

Letter re Accrual Basis Accounting

BZ10-330 Letter re Accrual Basis Accounting

Parliamentary document: Letter to Parliament | 06-10-2010 | Finance

Speaker of the House of Representatives of the States General
P.O. Box 20018
2500 EA The Hague

Date: June 10, 2010
Subject: Mastwijk Motion on Accrual Basis Accounting

Our ref.: BZ/2010/330 M
Your letter (ref.)

Attachments: 5

Dear Mr. Speaker:

On March 31, 2009, via the motion of Member of Parliament Mastwijk (TK 2008-2009, 31865, No. 3), the government was requested clarifications in respect of:

1. the developments in other countries in the area of accrual basis accounting;
2. the real cost of introducing accrual accounting across the government;
3. the differences between cash basis accounting and accrual basis accounting in connection with European reporting requirements.

The background for this motion is the discussion of February 19, 2009 of the House on the letter of September 23, 2008 (TK 2008-2009 28737, No. 17), which reported on the findings of the pilot project involving the implementation of accrual basis accounting in the Ministry of Agriculture, Nature and Food Quality. Based on the results of this pilot, the government looked at the advantages and disadvantages of full introduction of accrual basis accounting and concluded that the added value brought by implementation of accrual basis accounting is limited.

Purpose of this letter

The purpose of this letter is to summarize the three points in the motion introduced by Member of Parliament Mastwijk. Section 1 looks at developments in other countries and reports on international developments (purpose of research, choice of countries, further research on a few

countries). The experience with and application of budgetary systems in 14 OECD countries is then reviewed, along with the most recent academic findings on accrual basis accounting. The University of Amsterdam was commissioned by the government to conduct this academic research. Section 2 discusses the real costs of implementing accrual basis accounting across the government. Estimates of the cost of introducing accrual basis accounting in core departments are provided and substantiated. Section 3 looks at the European Commission's reporting requirements for government finances.

Attachments

Five attachments are included with this letter. Attachment 1 contains the complete study of the international developments and experience with accrual basis accounting. It was coordinated with the Auditor General's Office (Algemene Rekenkamer). Attachment 2 reports on the research that was done on the real cost of introducing accrual basis accounting government wide. This research was coordinated with the Center of Expertise (Het Expertise Centrum–HEC). Attachment 3 contains a report on the differences between the budgetary systems in connection with European reporting requirements. It was coordinated with the Central Bureau of Statistics (CBS). Attachment 4 contains the academic research done by the University of Amsterdam. Attachment 5 provides background material. It discusses the situation as regards accrual basis accounting in the Netherlands and looks at the key differences between cash basis accounting and accrual basis accounting.

1.1 International Experience of 14 OECD Countries

This section summarizes the experience with and application of budgetary systems in 14 OECD countries (for the complete research, see Attachment 1). The countries concerned are Australia, New Zealand, the United Kingdom, the United States, Canada, Switzerland, Germany, Austria, France, Denmark, Sweden, Norway, Romania and Lithuania. These are countries with varying views and backgrounds in the area of public administration and public finances, and thus provide a broad international perspective. The Scandinavian countries, English-language countries, countries that follow the Rhine model, and new members of the European Union are examined.

This section begins by looking at the reasons for introducing accrual basis accounting in the various countries, followed by a discussion of the specific details. Implementation is then discussed, and the section concludes with a description of the experience with accrual basis accounting systems.

The research suggests that there are many different reasons for considering accrual basis accounting:

- Some countries see it as a logical step to first introduce accrual basis accounting on a pilot basis in some line divisions, and then to expand it to the core ministries. In this way, the budgetary systems will be harmonized.
- Other countries see accrual basis accounting as an instrument for imposing sound financial management and enhancing the transparency of the budget and the accounts.
- A few countries have been led by national or international developments to reform their budgetary systems. In France, international trends, including accrual basis accounting, were

considered when its reforms were planned, while Germany saw the developments taking place in its states and municipalities as a reason for reform.

