

## **DO PRIVATE SECTOR FINANCIAL STATEMENTS PROVIDE A SUITABLE MODEL FOR PUBLIC SECTOR ACCOUNTS?**

Paper to be presented at the European Group of Public Administration annual conference on  
“Public Law and the Modernising State” in Oeiras (Portugal), 3-6 September 2003-08-09

By Andy Wynne

Head of Public Sector Technical Issues  
Association of Chartered Certified Accountants

### **Correspondence:**

Andy Wynne  
Technical Department  
ACCA 29 Lincoln's Inn Fields  
London WC2A 3EE  
e-mail: [a.wynne@accaglobal.com](mailto:a.wynne@accaglobal.com)  
tel: +44 207 396 5778

## Abstract

- IFAC Public Sector Committee issued their standard on the cash basis of accounting and the ASB (UK) issued its draft interpretation for public benefit entities (not-for-profit organisations) earlier this year. In each case the private sector model of accounts was followed closely.
- What is the experience in the UK of producing full accrual based accounts for public sector organisations? Have the increased value of these accounts been realised in practice?
- Who is the defining class of user for the accounts of public sector entities?
- What are the main objectives of public sector financial reporting? What are the key financial aspects which should be reported on in the accounts?
- Should public sector organisations clearly account for the level of their borrowings or debt? How should this be measured?
- How should public sector organisations account for aspects not found in the private sector, for example, heritage assets, military equipment, social policy obligations and taxation?
- Should public sector organisations be required to report on the extent to which they have adequately maintained their operational assets?
- What is the relative importance of financial accounting statements and budget out-turn reports in terms of public sector accounting?

**The views expressed in this paper are the views of the author only and do not necessarily represent the view of the ACCA Council.**

### Andy Wynne

Head of Public Sector Technical Issues with ACCA. Responsible for public sector developments and in particular co-ordinating ACCA's responses to public consultation documents.

Extensive experience of accounting and auditing across the public sector in the UK and Africa. Worked in internal audit in a large district council, then for a small NHS consortium. Later, worked for six years in a chartered accountancy practice in England providing financial services to a wide variety of public sector organisations.

ACCA is the largest, fastest growing, global professional accountancy body, with over 300,000 members and students in 160 countries. ACCA's mission is to provide quality professional opportunities to people of ability and application, to be a leader in the development of the global accountancy profession, to promote the highest ethical and governance standards and to work in the public interest. ACCA has over 5,000 members working in the UK public sector.

# DO PRIVATE SECTOR FINANCIAL STATEMENTS PROVIDE A SUITABLE MODEL FOR PUBLIC SECTOR ACCOUNTS?

## Introduction

There are two main schools of thought on public sector accounting each of which is linked to a view of the role of the public sector more generally. The first, traditional school holds that the public sector is necessary to manage the wider economy and to try and overcome some of its negative aspects, especially its inequitable and cyclical nature. The alternative, and currently dominant, view is that the public sector is a necessary evil for the provision of a restricted range of goods and services. According to this view, public sector accounting is part of the process of enabling competition and maximising efficiency and so ensuring that the public sector is managed at minimal cost to society. These two schools of thought can be seen as contestable paradigms or ideologies which have each secured dominance at various times over the history of public sector accounting over the last 150 years or so.

Under the traditional model of public administration cash accounting was generally considered more appropriate for the public sector, emphasis was placed on compliance with rules and regulations and so the usual public sector financial statement was a budget out-turn report. Under New Public Management the emphasis is on efficiency and so private sector style financial statements under the accrual concept are recommended for introduction.

Countries and administrations who are considering making the transition from the cash to the accruals basis of accounting should review carefully the validity and benefits that may be expected to accrue from such reforms in the context of their own local circumstances, conditions and priorities. General recommendations in favour of accrual accounting should not be considered overwhelmingly persuasive. The use of accrual accounting in the public sector context is a relatively recent phenomena and the balance of costs and benefits are still subject to some substantial debate by both academics and accounting practitioners.

The Accounting Standards Board (UK) is continuing this debate (2003) on the appropriate approach for public sector bodies to take when accounting for their financial affairs. In the summer the Accounting Standards Board issued its interpretation for not-for-profit organisations of its 'Statement of Principles for Financial Reporting'. This document argues that public sector organisations and charities should prepare their annual accounts following as closely as practically Generally Accepted Accounting Practice as it has developed in the private sector.

This paper considers whether this is an adequate approach for the democratic accountability of government entities and whether it is appropriate for bodies such as the IMF, World Bank, European Union and OECD to apply significant pressure on countries to adopt public sector accrual accounting. The first section of the paper briefly considers the introduction of private sector style financial statements and accrual accounting in the UK public sector over the last few years. The paper then goes on to consider the main users of public sector accounts, the objectives of these accounts and the particular aspects of public sector finance which should be reported. The paper then considers that public sector accrual accounting should be critically appraised and considered on its merits. An approach which lauds efficiency should itself also be assessed on this basis – what are its costs and what are the actual benefits which have been achieved?

## The UK experience

Accrual accounting was introduced for UK local authority accounts in the mid-nineteenth century and by the end of that century had been adopted by most of the larger, municipal councils (Coombs and Edwards 1996). All but the smallest councils, which were established with the reforms in 1974, adopted accrual accounting. However, this was not uniformly accepted and the cash basis of reporting was established by the Treasury as part of the major reforms introduced in 1866. Thus it was the cash basis which was used in the British colonies across the world over the next 100 years.

With the major reforms of the National Health Service in the early 1990's the internal market was adopted and hospitals established as quasi-independent businesses accounting on the accrual basis. At this time this approach was still being contested for central government and it was not until the mid-1990's that the move from the cash basis was agreed (Treasury 1995).

No cost benefit study has been undertaken of this move (Chow and Humphrey, 2003) despite the significant costs involved, for example, the increasing number of qualified accountants from nearly 600 in 1989 to 2200 in 2003 (personal communication with HM Treasury). Whether accrual-based accounting will deliver its promises remains an open question (Hodges & Mellett, 2003). As Likierman puts it (2000, p253) 'A full analysis will only be possible once the new systems have been working for a number of years'.

