TECHNICAL NOTES AND MANUALS

Implementing Accrual Accounting in the Public Sector

Prepared by Joe Cavanagh, Suzanne Flynn, and Delphine Moretti

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TECHNICAL NOTES AND MANUALS

Implementing Accrual Accounting in the Public Sector[1]

This note addresses the following issues:

- **What is accrual accounting in the public sector?**
- **How should governments prepare to move from cash to accrual accounting?**
- **How to sequence the move from cash to accrual accounting in the public sector?**
- **What does the transition to accrual accounting imply for the:**
  - Recognition of stocks and flows in government financial statements;
  - Government accounting policies and adoption of international standards;
  - Government accounting systems and practices; and
  - Institutional coverage of government financial statements?
- **What can be learned from countries that have successfully made the transition?**

I. INTRODUCTION

Over the past two decades, a growing number of governments have begun moving away from pure cash accounting toward accrual accounting. While accrual accounting has been the norm among private corporations for over a century, the vast majority of governments prepared their budgets and accounts on a cash basis up until the end of the last century. The recent spread of accrual accounting to the public sector can be attributed to a number of related factors, including: (i) a growing recognition of the limits of pure cash accounting (ii) the development of accrual-based international standards for government fiscal and financial reporting including Government Finance Statistics Manual (GFSM) and International Public Sector Accounting Standards (IPSAS);[2] (iii) the professionalization of the government accounting cadre and resulting introduction of private sector techniques into the public sector; and (iv) the advent of computerized financial management information systems (FMISs) which greatly reduce the transaction costs of collecting and consolidating

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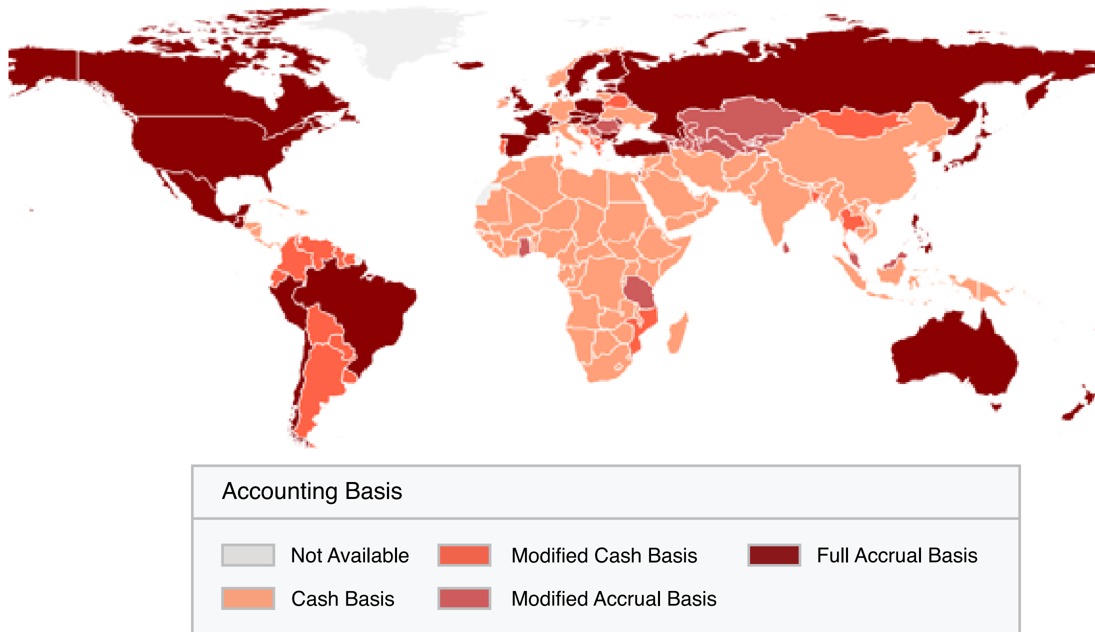
[2] International Monetary Fund (2014b), International Federation of Accountants (2014); a list of the IPSAS standards is in Appendix I.

accrual-based information. In 2015, 41 governments (21 percent) have completed the transition, 16 governments account on a modified accrual basis (8 percent), 28 governments (17 percent) are on a modified cash basis, and 114 governments (57 percent) remain on pure cash accounting (Figure 1).

Figure 1. Map of Countries Accounting Bases for Annual Financial Statements in 2015



Source: OECD and IMF staff estimates, based on public information, including Blöndal and Moretti (2016) and Eurostat (2014).

Pure cash accounting has a number of weaknesses from the point of view of government financial transparency, integrity, and accountability. Under cash accounting, transactions are recognized only when the associated cash is received or paid and economic events are not reported if there is no immediate exchange of cash. Governments have been tempted to exploit this weakness by deferring cash disbursements or bringing forward cash receipts as a means of artificially inflating their financial balance. Moreover, governments that follow cash accounting tend to not maintain comprehensive and up-to-date records of the value of their assets and liabilities. This enables them to transfer assets (such as land or mineral rights) or incur liabilities (such as pensions or public-private partnership contracts) to third-parties without disclosing their financial implications for the government and taxpayer.[3]

The term accrual accounting has come to be associated with four related innovations in government accounting over the last several decades. These innovations are:

- The recognition of economic events in flow reports at the time at which they occur, as well as when the related cash receipts and payments change hands. For this purposes an "economic event" is an event which results in the creation, transfer, or destruction of economic value. Economic events can include the delivery of a taxable service by a private company (for which

[3] International Monetary Fund (2012 and 2014a).

the government accrues tax revenue), performance of a public service by a government employee (for which the government accrues a salary and perhaps a pension expense), or the loss or theft of a government asset such as a vehicle or equipment (for which a reduction in the asset stock will be recognized). These economic events may directly generate a corresponding or simultaneous cash flow, but in many cases—such as depreciation, revaluations, or impairment—they do not. This is an important difference between cash and accrual bases. Note however these other economic events are real, and can be connected to previous or subsequent cash impacts: for example, depreciation usually represents the allocation of the cost of an asset over its useful life; and revaluation or impairment may reflect a changed view of the (cash) amount that can be recovered from the asset when sold.

- **The recording of all stocks of assets and liabilities, in balance sheets.** Governments that follow pure cash accounting typically account only for their cash holdings on the assets side and, possibly, debt on the liability side of their balance sheets. These are often valued at "book value" or the value at which they were initially acquired or issued. Under accrual accounting, governments recognize all assets and liabilities including financial assets (such as equities), non-financial assets (such as land and buildings), and liabilities other than debt securities and bonds (such as payment arrears and pension obligations). These stocks are usually recorded at their current market value, their value in use, or some approximation, and regularly revalued to ensure the balance sheet reflects the government's true financial position at a given point in time.
- **Enhanced monitoring of liabilities and contingent liabilities.** Liabilities such as employee entitlements, environmental obligations, insurance claim obligations, expected losses under guarantee schemes which are not typically recognized in a cash accounting environment receive much more attention once recognized under accruals.
- **The consolidation of all entities under government control.** Cash accounts typically only cover budgetary central government (central government ministries and agencies). Accrual-based international accounting standards call for financial statements which consolidate all entities under government control[4] (such as extra-budgetary funds, arms-length agencies, and public corporations).[5]

Accrual accounting therefore offers a number of benefits over traditional cash accounting from the point of view of government transparency, accountability, and financial management. First, by capturing both cash transactions and non-cash flows in financial statements, accrual-based fiscal reports provide a more comprehensive view of the government's financial performance and the cost of government activities. Second, accrual accounting can help focus greater attention on the part of policymakers and the public on the acquisition, disposal, and management of government assets, liabilities, and contingent liabilities. Third, by consolidating not only

[4] The definition of control will vary depending on the accounting framework considered, but can be summarized as the ability to determine or govern the financial and operational policies of an entity. In addition, consolidation of entities under government control is not *stricto sensu* an innovation to be associated with accrual accounting, as consolidation is an important feature of fiscal statistics. It is to be noted that statistical standards have different consolidation concepts.

[5] IPSAS uses the term "government business enterprise" rather than "public corporation", although the definitions are broadly similar. Under IPSAS, government business enterprises should follow commercial accounting standards, although their financial results may need to be restated in IPSAS terms so as to permit their consolidation in a Whole of Government account.

central government ministries and agencies but all institutional units under government control, accrual accounts provide a more complete picture of the financial position of the public sector as a whole. Fourth, by reporting stocks and flows within an integrated accounting framework based on internationally-accepted standards such as GFSM2014 and IPSAS, accrual accounting can improve the reliability and integrity of government financial data.

At the same time, as discussed later this note, governments need to establish a well-functioning cash accounting system before contemplating a move to accrual accounting. Comprehensive and timely monitoring of cash reserves and flows is vital to evaluating a government financing needs at any point in time. Accounting for uses of cash is also important to ensuring the integrity of the government finances and ensuring that all cash receipts and payments are authorized by law. Finally, most government budgets are on a cash or modified cash basis, therefore effective monitoring of cash receipts and outlays is needed to report on the execution of the budget even after moving to full accrual accounting.

This note provides those governments contemplating a move toward accrual accounting with guidance on the preparation, sequencing, and implementation of the reforms. The note builds on the conceptual guidance provided by Khan and Mayes' *Transition to Accrual Accounting* by providing practical advice on preparing for the transition to accrual accounting, as well as the necessary changes to the format of financial statements, content of accounting policies, and design of accounting systems at each phase of the transition.[6] It also identifies which IPSAS standards and elements of the GFSM2014 framework to adopt at each phase of the transition with the aim of achieving full compliance with both by the end of the transition.[7]

The remainder of the note is organized as follows:

- **Section II** describes the key tasks in **preparing** for transition to accrual accounting;
- **Section III** discusses the issues in **sequencing** the transition to accrual accounting;
- **Section IV** describes the content of government financial statements, accounting policies, and management systems under a system of **Cash Accounting (Phase Zero)**;
- **Section V** describes the reforms, to government financial statements, accounting policies, and operations required to introduce **Elementary Accrual Accounting (Phase One)**;
- **Section VI** describes the further reforms to the government's accounting framework required to move to **Advanced Accrual Accounting (Phase Two)**;
- **Section VII** describes the final set of reforms to the government's accounting framework require to complete the transition to **Full Accrual Accounting (Phase Three)**;
- **Section VIII** concludes with some reflections on the **lessons from experience** from countries that have successfully made the transition from cash to accrual accounting;

[6] Khan A. and S. Mayes (2007).

[7] A generalized description of the relationship between the government finance statistics reporting guidelines and the International Public Sector Accounting Standards can be found in Appendix 6 of the IMF's GFS Manual 2014.

- **Appendix I** provides a full **list of International Public Sector Accounting Standards**; and
- **Appendix II maps the above phasing onto GFSM2014** standards for fiscal statistics.

II. PREPARING FOR TRANSITION TO ACCRUAL ACCOUNTING

Political support and technical leadership are important prerequisites for the reform. Countries considering implementing accrual accounting in the public sector will come to the task from a range of different starting points, objectives, capacities, systems, and traditions. High- level leadership within the executive and support from the legislature and supreme audit institution are essential to ensuring that the accrual information is produced, understood, and used for fiscal decision-making, management, and accountability. In addition, the support of senior officials is critical to drive the change, ensure that momentum is maintained and that technical obstacles are overcome during the transition. This must include commitment of the necessary resources to implement the reform. Where such a prerequisite is not met, countries should start by implementing reforms with a limited scope (see phase 0 and 1 of the phasing discussed below).

Preparation for transition will typically involve the following preliminary tasks:

- **Clarify the objectives of the reform:** Having a common understanding of what the move to accrual accounting is expected to achieve is essential in order to shape the transition and gain the necessary commitment and ownership. Objectives may include: greater external transparency, more reliable internal management information, stricter controls over expenditure arrears and other liabilities, improved working capital management, more efficient management of government assets, stricter financial oversight of extra-budgetary entities, or a better understanding and management of fiscal risks. The relative importance attached to each of these objectives will, in turn, inform the sequencing of the different reforms involved in the transition.
- **Establish a representative reform team:** This should comprise all key stakeholders, including the: Ministry of Finance (MoF), government accountants, line ministries, local government, public enterprises, statistics compilers, Parliament, Supreme Audit Institution and accounting standard setters, and may need to be split into a steering committee and task forces to deal with specific technical issues. A core of full-time staff in the MoF with a strong understanding of accounting will be essential to drive the reform, deliver training, ensure preparations are made for each phase, and address technical problems as they arise.
- **Survey existing accounting policies, systems, skills and practices:** This survey should cover the entire public sector including central government ministries, extra-budgetary funds and agencies, local governments, and public corporations and assess each sector's current degree of compliance with the requirements of accrual accounting based on international standards. The results should inform both the costing of the reform and phasing of the transition. For example, it may be the case that some classes of public entities (such as local governments or public corporations) already apply accrual accounting in part or in full, and can therefore be brought into the reform effort sooner rather than later (see Box 1).

Box 1. Preparing for Adoption of Accrual Accounting in Chile

In 2010, the General Controller of Chile *(Contraloría General de la República, CGR)* announced its intention to adopt accrual accounting in the public sector based on IPSAS by 2019. One of the key preparatory tasks in the process was to conduct a gap analysis comparing existing government accounting practices with the requirements of IPSAS. The gap analysis categorized the 32 IPSAS into four categories that allowed the officials to create a framework for studying and applying the new standards:

- high priority, which comprised fixed assets, transfers, property investments, taxes, financial instruments and financial liabilities;
- medium priority, which included revenue from exchange transactions, associates and joint ventures, provisions, intangible assets, contingent assets and liabilities, leases and concession arrangements;
- low priority, which comprised financial statements, inventories, segment reporting, employee benefits, related party disclosures, effects of changes in foreign exchange rate, agriculture and accounting policies, changes in estimates and errors; and
- not applicable standards, such as financial reporting in hyperinflationary economies and construction contracts.

Source: Cavanagh and Fernandez Benito (2015).

- **Estimate the costs of reform:** Once the above gap analysis has been completed, the government should estimate the costs of the reform to determine whether the prospective benefits outweigh the costs, and secure budgetary resources to implement the reform—which may be phased or involve partial adoption. Recent experience indicates that financial and other costs of reforms can vary significantly depending on the state of accounting practices, degree of ambition, and links with other financial management reforms (Box 2).
- **Establish a mechanism for setting accounting standards:** Historically in many jurisdictions, accounting standards in the public sector have been set by the MoF. This is at odds with the need for objectivity, independence, and integrity in government financial reporting. Many countries introducing accrual accounting based on international accounting standards have taken the opportunity to externalize the setting of accounting standards for the public sector by:
  - Establishing independent boards designed to advise the government on the adoption or adaptation of international accounting standards (France, UK);
  - Vesting responsibility for determination of public sector accounting standards in an independent national body (New Zealand, Australia, Canada, South Africa);
  - Adopting standards developed by an international standard setter (Chile-see Box 1); and
  - Consulting the supreme audit institutions before enacting new accounting standards in the public sector (Austria-see Box 3).

Box 2. Estimating the Costs of Moving to Accrual Accounting

The cost of moving from cash to accrual accounting depends on the starting point, scope, ambition, and speed of the transition and relationship to other public financial management reforms. Based on experience in various countries, reform costs are likely to include: (i) investment in new IT systems; (ii) training of finance and operational staff, politicians, auditors; and (iii) in many cases, consultancy fees. Few countries have published a full ex post assessment of the cost of adopting accrual accounting.