- In Romania and Lithuania, the European Union is playing a role in implementation (planning). In Romania, the policy decision has been influenced by the requirements of Eurostat and the European twinning programs. In Lithuania, the accounting requirements of the EU Structural Funds have played a role in the decision to switch to accrual basis accounting starting in 2010.
- Finally, New Zealand, the United Kingdom and Australia were the front-runners, having introduced accrual basis accounting some ten years ago. They believed that this was a logical part of the “New Public Management.” Along with other reforms in the public sector (such as output based budgeting), accrual basis accounting was introduced to achieve greater efficiency and transparency in the government.

Reasons for the chosen budgetary system

The research showed that countries chose different approaches for their central government budgetary systems. The differences in the approaches result directly from the reasons for the reform and from the political system. As a result, different types of budgetary systems are found.

Five countries – New Zealand, Australia, Switzerland, Denmark and the United Kingdom – chose a full accrual basis system. This system uses accrual basis accounting as the foundation for the accounts and the budgets of the core ministries and agencies.¹ As well, this approach uses financial reports that are also used in the private sector, such as the balance sheet, the income statement and the cash flow statement.

Five countries – Canada, France, the United States, Sweden and Romania – chose to use a modified accrual basis system. In all of these countries, cash basis accounting is used for the budget, and an accrual basis system is used for the accounts to supplement the cash basis information. As in the case of a full accrual basis system, a (government) balance sheet is generally used.

Two countries – Germany and the Netherlands² – use a modified cash basis system. Cash basis accounting is used for both the budget and the accounts of the core ministries, but for some items it is supplemented by accrual basis information. Alongside this, the Netherlands also uses a commitment based accounting system. Agencies, external autonomous administrative entities (such as ZBOs and RWTs), municipalities and provinces use accrual basis accounting in the Netherlands. In Germany, some (primarily large) agencies use accrual basis accounting.

Three countries – Norway, Lithuania and Austria – use a full cash basis system. Cash basis is used for both the budget and the accounts of the core ministries, but for some items is supplemented with accrual basis data. Agencies in both [sic] countries use cash basis accounting.

¹ Different types of agencies exist around the world. Generally, an agency is an autonomous unit of a ministry that is responsible for its own management.

² The Netherlands is not one of the countries studied, but is included for comparison purposes only.

Implementation

Although accrual basis accounting has been implemented in various ways in the countries studied, it appears that for all countries it was a complex and wide-ranging process. The training of staff, compliance with accounting directives, the introduction of updated information systems, the valuation of assets, and the decision on where accrual basis accounting was to be implemented (budget and/or the accounts) were all factors.

Among the countries using a full accrual basis accounting system, only Australia and Switzerland chose simultaneous implementation for the budget and the accounts. Switzerland reports that implementation of full accrual basis accounting required a considerable effort, but that no major problems were encountered. Other countries implemented accrual basis accounting gradually, starting with agencies, then the accounts, and then, possibly, the budget, but implementation did seem to be a complicated matter nonetheless. France, Sweden, and the United States do not use accrual basis accounting for the budget. Canada is still considering this. Norway, Germany, Lithuania and Austria see the introduction of accrual basis accounting for the accounts as difficult, with Lithuania expecting to take this step in 2010. After consideration, Norway and Germany have decided not to take this step.

Many countries are still in the middle of the implementation process. Some ten years after implementing accrual basis accounting, Australia has still not succeeded in creating a fully functional financial information system, and it is currently working on the development of its third system. In the United Kingdom, the poorly functioning financial information system became a bottleneck during the implementation of accrual basis accounting. In France, a new information system is being implemented as the old system cannot deliver the desired policy information and accrual basis data. Not all countries encountered serious problems with their information systems, however. Denmark and Sweden report that their systems required only minimal adjustments. Both countries benefited a great deal from the experience of their agencies in this regard. All countries report that at the beginning of the implementation process a great deal of energy was spent on the valuation of their assets and liabilities, and this apparently remains an ongoing concern in New Zealand and the United States.