In the private sector, the annual financial accounts of a company identify the financial impact of the company on its individual share holders. In contrast, it is a country's taxation system, not the government's accounts, which identify the financial consequences of government policies for individual citizens. As a result, public sector accounts do not have the significance of their private sector equivalents. This can lead to significant disappointments thus, for example, the National Audit Office and the Audit Commission in the UK have been critical of the level of interest in and lack of ownership of public sector entities' financial statements.

In its annual report for 2000-01, the NAO (2002, p. 5) reported that some of the financial errors it had uncovered should have been identified and corrected by the management of the relevant organisation. It stated that, "many of these problems would have been avoided by a greater degree of ownership and review by management of their financial statements". The Audit Commission (2001, p. 34) has also commented that many local government "officers are sceptical about the value of published financial statements" and that elected members had yet to accept ownership of their published accounts.

Most public sector organisations in the UK now produce financial statements which are comparable to those produced by private sector entities. In some cases at least, one of the results of this change has been that the stewardship function of financial accounting in the public sector has been lost. Local authorities and most health service entities, for example, now publish annual financial statements which do not necessarily include a comparison of actual income and expenditure with that authorised in the organisation's annual budget. The budgeting setting process is still seen as a fundamental aspect of financial control, but the actual financial results of the organisation and their comparison with the previously agreed budget are not necessarily specifically audited, published nor given appropriate publicity.

## Primary users of public sector financial statements

The starting point for standards or guidance on financial reporting should be clarity on the group of people to whom the accounts are to be primarily addressed. Living in democracies, there is a natural assumption that the political accountability of government to the electorate should take precedence. Thus the accounts of the various public sector organisations should be addressed to the electorate. This is in contrast to the predominantly financial accountability of the management of a private sector company to its shareholders. The financial accountability of government to the electorate is supported by the Government Accounting Standards Board in the US (GASB, 1987). It argues (on page 12) that:

*There are three groups of primary users of ... governmental financial reports. They are (a) those to whom the government is primarily accountable (the citizenry), (b) those who directly represent the citizens (legislative and oversight bodies), and (c) those who lend or who participate in the lending process (investors and creditors).*

In the private sector it is accepted that the defining class of user of financial statements is “the investor that has supplied risk capital in expectation of a financial return on capital” (Accounting Standards Board 2003). Although a multi-stakeholder approach is gaining ground (Global Reporting Initiative 2002). In contrast, for the public sector, the accountability equation is fundamentally different. In place of the financial accountability of the management of a company to its shareholders we have the political accountability of the government to the electorate and its elected representatives in parliament or the council chamber.

Thus the defining class of user of financial statements in the public sector should be the electorate. Their elected representatives act on their behalf and use the financial statements to hold the government and the civil service to account for the resources which they were allocated to provide the agreed level of goods and services.

This is largely the position which was taken by the Office of Management and Budget in the US (1993, paragraph 8). Thus in its Statement of Federal Financial Accounting Concepts 1, *Objectives of Federal Financial Reporting* it stated that:

*The federal government derives its just powers from the consent of the governed. It therefore has a special responsibility to report of its actions and the results of those actions. These reports must accurately reflect the distinctive nature of the federal government and must provide information useful to the citizens, their elected representatives, federal executives [the government], and program managers [public sector managers].*

In contrast, the Accounting Standards Board (2003, page 29) argues that 'the defining class of user for the financial statements of public benefit entities is the funders and financial supporters'. It arrives at this conclusion because of its attempt to interpret its principles of financial reporting for the public sector with the minimum of translation or change. As the ASB's discussion paper states, “the Board believes that a common set of principles should underlie financial reporting by all entities” (Accounting Standards Board 2003, page 3). Shareholders are the accepted “defining class of user” for the financial statements of private sector organisations - so the corresponding group for public sector accounts is seen to be the funders and financial supporters of the sector or more simply the tax payers.

This would appear to be a distortion of the accepted principle of democracy of one person one vote - to be replaced by the principle of one pound (of other unit of currency) one vote which rules in the market place. The idea of privatisation of the state which has gained dominance in the last couple of decades is thus extended to include the privatisation of the accountability of the state!

The Accounting Standards Board discussion paper (Accounting Standards Board 2003, page 24) recognises that the objectives of financial statements are to provide information to users to assist them assessing the stewardship of the entity's management and for making decisions. This analysis is confirmed by the IFAC Public Sector Committee (IFAC 2000a, paragraph 13) which states that "the objectives of general purpose financial reporting in the public sector should be to provide information useful for decision making, and to demonstrate the accountability of the entity for the resources entrusted to it".

The electorate can use the information provided in a public sector organisation's financial statements to make political decisions on whether to support the government or not. In contrast, taxpayers "are involuntary resource providers; they cannot choose whether or not to pay taxes" (GASB 1987, paragraph 17.a). This lack of decision making by taxpayers is down played in the Accounting Standards Board discussion paper which merely states that taxation "may be compulsory" (Accounting Standards Board 2003, page 20 of the preface).

However, IFAC still argues for private sector style stakeholders as the main users of public sector accounts. Thus, for example, in its standard for financial reporting under the cash basis of accounting (IFAC 2003) its Public Sector Committee states that "[u]sers of general purpose financial statements include tax payers and ratepayers, members of the legislature, creditors, suppliers, the media and employees" (paragraph 1.1.2).

### **Different objectives - same accounting basis?**

A fundamental objective of the financial statements for any public sector organisation should be to fulfil the stewardship function by providing an audited comparison of the actual use of resources with the agreed budget. A government's financial accountability arises from the budget setting process during which it gains agreement to the levels of taxation which will be levied and to the funding which will be allocated to the various services which it intends to provide. Thus the budget out-turn report is the prime document by which governments are held to account for the regularity and probity of their financial management.

James L. Chan (2003) has argued that government accounting has, in order of priority, the following three purposes:

- safeguarding the public treasury by preventing and detecting corruption and graft
  - facilitating sound financial management through financial management, budgetary control and value for money
- and
- to help government discharge its public accountability.

In contrast, accrual accounting was specifically developed to measure the profit earned by an entity that should be attributed to a particular financial year. Accrual accounting also enables private sector businesses to match the cost of the provision of goods and services with the revenue gained from their sale. For private sector companies, this single performance measure neatly encapsulates their financial performance and the achievement of their prime objective, to make a profit. For public sector organisations the same concept, profit, cannot be expected to be as effective.