However, a recent study published by EUROSTAT based on a survey of EU Member States estimates the cost of such reforms for the EU as a whole at between €1.2 and €6.9 billion, which represents 0.009 to 0.053 percent of the EU GDP. [1/] The Austrian Federal Government, who made the transition between 2009 and 2013, estimated the cost of transition at €30 million (0.007 percent of GDP). Outside the EU, Switzerland has estimated the cost of implementing accrual accounting and accrual budgeting at the Federal Government level to be around €40 million (0.005 percent of GDP) with approximately 80 percent of this cost being for the new IT system. However, these estimations focus on advanced economies. Costs are likely to be higher in developing and low-income countries where the "gap" to be closed in terms of capacity and IT systems will likely be larger.

A number of factors need to be taken into account when considering these cost estimates. First, implementation of accrual accounting is seldom the only reform being implemented at the time, so part of the cost is associated with other reforms such adoption of new fiscal rules, introduction of program and performance budgeting, or improvements in internal or external audit practices. Second, the counterfactual of not introducing accrual accounting does not entail zero cost. The largest single cost associated with most moves to accrual accounting is the upgrading or replacement of IT systems - both hardware and software. However, like all IT systems, government systems become obsolete and need to be replaced or upgraded regardless of the government's reform intentions. Third, adoption of accrual accounting is likely to bring benefits in terms of incentives for better maintenance of assets, avoidance of costly expenditure arrears, and enhanced surveillance of fiscal risks, which need to be weighed against the costs but are difficult to measure.

Source: Price Waterhouse Coopers (2014).

[1] This estimated cost is indicative only. The study notes that to estimate reliably the cost of accrual accounting implementation (and more specifically the implementation of European Public Sector Accounting Standards – EPSAS) for the EU as a whole or for a specific government, an in-depth assessment should be carried out at the level of each government within each Member State.

Box 3. Setting Public Sector Accounting Standards in Austria

In Austria, the introduction of accrual accounting reform primarily driven by the desire for better information for budget decision-making. The Ministry of Finance therefore sought to balance the desire for greater comprehensiveness and accuracy in financial reporting against the relevance of the additional information and the cost of obtaining it.

Hence, while IPSASs were considered as a reference point, full compliance with all standards was not the ultimate goal of the reform. Deviations from specific standards were sanctioned on the grounds of cost or relevance, and those perceived to have a limited impact on public finances or thought too complex were not considered for transposition.

Currently Austria fully applies 20 IPSAS, partially applies 5 (including those on consolidation, employee benefits, and tax revenue) and does not apply 7 of 32[1] IPSAS standards (including joint ventures, hyperinflation, and construction contracts). For those IPSASs which are fully or partially adopted, national standards were prepared directly by the Ministry of Finance based on concept notes setting out guiding principles, draft statements, valuation rules, and recognition and disclosure principles of the different elements. The legal drafts of the standards are finalized in cooperation with the Court of Audit and following a formal consultation process with ministries and local governments.

[1] There were 38 IPSAS standards at end-2015, of which one is superseded. The six most recent standards come into force at the start of 2017. A full list is at Appendix 1.

- **Training and change management:** The introduction of accrual elements into government accounts will require significant training of preparers of the financial statements in new concepts, systems, and accounting methods. This training also needs to extend to the users of financial statements including ministers and senior officials in the MoF, parliamentarians, civil society, and the supreme audit institution (SAI).[8] To reach this diverse range of stakeholders, training needs to make use of a variety of modalities including lectures, hands-on or online tutorials, guidance notes, and a dedicated helpdesk facility.
- **Develop an action plan for the transition:** The transition to accrual accounting is seldom, if ever, made in a single step. In most cases a transition plan needs to be defined, which sets out the key stages of the reform, including the responsibilities and timing for the preparatory tasks, reforms to the relevant systems and processes, and format and content of financial statements at each stage. The plan should also consider whether pilot exercises or parallel running of cash and accrual systems are required. *IPSAS 33* provides further guidance for when an entity first adopts accrual basis IPSASs., including voluntary exemptions (or "reliefs") during the transition period. The following section discusses a stylized phasing for the transition and the policy and operational reforms involved at each stage.

[8] In most countries, the SAI will be responsible for certifying the final accounts prepared on an accrual basis. In this context, most SAI will have to broaden the scope of their audit, from "compliance audit" (based largely on the legality of transactions) to "financial audit" (which extends to whether the accounts give a true and fair view). This will require the SAI to adopt international audit standards (the International Standards of Supreme Audit Institutions, ISSAI, are issued by the International Organization of Supreme Audit Institutions, (INTOSAI); for more information: www.issai.org.), and train the auditors in new auditing techniques (such as the risk-based audit approach).

III. SEQUENCING THE TRANSITION TO ACCRUAL ACCOUNTING

The sequencing of reforms and the length of time needed to implement accrual accounting can vary greatly. Some countries progressively add accrual elements or disclosures to their financial statements without setting a specific date for a full implementation of accrual accounting (e.g., Philippines, South Africa, and Sri Lanka – see Box 4). Countries that have looked to implement accrual accounting at the budgetary central government or central government level have undertaken the transition in three (e.g., New Zealand) to five years (e.g., France, Austria). Other countries have started the implementation at sub-national level to address specific concerns around accumulation of liabilities at that level (e.g., China). Countries which sought to implement accrual accounting for the whole of the public sector, such as Peru and the United Kingdom, took more than ten years to complete the transition (see Box 5).

Box 4. Sequencing the Introduction of Accrual Accounting in Sri Lanka

Sri Lanka has been moving towards accrual accounting based on IPSAS since 2004. Beginning in 2005 the government adopted a revised format for its financial statements, which closely mirrors the four financial statements required by IPSAS 1 (Statements of Financial Performance, Financial Position, Cash Flows, and Changes in Net Assets). A Statement of Budgetary Performance is also provided in the notes to the accounts to maintain alignment between budget and outturn data. All of these statements are presented on a modified cash basis with valuation at historic cost. The Statement of Financial Position includes financial assets and liabilities other than cash, including on-lending and the capital contribution in SOEs, as well as external borrowing.

The government plans to expand incrementally the coverage of the financial statements to a point where the move to full accruals is possible. Currently, the notes to the financial statements include a schedule of movable assets acquired since 2004. For land and buildings, there is a current process of valuation or revaluation which, once completed and together with the data on movable assets, should permit a switch to accruals-based disclosure of fixed assets.

Source: Authors.

Building on international experience, this section provides an indicative phasing for the transition from cash to accrual accounting in the public sector. In this phasing, the transition to accrual accounting entails reforms in three parallel dimensions of fiscal reporting, which are summarized in Table 1. These are:

- **Recording of stocks in the balance sheet,** beginning with a financial balance sheet and with the ultimate goal of publishing a comprehensive balance sheet of the government's financial and non-financial assets and liabilities valued in accordance with international standards;
- **Recognition of flows in the operating statement** with the ultimate goal of recording all transactions at the time economic value is transferred (rather that at the point cash payments

are made) and as well as other economic flows that affect the government's net worth (such as changes in the value of government asset holdings); and

- **Consolidation of institutions** with the ultimate goal of including all institutional units under the effective control of government in fiscal reports, regardless of their constitutional status or legal form.

Box 5. Adopting Accrual Accounting in the United Kingdom Public Sector

In the UK, most areas of the public sector outside central government had operated variations of the accrual basis for many years. In 1995, HM Treasury announced its intention to move central government to an accrual basis for both budgeting and accounting for individual government departments under the term "resource accounting and budgeting" or RAB. RAB's first full year of operation was originally intended to be 2001–02. Although the introduction of accrual accounting as a precursor to accrual budgeting proceeded according to plan, concerns over data quality meant that the introduction of accrual budgeting occurred in two phases, with depreciation and provisions included in accrual budgets two years later than originally planned.

In 1998, HM Treasury and the National Audit Office initiated a joint study to examine the merits and feasibility of producing a set of consolidated accrual-based accounts, not just for central government but for the whole public sector, termed "whole of government accounts" (or WGA). The production of accrual-based WGA was adopted as the revised objective of the reform in the Government Resources and Accounts Act passed in 2000.

Due to the more ambitious scope of the reform, HM Treasury planned a three-stage implementation approach.

- Stage one involved the production of an unaudited whole of government accounts based on statistical rather than accounting data.
- Stage two involved preparing unaudited consolidated Central Government Accounts (CGA), incorporating the accounts of all central government departments but excluding local government, trading funds, and some other non-departmental bodies.
- Stage three involved the publication of full accrual-based audited WGA.

As a result of delays in taking the final publication decision, the first full set of audited WGA was finally published on 29 November 2011, more than a decade after the passage of the originating legislation. Since then, an action plan has been defined to raise the quality of the data and address issues leading to audit qualifications. Improvements in 2013-2014 included: consolidation of the assets and liabilities of the national rail network, improvements to schools' valuation of fixed assets, and faster WGA publication.

Source: 2007, Danny S.L. Chow et al. (2007), European Commission (2014), authors.

TABLE 1. TRANSITION TO ACCRUAL ACCOUNTING: MAIN ELEMENTS ADDED AT EACH PHASE[1]						
	BALANCE SHEET		**OPERATING STATEMENT**			**INSTITUTIONS**
	ASSETS	**LIABILITIES**	**REVENUES**	**EXPENSES**	**OTHER FLOWS**	
Phase 0: Cash Accounting	Cash balances	Bank overdrafts Debt	Cash receipts	Cash payments	None	Budgetary Central Government
Phase 1: Elementary Accrual Accounting	Trade receivables Prepayments	Trade payables	Accrued trade revenue	Accrued expenses *excluding depreciation*	None	Central Government
Phase 2: Advanced Accrual Accounting	Equity Investments	Other financial liabilities Long-term liabilities (e.g., pensions)	Accrued non-tax receivables	None	Valuation changes in financial assets and liabilities Provisions	General Government
Phase 3: Full Accrual Accounting	Fixed and intangible assets Inventories Tax receivables	Monetary financial instruments	Accrued receivables	Depreciation	Valuation changes in non-financial assets	Public Sector

Source: Authors.

[1] For the purpose of this note, the terms operating statement and balance sheet are used. International accounting standards use the terms *statement of financial performance* and *statement of financial position* respectively.

The actual sequencing of reforms followed by a particular government will therefore depend upon a number of considerations. These include:

- The government's **starting point** in terms of both the completeness of cash-based reporting and the extent to which accrual stocks and flows are already being recorded or recognized. Many countries already record some accrual flows or balance sheet items for internal management purposes, which can be easily recognized in published accounts. In some countries, local governments have already advanced in applying accruals. Moreover, if a country is already using modified cash accounting, it may make more sense to complete the transition to accrual accounting than to adopt the Cash IPSAS standard.[9]
- The government's **objectives** of moving to accrual accounting which, as discussed in Section I, can include strengthening monitoring and control of expenditure arrears, getting a clearer picture of the fiscal position of public entities outside the central government budget, or gaining a better understanding of the long-term sustainability of the public finances.
- The **materiality** of stocks, flows, and entities outside government accounts, with attention focused on the largest and most readily recognizable. For example, countries with large public corporations which already follow accrual-based International Financial Reporting Standards (IFRS) may find is easier to incorporate these into summary financial statements before bringing in local governments.

[9] The IPSAS Board is proposing to make amendments to the Cash Basis IPSAS to overcome obstacles to its adoption that result from the current requirements for the preparation of consolidated financial statements and disclosures of information about external assistance and third party payments.

- The **duration** of each phase which will depend on the level commitment to reform implementation, the resources available, the maturity of systems, and the accounting and financial capacities across the public sector.

The phasing proposed in the next four sections, and summarize in Table 1, provides an indicative road map to accrual accounting for a country starting with incomplete cash accounting. It is designed to recognize the simplest and most important stocks and transactions first, and then to gradually recognize more complex stocks and transactions in subsequent phases. It also progressively extends the coverage of the financial statements from the budgetary central government to the whole of the public sector. The proposed phasing is also designed such that, at each phase of the transition, an integrated and internally consistent set of balance sheets and operating statements are produced. This will allow for regular reconciliation of stocks and flows and maintains the overall integrity of financial reporting at each stage. In the following sections, each stylized phase of the transition from cash to accrual accounting is discussed in terms of elements reported in the balance sheet and the operating statement, and the institutions included in the consolidated financial statements.

Whilst the sequencing of reform in this Note is based on the parallel extension of accruals in two dimensions—balance sheet coverage and institutional coverage—it should be noted that these two dimensions do not have to develop in parallel. Much will depend on the state of readiness, and capacity (both human and systems) in each part of the public sector. So all sub-sectors may advance together, for example, or some balance sheet items be included at earlier phases if reliable data is available. Nor does the phasing imply that important preparatory work cannot or should not be started earlier: data collection for later phases may need to start in preceding stages, for example the preparation of inventories of non-financial assets will need to start early in preparation for reaching that stage.

IV. PHASE ZERO: CASH ACCOUNTING

This section discusses the accounting policies, operations, and financial statements required for a well-functioning cash accounting system. Operating in a cash accounting environment mainly involves producing reliable and complete information on the cash transactions, cash holdings, and the short-term debt position of budgetary central government.

TABLE 2. ELEMENTS REPORTED IN PHASE 0: CASH ACCOUNTING

	BALANCE SHEET		OPERATING STATEMENT			INSTITUTIONS
	ASSETS	LIABILITIES	REVENUES	EXPENSES	OTHER FLOWS	
Phase 0 Cash Accounting	Cash balances	Bank overdrafts Debt	Cash receipts	Cash payments	None	Budgetary Central Government

Source: Authors.

Cash accounting has the benefit of being relatively simple and easy to administer. It is therefore appropriate for countries that need to build capacities and improve the reliability and integrity of their systems before moving to accrual accounting. For such countries, it is usually consistent with the government budget, which will also be prepared on a cash or modified cash basis, and allows the government, parliament, and citizens to assess how the voted budget has been executed. Lastly, although it does not provide a sufficiently detailed picture of government's financial position, by comparing cash balances with outstanding debt, markets and stakeholders can use cash-based accounts to assess the government's immediate solvency and liquidity.

A. Financial Statements

At this stage the financial statements will comprise a *cash flow statement*, and ideally an *elementary balance sheet*,[10] with accompanying notes to enhance the understanding and interpretation of the statements. Where no balance sheet is produced, information on debt should be disclosed in notes to the cash flow statement.

Cash flow statement

The cash flow statement, which is required for both cash and accrual accounting, should present the government's cash receipts and payments. The cash flow statement should distinguish between operating, investing, and financing activities[11] to enable reconciliation with incurrence and repayment of debt in the balance sheet. As shown in Figure 2, the cash flow statement in Phase 0 should show:

- Cash receipts and payments relating to governments operating activities classified in accordance with the government's national economic or line-item classification. These include such items as taxes collected and invoices paid;
- Cash flows relating to the government's investing activities. These include cash flows derived from purchases or sales of physical assets such as property, plant, and equipment as well as financial assets such as loans to individuals and private sector companies, or equity and debt instruments of other government owned entities;
- Cash flows from financing activities including payments and receipts related to government's stock of borrowing; and
- Reconciliation between the opening cash balance brought forward from the previous year; movements in cash due to operating, investment and financing activities during the year; and the closing cash balance at the end of the year.

[10] Such a balance sheet is not required under *Cash basis IPSAS*.

