, Consumer Unity & Trust Society (CUTS),Jaipur
2.	Ms. Neelu Bahl	Senior Manager, Ernst & Young (E & Y), Gurgaon
3.	Mr. Shailendra Gupta	Associate Director, PwC, Gurgaon
4.	Ms. Neeti Srivastava	Senior Accounts Officer, Bharat Heavy Electricals Limited (BHEL), New Delhi
5.	Ms. Ananta Mittal	Deputy Manager, Controlling Finance and Accounts, Bosch Limited, Jaipur
6.	Mr. Lalit Kumar Kesnani	Proprietor, LalitKesnani& Associates, Chartered Accountants, Jaipur
7.	Ms. Swati Bhutoria	Manager, SIDBI, Jaipur
8.	Ms. Chandni Moolrajani	Company Secretary (CS), Udaipur
9.	Mr. Pankaj Somani	Senior Accounts Officer, Crompton Greaves Limited, New Delhi
10.	Mr. Gaurav Sharma	Partner, Gopal Sharma &Company, Chartered Accountants, Jaipur

Notes

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

Committee on Public Finance and Government Accounting
ICAI Bhawan, A-29, Sector 62, Administrative Wing (III Floor),
Noida-201309, www.cpfga.icai.org | www.icai.org