Despite the role and objectives of accounting being different in the public and private sectors (due to the different objectives of entities in these two sectors), these differences are frequently ignored. For example, the Public Audit Forum (2002, page 16) states that, "it is clear that the benefits of accruals accounting for the public sector are very similar to the benefits achieved by businesses and a considerable improvement on the equivalent cash-based information".

The Accounting Standards Board (2003, page 24) defines the objectives of public sector financial statements as being to provide:

*Information about the reporting entity's financial performance and financial position that is useful to [users] evaluating the proper and efficient use of the entity's resources and in assessing the entity's future cash needs and its financial adaptability.*

The ASB does recognise, that at least for some users, their interest in the financial statements is "simply in order to assess the adequacy of stewardship exercised by the entity's management and not always to make economic decisions" (Accounting Standards Board 2003, page 26). Thus the key difference in function between private sector financial statements and those produced for public sector entities is recognised, but the implications of this insight are not then explored, or at least only briefly.

"Governments uniquely provide public goods and finance them through taxation... These characteristics sever the link between service delivery and revenue recognition, making it impossible to match revenues and expenses" (Chan 2003, p. 5). In addition, the concept of profit (or surplus) in government accounts is largely meaning less. A surplus does not necessarily equate with good management - it may just mean that the service was over funded. Similarly a deficit in governments accounts may merely mean that there was a failure to match revenue receipts with actual expenditure. In each case, the surplus or deficit does not necessarily reflect the quality of the management of the public entity concerned.

"Anglo-Saxon commercial accounting involving accruals-based annual financial statements is [not] necessary for accountability, control and decision-making relating to government" (Nobes, 1988, quoted in Chan 2003, p.5).

### **Budget out-turn reports**

In the private sector the primary purpose of the financial statements is to report the annual and accumulated profit earned by the company. In contrast, in the public sector, the primary purpose of financial statements (or the budget out-turn report) is as part of the process of public stewardship and accountability. "Many believe the budget is the most significant financial document produced by a governmental entity" (GASB 1987, page 8).

However, the importance of budget out-turn reporting for fulfilling the public stewardship function of public sector organisations is underplayed by both the ASB (Accounting Standards Board 2003) and IFAC (IFAC 2003). In each case budget out-turn reports are seen as one of the optional additional statements which public sector organisations may produce.

The public audit process provides comfort to the electorate that the government does not spend more in total than it agreed in the budget and that it is spent on the goods and services which parliament determined. It also provides comfort that the public service operates with appropriate propriety and regularity. If the government's spending is not regular and proper then the media will provide the main means by which the adverse audit reports are communicated to the electorate.

The secondary role which may be fulfilled by a modified balance sheet is to report on issues of inter-year or inter-generational resources flows and thus equity. On one side there are a range of capital assets which are in use for many years on the other side most governments and many public entities have debts which have to be paid back in later years.

The discussion paper (ASB 2003) does recognise that this stewardship function “plays an important role in the preparation of financial statements by public benefit entities” (paragraph 1.5). The implications of this insight are not, however, adequately explored and the discussion paper suggests that the provision of information on the “reporting entity’s financial performance and financial position” (page 24) is significantly more important. The references in the discussion paper to budgetary reporting suggest that this is just one example of other types of financial information which may be provided. Thus, for example, paragraph 7.19 states that “it may be useful to provide information on a comparison to budget... within general purpose financial reports, as part of the accompanying information”.

Despite this, the introduction of budget out-turn reports have been dropped when accrual accounting is introduced in the public sector. For example, English local authorities are not required to produce them and they have not been produced with the change to accrual accounting in Romanian central government accounts (McKendrick 2003).

## **Public debt**

The level of government debt is now considered to be one of the key aspects of the management of public finances and it is now generally accepted that it should be reduced to a sustainable level. Government debt may be reported in a set of accrual accounts, but it may be hidden unless given particularly attention or reported separately in additional financial statements. In contrast, the cash based financial statements of the Nigerian Government, for example, consist of a series of annual accounts, two of which concentrate on providing details of the government’s domestic and international debt.

Since becoming the UK Chancellor of the Exchequer, in May 1997, Gordon Brown has defined his prudent approach to public finance through two strict fiscal rules:

- the golden rule: over the economic cycle, the government will borrow only to invest and not to fund current spending

and

- the sustainable investment rule: over the economic cycle, the ratio of net public sector debt to GDP will be set at a 'stable and prudent' level, defined by the Chancellor as 40 per cent of GDP.

The government has provided no justification for a net debt target of 40 per cent of GDP – it could just as easily have chosen 35 per cent or 45 per cent. The Maastricht Treaty, for instance, allows UK gross general government debt of no more than 60 per cent of GDP. This is consistent with net public debt being considerably higher than 40 per cent of GDP (Institute for Fiscal Studies April 2001). Historically 40% is a very low level. For most of the century between 1750 and 1850 and for much of the 20<sup>th</sup> century the UK national debt was worth more than 100% of its national income. During the Second World War it peaked at over double the national income. The UK currently has one of the lowest debts of any industrialised country. Italy has a government debt of around 100% of GDP and Japan has the highest government debt in the industrialised world at 140% of GDP (Watts, J., 1 August 2003).

In addition, whilst the Labour administration continued the change to accrual accounting in the UK central government accounts on coming to power in 1997, it also continued and extended the Private Finance Initiative. "We are left with the contradictory position that the government, while promoting the application of accrual-based accounting in the public sector, is actively encouraging off balance sheet financing schemes, such as the PFI" (Hodges & Mellett 2003).

An additional problem with reporting government debt is that there are a variety of definitions of debt. The figures used in the UK, for example, are of net debt and are significantly different from the gross debt used by the EU to measure adherence to the Maastricht Criteria. In contrast to the EU comparison of government debt to GDP, the IMF and World Bank compare the debt of a country with its export earnings to determine whether the debt is sustainable. They consider this to be the case if the total debt is no more than 150% of annual export earnings (it was agreed to reduce this from 200-250% of a country's exports at the G8 Summit in Cologne in June 1999 (Jubilee Research April 2003).

There are still further ways of reporting the level of government debt. In Mauritius, for example, the cost of servicing public debt (including capital repayments, interest, management service charges and sinking fund contributions) is compared to the Government recurrent expenditure (Director of Audit November 2002).