[11] IPSAS 2, which stipulates the format of the cash flow statement, leaves room for interpretation as to the classification of "current" receipts and payments relating to investing and financing, such as dividends or interest received, or interest paid and other finance charges. In this Note, we follow the preferred treatment under IPSAS 2 and treat these current flows as part of operating activities, leaving investing and financing flows as those which change the stock of investment or financing. The logic is that the operating section of the cash flow statement thus more closely resembles the eventual operating statement under accruals, whilst the items under investing and financing affect only the balance sheet position.

Figure 2. Cash Flow Statement in Phase Zero

	YEAR N	YEAR N-1
Cash Flow from Operating Activities		
Taxation	441	411
Sales of goods and services	32	27
Grants Received	23	27
Dividends and interest received	10	7
Other receipts	11	12
Salaries and wages	-288	-265
Purchase of goods and services	-105	-89
Grants and subsidies	-52	-43
Interest and debt charges	-37	-31
Other payments	-25	-19
Net Cash Flows from Operating Activities	**10**	**37**
Cash Flow from Investing Activities		
Purchase of property, plant and equipment	-49	-50
Purchase of new investments	-30	-28
Proceeds from sale of property, plant and equipment	45	37
Proceeds from sale of investments	15	5
Net Cash Flows from Investing Activities	**-19**	**-36**
Cash Flow from Financing Activities		
New borrowing	27	10
Repayment of borrowing	-11	-7
Net Cash Flows from Financing Activities	**16**	**3**
Net increase/decrease in cash	**7**	**4**
Cash at the beginning of the period	**25**	**21**
Cash at the end of the period	**32**	**25**

Source: IPSAS1 Presentation of financial statements; Authors.

Balance sheet

Even under cash accounting, it should be possible to prepare an elementary balance sheet. Most purely cash-based financial statements do not have separate balance sheets, just opening and closing cash balances, with some countries including information on public debt as a memorandum item. However, as a step towards accruals accounting, these assets and liabilities could be reported in an elementary form of balance sheet, which will be expanded over the next phases. In this elementary form of balance sheet, as shown in Figure 3, the only asset recognized is the government's holdings of cash, and the only liabilities reported are government debt:

- Cash includes cash on hand, such as bank balances, cash awaiting banking, petty cash, and cash in transit; and cash equivalents such as short-term deposits and deposits on call; and

- Debt can take the form of bank overdrafts and other short-term credit, loans from commercial banks or bilateral or multilateral creditors, and securities such as treasury bills or sovereign bonds.[12]

Figure 3. Balance Sheet in Phase Zero

	YEAR N	YEAR N-1
Current Assets	32	25
Cash and cash equivalents	32	25
Total Assets	32	25
Non-current Liabilities	767	741
Borrowing and financing	767	741
Current Liabilities	214	224
Borrowing and financing	214	224
Total Liabilities	981	965
Net Assets	-949	-940

Source: IPSAS1 Presentation of financial statements; Authors.

Note: The Balance Sheet distinguishes "current" from "non-current" assets and liabilities. "Current" are those which assets and liabilities which "crystallize" (fall due or are convertible to cash) within 12 months of the Balance Sheet date. Many classes of asset and liability will fall entirely within either current or non-current but in other cases, especially debt, the asset or liability will need to split out to differentiate current and non-current.

B. Accounting Policies

Presentation of the cash flow statement

There are two main options for presentation of the cash flow statement:

- *IPSAS 2: Cash Flow Statement* requires that cash flows be reported by operating, investing and financing activities, as presented in Figure 2. This has the advantage of presenting the cash flows in the same format as the cash flow statement within the eventual set of accrual-based financial statements. However, such a presentation is unlikely to be consistent with the traditional presentation of the annual budget;[13] and
- *Cash basis IPSAS* therefore allows presentation of cash flows using a classification basis appropriate to the entity's operations. For government, this is usually the same presentation as the budget, which facilitates comparison between budgeted and actual amounts.

[12] Note that the change in the stock of debt is not explained only by cash transactions (for example, they include holding gains and losses due to currency fluctuations, and debt renegotiation and forgiveness). Therefore, including debt in the balance sheet under phase 0 implies that the balance sheet and cash flow statement will not reconcile directly: consequently, a reconciliation table needs to be disclosed in the notes to the financial statement. Countries that do not establish a balance sheet under phase 0 should at least report debt as a memorandum item until it is properly integrated into the accounts, at Phase 1.

[13] A traditional budget presentation is to classify revenues by economic category, but expenditures by organic (i.e., organizational) category. This traditional presentation does not directly align with IPSAS 2 differentiation of operating, investing and financing flows; hence the need for a separate statement of budget performance.

In practice, governments may present the information in both formats to enable comparison with both the national budget and financial statements of other governments that apply international accounting standards.[14]

Box 6. Cash Basis IPSAS

Cash basis IPSAS covers the required and recommended disclosures for entities accounting in pure cash terms but also recommends additional accruals-type disclosures to accompany the accounts, such as a statement of outstanding invoices, statement of contingent liabilities, and statement of cash assets and fund balances. Therefore, Cash basis IPSAS can be viewed as a goal in its own right, but is more often seen as a first step on the transition to accruals.

However, few countries have successfully achieved full compliance with cash basis IPSAS for two main reasons: (i) the mandatory requirement to consolidate all government controlled entities (including public corporations); and (ii) the requirement to include external assistance payments made by third parties directly to suppliers. Significant work may be required to attain full compliance with cash basis IPSAS in countries where there is a weak reporting framework for public corporations, or which is not compliant with IFRS, and this may take several years.

Since most countries may already use some form of modified cash or accrual and report on their public debt, adoption of cash based financial statements is sometimes perceived as a backward step, and instead countries may wish to build on their modified cash data and financial statements to continue the transition to accruals. IPSASB has recently published proposals to revise the cash basis IPSAS in order to address these issues. Countries should therefore assess during the preparation stage whether full compliance with the cash basis IPSAS is achievable in the short term, or whether an incremental approach to adoption of accrual basis IPSASs would provide more useful and comprehensible information to stakeholders during the transition.

Source: IPSAS1 Presentation of financial statements; Authors.

Recognition and measurement of cash and financing operations

Accounting policies should prescribe that all government's transactions be recorded as soon as cash is received or disbursed. These transactions are usually reported at their cash value and stocks at face value.[15] Foreign currency transactions should be recorded in the national currency using the exchange rate at the date of the receipt or payment. The gains and losses between when the currency was acquired and the end of the year should be reported in a note to the statement in

[14] Most governments operating under a cash accounting environment will also establish a statistical reporting consistent with GFSM: cash receipts are classified by nature; cash payments are classified using a functional and economic classification.

[15] The Face value of a debt instrument is the undiscounted amount of principal to be repaid at (or before) maturity. Its nominal value at any moment in time is the amount that the debtor owes to the creditor.

order to reconcile cash at the beginning and end of the period.[16] Debt operations are also typically recognized at nominal value in a cash accounting environment and subsequently adjusted to reflect repayments of the principal or debt forgiveness operations. Disclosures should show total domestic debt and total debt denominated in foreign currencies. Arrears[17] related to debt repayments, suppliers or other third parties should be disclosed in a note to the accounts.

C. Operational Implications

Governments operating a Treasury Single Account (TSA), or a limited number of commercial bank accounts, will find it easier to capture all cash balances and transactions in their financial information system and statements.[18] Some government cash balances and transactions may, however, continue to operate outside the TSA in the case of, for example, donor-funded project accounts, overseas and locally-operated accounts of government, or accounts operated by extra-budgetary agencies or state-owned enterprises. Where there is no TSA, establishing the cash flow statements and determining the cash balances at year-end will require the collation of reconciled bank statements for all government bank accounts.

Preparation of an integrated set of cash accounts will be greatly facilitated if governments operate a double-entry book keeping system, in which every accounting entry requires a corresponding and opposite entry to a different account within a "General Ledger."[19] Under a cash basis environment, operating with a double-entry book keeping system means that, for a given financial transaction, an entry will reflect the cash receipt or payment, and another one will reflect the corresponding change in the entity's cash or debt balance.[20] This ensures that the cash flow statement and the balance sheet, even if in elementary form, are integrated and that each financial operation is captured in both statements.[21]

To record the outstanding stock of debt on the balance sheet, a comprehensive register of debt is also required. The register should record the outstanding stock and composition of its debt liabilities,

[16] Cash basis IPSAS provides more detailed guidance on how to measure and report currency effects in a cash accounting environment.

[17] Expenditure arrears are a subset of payables that have remained unpaid beyond a specified due date for payment. In cases where no due date is specified, arrears are defined as payables that have remained unpaid after a specified number of days after the date on the invoice or contract, in accordance with a law, regulation, government payment policy, or local practice. Source: Prevention and Management of Government Expenditure Arrears, Suzanne Flynn and Mario Pessoa, Fiscal Affairs Department, IMF.

[18] This may be difficult to achieve for countries that benefit from external assistance, for example expenses related to a project financed by a donors' grant may be managed in separate systems, which are not monitored by the Treasury. In some cases, revenue may be recorded in a separate IT system, also. Where this is the case, procedures should be in place for ensuring that these separate IT systems are either integrated or interfaced with the main accounting system. In all cases, complete information should be communicated to the Treasury in a regular and timely manner.

[19] The General Ledger is a central repository or database of accounting transactions which will be needed for financial reporting, and represents the backbone of an accounting system.

[20] The double-entry book keeping system is also an error detection tool. The sum of debits and the sum of the credits must be equal in value: if the sum of debits and credits in "Cash balances" does not equal the corresponding sum of credits and debit on "Cash receipts" and "Cash payments" for all accounts, an error has occurred.

[21] Double-entry book-keeping is a worthwhile reform from a financial integrity perspective regardless of whether a country decides to move to accruals.

including their currency denomination, maturity, and interest rate structure. Governments will often have a standalone debt management system, which can provide such data; although in time this may need to be integrated with the main accounting system, to ensure consistency and data integrity.

D. Institutional Coverage

During this phase, the financial statements' coverage should be the same as the annual budget—generally termed budgetary central government. This ensures that taxes and other revenues collected and cash appropriations approved by the legislature are fully accounted for and financial statements are directly comparable to the budget.

Consolidation policies

Accounting policies should require that entities whose activities are financed primarily through the budget are consolidated in the financial statements. These entities typically include central government ministries, departments, and agencies. Specialized boards, commissions, and agencies with significant own-source revenues are often outside the boundary of the budgetary central government, and only the transfer from the budget to those agencies, or budget income remitted by them, is included in the government's budget and accounts. For the purpose of transparency, notes to the financial statements should disclose the institutions consolidated in the accounts at each phase of the transition.

Accounting policies should clarify the treatment of third party assets. A common feature of public accounting is that governments will be responsible for the administration or custodianship of third party funds (for example, funds deposited with courts, trust funds based on public subscription, or a guarantee or mutual funds based on industry contributions). Where the public body is acting purely as agent, has no discretion over the use of these funds, and has no financial interest in them, these should be treated as third party assets, outside of the control of the entity, and excluded from the principal financial statements. However, the government's holdings and administration of these funds should be disclosed in the notes to the accounts. There should be separate published accounts for these funds.[22]

Consolidation processes

The ease with which consolidated financial statements for the budgetary central government can be prepared depends on the degree of automation and integration of government accounting systems. In some countries, all ministries process their financial transactions through an integrated financial management information system (IFMIS) managed by the ministry of finance, enabling a set of financial statements to be produced directly from the system at year-end. In other countries, ministries operate separate information systems and a manual consolidation of individual ministry accounts is needed at year-end. To achieve

[22] From the statistical viewpoint, these transactions may be recorded differently. For example, mandatory industry contributions may be reported as taxes.

this, standard reporting templates should be developed by the MoF which identify any intra-governmental transactions and balances. The MoF will need to develop its own database to capture the information and perform the consolidation, eliminating any intra-governmental transactions and balances. *Cash basis IPSAS* sets out broad principles for undertaking this consolidation, the main one being that cash balances and cash transactions between consolidated entities should be fully eliminated. At this stage, eliminations should be more limited in number, as cash transfers and transactions between ministries are usually few, compared with the number of transactions between entities in the wider public sector.

V. PHASE ONE: ELEMENTARY ACCRUAL ACCOUNTING

This section discusses the reforms to government accounting policies, operations, and financial statements involved in moving from *Phase 0: Cash Accounting to Phase 1: Elementary Accrual Accounting.* This first phase in the transition to accrual accounting involves developing a system for recording some "in transit" receipts and expenses in the operating statement, and recognizing the related stocks of unpaid invoices from suppliers as liabilities and unpaid bills issued to customers for services rendered as assets on the government's balance sheet. Note that once accrual elements are introduced into the accounts, the terminology changes from the terms "receipts" and "payments" (or expenditures) used in a cash accounting environment to the terms "revenue" (or "income") and "expenses" used in an accrual accounting environment. Note too that at this stage the accounts begin to capture "other flows" for which there is no corresponding cash movement.

TABLE 3. ADDITIONAL ELEMENTS REPORTED IN PHASE 1: ELEMENTARY ACCRUAL ACCOUNTING

	BALANCE SHEET		OPERATING STATEMENT			INSTITUTIONS
	ASSETS	LIABILITIES	REVENUES	EXPENSES	OTHER FLOWS	
Phase 1 Elementary Accrual Accounting	Trade receivables Prepayments	Trade payables	Accrued trade revenue	Accrued expenses *excluding depreciation*	None	Central Government

Source: Authors.

This elementary form of accrual accounting enables governments to monitor the accumulation of expenditure obligations, ensure they are liquidated in timely manner, and prevent expenditure arrears. It also provides internal and external stakeholders with a more complete picture of the costs of the public services and the deficit/surplus in a given year, as these costs cannot be hidden by delaying cash payments and generating arrears.

A. Financial Statements

The financial statements at this stage will include the cash flow statement as described in the previous phase, a more developed balance sheet, and, for the first time, an operating statement and accompanying notes. These statements should make up an integrated set of accounts—in the sense that they are internally reconcilable.

Balance sheet

Trade receivables should be recognized as assets in elementary accrual accounting. Trade receivables are a subset of accounts receivable and are unpaid amounts owed to government by the commercial sector or individuals arising from the rendering of services, the sale of goods, or accrual of interest, royalties or dividends.

Accounts payable should be recognized as liabilities in this phase of the transition. Accounts payable are unpaid invoices owed by government to the commercial sector and other pending payments to third parties such as international institutions or citizens (e.g., tax refunds).

Thus, in addition to the cash holdings and debt shown in the phase zero balance sheet, the balance sheet will include the additional items highlighted in blue in Figure 4. These are:

- on the asset side - trade receivables and prepayments;
- on the liabilities side - amounts payable to suppliers, and
- on the bottom line - the corresponding impact on net assets.

Figure 4. Development of the Balance Sheet in Phase One

	YEAR N	YEAR N-1
Current Assets	**40**	**31**
Cash and cash equivalents	32	25
Grants receivable	3	3
Trade receivables	5	3
Total Assets	**40**	**31**
Non-current Liabilities	**767**	**741**
Borrowing and financing	767	741
Current Liabilities	**241**	**247**
Borrowing and financing	214	224
Salaries and wages payables	12	11
Grants and subsidies payables	4	3
Trade payables	11	9
Total Liabilities	**1,008**	**988**
Net Assets	**-968**	**-957**

Elements added on accruals basis in phase 1

Source: IPSAS1 Presentation of financial statements; Authors.

Note: this illustrative example assumes no contributed capital and no minority interest, which would change the equity section of the statement.