### **Difficulties of applying private sector accounting concepts to the public sector**

It is reasonable to assume that "the objective of financial statements is to provide information that is useful to those for whom they are prepared" (Accounting Standards Board 2003, page 24). In the public sector, however, this information is primarily used for making political rather than economic decisions. As a result, the information requirements of the users will be different to those of the users of private sector financial statements.

The Accounting Standards Board's paper (2003, page 46) adopts the private sector definition of an asset as "rights or other access to future economic benefits controlled by an entity as a result of past transactions or events". This definition is then extended to include future service potential. But even this concept is expanded to include heritage assets "even where, for example, such items are not on display, their preservation alone will meet the asset definition" (Accounting Standards Board 2003, page 48). This appears to be extending the

concept of future economic benefits to a ridiculous extent and clearly demonstrates some of the problems of adopting private sector concepts to the circumstances in the public sector.

However, the imprecision of accrual-based accounting is not removed by the use of such undefined notions (Page and Spira 1999, p494). The equivalent definition of assets in the U.S.A. has been described as “so complex, so abstract, so open ended, so all-inclusive and so vague that we cannot use it to solve problems” (Scheutze 2001, p12) and there are a number of difficulties in their application to public sector entities. For example, some public facilities may be provided by natural endowment or gift and so there is no equivalent of historical cost incurred by the purchase of these assets. Some facilities must be maintained and preserved for future public use and there may be no private market available to realise the economic benefit from their use. Additionally, there may be restrictions imposed so that disposal of the facilities is prohibited or requires government approval (Hodges & Mellett, 2003). These features have led to views that community facilities (such as national parks, monuments and museum collections) and infrastructure (such as public roads and footpaths) are assets (Rowles 1992; Micallef and Peirson 1997), liabilities (Mautz 1988) or a special category of item (Pallot 1990; Barton 2000).

IFAC Public Sector Committee is also struggling with the most appropriate way of reporting uniquely public sector concepts such as state pensions and taxation. Over the reporting of state pensions a working party could not agree an approach and provided the Committee with four different options. One of these, 'pay as you go', is basically the current approach adopted by most governments and accounted for on a cash basis. The Committee at its meeting in April, earlier this year, could also not agree and asked the working party to review its approach.

Similarly with reporting of taxation, the IFAC Public Sector Committee, also at its April 2003 meeting, asked a separate working party to revise its approach and report back to the next meeting of the Committee. In contrast, the Accounting Standards Board appears to give up on trying to report government taxation revenue on an accrual basis and concluded a discussion on this issue by admitting that “the recognition criteria are likely to be met when the resources are received” (Accounting Standards Board 2003, page 68). That is the major element of government revenue, its taxation receipts, should be accounted for on the traditional cash basis.

### **Maintenance of assets**

The move in recent years for the public sector to adopt private sector style financial statements means that different information is being provided. This information is not necessarily better, in the sense of better meeting the users' needs, as the objectives of the two sets of financial statements are different. For example, in the private sector the recognition and valuation of the company's assets will have a significant impact on the bottom line profit which is reported. In the public sector, the valuation of assets is of much less importance. Thus HM Treasury have adopted a cost benefit trade off in determining which assets are to be valued in its resource accounts. Non-operating assets such as the crown jewels, Stonehenge and paintings in the National Portrait Gallery are all given a nominal value whilst new additions to the latter collection will be included in the balance sheet at their purchase price or value when acquired.

In contrast, reporting the extent to which public sector capital assets are maintained is far more important than reporting their total value. As long as a school or hospital is being kept

for its current use, its capital value is of little interest, but the extent to which such assets are being adequately maintained is of much greater value.

In recent years, it has become apparent in the UK that there had been a failure to maintain adequately the public infrastructure which has resulted in a significant backlog of maintenance expenditure. Thus for example, the government has estimated that this is approximately £19 billions for public housing and £7 billions for major roads. This suggests that governments need to be held to account for this aspect of the management of public services rather than for the value of the infrastructure which could be measured within a traditional balance sheet. This backlog maintenance was not identified with the introduction of accrual accounting in local government or in the NHS (from the early 1990's) where backlog maintenance was estimated to be nearly 10% of its annual budget by the turn of the millennium.

This problem was recognised in GASB's Concepts Statement No.1 (GASB 1987) which explained that:

*Maintenance programs for non-revenue producing capital assets can be altered, suspended, or even ignored because of the competition for limited resources. Government's implicit commitment to maintenance and its ability to delay maintenance and rehabilitation expenditures, especially for non-revenue producing capital assets, needs to be considered when developing financial reporting objectives.*

Adopting a private sector style balance sheet thus does not effectively report the two important aspects of public sector finances of government debt or asset maintenance.

## **Two contested paradigms**

There are two main paradigms or schools of thought on the role of the public sector. The first school holds that the public sector is necessary to manage the wider economy and to try and overcome some of its negative aspects, especially its inequitable and cyclical nature (Minogue 2000). Accounting in the public sector, according to this school is seen as part of the process of stewardship and democratic accountability for the use of resources which have been allocated through the democratic process for the provision of essential goods and services.

The alternative and currently dominant view is that the public sector is a necessary evil for the provision of a restricted range of goods and services. According to this view, the market is seen as the most effective means of allocating society's scarce resources. Thus care should be taken to ensure that the growth of the public sector does not upset this essential optimising system and where possible, the market or quasi-market mechanisms should be used to allocate resources and to maximise the managerial efficiency of all, private and public, organisations. Public sector accounting is seen as part of the process of enabling competition and maximising efficiency and so ensuring that the public sector is managed at minimal cost to society.

This is the view detailed in the Accounting Standards Board's discussion paper (Accounting Standards Board 2003) which sees the prime objective of the financial statements of public sector organisations is "to provide information about the reporting entity's financial performance and financial position" (page 24). Financial performance is considered to be the financial efficiency or value for money with which the public sector organisation has

provided the agreed goods and services. This financial efficiency is measured by comparing the performance of the organisation with other public sector organisations and possible private sector competitors (see paragraph 6.11 of the ASB discussion paper).

These two schools of thought can be seen as contestable paradigms or ideologies which have each secured dominance at various times over the history of the public sector over the last 200 years or so. In the nineteenth century, especially during the boom from 1850 to 1873, free market ideas gain ascendancy (Hobsbawm 1962). As a result accrual accounting was used in English local authorities from around 1850 (Coombs and Edwards 1996).

The world slump in the 1930's facilitated the introduction of Keynesian ideas of state management of the economy in the west at the same time as state dominated economies were introduced in the east. The newly independent countries in the south were established in the 1960's against this background and so adopted the ideology of state led development.

For most of the twentieth century, until around 20 years ago public sector accountability was clearly distinguished from its private sector counterpart. With the world economic slow-down in the 1970's and 1980's and the coming to power of Ronald Regan (in the United States) and Margaret Thatcher (in the UK), the ideas of Neo-Liberalism again achieved ascendancy. Through a major political and philosophical struggle Neo-liberalism replaced Keynesianism as the economic orthodoxy. Fiscal discipline, liberalisation, privatisation and de-regulation became the norm. This was a complete change of view from that of the previous thirty or more years. As Susan George has said:

*In 1945 or 1950, if you had seriously proposed any of the ideas and policies in today's standard neo-liberal tool-kit you would have been laughed off the stage or sent to the insane asylum. (George, 2000)*

Private sector style management approaches were introduced into the public sector and came to be termed New Public Management (Hood 1991). This included the use of private sector style accrual accounts. This approach was first trialled at a national level after the over-throw of the democratically elected socialist government of Salvador Allende in 1973. Consultants from Milton Friedman's department at Chicago University were heavily influential (Williamson 1994). Neo-Liberal economic ideas were introduced including widespread privatisation and accrual accounting for the much reduced public sector (Perez and Hernandez, 2003). One of the consultants "argued, if private sector enterprise and the market is good for producing steel, should they not also be good at producing pensions" (Williamson 1994).

These experiments were quietly forgotten, perhaps because of the violence of the Pinochet regime. New Zealand, a parliamentary democracy, is now almost universally quoted as the originator of New Public Management ideas and the associated approaches to public sector accounting.

By the end of the 1980's the world scene had become highly favourable to the generalisation and spread of these new economic policies. On the one hand the debt crisis gave the IMF and the World Bank the leverage necessary to coerce third world governments into accepting structural adjustment programmes (Minogue 2000). On the other hand, the collapse of the centrally planned economies of Eastern Europe and Russia removed the ideological justification for the previous arguments for state-led economic development.

The European Union and the OECD are also playing their part in spreading the ideas of New Public Management and ensuring their introduction. For example, the EU is strongly encouraging applicant countries to adopt accrual accounting (McKendrick 2003 and Olson et al 1998).

Is it really appropriate for these international bodies to apply significant pressure on countries to adopt public sector accrual accounting (McKendrick 2003), especially when, in some cases at least, this pressure is coming from bodies some of whose members have yet to adopt this approach. For example, accrual accounting is strongly recommended for candidate countries hoping to join the European Union despite its Commission not planning to adopt this approach itself until 2005 (McKendrick 2003).

### **New Public Management**

The dominant attitude to public sector accounting has developed from these changes to more general economic views. It is the neo-liberal approach to economics which underpins the New Public Management approach to public sector financial management (Olson et al 1998). The adherents to this approach argue that:

- large state bureaucracies were inherently defective and wasteful
- the free market was the most efficient method of allocating scarce resources
- private sector management techniques are a suitable model for the public sector  
and
- if the preferred approach of privatisation is not considered to be appropriate then commercialisation or pseudo-markets are introduced as the second best alternative (Minogue 2000).

Typical features of New Public Management type reforms include:

- increased orientation on the private sector to provide public services and as a model for managing these services
- devolution of responsibilities, an increased emphasis on managerialism and giving managers the power and right to take an increasing range of decisions  
and
- a move from the state being a provider of services to purchasing these services from the private or voluntary sectors through out-sourcing, contracting or public private partnerships.

New Public Management emphasises the introduction of private sector management techniques and the application or simulation of competitive market behaviour. In the field of accountancy, this has led to the adoption of the accrual basis of accounting and private

sector style financial statements in contrast to the budget out-turn reports prepared on the cash basis which had been universally accepted in the past.

Accrual accounting should not be considered in isolation, but as part of a package of reforms which have come to be known as New Public Management. Accrual accounting is not "an end in itself, but rather, as a means of shifting the emphasis of the budgetary process away from cash inputs, towards outputs and outcomes, in the hope that this will result in greater management efficiencies, and hence, better outcomes for Governments and the communities they serve" (Carlin and Guthrie, 2000 p.3). The move to accrual accounting is primarily aimed at facilitating comparisons with potential private sector providers of public services for governments that have accepted that private sector provision of public services is acceptable and advantageous.

Many of the approaches adopted as part of the New Public Management package of reforms are not new, as has been described above, accrual accounting was used in English local authorities from around 1850 (Coombs and Edwards 1996). As also mentioned above, accrual accounting was first introduced by a national government in Chile after 1973. At local government level, it was introduced in some Cantons of Switzerland from the 1940's and all agreed to introduce it in 1977 (Olson et al 1998).

Despite this, the introduction of accrual accounting is often claimed to be the introduction of up-to-date and modern accounting techniques. Thus when the European Commission announced its intention to move to the accrual basis of accounting it made great play on what a modern accounting system it would then have and continually emphasised the reform as modernisation.

When first introduced, New Public Management reforms were seen as highly political and ideological. Over the years, the ideological element of the reforms has been de-emphasised and they are instead described and argued for in terms of their technical superiority. New Public Management has become a trend, its ideas have come to be regarded as universal and as being applicable everywhere, regardless of the special circumstances of different countries or regions of the world (Christensen and Laegreid 2002).

The techniques associated with New Public Management, including accrual accounting, have now become generalised in the sense that they are now often claimed to be how public sector entities in general should be managed, controlled and structured. They have become apolitical and are now promulgated and defended on the basis of technical expertise rather than their ideological considerations. Thus in the UK the Blair Government has continued with the public sector reforms initiated by the previous Conservative governments, including the introduction of accrual accounting. Tony Blair has recently stated (Office of Public Services Reform 2002) that his overall long-term strategy for public services is underpinned by the following set of four principles:

- national standards and targets agreed, independently monitored and reported for all public services
- devolution of responsibility to deliver these standards to successful front-line professionals

- flexibility in the delivery of services and the removal of artificial bureaucratic barriers which prevent staff improving local services

and

- providing consumers of public service consumers with the kind of options that they take for granted from the private sector.