Operating statement

In addition to the Cash Flow Statement shown in Phase Zero, Phase One sees the publication of the first operating statement incorporating some accrual flows. Amounts recorded as payables and receivables in the balance sheet will generate corresponding flows in the operating statement, which will develop as presented in the Figure 5 below:

- On the revenue side, tax revenues (non-exchange revenues) are shown on a cash basis, while non-tax revenues (exchange revenues), including receipts from sales of goods, fees and charges for provision of services, and capital receipts or investment revenues (e.g., sale of government's shareholding), are shown on an accrual basis;[23]
- On the expenditure side, wages and salaries, grants and subsidies, purchase of goods (including fixed assets), and purchase of services are accounted for on an accrual basis. However, amortization or depreciation of assets will not be accounted for at this stage; and
- The use of "net change in cash" as the summary aggregate in a cash account (Phase 0) becomes the more familiar and useful "Surplus or deficit" under accrual accounting.

Figure 5. Development of the Operating Statement in Phase One[1]

	YEAR N	YEAR N-1	ACCOUNTING BASIS
Tax revenue from direct taxes	235	218	*Cash*
Tax revenue from indirect taxes	159	151	*Cash*
Tax revenue from local taxes	47	41	*Cash*
Grants received	24	26	*Accrual*
Revenue from sales of goods and services	37	32	*Accrual*
Dividends and interest received	11	8	*Accrual*
Proceeds from sale of investments	15	5	*Cash*
Proceeds from sale of property, plant and equipment	45	37	*Cash*
Other revenue	8	9	*Accrual*
Total Revenue	**581**	**527**	
Salaries	289	271	*Accrual*
Purchase of goods and services	100	87	*Accrual*
Grants and subsidies	56	45	*Accrual*
Purchase of investments	30	28	*Cash*
Purchase of property, plant and equipment	49	50	*Partial Accrual*
Finance costs	37	31	*Cash*
Other expenses	32	35	*Accrual*
Total Expenses	**593**	**547**	
Gain on foreign exchange transactions	1	2	*Cash*
Other gain (or losses)	**1**	**2**	
Surplus or Deficit	**-11**	**-18**	

Elements recorded on an accrual basis in phase 1

Source: IPSAS1 Presentation of financial statements, Authors.

[1] The presentation of the operating statement used by countries that have transitioned to accrual accounting may vary—international standards do not specify an exact or detailed format to be followed. For example, the United Kingdom's operating statement is presented as follows: (i) total revenue, (ii) total expenditure, (iii) net expenditure before financing costs, (iv) net financing costs, and (v) net expenditure for the year. The net expenditure before financing cost is not disclosed. However, independently from the presentation adopted, operating statements should include similar type of flows and aggregates.

[23] Transactions where the government receives a revenue without providing any service or good in exchange are called "non-exchange transactions" (typically, tax revenue); transactions where the government receives a revenue in exchange for a service or a good are called "exchange transactions" (for example, sale of a government's building).

B. Accounting Policies

Payables

Payables should be recognized in the balance sheet at the time an obligation to pay an amount to a third party was created for the government. Accounting policies need to define triggering events consistent with this principle. They are usually as follows:

- For goods and services, the delivery of goods, the provision of a service, or the fulfilment of a contract;
- For grants and subsidies, the existence of a valid claim, that is when all requirements and conditions for receiving a subsidy or benefit are satisfied by the third party;[24]
- For wages and salaries, when an employee earns an entitlement to receive a cash remuneration or similar benefit, as specified in the law or employment contract; and
- For trade receivables, when the government is entitled to receive a payment from a third party according to the contract.

However, where information systems or business processes do not allow tracking of these triggering events as they occur, transitional accounting policies may be needed, which will rely upon delayed or indirect recognition of trade payables. In Francophone and Latin countries, which record expenditures in seven administrative stages, the *payment order* may be used as a delayed triggering event for recognizing the trade payables (see Box 7 below). Another common *delayed triggering* event will be the receipt of the invoice for goods or services delivered to government.

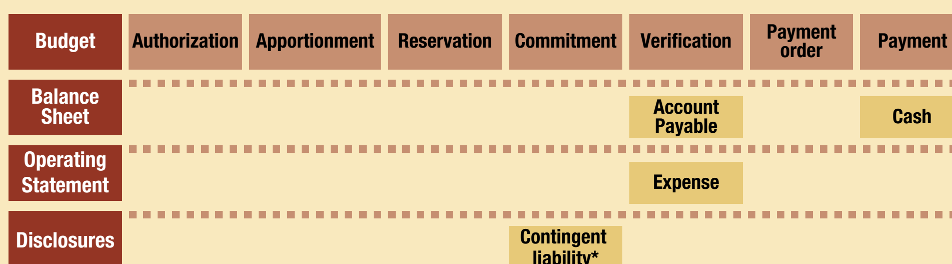
Policies for the valuation of trade receivables and accounts payable should be clearly stated. These assets and liabilities will usually be recorded in the accounts at nominal value. If it is likely that the full amount due from a third party will not be recovered, an adjustment for doubtful debt should be made and an entry recorded in the balance sheet for the amount unlikely to be recovered, or the receivable should be written-off.[25]

[24] Independently from the fact that this third party has made the claim.

[25] Statistical standards record write-offs as other economic flows.

Box 7. Expenditure Chain and Accrual Accounting

In Francophone and Latin countries, expenses are recognized in the budget following a clearly defined process, which is usually referred to as the *expenditure chain*. It consists of seven keys stages: authorization, apportionment, reservation, commitment, verification, payment order and payment. If these stages are recorded in a reliable and timely fashion, establishing a relationship between the steps in the process and the triggering event for recognizing accrued expenses will help countries in transitioning to accrual accounting. The verification stage (or *Liquidation*), when the administration acknowledges that services or goods have been received and that a third-party is entitled to receive a payment is similar to the triggering event for recognizing expenses under accrual accounting (i.e., the occurrence of an economic event creating an obligation). The verification stage could therefore be considered a proxy for accruing an expense in the first phase of the transition to accrual accounting.



Source: Authors.

C. Operational Implications

The transition to accrual accounting usually requires a new Chart of Accounts. A Chart of Accounts is the universal system of codes which are used to classify transactions and ultimately their presentation in the financial statements. Additional categories or segments of the Chart will be needed to accommodate the accrual equivalents of traditional cash transactions; to accommodate new classes for assets and liabilities; and to incorporate non-cash transactions such as depreciation or provisions. For example, in the Philippines, a first step in their current financial reform has been to produce a "Unified Accounts Code Structure" (UACS) which meets the needs of accrual accounting and statistics by linking financial accounts codes to GFS codes. There is an automatic mapping from accounts codes to the relevant GFS codes, and thus both financial and fiscal reports can be generated from the same data. Users need only enter the accounting code, with the cross-coding to GFS being done in the background by way of reference or linking tables within the system.

To determine the opening balances for *trade payables,* an inventory of all known accounts payable related to goods and services should be compiled. This should be done for all services and goods received and contracts let up to the balance sheet date. Such an inventory should also

be compiled at year-end to determine the closing balance for accounts payable. It is also advisable to survey major suppliers or third parties (e.g., large local governments or public corporations receiving transfers) to confirm the accuracy of the amounts outstanding, and to review the invoices received post period-end to identify accounts payable that should have been recognized in the balance sheet at the closing date. A switch to accruals makes it even more important that the source documentation, such as delivery notes, invoices, contracts, confirmation letters from suppliers, should be systematically filed and available for audit.

A better approach to a year-end inventory of receivables and payables is to record goods delivered and services received in the accounts as transactions occur. To achieve this, accounting procedures and information systems should be set up to ensure that expenses are recorded systematically, from the purchase order through receipt of goods to payment of the invoice, including the dates at each stage, with capture of equivalent data on the trade receivables cycle. When expenditure can be incurred without a purchase order, or receivables registered without an invoice being issued - i.e., outside of the ledger system – there is a risk that the accounts payable or receivable may not be recorded in a comprehensive or timely manner.

This systematic tracking of the processing of revenues and expenses often requires a reconfiguration of the existing information system or the purchase of an IFMIS to record the date, value, and status of each invoice for goods and services. Without an IFMIS, manual records should be maintained, with regular internal audit to ensure that all invoices presented for payment have been recorded in a timely manner. Compliance with these accounting rules is critical to the accurate recording of accounting information, and an effective sanction regime for officials who fail to record all invoices should be instituted.

For wages and salaries and grants and subsidies similar procedures need to be performed for establishing the opening and closing balances of payables. Wage and salary-related accruals present special challenges which need to be reflected in the interface between human resource, payroll, and accounting systems to ensure that triggering events can be effectively monitored. At this stage it may only be possible to accrue simpler elements such as salaries, short-term benefits and accumulated leave if these data are readily available. Long-term benefits such as pensions will need to be included at a later stage.[26] For grants and subsidies, these non-exchange items are partly covered by *IPSAS 23*[27] and should obey the general rules for recognition – they become an asset (or liability, for the grantor) when a legally enforceable claim arises (i.e., when it is reasonably certain that the transfer of resources will occur, and its value can be reliably measured). The ability to accrue for such items at this stage will depend on government's systems for recording them. Each type of grant or subsidy may merit different treatment.

[26] Long term employee benefits such as pensions represent specific challenges which will be dealt with in Phase two.

[27] IPSAS 23 deals with the receipt of such revenues, but the accounting treatment for such expenses can be imputed. A July 2015 IPSASB consultation paper "Recognition and Measurement of Social Benefits" has proposed possible accounting treatments for social benefits.

Box 8. Meeting the Requirements of Cash Budget Reports and Accrual Accounting in Brazil

Brazil is part way through the transition to accrual accounting, based on IPSAS, across all government bodies. These accruals accounts are to be produced alongside traditional budgetary statements which are cash-based. Brazil started out with the advantage of a unified IT system for accounting (SIAFI) in all bodies at the federal level; and similar (but not identical) systems at state and local level. At federal level, where the transition is most advanced, it was recognized that this IT system needed to be adapted to serve the purposes of budgetary and accrual accounting. The key to meeting this dual requirement has been to develop a system which in effect maintains two sets of accounting ledgers—one for budgetary cash-based accounting and another for accruals. Postings for both accruals and cash (where there is a cash effect) are generated automatically and in parallel, and the system maintains controls to ensure that the two ledgers are integrated and consistent.

This dual ledger approach was needed because in general it is not possible for one set of ledgers to support both cash and accruals accounting. For example, the purchase of a capital item would have one treatment under a cash accounting regime, and an entirely different treatment under accruals, and this would be difficult to achieve in a single set of integrated accounts ledgers, without significant recoding or reanalysis of the accounting data. The consistency between the ledgers are assured by automatic reconciliation through accounting formulas. The system generates reports on IPSAS accounting financial statements (assets and liabilities on accruals), budget reports (cash), financial reports (cash), cash flow statement (cash), cost accounting (accruals), and other control reports. The first IPSAS compliant financial statement was published in April 2015.

Source: Authors.

The accruals statements should be subject to audit, with the audit based on the accounting policies adopted to that point. Partial accrual accounts will receive a qualified audit opinion until transition is complete. Qualification of the accounts because of the uneven quality of data, or concerns about the application of the accounting standards would have negative implications for the credibility of the financial reporting of the government, and undermine confidence in its fiscal position. It is therefore recommended that the SAI and government make use of "dry-run" audits to enable the SAI to become familiar with the new format of the accounts and provide feedback to the executive on the quality of the accrual data before the first formal audit of the financial statements.[28]

In many countries the transition to accruals provides an opportunity to rethink budget presentations. While budgets can continue to be presented and executed on a cash or commitment

[28] Alternatively, governments may consider preparing the new accruals statements in draft, shadow or trial run form, possibly unaudited, in parallel with the cash accounts, until full accruals reporting is possible.

basis, this can provide some challenges. In such situations, the chart of accounts and IT system will need to meet the dual demand of cash or commitment-based budget reports, and accrual accounting (see Box 8 on Brazil).[29] The move to accrual may however provide an opportunity to rethink the presentation of budget reports. In Austria, for example, the accrual reform, which covered the federal government, was part of a wider PFM reform package. The budget and financial statements were revised simultaneously, and, since 2012, the budget also includes a cash flow statement, accrual-based operating statement, and balance sheet.

D. Institutional Coverage

During Phase 1, the institutional coverage of financial statements should encompass the consolidated central government. This implies bringing into the financial statements the extra-budgetary agencies and funds of the central government, which are financed primarily from their own non-commercial resources such as earmarked taxes, fees, and charges. Examples of such entities can include regulatory authorities, revolving funds, and autonomous agencies.

Consolidation policies

Accounting policies should require that all entities controlled by the central government and engaged in non-market activities be consolidated (see Box 9). They may have their own legal status, governance structures, financing, and administrative arrangements that are independent of government ministries and departments.[30]

Under Phase I, consolidation means presenting the assets, liabilities, net assets/equity, revenue, expenses and cash flows of the central government and its controlled entities (such as extra-budgetary agencies and funds) as if they were a single entity. Consolidation thus combines their accounts (operating statement, balance sheet, etc.) line by line. To effect the consolidation, entities' financial years ideally need to align with government and accounting policies and instructions need to define how internal transactions and balances should be eliminated. At this phase, these intra-central government transactions would typically include transfers from government to agencies, and taxes paid by agencies to government.

This elimination of these internal transactions involves the following steps:

- identification by both parties of any intra-CG transactions that are to be eliminated;
- verification that internal transactions and balances reported are the same amounts and classified similarly by both parties; and
- elimination of the transactions and balances from both entities' financial statements.

[29] See guidance in *Chart of Accounts: A Critical Element of the Public Financial Management Framework,* Julie Cooper and *Sailendra Pattanayak,* Fiscal Affairs Department, Technical Notes and Manuals, International Monetary Fund, August 2011

[30] Social security funds, which are a special category of extra-budgetary funds, may be consolidated at the next stage of the transition to accrual accounting, as the accounting treatment of their main financial operations (operating social security schemes) entails developing some specific accounting treatments and actuarial competencies.

Box 9. Coverage of the Consolidated Financial Statements: IPSAS vs. GFSM

The definition of "government" for financial reporting purposes differs between the two principal international financial reporting standards for the public sector: IPSAS and GFSM2014.

Under IPSAS, the requirement for consolidation is based on the concept of "control," used in private sector accounting to define the "reporting entity" for the purposes of corporate financial reporting. Under this approach, a controlling entity should consolidate all the entities it controls, with the notion of "control" being defined in accounting standards. For the public sector, *IPSAS 35: Consolidated Financial Statements*[1] defines "control" in detail, the overall principle being that an entity controls another entity when it is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature and amount of those benefits through its power over the other entity. This means that not only all central government ministries, agencies, and extra-budgetary funds but also most enterprises in which central government owns a controlling stake or otherwise directs their financial and operating policies should be included in the consolidated central government financial statement.

This approach has been adopted by governments that have adopted international accounting standards in the public sector such as Australia and New Zealand. However, the drawback of the control-based approach to defining the boundaries of government is that local governments and possibly some other bodies may, depending on the constitutional and legislative framework, be considered independent of central government "control," and therefore are not included in consolidated government financial statements. To address this concern, IPSAS 22 *Disclosure of information about the General Government sector* provides for reporting on general government (consolidated central and local government), as defined according to *GFSM2014*, as part of "Segment Reporting" in the disclosures to the financial statements. Some governments may go further and choose to report on the whole public sector (or "Whole of Government") as an economic and accounting entity in its own right, as is done in the United Kingdom.[2]

In contrast to IPSAS, under *GFSM2014* and ESA 2010, although the inclusion/sector classification of individual bodies is also determined using control-based tests similar to those in IPSAS 35, the boundaries of government are dictated by the economic nature of the activities carried out within it. Under this approach, all public sector entities that are primarily engaged in market activity are deemed to be part of the corporate sector, while all public sector entities primarily engaged in "non-market" activity are deemed to be part of the general government sector which constitutes the principal reporting entity under statistical standards. However, *GFSM2014* also recognizes the value of providing an overview of the finances of the public sector as a whole, consolidating both central and local government with all of the public corporations which they own or control. It therefore encourages publication of consolidated public sector data as a supplementary disclosure to the standard general government financial statistics where possible.