### **Opposition to New Public Management**

Nevertheless, in recent years there has been an increasing widespread view that New Public Management and associated policies are no longer tenable. Thus there have been a series of large anti-capitalist demonstrations in various major cities since the one in Seattle in late 1999. In addition, academic criticism of New Public Management has developed as "there is little evidence that the application of reform strategies based on New Public Management actually leads to the desired results" (Christensen and Laegreid 1999, p. 1). "It is tempting to speculate that the massive rejection of the UK Conservative government in 1997 was also driven by anxieties about the effects of new public management reforms on public services" (Minogue 2000).

There has always been a view that accrual accounting is not appropriate for government accounts. So, for example, George Jones (1997, p. 34) has argued that the introduction of accrual accounting by the UK Government is:

*"based on a false notion of governing. It assumes that governing requires the setting of clear specific objectives; and that government consists of discrete programs to which coherent sets of activities can be related, driven by the specific objectives. But government is more about managing networks within constraints, about regulating relationships, not about achieving set objectives. It is about coping with ambiguity, conflict and instability. The so-called rationality of focusing on objectives is to view people like rats in a maze with clear objectives of seeking food or a way out".*

Others have argued that, whilst the transition to accruals accounting is valid for developing countries, it may not necessarily be suitable for less developed or transitional economies (McKendrick 2003). For example, SIGMA, an organisation set up to assist central European countries prepare for EU membership, has observed that:

*both the effectiveness of the reforms in countries where they have been implemented and their suitability for transition economies remain the subject of debate among academics as well as practitioners (SIGMA 2001).*

Similarly there has, in recent years, been concern expressed in developed countries as to whether the practical achievements of accrual accounting stand up to scrutiny and there is some evidence that the adoption of accrual accounting has not produced the gains originally expected of it (Froud, Haslam, Sukhdev, Shaoul & Williams 1998; Guthrie 1998; Olson, Guthrie & Humphrey 1998; Stanton and Stanton 1998). In addition, a number of authors have questioned the adoption of private sector accounting in a public sector context (for examples see Mellett 1997; Robinson 1998; Van Peurse and Pratt 1998; Barton 1999).

## **Emphasis on advantages of accrual accounting by IFAC Public Sector Committee**

IFAC Public Sector Committee has made considerable progress over the last few years in developing a set of International Public Sector Accounting Standards for public sector financial reporting on the accrual basis of accounting (Sutcliffe 2003). However, as the Standards are not comprehensive, there are as yet no agreed standards for such significant areas as taxation and social policy obligations (for example, state pensions). In addition there is no universally agreed approach to the valuation of particular sets of assets such as heritage, infrastructural or military assets. As a result, individual governments that wish to move to the accrual basis will have to develop their own standards (Hepworth 2003). This may involve adapting private sector standards or, for some public sector activities such as for the treatment of tax revenues and social policy obligations, either inventing new country standards or acting in a way that effectively ignores the problems that exist.

Despite this, the emphasis of the IFAC Public Sector Committee has been on encouraging all governments and other public sector entities to make the transition to the accrual basis of accounting for their general purpose financial statements. The Committee "has commented extensively on the benefits of accrual accounting for governments and individual public sector entities in previous studies (Studies 5, 6, 8, 9, 10, and 11) and Occasional Papers (Papers 1 and 3)" (IFAC Public Sector Committee 2002, p.7). Even the introduction of the International Public Sector Accounting Standard for the cash basis of accounting states that, "the Committee encourages governments to progress to the accrual basis of accounting" (IFAC 2003, p. 1).

The Committee has expended less effort on considering whether the transition to the accrual basis of accounting is universally applicable and, if so, describing the particular preconditions for its success which have been detailed by, for example, Schick (1998) and Hepworth (2003). Although IFAC does recognise that standard-setters and those responsible for the preparation of financial statements should be aware that the balance between benefit and cost is a pervasive constraint (IFAC 2000a, page 86). At the same time it admits that "it is difficult to apply a benefit-cost test in any particular case". We are left with the assumption that accrual accounting is being recommended on the basis of the belief that the increased comparability it will allow with alternative providers of public services will more than compensate for the additional cost involved and so result in a significant increase in efficiency or reduction in cost of the provision of such services.

### **The continued validity of cash accounting**

At the national level, the Chilean Government introduced accrual based financial statements from the mid-seventies (Perez and Hernandez 2003). New Zealand followed in 1990 and the federal government in the US made the move to accruals in 1997, but state and local governments are only now making the change. By the year 2000, only three other central governments had adopted the accruals basis for their annual financial accounts. Canada and the UK joined them in 2001-2002. By 2000 eight of the 30 most developed countries - those which are members of the OECD - had not adopted accruals accounting for any aspect of their public sectors. Again in 2000, Malaysia and Tanzania were the only non-OECD countries that were planning to adopt the accruals basis for their central government accounts (IFAC Public Sector Committee, 2000b). Malaysia has since decided not to introduce accrual accounting (Zakiah 2003) and Tanzania is unlikely to in the near future (personal correspondence), however, South Africa has agreed a specific programme to change to the accrual basis. By July 2002 only three of the nine member governments of

the European Union had completed the transition to accrual accounting and the European Commission itself is not expected to achieve this before 2005 (Luder 2003).