Such an approach has been adopted by the United Kingdom, which aligns the boundaries of the Whole of Government accounts with those of the Public Sector in national statistics published by the Office of National Statistics (subject to a limited number of differences identified in the financial statements).

For the purposes of this TNM, it is suggested that countries progressively expand the institutional coverage of their financial statements, starting with Central Government in Phase I, General Government in Phase II, and Public Sector in Phase III.

A consolidation of the whole public sector has much to commend it—since such an account should capture all the finances, as well as the risks, attaching to the public purse and the taxpayer; especially considering that past fiscal crises in various countries can be traced back to liabilities accumulated at subnational levels. The approach adopted by the UK to defining the accounting entity (see note 2) provides one way forward.

Source: Australian Government (2015), HM Treasury (2014), and Authors.

[1] IPSAS 35 is effective for annual reporting periods beginning on or after January 1, 2017, with earlier application permitted.

[2] The UK Treasury defines the Whole of Government as "a group of entities that appears to exercise functions of a public nature, or to be entirely or substantially funded from public money."

Within the CG, the main eliminations will include transfers and grants from the government; tax paid to the government by consolidated entities, as well as associated debtor/creditor balances. *IPSAS 35: Consolidated Financial Statements* set out requirements for the preparation of consolidated statements (notably the consolidation methods to be applied), and provides guidance on consolidation procedures.[31]

Consolidation processes

Accounts of entities to be consolidated must be subject to similar accounting policies, formats and reporting timeframes. To achieve this objective completely, all units or entities must be migrated to a harmonized accounting framework (and ideally an integrated financial information system). While this may present some practical challenges, it should not prevent consolidation. For the purposes of preparing consolidated financial statements, extra-budgetary entities may need to configure additional reports within their IT system to restate their individual accounts in line with the government chart of accounts and accounting policies. The required reports will consist of the operating statement, the balance sheet in the format specified by the MoF, the cash flow statement and information needed for disclosures to support the consolidated financial statements. It is important for audit purposes that information provided to the MoF can be fully reconciled to the entity's own audited financial statements.

Materiality considerations should be taken into account for deciding the scope of the consolidation. Small bodies that have little or no income except the grant they receive from another

[31] The draft GFSM 2014 also provides guidance in paragraphs 9.18 and 9.19.

part of government and minimal assets or liabilities may be consolidated at later stages or excluded as immaterial (but listed in the disclosure notes). Attention should be paid however to whether these public sector entities have contingent liabilities that could be material.

In some countries, smaller public entities may be months or even years behind in producing financial statements, or statements may not have been audited. In this case, efforts will be needed to address the backlog and the timeliness of entities' reporting, or at the very least focus attention on producing accounts for the first year to be consolidated. In the absence of previous years' accounts, additional work may be needed to establish opening balances. As a last resort, the consolidation of central government accounts may have to go ahead without these entities, and this omission must be made clear in the statement of accounting policies. Their omission may however result in an adverse audit opinion, if the entities' finances are material to the consolidated account.

Finally, consolidation usually requires specialist accounting software, or a custom-built consolidation system. This should be accompanied by timetables and procedures for consolidation so that all the requisite data becomes available to the MoF in a timely way. The consolidated financial statements should ideally be published consistent with the annual cycle of accountability, preferably with formal publication and discussion in the legislature, so that they are not seen as an irrelevance by the time they are produced.

VI. PHASE TWO: ADVANCED ACCRUAL ACCOUNTING

This section discusses the reforms to government financial statements, accounting policies, and operational considerations, involved in moving from *Phase 1: Elementary Accrual Accounting to Phase 2: Advanced Accrual Accounting.* The second phase of the transition completes the recognition of financial liabilities and financial assets in the balance sheet, records changes in the value of those stocks in the operating statement, and further extends the institutional coverage of financial statements to the consolidated general government.

TABLE 4. ADDITIONAL ELEMENTS REPORTED IN PHASE 2: ADVANCED ACCRUAL ACCOUNTING

	BALANCE SHEET		OPERATING STATEMENT			INSTITUTIONS
	ASSETS	LIABILITIES	REVENUES	EXPENSES	OTHER FLOWS	
Phase 2 Advanced Accrual Accounting	Equity Investments	Other financial liabilities Long-term liabilities (e.g., pensions)	Accrued non-tax receivables	None	Valuation changes in financial assets and liabilities Provisions	General Government

Source: Authors

This phase gives government a complete picture of its financial balance sheet and its *Net Financial Worth (or Net Financial Wealth).* Recording financial liabilities (such as pensions or debt related to public-private partnerships—PPPs) and disclosing financial contingent

liabilities, also allows internal and external stakeholders to have a better understanding of the long-term financial impact of government decisions and commitments.

A. Financial Statements

Financial statements produced at this stage would include the full set of statements required under accrual accounting. This includes a cash flow statement, a balance sheet which now includes all financial assets and liabilities, an operating statement which now reflects all transactions in financial assets and liabilities, and, for the first time, a statement of changes in net assets/equity reflecting all valuation changes in financial assets and liabilities.[32]

Balance sheet

The nature of financial liabilities and financial assets included in the balance sheet will depend on the activities of a given government. They will typically include:

- Cash, as in Phase 0;
- Financial assets, mainly equity shares owned by the government in public or private companies, over the long or short term;
- Complex financial instruments, such as derivatives;
- Government debt, as in Phase 0;
- Financial liabilities other than loans that the government may have entered into, such as those related to public private partnerships. Some countries may wish to include but separately identify the liabilities (and the assets) related to PPPs (following IPSAS 32), or this analysis can be done through a disclosure note;
- Long term liabilities, such as public service pension schemes and other pension schemes managed by the government; and
- At this phase, there may also be recognition of some “provisions.” These are liabilities of uncertain amount or timing.

Figure 6 below shows how these additional items would appear on the government balance sheet and thei impact on its net asset position.

[32] IPSAS 1 requires a statement of changes in net assets/equity which shows movements in equity which are not recognized in the operating statement surplus or deficit. The general rule is that most changes affecting net assets should be reflected in the operating statement.

Figure 6. Development of the Balance Sheet in Phase Two

	YEAR N	YEAR N-1
Non-current Assets	**20**	**21**
Equity investments	20	21
Current Assets	**96**	**93**
Cash and cash equivalents	32	25
Grants receivable	3	3
Trade receivables	5	3
Equity investments held-for-sale	56	62
Total Assets	**116**	**114**
Non-current Liabilities	**2,505**	**2,484**
Borrowing and financing	767	741
Public service pensions	1,357	1,256
Post-employment and other social benefits	258	235
Other financial liabilities	123	252
Current Liabilities	**259**	**265**
Borrowing and financing	214	224
Salaries and wages payables	12	11
Grants and subsidies payables	4	3
Trade payables	11	9
Provisions	18	18
Total Liabilities	**2,764**	**2,749**
Net Assets	**-2,648**	**-2,635**

Elements on an accruals basis added in phase 2.

Source: IPSAS1 Presentation of financial statements; Authors.

Operating statement

With all financial liabilities and assets being recognized in the balance sheet, the operating statement needs to record changes in their value.[33] These non-transactional "other flows" include changes in the market value of financial instruments and in the equity value of the shares owned by the government that are not held to maturity. Impairments, and gain or losses on the sales of financial assets,[34] will also be recorded in the operating statement. Figure 7 below shows how the operating statement develops in Phase 2 as additional elements are recorded on an accrual basis.

[33] However, not all changes assets and liabilities' values are captured in the Operating Statement. Changes such as revaluation arising from unrealized foreign exchange differences, and retrospective adjustments to reflect changes in accounting policies, will appear in the Statement of Changes in Net Assets.

[34] That is the difference between the book value of these assets and the fair value.

Figure 7. Development of the Operating Statement in Phase Two

	YEAR N	YEAR N-1	ACCOUNTING BASIS
Tax revenue from direct taxes	235	218	*Cash*
Tax revenue from indirect taxes	159	151	*Cash*
Tax revenue from local taxes	47	41	*Cash*
Grants received	24	26	*Accrual*
Revenue from sales of goods and services	37	32	*Accrual*
Dividends and interest received	11	8	*Accrual*
Gain (loss) on sale of investments	5	-2	*Accrual*
Proceeds from sale of property, plant and equipment	45	37	*Cash*
Other revenue	8	9	*Accrual*
Total Revenue	**571**	**520**	
Salaries	289	271	*Accrual*
Purchase of goods and services	100	87	*Accrual*
Grants and subsidies	56	45	*Accrual*
Purchase of property, plant and equipment	49	50	*Cash*
Finance costs	39	33	*Accrual*
Other expenses	32	35	*Accrual*
Total Expenses	**565**	**521**	
Gain (or loss) on foreign exchange transactions	3	2	*Accrual*
Unrealized gain (or loss) on fair value of investments	-12	3	*Accrual*
Actuarial gain (or loss) on pension liabilities	-10	-28	*Accrual*
Other gains (or losses)	**-19**	**-23**	
Surplus or Deficit	**-13**	**-24**	

Elements recorded on an accrual basis in phase 2.

Source: IPSAS1 Presentation of financial statements; Authors.

B. Accounting Policies

Post-Employment benefits

Countries' public pension and social security systems are established by law and can differ greatly. Systems may be funded or unfunded, mandatory or voluntary. In most countries, different types of pension and social security schemes may co-exist. They will typically include (i) national pension or social security schemes, to which private and public sector employees are required to contribute; (ii) a public servants pension scheme; and (iii) some benefits or pension schemes for specific categories of employees (such as a military or teacher pension schemes).

Special accounting treatment is required for post-employment benefits which are usually earned on a continuing basis, but may not be paid directly or until sometime in the future. Governments that are involved in such arrangements should therefore develop accounting policies that define how to estimate the government's obligations. Accrued benefits to be recorded include:

- short-term employee benefits, such as wages, salaries, and social security contributions; paid annual leave and sick leave; profit-sharing and bonuses, as well as non-monetary benefits (such as medical care, housing, cars, and free or subsidized goods or services) for current employees (dealt with in phase one);
- post-employment benefits such as pensions, other retirement benefits, post-employment life insurance, and post-employment medical care;
- other long-term employee benefits, which may include long-service leave or sabbatical leave, long-service benefits, long-term disability benefits, as well as bonuses or profit-sharing payable beyond a 12-month horizon; and
- termination benefits.

The treatment of long-term pensions and similar benefits is complex because of the timescales and uncertainties attaching to them. A distinction needs to be drawn between "defined contribution" schemes and "defined benefits" schemes.

- In a defined contribution plan, the entity is only obliged to make contributions (for example, where they pay into a private retirement plan), and all financial risk related to future benefits rests with the employee. Contributions payable are recognized as a liability (accrued expense) when they are earned and extinguished when the contributions are paid. Valuation is generally at undiscounted (i.e., cash) value, and no actuarial valuations are needed.
- In a defined benefits plan, the entity has a long-term obligation to pay specified benefits, and the financial risk rests with the entity. These obligations may be funded, unfunded or a mixture of both. Accounting is complex because actuarial valuations (with discounting) are needed to measure the obligation and associated expense, and the value of funds needed to meet those obligations. In some cases, estimates, averages, and computational short cuts may provide a reliable approximation in lieu of detailed computations.[35]

Other long-term benefits, such as sabbatical leave or long service benefits, are not subject to the same uncertainty as pensions since they are not so open-ended a commitment. Whilst much of the same valuation thinking is applied as for pensions, all the impacts of changes in entitlement are recognized in the current year rather than being spread over a period. For termination benefits, these are recognized as a liability and expense as soon as they are certain (for example, in a voluntary redundancy program, once the number, value and timing of redundancies are confirmed). Any benefits due beyond the 12-month horizon should be discounted to current

[35] Differences in pension systems and/or differences in accounting rules therefore lead to somewhat different outcomes in the financial accounts. The financial statements of the governments of Australia, Canada, New Zealand, the United Kingdom, and the United States include liabilities in relation to the pensions of government employees. In these countries as well as in most European Union countries (for example, France and Spain), the governments also provide payments to private-sector employees or to all citizens of a certain age, but these payments are not treated as creating liabilities for the government since they are viewed as ongoing social benefits. Part of the reason is that the government does not have a contractual obligation to make these payments, and it could reduce them by changing the law—though from a practical point of view the government's room for maneuver may be very limited. Where these payments are funded by ordinary taxes, there is also a concern that to record a liability for them would not make sense unless an asset was also recorded in relation to the taxes.

values. *IPSAS 25: Employee Benefits* provides guidance on the recording of these benefits, and other types of long-term benefits.

Other social benefits

For social security schemes, contributions from beneficiaries, if any, are recorded as revenue, and benefits paid out under certain eligibility criteria are recorded as transfers or expenses. Government may choose to record these when the eligibility criteria are met, or when the benefits are paid. The financial assets related to the schemes should also be recorded and valued, according to the principles discussed in paragraph on *Financial Investments* below. IPSASB is currently working on a draft standard on how to record these schemes in financial accounts, which should be aligned with the statistical treatment defined in the GFSM 2014.

Public-Private Partnerships (PPPs) and leases

Most governments and public bodies enter into a variety of partnerships with the private sector. These agreements include leases and service concession arrangements (commonly termed PPPs). Governments should recognize the asset created by such arrangements, where the risks associated with the asset rest with the public entity, or the use of the asset is controlled or regulated by the public authority and the public body has a residual interest in the asset at the end of the contract. A newly created asset should be recognized at fair value. The obligation to pay the contractor should be recognized as a financial liability. Payments in each period should differentiate the reduction in the liability, finance charges and service charges (if any) in the operating statement. Service concession arrangements are discussed in detail in *IPSAS 32: Service Concession Arrangements: Grantor.*

Financial investments

A government portfolio may include many types of investment, including loans and shareholdings in companies (both public and private). To determine the right accounting treatment, it is important to distinguish the nature of the investment. The main distinction is between investments held for sale or trading, and those held for longer-term purposes.[36] Within this latter group, treatment will depend on the extent of government's ownership and control:

- Government equity investments held with a view to sale, for example as part of a trading operation or, less commonly, as part of a government short-term financial rescue. Such investments would be accounted for as current assets on the basis of fair market value, and not consolidated.
- For other investments, the degree of government control determines the treatment:
  - Government as minority stakeholder: these investments are covered by IPSAS 28, 29, and 30 on Financial Instruments (see next section);

[36] In GFSM and other macroeconomic statistics, the distinction is at the instrument level, no distinction is made between investments for sale or trading and longer term investments.

– Government with control, and power over the entity: these investments should be consolidated line by line, but showing minority interests (*IPSAS 35: Consolidated Financial Statements*, and see consolidation sections above and below); and
– Government interest in in associates and joint ventures: where there is significant influence but not control of an entity, these are accounted for using the equity method (IPSAS 36: *Investments in Associates and Joint Ventures*).