Cash-based accounting has the virtues of simplicity and objectivity. SIGMA has argued recently that, "a cash-based financial reporting system has the advantage of being simple and comparable to monetary data" (OECD/SIGMA 2001, p, 291) These virtues should not be underestimated, particularly where, as in many government organisations, there are few, if any, skilled accountants employed and where financial management is seen as of lesser importance than legal compliance. It should be recognised that the cash basis of accounting has served many countries well over at least the last two hundred years. The standards for accounting on the cash basis may not have been independently and formally agreed, but they do provide a number of well tried and tested approaches to public sector financial accounting. In many cases these approaches have been developed and refined by professional accountants and their use until relatively recently was almost universally accepted. So, for example, Sir Andrew Likierman (the person who was later responsible for the transition to accrual accounting in UK central government) was able to say, in a book published as late as 1992 that:

*Those who believe that private sector accounts are superior need to bear two factors in mind. First, that there are no immutable accounting or other financial reporting rules which apply irrespective of the nature and purposes of the organisation whose activities and results are being displayed or the objectives of presentation. Second, that cash accounts, despite their crudeness, have a degree of transparency that accrual accounts cannot give and that many private sector financial reports do not seek to offer (Likierman 1992: page 23).*

Perrin observed the situation in the 1970s and explained the view then held by the UK Treasury of accounting for central government departments:

*"The Treasury view was that accruals accounting involving allocating costs between years on the basis of resource use rather than cash funding was incompatible with Parliamentary sovereignty and therefore unacceptable. Parliament voted cash funding year-on-year, so therefore the main control accounts, reports and accountability must be on an annual cash basis" (Perrin, 1998, page 8).*

Cash accounting is simple, relatively cheap to operate and objective. It also has close links to fiscal control and the monitoring of public finance. Cash accounting, as Guthrie (1998, page 5) explains,

*reflects the fundamental principle that no public monies should be spent in ways and in amounts not specified in annual parliamentary appropriations. Cash accounting records the cash receipts, payments and balances at the time cash is exchanged, hence cash accounting financial statements have traditionally shown sources of cash receipts, the allocation of cash expenditure and provided a comparison of actual against budgeted expenditures.*

With IFAC Public Sector Committee issuing its International Public Sector Accounting Standard on cash accounting early in 2003 (IFAC, 2003), this standard and the cash basis of accounting should be accorded the appropriate status as a valid, modern approach to public sector financial accounting.

## Conclusions

The cash basis of accounting is a simple, robust and well-trying and tested approach to the accounting for public sector organisations. In contrast, the accruals basis fails, even in its own terms to account adequately for government debt and many other unique aspects of public sector accounting have yet to be adequately resolved. For many countries, especially transitional and underdeveloped countries the adoption of the accruals basis of accounting for their public sector organisations may not be appropriate and certainly should not be considered to be a high priority.

Reform of public sector financial accounting can bring many benefits in terms of the quantity and the quality of services that are provided to the citizens of many countries across the world. However, these reforms should be considered carefully. Aspects, such as the basis of accounting which are to be adopted, should be decided in the context of the overall priorities of the reform process and not just of the basis of the perceived superiority of one basis of accounting over another. Accrual accounting may facilitate New Public Management reforms but it is not an end in itself.

The transition to the accrual basis of accounting may bring certain advantages in the appropriate context. In contrast, the cash basis of accounting has served almost all governments well for at least two hundred years. The issue by IFAC Public Sector Committee of its International Public Sector Accounting Standard on the cash basis of accounting should further underline this fact and add the benefits of clear international credibility and standardisation to the advantages of the cash basis of accounting.

The Accounting Standards Board's attempt to interpret its "Statement of Principles for Financial Reporting" for the public sector environment appears not to be over successful. The use of financial statements developed to report the level of profit earned by a private sector entity fails to report clearly such key aspects as government debt and maintenance of the government's operational assets. In addition, both the IFAC Public Sector Committee and the Accounting Standards Board are at best struggling to adequately account for either state pensions or government taxation using Generally Accepted Accounting Practice as developed in the private sector.

Perhaps an alternative approach should be adopted. If the range of financial statements published by many governments over the last 150 are not considered to be adequate, then an approach should be developed which correctly identifies to whom governments should be accountable and what their financial information needs are. We should recognise that the aims and objectives of public sector organisations are fundamentally different from those of private sector companies. Consequently their financial statements are also likely to be fundamentally different.

## References

Accounting Standards Board (2003) 'Statement of Principles for Financial Reporting – Proposed Interpretation for Public Benefit Entities' Accounting Standards Board

Audit Commission (2001) 'A New Framework of Financial Reporting and Accountability in Local Government: issues for stakeholders' Second Think Piece, Audit Commission.

Barton, A. D. (2000) 'Accounting for public heritage facilities – assets or liabilities of the government?'. *Accounting, Auditing and Accountability Journal*, 13(2) pp 219—35

Carlin, T. M. and Guthrie, J. (2000) 'A Review of Australian and New Zealand Experiences with Accrual Output Based Budgeting', Third Bi-annual Conference of the International Public Management Network, Sydney, Australia

Chan, J. L. (2003) 'Government Accounting: An Assessment of Theory, Purposes and Standards' *Public Money and Management*, April

Chow, D. and Humphrey, C. (2003) 'Whole of Government Accounting: an aide to performance, management and accountability?' 9<sup>th</sup> CIGAR Conference, Bodo, Norway

Christensen, T. and Laegreid, P. Eds, (2002) *New Public Management*

Coombs, H.M and Edwards, J.R. (1996) 'Accounting Innovation: Municipal Corporations 1835-1935

Department for International Development (March 2001) 'Understanding and Reforming Public Expenditure Management - Guidelines for DFID' London: Department for International Development

Devlin, P., Godfrey A.D. and Merrouche, C. (2003) 'Accountants: high priests of the cult(ure) of efficiency' 9<sup>th</sup> CIGAR Conference, Bodo, Norway

Director of Audit (November 2002) 'Report for the Year Ended 30 June 2002' Government Audit Bureau, Mauritius

Evans, M. (1995) 'Resource Accounting and Budgeting' CIPFA

Froud, J., Haslam, C., Sukhdev, J, Shaoul, J., & Williams, K. (1998) 'Persuasion without Numbers? Public Policy and the Justification of Capital Charging in NHS Trust Hospitals' *Accounting, Auditing and Accountability Journal*, (1), pp 99-125

George, S. (2000) 'A Short History Of Neo-Liberalism' pg 27 in W.Bello et al., Eds 'Global Finance' London

Global Reporting Initiative (2002) 'Sustainability Reporting Guidelines 2002' Global Reporting Initiative

Government Accounting Standards Board (1987) 'Concepts Statement No.1: Objective of Financial Reporting' GASB