General policies on financial instruments

Accounting policies should prescribe the recognition of a financial liability or asset when the entity becomes a party to the contractual provisions of the financial instrument[37] and specify the measurement of the instruments at either fair value or at amortized cost. *IPSAS 28: Financial Instruments: Presentation; IPSAS 29: Financial Instruments: Recognition and measurement;* and *IPSAS 30:* Financial Instruments: *Disclosures* are the standards that establish principles for presenting, recognizing, and measuring financial assets, financial liabilities and some specific financial contracts, such as concessionary loans. *IPSAS 30* requires detailed disclosure, if not already in the main financial statements, about the holdings of financial instruments, by type. The standard also requires disclosure in the notes about the types and levels of risk attaching to each class of financial instrument, including sensitivity analysis of those risks, as well as the policies for managing risk.

However, full compliance may be challenging during the first years of the transition to accrual accounting. Capacity may not be available in governments for identifying, classifying and measuring some categories of financial instruments. Transitional accounting policies may therefore be necessary—for example, simplified measurement methods for some categories of financial instruments.

Provisions and contingent liabilities

One important issue to be dealt with in the accounting policies will be the distinction between unconditional and conditional financial obligations of the government. The former will be recorded as liabilities in the balance sheet, while the latter will be reported only in the disclosures. Broadly speaking, payables and provisions are liabilities, and contingent liabilities are conditional. They can be described as follows:

- A liability, as discussed above, is an *unconditional* obligation arising from a past event, the ultimate settlement of which is expected to result in a future outflow of economic benefits or service potential from the entity. Loans repayable in the future are one example. This should be recorded as a liability in the balance sheet in Phase I.

[37] Financial instruments can be either cash instruments or derivatives. Cash instruments are instruments whose value is determined directly by the markets. They can be securities, loans or deposits. Derivatives derive their value from the value and characteristics of one or more underlying entities such as an asset, index, or interest rate. They include – but are not limited to - interest rate swaps, interest rate caps and floors, and interest rate options.

- A provision, a specific type of liability, is a *probable* obligation, albeit of uncertain amount or timing. It relies on estimation, something that distinguishes it from the comparative certainties of cash accounting. Examples of provisions include the probable cost of decommissioning nuclear facilities or cleaning up contaminated land, or the settlement of warranties on goods that have been sold. The amount recognized in the balance sheet as a provision should be the best estimate of the expenditure required to settle the obligation, using present value techniques if spread over a number of years. Changes in a provision during the year would be recognized as an expense. Sometimes the word "provision" is also used in a looser sense, for recognizing items such as doubtful debts or the impairment of assets. However, these are adjustments to the carrying amounts of assets, based on estimates, rather than provisions within a strict interpretation of IPSAS 19.
- In contrast, a contingent liability is a *possible* obligation arising from a past event whose existence will only be confirmed by future events. They represent a financial risk for the government however, and should be reported in the notes to the financial statements. An example of a contingent liability is a loan guarantee given by a government to a local government or a state owned enterprise, or a guarantee on bank deposits.

Accounting policies should therefore set up criteria for classifying the financial obligations of the government as liabilities, provisions or contingent liabilities, based on the government's actual financial operations. Guidance on this topic is provided in *IPSAS 19: Provisions, Contingent Liabilities and Contingent Assets.*

C. Operational Implications

A comprehensive inventory of all financial instruments will be a key task at this stage. Most governments maintain records of "primary" financial instruments, such as cash, loans made and received, bonds held and issued, and equity investments. In addition to these, a complete and reliable inventory and valuation of more complex instruments, such as derivatives and debt related to public-private partnerships will be required. Collection of information on financial liabilities and assets needs therefore to be coordinated by the MoF, and undertaken at the line ministries' and public agencies' level, as appropriate. The inventories and analyses should ideally be performed in a limited number of pilot ministries and agencies at first, and extended progressively. Among the practical tasks to be implemented are:

- Inventorying and classifying of contracts signed with service providers and developing standardized toolkits or checklists for and defining the appropriate accounting treatment of obligations entered into by the government.
- Compiling a list and conducting an assessment of existing and proposed service concession arrangements (PPPs) and leases, including those under contracts with state-owned enterprises to identify conditions related to control over the asset, both during and at the end of the arrangement. Define and disclose those where the liabilities and assets are to be recognized in the government's financial statements.

- Ensuring that equity stakes in public corporations are recorded and regularly revalued. This may require new laws or regulations to clarify or strengthen reporting requirements for these enterprises, and to assign oversight responsibility to a dedicated government unit.
- The valuation of pension liabilities will require at least an annual exercise to bring together data on the various funds and pensions schemes for which government is responsible. Fund managers will need to provide updated data on beneficiaries and rates, and in each case an actuarial valuation of consequent liabilities (and assets, if the scheme is funded) will be needed. An important issue which will need to be decided and updated each year will be the discount rate to be applied to future flows in such valuations – the policy on how the discount rate is set should be consistent year to year even if it results in annual variations. Small variations in discount rates can generate large changes in values (because such liabilities typically stretch over 30 years or more).

Capacity for establishing the market value of financial instruments may need to be developed within ministries of finance, or alternatively contracted to a qualified expert. Contracting experts is likely to be necessary for conducting actuarial estimates of the expected cost of providing post-employment and other long-term benefits.[38] The identification and reporting of contingent liabilities may also require new reporting systems to be developed, since most contingent liabilities are not automatically captured by government accounting systems. Instead, there need to be systems for capturing and aggregating information on potential legal claims, guarantees provided, or any other form of potential claim on the entity. Such reporting should be by type and nature, allowing similar items to be grouped. Accounting standards require the disclosure of the estimated financial effect of the contingent liability except in those rare cases where such disclosure would be severely prejudicial to the interests of the reporting entity (for example, in a major legal claim), and thus systems should capture such estimated values. In countries where commitments are included within contingent liabilities, the value of these commitments should be available from within the IFMIS which tracks expenditures through each stage of the payment process.

D. Institutional Coverage

At this stage, as discussed in Box 9, accounts should be consolidated in accordance with the statistical concept of "general government." This includes the central, state and local government and social security funds but not public enterprises. This provides parliament and the public with a comprehensive overview of all public activities funded primarily through taxes and other compulsory levies. It also provides a summary picture of the sustainability of the financial obligations of the central and subnational governments, including their long-term commitments in the form of pension obligations and PPPs.

[38] For evaluating this cost, demographic and financial assumptions (such as assumptions on mortality rates, future salary levels, and discount rates) need to be established and regularly re-assessed. The fair value of any plan assets, which is deducted in determining the obligation to be recognized in the financial statements, is also to be estimated.

Consolidation policies

Accounting policies should require that all entities engaged in non-market activities be consolidated. They include, in addition to entities previously consolidated, subnational government (e.g., state or regional government, local councils, metropolitan authorities, local assemblies, etc.) and the local non-commercial entities they control (e.g., police authorities, schools, hospitals, park agencies, or utility companies), and social security funds.[39]

Consolidation processes

While governments will learn from the experience gained during the first phase of the transition to accrual for undertaking this task, consolidating the financial statements of subnational governments may prove a lengthy process. This is because in some countries: (i) the Constitution, laws, or regulations defining the accountability requirements and responsibilities of the subnational government may not be harmonized; (ii) accounting and systems capacity may be weaker at the subnational government level; (iii) accounting standards may have been developed at subnational level under a different basis of accounting and charts of account; and (iv) subnational government may have different reporting cycles than central government.

It is therefore particularly recommended that a gap analysis be undertaken for subnational governments to identify the differences between the targeted and the existing accounting frameworks. The analysis can then allow both central and local government to define an action plan to close the gap. Ideally this should be done before the transition starts, but more detailed analysis can be made during Phase 1. It is recommended, for consolidating subnational government, that pilot exercises be conducted as early as possible at all levels of local government (see Box 10 on China's experience below).

Social Security Funds, which are government entities devoted to the operation of one or more social security schemes, should also be consolidated during Phase 2. They will typically include (i) national pension or social security schemes, to which both private and public sector employees are required to contribute; (ii) public servants pension scheme; and (iii) some benefits or pension schemes for specific categories of public servants or private sector employees.[40] For funds that are operating on a cash accounting basis, the transition to accrual accounting will imply recording pensions and/or benefits on an accrual basis, according to the principles discussed above. External assistance from professional actuaries will be needed. Sovereign Wealth Funds should also be analyzed and categorized during this phase to establish whether they are part of the general government and consolidated in this phase, or public corporations and consolidated in phase 3. Further guidance is provided in the GFS Manual (2014).

[39] The concept of "non-market activity" is described in paragraph 2.65 of the Government Finance Statistics Manual (GFSM) 2014, IMF (2014).

[40] However, not all social security schemes are managed by social security funds. For example, health or post-employment benefits specific to police or defense employees may be operated directly by the line Ministry.

Box 10. Transition to Accrual Accounting at Local Government Level in China

An earlier decision to migrate to accruals was reconfirmed at the Third Plenum of the 18th Central Committee of the Communist Party of China, in late 2013.The objectives of the reform include improving fiscal management and public accountability at all levels of government; identifying and managing fiscal risks, particularly direct and contingent liabilities at the sub-national level; improving the management of infrastructure assets; greater prudence about new initiatives to ensure the right balance between maintenance expenditure and new investment; and expanding the accounting function to provide more diversified information to meet these objectives.

The Ministry of Finance has undertaken extensive research to fully understand the issues, and with a view to designing the reform process and support measures. This research program included (i) a feasibility study of implementing a modified accrual-based accounting system based on the present status of government accounting in China. That study included policy recommendations on the direction of reforms and a basic implementation roadmap; (ii) work to define the scope of the government reporting entity, based on an analysis of the Chinese political and governance structure and drawing on international standards and country practices; (iii) preliminary work on establishing government accounting standards including content, phasing, and implementation plans; (iv) work to design government financial statements including their scope, content, compilation procedures, analysis and possible uses; and (v) and a series of accrual accounting pilots.

Beginning with 11 provinces in 2011, the coverage of these pilots was expanded to 23 provinces in 2012, and to all 36 provinces and some cities and county governments in 2013. From 2011 to 2014, the pilots have involved preparation of year-end financial statements on an accrual basis by adjusting and transposing the cash-based statements with additional accrual information. Starting from 2014, government departments were required to change their bookkeeping and record accruals at transaction level for the recognition of expenses, non-tax revenues, assets, liabilities (except pension liabilities) and equity. New instructions also covered the valuation of non-financial assets and an improved format of financial statements. Other steps planned include the preparation of a reform action plan; extending the pilots at local level; developing rules for consolidated reporting; further work on accounting standards; more work on the classification of public bodies; and supporting measures on IT systems and capacity building.

Source: Authors.

When eliminating internal transactions, governments may decide to apply temporarily a simplified methodology, and eliminate internal transactions at an aggregate level. The UK, for example, used the total revenue reported from central government sources for central to local government grants.[41]

VII. PHASE THREE: FULL ACCRUAL ACCOUNTING

This section discusses the reforms to government accounting policies, operations, and financial statements involved in moving from *Phase 2: Advanced Accrual Accounting* to *Phase 3: Full Accrual Accounting*. During this third and final phase of the transition, governments will publish a complete set of accrual-based financial statements including a full balance sheet and operating statement, provide a full set of disclosures in the financial statements, and expand the institutional coverage of the financial statements to the whole of the public sector. This will provide the government, parliament, and citizens a comprehensive overview of public sector revenues, expenditures, assets, liabilities, and net worth.

TABLE 5. ADDITIONAL ELEMENTS REPORTED IN PHASE 3: FULL ACCRUAL ACCOUNTING

	BALANCE SHEET		OPERATING STATEMENT			INSTITUTIONS
	ASSETS	LIABILITIES	REVENUES	EXPENSES	OTHER FLOWS	
Phase 3 Full Accrual Accounting	Fixed and intangible assets Inventories Tax receivables	Monetary financial instruments	Accrued receivables	Depreciation	Valuation changes in non-financial assets	Public Sector

Source: Authors

A. Financial Statements

Balance sheet

The final set of missing assets are being added to the balance sheet under the last phase of the transition to accrual accounting. They are as follows:

- Physical and intangible assets: For the government, these will include mainly infrastructure, land and buildings, military and civil equipment, computer software, and possibly biological assets and natural resources. Inclusion of heritage assets is currently optional under IPSAS, but they can be included at nominal value to bring then within the overall asset management framework. For the state-owned enterprises, these will include investment buildings, plants, patents and copyrights, etc.
- Inventories: For the government, these will include material and supplies such as ammunition, maintenance material or medical supplies. For state owned enterprises, inventories will include material and supplies in the process of production for sale.

[41] *See Whole of Government Accounts 2012 to 2013.*

- Government's specific financial instruments, such as monetary gold and holdings of IMF Special Drawing Rights;[42] in contrast, currency in circulation is typically a financial liability the monetary authorities including the Government and Central Bank.
- Tax receivables, which are payments outstanding or due from taxpayers

Figure 8. Development of the Balance Sheet in Phase Three

	YEAR N	YEAR N-1
Non-current Assets	**5,160**	**5,310**
Property, plant and equipment	382	380
Infrastructures	4,748	4,900
Intangible assets	10	9
Equity investments	20	21
Current Assets	**159**	**85**
Cash and cash equivalents	32	25
Gold holdings	5	3
Tax receivables	52	45
Grants receivable	3	3
Trade receivables	5	3
Inventories	6	4
Equity investments held-for-sale	56	2
Total Assets	**5,319**	**5,395**
Non-current Liabilities	**2,505**	**2,484**
Borrowing and financing	767	741
Public service pensions	1,357	1,256
Post-employment and other social benefits	258	235
Other financial liabilities	123	252
Current Liabilities	**259**	**265**
Borrowing and financing	214	224
Salaries and wages payables	12	11
Grants and subsidies payables	4	3
Trade payables	11	9
Provisions	18	18
Total Liabilities	**2,764**	**2,749**
Net assets	**2,555**	**2,646**

Elements added on an accrual basis in phase 3

Source: IPSAS1 Presentation of financial statements; Authors.

[42] The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies, and SDRs can be exchanged for freely usable currencies. As of September 2015, over 200 billion SDRs had been created and allocated to members (equivalent to about US$280 billion). Countries' holdings will comprise their allocation from the IMF, net of sales and transfers of SDRs to other members.

Operating statement

Additional flows reported in this final phase of the transition to accruals correspond to the additional assets and liabilities recognized in the balance sheet. These will include:

- Accrued tax revenue, which represents the amount of tax which is will probably be collected in the year, where the amounts can be reliably measured, rather than the amount collected, as appears under cash accounting;
- Changes in value, or depreciation, or amortization of intangible and tangible assets, as well as inventories, and (possibly) charges relating to the impairment of physical assets.

Figure 9. Development of the Operating Statement in Phase Three

	YEAR N	YEAR N-1	ACCOUNTING BASIS
Tax revenue from direct taxes	240	225	*Accrual*
Tax revenue from indirect taxes	162	148	*Accrual*
Tax revenue from local taxes	51	44	*Accrual*
Grants received	24	26	*Accrual*
Revenue from sales of goods and services	37	32	*Accrual*
Dividends and interest received	11	8	
Gain (loss) on sale of investments	5	-2	*Accrual*
Gain (loss) on disposal of property, plant and equipment	9	-4	*Accrual*
Other revenue	8	9	*Accrual*
Total Revenue	**547**	**486**	
Salaries	289	271	*Accrual*
Purchase of goods and services	100	87	*Accrual*
Grants and subsidies	56	45	*Accrual*
Finance costs	39	33	*Accrual*
Depreciation and amortization of assets	89	78	*Accrual*
Impairment of assets	12	16	*Accrual*
Other expenses	32	35	*Accrual*
Total Expenses	**617**	**565**	
Gain (or loss) on foreign exchange transations	1	2	*Accrual*
Unrealized gain (or loss) on fair value of investments	-12	3	*Accrual*
Actuarial gain (or loss) on pension liabilities	-10	-28	*Accrual*
Other gains (or losses)	**-21**	**-23**	
Surplus or Deficit	**-91**	**-103**	

Elements recorded on an accrual basis in phase 3

Source: IPSAS1 Presentation of financial statements; Authors.

Note: As state-owned enterprises are consolidated under phase 3, the revenue from sales and services could be more detailed in the balance sheet (for example, sale of water and electricity, rendering of services, etc.)

B. Accounting Policies

Goods used over more than one financial year by the government or another public sector entity for delivering its functions should be recorded in the balance sheet as physical or intangible assets. Goods that are stocked to be consumed or distributed in the rendering of services or for sale should be recorded in the balance sheet as inventories. Accounting policies need to define how these assets should be categorized, and their respective valuation method, including the policies for their depreciation and impairment.

Physical assets

All physical assets, including land, buildings, plant and equipment, infrastructure, subsoil, and heritage assets would normally be evaluated at cost, including all the costs associated with their acquisition and preparation for use, or at current value where possible.[43] Valuations would normally be carried out by professional valuers, on a frequency determined by the nature of the asset and the volatility in value: the more volatile the value, the more frequent the valuation. Some assets may require annual valuation, whilst other classes may justify a 3 or 5-year revaluation cycle. Thereafter, the asset is depreciated over its useful life using either the cost model or the revaluation model. The same model, cost or revaluation, must be applied to all assets in the same class:

- under the cost model: the asset is carried at cost, less accumulated depreciation and impairment losses; while
- under the revaluation model: the asset is carried at revalued amount, which is the current value at revaluation date, less subsequent depreciation and impairment losses.

Depreciation is charged as an expense over the asset's useful life. Depreciation should follow a systematic basis (e.g., straight line, unit of use/production, diminishing balance) which should be specified in accounting policies. Land, because it has an unlimited useful life, is not depreciated. Upon disposal or retirement of an asset, there may well be a gain or loss (that is the difference between the sale price and the value in the balance sheet) that needs to be recognized in the operating statement.

Practical considerations in developing accounting policies for tangible assets include:

- A capitalization threshold should be used for inclusion of physical and intangible assets in the balance sheet, since low value items will not affect the interpretation of the asset balances.
- Information provided in the balance sheet and disclosures should be detailed enough to provide a complete and relevant picture of all public assets. This may involve identifying different categories within governments' infrastructure, buildings, equipment, or natural resources, such as: roads, airports, schools, hospitals, prisons, office buildings, military equipment, national security equipment, agricultural products held by the government, proven oil or gas reserves, etc.

[43] Fair value would normally be based on market values, although the absence of a market may require other approaches, such as the market value of analogous assets, depreciated replacement cost or restoration cost.

- Governments should report on assets they control, and not just the assets that they own. Control is the power to govern the use of an asset, to benefit or to bear the risks from its use. Accounting policies therefore need to elaborate on how this principle should be interpreted, by setting control criteria or indicators for the main categories of assets;[44] and
- The valuation methods for assets will typically be an initial recognition at cost, and a subsequent one at amortized cost, market value, or replacement cost. For assets that are measured at amortized cost, a useful life needs to be determined appropriately in the accounting policies, based on information provided by that supply or maintain these assets. Where initial recognition at cost or market value is not possible, because supporting information is not available, or there is no observable market price,[45] accounting policies may authorize simplified methods, such as statistical estimations (see Box 11 on France).

Box 11. Valuation of Tangible Assets in France

The French accounting standards for the central government define two broad categories of tangible assets, with different accounting rules applying to these depending on whether (i) the useful life of the asset can be determined or not; and (ii) whether there is an active market for the asset, or not. Assets with a useful life are amortized, assets that cannot be amortized are measured at market value if possible, and, if not, with other methods (replacement cost or symbolic cost).

All of these valuation methods have been used for preparing the opening balance sheet. However, a number of transitional provisions have been authorized in the accounting standard where reconstituting costs or establishing market value was considered impossible, due to the lack of information or time. In particular, the cost of some military, civil equipment and buildings has been evaluated using statistical estimations based on military capital expenses budgeted prior to the move to accrual accounting. These estimations have been replaced over time with actual costs, or present market values as they became available.

However, in 2013 – seven years after the first publication of the French central government financial statements – the auditor's report still includes a qualification on the valuation of military equipment. The report notes that considerable progress has been made in recording and evaluating military assets, but that some equipment's costs have not been reconstituted, and that the physical inventories and the amounts reported in the general ledger cannot be fully reconciled.

Source: Government of France (2014), Authors.

[44] In statistics, concept of economic ownership (as opposed to legal ownership, although in most cases they are the same) is used, this means that the economic owner is entitled to claim the benefits of ownership and accepts the associated risks.

[45] This may be the case for some government infrastructure such as roads, prisons, or heritage assets.

IPSAS 17 **provides guidance on accounting treatment for tangible assets, but there is currently no IPSAS defining the treatment of heritage assets and natural resources.** The accounting policies adopted for natural resources and heritage assets should therefore be defined at the local level, based ideally on the principles established in other standards, such as *GFSM2014*. Impairment (i.e. a loss of future economic benefit or service potential over and above systematic depreciation) is recognized following *IPSAS 21* (for non-cash-generating assets) and *IPSAS 26* (for cash-generating assets).

Leases

A lease is an agreement in which the entity (the lessee) enjoys the use of an asset supplied by a third party (the lessor), over a defined period, in return for a payment or series of payments. The main distinction is between "finance" and "operating" leases:[46]

- A finance lease is one which transfers all the risks of ownership to the lessee. This may include transfer of ownership at the end of the lease period. For finance leases, the asset should be recognized on the lessee's balance sheet, alongside a liability for the lease obligations. In each accounting period of the lease, there will be a depreciation expense and a finance expense.
- An operating lease is one where the risks of ownership remain with the lessor. Accounting is simpler in that there is no need to recognize the asset and lease obligations on the balance sheet. Instead, the total value of the lease is spread over the lifetime of the lease on a straight-line basis and recognized as an expense in each period.

IPSAS 13 provides detailed guidance on the accounting treatment for these contracts.

Intangible assets

Intangible assets are identifiable non-monetary assets without physical substance. For governments, they typically include intellectual property, trademarks, broadcasting rights, patents, airport landing rights, accumulated data such as health, geographical or meteorological data which are capable of resale, and in some cases the costs of research and development. Assets should be measured initially at cost, unless they are acquired through a non-exchange transaction when they should be measured at their fair value on acquisition. Subsequent valuation should use the cost or revaluation method, with all assets in the same class adopting the same method. Intangible assets with a definite lifespan are amortized using a systematic method over their useful lives, whilst those with an indefinite life are not depreciated. Guidance on the treatment of intangibles is provided in *IPSAS 31*.

Inventories

Goods that are stocked to be consumed or distributed in the rendering of services or for sale should be recorded in the balance sheet as inventories. Typically, inventories

[46] A similar conceptual distinction is used in the separate standard for service concession arrangements (often referred to as PPPs).

may include consumable stores, maintenance materials, spare parts for plant and equipment, strategic stockpiles (for example, energy reserves), stocks of unissued currency, ammunition, postal service supplies held for sale (for example, stamps), and work in progress. They should be recognized at the lower of cost and net realizable value. The accounting treatment of inventories is covered by *IPSAS 12*.

Tax receivables and revenue

Tax revenue should be recorded when the event generating a legal right to receive a tax has occurred, and the revenue can be measured reliably. *IPSAS 23: Revenue from Non-Exchange Transactions (Taxes and Transfers)* provides guidance on the triggering event for recording typical tax streams (see Table 2 below). As the occurrence of these triggering events is likely to be unknown by the government before the taxpayer declares them, models for estimating future tax claims need to be developed for recording tax revenue on an accrual basis.[47] However, capacities for developing such models may be not available in tax administrations, and a reliance on estimations may be considered as too risky.[48] Where that is the case, accounting policies might prescribe a more conservative approach to accruing tax revenue, by recording tax receivables at the time when the tax administration establishes a claim, based on information provided by the taxpayer or by other sources. Other approaches are possible: for example, the federal government in the United States of America records only tax receivables that are uncollected tax assessments, penalties and interest when tax payers have agreed or a court has determined the assessments are owed. Although not recorded, within the 'Other Information' portion of the annual report of the United States of America, the Tax Gap, which is the difference between what taxpayers should pay and what they actually pay on time, is disclosed.

TABLE 6. ADDITIONAL ELEMENTS REPORTED IN PHASE 3: FULL ACCRUAL ACCOUNTING

TAXES	TRIGGERING EVENT FOR RECOGNITION
Income tax	The earning of assessable income during the taxation period by the taxpayer
Value-added tax	The undertaking of taxable activity during the taxation period by the taxpayer
Goods and services tax	The purchase or sale of taxable goods and services during the taxation period
Customs duty	The movement of dutiable goods or services across the customs boundary
Property tax	The passing of the date on which the tax is levied, or the period for which the tax is levied, if the tax is levied on a periodic basis

Source: IPSAS standards.

[47] Models for estimating the tax accrual should use the most recent available data from tax assessments and trend analyses to produce a reliable measurement of the taxable activity and the amount of tax to be collected for the period. The detailed determination as to what is sufficient to provide a reliable measurement is a matter of negotiation between the preparers of the financial reports and the auditors, with the involvement of tax forecasters so that ex ante forecasts of the debtor are not based on false assumptions about the accrual accounting methodology.

[48] Some countries that have moved to accrual accounting have not adopted a full accrual approach for recording tax revenue.

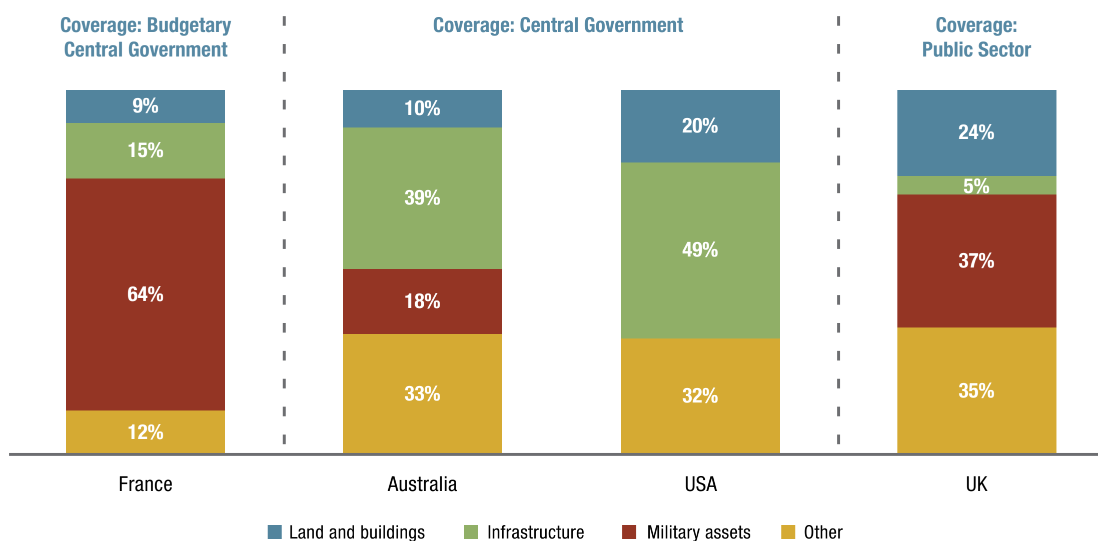
The likelihood of the amounts being recovered needs to be assessed periodically, to ensure that tax receivables balances are realistic. Where the assessed recoverable amount is lower than the balance recorded as receivable, a provision for tax uncollected should be recorded. However, accounting policies should make clear that the amortization of tax receivable balance does not prejudice the government's legal right to recover the full amount that is receivable.[49]

C. Operational Implications

Asset and inventory records

Accounting for physical assets (property, plant and equipment) provides perhaps the largest practical challenges in this last phase of the transition. A significant effort may be needed to bring asset records up to date, to verify the existence and condition of such assets, and to determine initial valuations. Lists of assets owned or controlled by public sector entities need to be maintained, in the form of asset registers. Asset registers may be a simple spreadsheet or database, but, ideally, they should be maintained in an information system that interfaces directly with the general ledger. Governments transitioning to accruals may not have such information readily available, and will have to undertake an initial inventory of their physical and intangible assets, together with evidence of physical verification. Based on international experience, infrastructure and military equipment are likely to represent the most significant items in governments' balance sheets (see Figure 10 below). Governments are therefore encouraged to start identifying, inventorying and valuing these assets at an earlier phase.

Figure 10. Tangible Assets Reported in the Balance Sheet for Selected Countries



Source: Government financial statements (France: 2013; UK: 31 March 2013; Australia: 30 June 2012; USA: Fiscal year 2013). Notes: (1) The Financial report of the United States government aggregate values of buildings, infrastructure and facilities. (2) The Australian and French governments evaluate their heritage and cultural assets, which are included in the category "other" in the Figure above. (3) For France, the amount reported for infrastructures includes assets controlled by the government under concession arrangements and public private partnerships, which value represent more than 60 percent of the total amount reported for infrastructure.

[49] The statistical approach is to reduce revenue rather than write down the receivable asset.

Following initial inventories, all movements of assets (addition, disposal, or transfer) should be updated in this register. In addition to movements, inventories should also allow identifying damages to assets that would impair their value (for example, earthquake damage to infrastructure).

Assets are usually valued internally, using invoices, contracts or other sources of information on their costs. Some assets may however be measured externally by professional valuers (e.g., real estate agents establishing the market value of the public buildings or land). In all cases, the valuation of the assets will have to be supported by identifiable, documented sources, to provide an audit trail in support of the valuation.

Tax receivables and revenue

Most tax administration information systems will include information on prepayments, actual payments, and outstanding tax payments. This information should be used to record corresponding entries in the general ledger: prepayments are cash movements and temporary liabilities to taxpayers, actual payments are cash movements and revenue, and outstanding payments are tax receivables and accrued revenue.

However, the information already available in the tax administration system may need to be supplemented by estimates to record tax revenue on a full accrual basis. Recording provisions on tax receivables will entail estimating historical trends on tax recovery and tax relief. Recording tax revenue when the events generating a legal right to receive a tax has occurred – as opposed to the time of the establishment of the claim by the tax administration – will entail establishing economic assumptions and statistical models. Capacities for establishing the evaluations may have to be developed within the tax administration, or in other departments of the ministry of finance, depending on the capabilities of the underlying systems and approaches to collection. For example, the UK estimates tax revenue for personal income and corporate taxes with longer collection periods using statistical models based on a combination of projections derived from the most recent revenue flows and forecasts of economic variables on which future revenue flows depend.[50] Likewise, in the consolidated financial statements of the Australian government, a number of taxation revenue items are reported based on estimations of the probable flows of taxes from transactions that have occurred in the economy, but are not yet reported to the tax administration.