- Guthrie, J. (1998) 'Accrual Accounting in the Australian Public Sector' *Financial Accountability and Management*, 14 (1) pp 1-19
- Hepworth, N. (2003) 'Preconditions for Successful Implementation of Accrual Accounting in Central Government' *Public Money & Management* 23(1), pp 37-43
- Hobsbawm, E. (1962) 'The Age of Capital 1848 – 1875' Weidenfeld
- Hood, C. (1991) 'A Public Management for all Seasons' *Public Administration*, 69 Spring pp 3-19
- IFAC Public Sector Committee (2000a) 'IPSAS 1 – Presentation of Financial Statements' IFAC
- IFAC Public Sector Committee (2000b), Study 11 'Government Financial Reporting, Accounting Issues and Practices' IFAC
- IFAC Public Sector Committee (2002), Study 14 'Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities' IFAC
- IFAC Public Sector Committee (2003) 'Cash Basis International Public Sector Accounting Standard: Financial Reporting Under the Cash Basis of Accounting' IFAC
- Institute for Fiscal Studies (April 2001) 'The Government's Fiscal Rules' Briefing Note No. 16, IFS
- Jones, G. (1997) 'Resource Accounting and Budgeting: Another False Trail?' pp 33—7, in *Occasional Paper 3: Perspectives on Accrual Accounting*, IFAC
- Jubilee Research (May 2003) 'Did the G8 Drop the Debt?' CAFOD and Jubilee Debt Campaign
- Likierman, A. (1992) 'Financial Reporting in the Public Sector' in *Public Sector Accounting and Financial Control*, Edited by Sir Douglas Henley, Clive Holtman, Chapman & Hall
- Likierman, A. (2000) 'Changes to Managerial Decision-Taking in U.K. Central Government' *Management Accounting Research*, 11(2) pp 253—261
- Luder, K. and Jones, R. (2003) 'The EURO-CIGAR Project' 9<sup>th</sup> CIGAR Conference, Bodo, Norway
- Martin, B. (2000) 'New Fig Leaf? The Challenge of the New Washington Consensus', *Bretton Woods Project and Public Services International*
- Mautz, R. K. (1988) 'Monuments, Mistakes and Opportunities' *Accounting Horizons*, 2(2) pp 123—8
- McKendrick, J. (2003) 'Modernisation of the Public Accounting Systems in Centran and Eastern Europe Countries – the case of Romania' 9<sup>th</sup> CIGAR Conference, Bodo, Norway

Mellett, H. (1997) 'The Role of Resource Accounting in the UK Government's Quest for "Better Accounting"' *Accounting and Business Research*, 27(2) pp 157—68

Micallef, F. and Peirson, G. (1997) 'Financial Reporting of Cultural, Heritage, Scientific and Community Collections' *Australian Accounting Review*, 7(1) pp 28—44

Minogue, M. (2000). 'Should Flawed Models of Public Management be Exported? Issues and Practices.' Public Policy and Management Working Paper Series, Working Paper No. 15, Institute for Development Policy and Management, University of Manchester

NAO (2002) '2000-01 General Report of the Comptroller and Auditor General' National Audit Office, London

OECD/SIGMA (2001) 'Managing Public Expenditure - a reference book for transition countries' Edited by Richard Allen and Daniel Tommasi OECD/SIGMA

Office of Public Services Reform (2002) 'Reforming our Public Services: Principles into Practice' The Prime Minister's Office of Public Services Reform

Office of Management and Budget (1993) 'Statement of Federal Financial Accounting Concepts 1, Objectives of Federal Financial Reporting' OMB

Olson, O., Guthrie, J., and Humphrey, C., (eds) (1998) 'Global Warning: International Financial Management Changes' Cappelan Akademisk Forlag

Page, M. and Spira, L. (1999) 'The Conceptual Underwear of Financial Reporting' *Accounting, Auditing and Accountability Journal* 12(4) pp 489 – 501

Pallot, J. (1990) 'The Nature of Public Sector Assets: a reply to Mautz' *Accounting Horizons*, 4(2) pp 79—85

Pallot, J. (1992) 'Elements of a theoretical framework for public sector accounting' *Accounting, Auditing and Accountability Journal*, 5 (1) pp38-59

Perez, C.C. and Hernandez (2003) 'The Impact of the Political System on Governmental Accounting Innovation' 9<sup>th</sup> CIGAR Conference, Bodo, Norway

Perrin, J., (1998) 'From Cash to Accruals in 25 Years' *Public Money and Management*, 18 (2), pp. 7-10

Public Audit Forum (2002) 'The Whole Truth: or Why Accruals Accounting Means Better Management', Public Audit Forum

Robinson, M. (1998) 'Accrual Accounting and the Efficiency of the Core Public Sector'. *Financial Accountability & Management*, 14(1) pp21—38

Rowles, T. R. (1992) Discussion Paper 17: 'Financial Reporting of Infrastructure and Heritage Assets by Public Sector Entities', Melbourne: AARF

Scheutze, W.P. (2001) 'What are assets and liabilities? Where is the True North?' *Abacus*, 37 (1) pp 265-280

Schick, A. (February 1998) 'Why Most Developing Countries Should Not Try New Zealand Reforms' *The World Bank Research Observer*, 13(1) pp 123-131

SIGMA (September 2001) 'Financial Management and Control of Public Agencies' *SIGMA Papers*: No. 32, OECD

Stanton, P. & Stanton, J (1998) 'The Questionable Economics of Governmental Accounting' *Accounting, Auditing and Accountability Journal*, 11(2), pp 191-203

Sutcliffe, P. (2003) 'The Standards Programme of IFAC's Public Sector Committee' *Public Money & Management* 23(1), pp 29-36

Treasury (1995) 'Better Accounting for the Taxpayer's Money: The Government's Proposals for Resource Accounting and Budgeting in Government' Cm. 2929, HMSO

Van Peurse, K. A. and Pratt, M. J. (1998) 'Are Private Sector Standards Enough? An Example from Public Sector Hospitals in New Zealand' *Financial Accountability & Management*, 14(2) pp 123—40

Watts, J., (2003) 'Japan Slumps into cosy retirement' 1 August *The Guardian*

Williamson, J. (1994) 'The Political Economy of Policy Reform' *Institute for International Economics*

Zakiah, S. (2003), 'Government Accounting and Reporting in Malaysia' 9<sup>th</sup> CIGAR Conference, Bodo, Norway.