D. Institutional Coverage

In Phase 4, in addition to the public entities previously consolidated, governments should consolidate all corporations that they control. In many countries, public corporations deliver public services, protect key resources, and can generate both profits and impose risks for the

[50] As noted in the *Whole of Government Accounts*, dated June 2014, that there will inevitably be differences between the forecasts and future outturns. These differences arise because of the need to make judgments on areas of uncertainty and are not indicative of deficiencies in the models. The maximum overall uncertainty is estimated and disclosed in the financial statements; it amounts to £4 million—less than 1 percent of the tax revenue reported in the operating statement.

government. In undertaking these activities, these corporations will collect trade revenue, incur expenses, and to develop stocks of assets and liabilities (for example, natural resources, infrastructures, financial investments, pension schemes, etc.), all of which are likely to be significant. Where these flows and stocks are not consolidated, the overall financial position of the government, the sustainability of the public sector finances, and the fiscal risks associated with these assets and liabilities are unknown, or, more likely, will be misinterpreted.

Consolidation policies

The entities that should be included in the government financial statements at the final stage of the consolidation are all corporations controlled by the government. This includes both non-financial corporations (such as national airlines, electricity companies, railways) and financial corporations (such as bank, insurance companies, sovereign wealth funds, and the Central Bank).[51] Control should be defined in line with the IPSAS and GFSM2014 standards discussed in Box 7.

At this stage, and if they have not already done so at an earlier phase, governments should consider using segment reporting. So, for example, a "Whole of Government" consolidated account might present segment information for the different parts of the public sector (central government, local government, public enterprises).[52] Or a government department might present information for "core" (government) activity and "consolidated" (including controlled corporations) activity. Such segment information is provided as an adjunct to the main financial statements but is not part of them. Guidance on this topic is in *IPSAS 18: Segment Reporting*.

Consolidation processes

In most advanced and many emerging and developing countries, large public corporations generally apply International Financial Reporting Standards (IFRS). In some countries however, public corporations have their own specific requirements that determine the format and content of their accounting. Consolidation of public sector accounts will entail consolidation of IFRS-based data with accrual-based data based on IPSAS. Where necessary, accounting policies will be required to explain the adjustments made to the financial statements of public corporations to bring the accounting policies into line with those used by the government.[53]

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[51] Entities such as airlines, railways or other companies or entities owned by government may be government units themselves, if they are operating in a non-market way—entities are classified as corporations outside the general government sector only if they are market producers.

[52] For example, the New Zealand Financial Statements show separately: core crown, crown entities, state-owned enterprises and inter segment eliminations, summed to the total crown. See: *www.treasury.govt.nz/government/financialstatements*

[53] IFRSs are produced by the International Accounting Standards Board (IASB) for the private sector. IPSAS are established by the International Public Sector Accounting Standards Board (IPSASB), which is operating under the auspices of the International Federation of Accountants (IFAC). IPSAS are based where appropriate on IFRSs, with interpretation and adaptations where necessary for the public sector. Where there is no equivalent IFRS, the Board develops standards from scratch (such as, for example, the accounting treatment of tax revenue).

Intra public sector transactions and balances which will need to be eliminated will include payables and receivables, dividends, government loans and grants to corporations, and taxes due. To achieve this, templates need to be defined which (i) require public corporations to provide reconciled data from their own audited financial statements in the format of the government's chart of accounts; and (ii) identify amounts to be eliminated reconciled to the counter party amount. Material differences need to be identified and eliminated. Further consolidation guidance is available in *GFSM 2014*.[54] All reports and eliminations will need to be available for audit during the audit of the government's financial statements.

IV. CONCLUSION: LESSONS FROM EXPERIENCE

In addition to the specific policy and operational guidance provided above, there are a number of more general lessons than can be gleaned from the experience of those countries that have implemented accrual accounting in the public sector:

- **First, the pace, scope, and sequencing of the reform depends crucially on the desired objectives. Countries focusing on improving management of government property may prioritize recognition of fixed assets over recognition of pensions or financial instruments in government balance sheets.** Countries wanting to enhance surveillance of public enterprises may consolidate these entities in financial statements before bringing in local governments.
- **Second, implementing accrual accounting is about much more than adopting new standards. Standards set principles, but most of the challenges reside in implementing these principles.** This requires the collection of additional data, reforms to business processes, modernization of IT systems, and capacity building both within and outside of government.
- **Third, it is important to preserve the benefits of cash and budgetary accounting even after completing the transition to accrual accounting.** Adopting accrual accounting should not and does not imply an end to reporting "hard" data on government cash flows and reserves. Moreover, presentation of financial statements in line with international standards should not and does not imply no longer presenting outturn data in format comparable with the annual budget.
- **Fourth, it is important to ensure an integrated set of financial data at each stage of the transition from cash to accrual accounting.** This requires a one-to-one correspondence between the additional stocks being recognized in balance sheets and the additional flows being recorded in flow statements. This enables standard consistency checks and audit techniques to be applied. Countries should make use of "dry run" accounts preparation and audits throughout the transition to gain an overview of the integrity of the financial data being produced, and provide feedback on the problems that need to be addressed.
- **Fifth, implementing accrual accounting in the public sector takes a long time.** Few countries have done it in less than three years and many countries have taken more than ten. Moreover, publishing the first set of financial statements is not the end of the story. Countries continue to improve the quality, coverage, timeliness, and relevance of their financial data many years after publication of their first set of accrual accounts.

[54] *GFSM 2014*, paragraphs 3.152-3.168. IMF (2008), Non-financial Public Sector Statistics-Consolidation, *GFSM 2001 Companion Material*.

APPENDIX I. CURRENT LIST OF IPSAS STANDARDS

Since 1997, the IPSAS Board has developed and issued 38 accrual standards, and a cash basis standard for countries moving toward full accrual accounting.

Accrual-based IPSAS

IPSAS 1 Presentation of Financial Statements

IPSAS 2 Cash Flow Statements

IPSAS 3 Accounting Policies, Changes in Accounting Estimates and Errors

IPSAS 4 The Effects of Changes in Foreign Exchange Rates

IPSAS 5 Borrowing Costs

IPSAS 6 Consolidated and Separate Financial Statements

IPSAS 7 Investments in Associates

IPSAS 8 Interests in Joint Ventures

IPSAS 9 Revenue from Exchange Transactions

IPSAS 10 Financial Reporting in Hyperinflationary Economies

IPSAS 11 Construction Contracts

IPSAS 12 Inventories

IPSAS 13 Leases

IPSAS 14 Events after the Reporting Date

IPSAS 15 Financial Instruments: Disclosure and Presentation (superseded by IPSAS 28-30)

IPSAS 16 Investment Property

IPSAS 17 Property, Plant and Equipment

IPSAS 18 Segment Reporting

IPSAS 19 Provisions, Contingent Liabilities, Contingent Assets

IPSAS 20 Related Party Disclosures

IPSAS 21 Impairment of Non-cash generating Assets

IPSAS 22 Disclosure of Financial Information about the General Government Sector

IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers)

IPSAS 24 Presentation of Budget Information in Financial Statements

IPSAS 25 Employee Benefits

IPSAS 26 Impairment of Cash-Generating Assets

IPSAS 27 Agriculture

IPSAS 28 Financial Instruments: Presentation

IPSAS 29 Financial Instruments: Recognition and Measurement

IPSAS 30 Financial Instruments: Disclosures

IPSAS 31 Intangible Assets

IPSAS 32 Service Concession Arrangements: Grantor

Accrual IPSASs forthcoming in 2017:

IPSAS 33 First-time Adoption of Accrual Basis IPSAS

IPSAS 34 Separate Financial Statements

IPSAS 35 Consolidated Financial Statements

IPSAS 36 Investments in Associates and Joint Ventures

IPSAS 37 Joint Arrangements

IPSAS 38 Disclosure of Interests in Other Entities

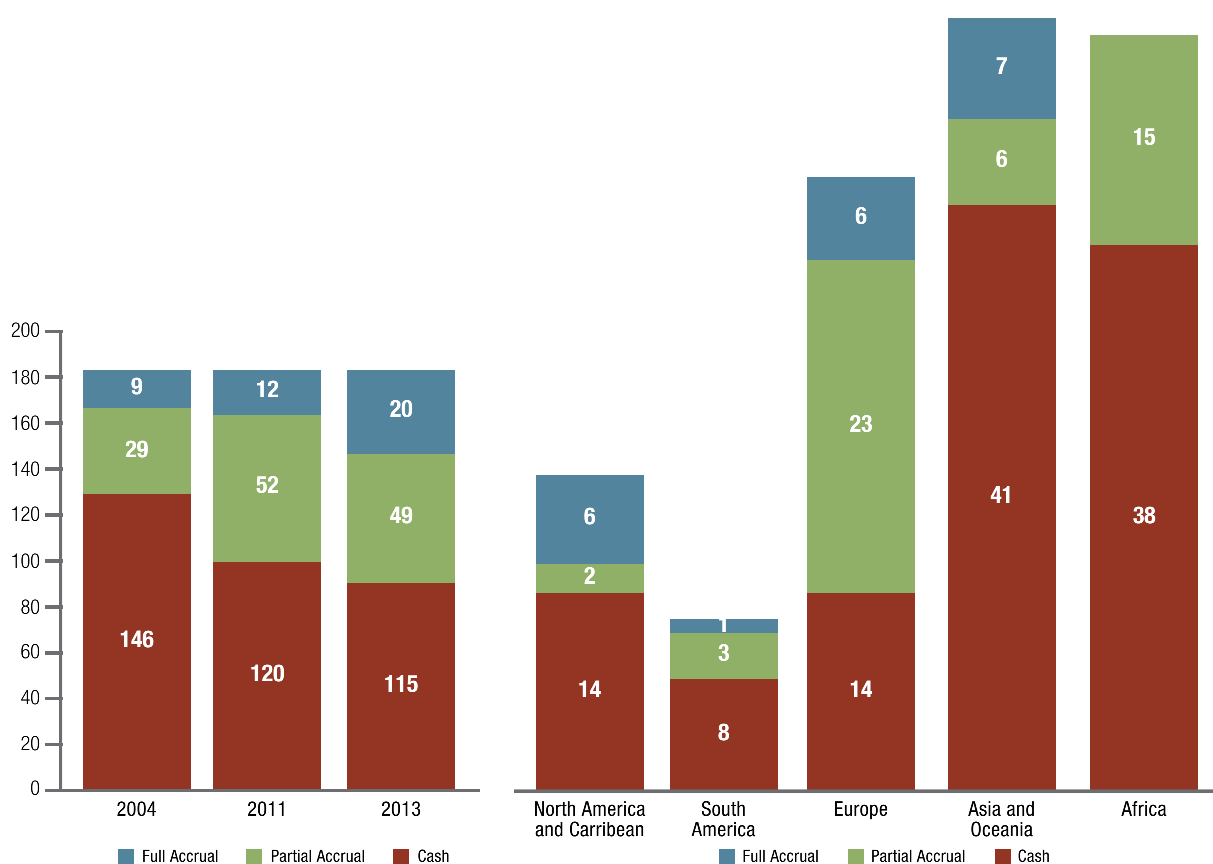
Cash-based IPSAS

Cash Basis IPSAS Financial Reporting Under the Cash Basis of Accounting

APPENDIX II. ACCRUAL BASIS FOR FISCAL STATISTICS

Trends in adoption of accrual accounting differ for financial accounts (or financial statements) and fiscal statistics. Indeed, while a significant number of countries have started reporting their statistics on an accrual basis (see Figure A. 1), less have followed a similar trend for their financial accounts. Indeed, fiscal statistics and fiscal statements are usually produced by different departments or offices within or outside of the ministry of finance (many countries have established independent statistical agencies). Fiscal statistics may be produced on an accrual basis despite financial accounts being on a cash basis, through making ad-hoc adjustments to cash data. Consequently, a country may produce different fiscal reports, with different basis of accounting.

Figure A.1. Trends in Adopting the Accrual Concepts in Fiscal Statistics



Source: GFSY 2004; GFSY 2011; GFSY 2013.

Source: GFSY 2013.

Note: Partial accrual includes countries that report transactions and other economic flows on an accrual basis but do not prepare a full balance sheet. Full accrual includes countries that record transactions and other economic flows on an accrual basis and publish a full balance sheet.

However, an underlying accrual based accounting system is important for ensuring the comprehensiveness and accuracy of accrual based fiscal statistics.[55] Countries that will implement a

[55] The European Commission has recently proposed a transition to accrual accounting for all its Members Countries, with the objective to increase the reliability of the fiscal statistics and improve regional surveillance of public finances.

transition to accrual accounting based on the phasing described above are therefore encouraged to reflect the accrual elements reported in their financial statements in their fiscal statistics. The tables below show how the accrual stocks and flows reported in the financial statements under the three phases described in this TNM can help populate accrual based fiscal statistics in compliance with GFSM 2014.

Balance sheet

		PHASE 1 ELEMENTARY ACCRUAL	PHASE 2 ADVANCED ACCRUAL	PHASE 3 FULL ACCRUAL
6	**Net Worth**			
61	**Non-financial assets**			
611	Fixed assets			
612	Inventories			
613	Valuables			
614	Non-produced assets			
62	**Financial assets**			
6201	Monetary gold and SDRs			
6202	Currency and deposits			
6203	Debt securities			
6204	Loans			
6205	Equity and investment fund shares			
6206	Insurance, pension and SGSs			
6207	Financial derivatives and ESOs			
6208	Other accounts receivable	*trade-related only*	*Other than tax*	
63	**Liabilities**			
6301	SDRs			
6302	Currency and deposits			
6303	Debt securities			
6304	Loans			
6305	Equity and investment fund shares			
6306	Insurance, pension and SGSs			
6307	Financial derivatives and ESOs			
6308	Other accounts payable			

Partial compliance
Full compliance
No disclosure

Statement of government operations

		PHASE 1 ELEMENTARY ACCRUAL	PHASE 2 ADVANCED ACCRUAL	PHASE 3 FULL ACCRUAL
1	**Revenue**			
11	Taxes	*cash*	*cash*	
12	Social contributions	*cash*	*cash*	
13	Grants			
14	Other revenue	*cash except sales*		
2	**Expense**			
21	Compensation of employees			
22	Use of goods and services			
23	Consumption of fixed capital			
24	Interest			
25	Subsidies			
26	Grants			
27	Social benefits			
28	Other expense			
	Operating balance (1-2)	*gross*	*gross*	
31	**Investment in non-financial assets**	*gross*	*gross*	
311	Fixed assets	*gross*	*gross*	
312	Inventories			
313	Valuables			
314	Non-produced assets			
2M	**Expenditure (2+31)**			
NLB	***Net lending / net borrowing (1-2M)***			
32	Net acquisition of financial assets			
33	Net incurrence of liabilities			

Statement of other economic flows[1]

		PHASE 1 ELEMENTARY ACCRUAL	PHASE 2 ADVANCED ACCRUAL	PHASE 3 FULL ACCRUAL
9	**Change in NW due to OEFs (4+5)**			
4	**Change in NW due to HGL**			
41	Non-financial assets			
42	Financial assets		*Other than tax*	
43	Liabilities			
5	**Change in NW due to OCV**			
51	Non-financial assets			
52	Financial assets		*Other than tax*	
53	Liabilities			

[1] Other economic flows (OEFs) in GFS refer to changes in the volume or value of assets and liabilities that do not result from interactions between institutional units by mutual agreement or through the operation of law. They include holding gains and losses (HGLs, resulting from changes in the level and structure of prices, e.g. revaluations) and other changes in volume (OCVs, e.g. write-offs, reclassification of units).

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