The lack of knowledge of accrual basis accounting is an obstacle to implementation in many countries. It appears that the civil service cannot compete with the business sector in attracting employees who are experienced with accrual basis accounting. France, Australia and Switzerland brought in external consultants (to a greater or lesser extent). In Germany, lawyers traditionally predominate in government institutions, while Romania suffers from a chronic shortage of accountants. In Australia, line ministries have difficulty attracting financial staff, and Lithuania already foresees problems with the planned implementation of accrual basis accounting for the accounts owing to the shortage of accountants. Apart from attracting and retaining staff, training is seen as a critical factor for successful implementation of accrual basis accounting in many countries.

The accounting directives also play an important role in the implementation of accrual basis accounting. Generally, countries took a pragmatic approach in this area. All countries, including

those that specifically state that they follow the IFRS³ or IPSAS⁴ guidelines, use a national interpretation of these reporting guidelines. Canada and the United States use their own standard, which is not based on either IPSAS or IFRS. Australia, New Zealand and the United Kingdom are the only countries that apply the IFRS guidelines. Switzerland, Sweden, Denmark and Romania use IPSAS as their accounting standard.

Experience

The research shows that experience with the implementation of accrual basis accounting varied from country to country. Of the trail blazers, the United Kingdom reports that the reactions to the introduction of accrual basis accounting were generally positive (including the reaction of Parliament). The New Zealand Treasury also reports that the reform of the budgetary system has brought added value. No formal, published evaluations were prepared in either New Zealand or the United Kingdom. Such an evaluation was prepared in Australia (both by the Department of Finance and Parliament). The “Operation Sunlight” evaluation report issued by the Australian government discusses the budget process in detail, with the emphasis being on improving the transparency and openness of the process. After the introduction of accrual basis accounting and output based budgeting, Parliament felt that it had less influence on the management of the budget. The report has recommended a reform agenda for the budgetary system that focuses on the entire relationship between Parliament and the government, including accrual basis accounting. One of the proposed reforms is to allow budget allocations to be cash basis rather than accrual basis. Denmark and Switzerland are countries that have recently switch to accrual basis accounting. Both countries report that it is too early to come to any conclusions about the specific benefits achieved.

The main benefits of accrual basis accounting that are mentioned are:

- Information on costs: Accrual basis accounting brings the costs of government activities into better focus.
- Information on the financial position: The valuation of assets and liabilities provides a better understanding of the government’s financial position. In fact, Australia, the United States and New Zealand give this as one of the reasons for the introduction of accrual basis accounting. It should be noted in this regard that while preparation of a government balance sheet is an essential component of accrual basis accounting, a balance sheet can also be prepared in a cash basis accounting system.
- Harmonized reporting: Sweden and Switzerland report that the introduction of accrual basis accounting resulted in fewer reporting differences between the private sector and the government and among government institutions.

The most significant disadvantages of accrual basis accounting mentioned by all countries are:

- Its complexity: Most countries concur in the view that an accrual basis accounting system is more complex than a cash basis system. They report that the financial information provided by an accrual basis system is more complex.
- Accessibility of financial data: France, Germany and Norway prefer not to prepare the budget on an accrual basis as this makes the financial data less accessible for Parliament. Cash

³ International Financial Reporting Standards.

⁴ International Public Sector Accounting Standards.

basis budgeting is seen as more reliable, as it gives a better overview of the budget. Australia and the United States had similar experiences. This is one of the reasons why most countries that introduce accrual basis accounting for the accounts still choose cash basis accounting for the budget.

- Little added value: Germany reports that accrual basis accounting provides little added value in the core ministries. Accrual basis information is relevant for a maximum of 20 percent of the expenditures of the core departments; for the remainder it makes little difference which system is used.
- Decentralization of authority: Norway states that accrual basis accounting involves a decentralization of authority. The authority comes to lie more with the administrators and financial experts; it is shifted from the political level to the administrative level.

Experience with the effects of accrual basis accounting on Parliament's authorization function varies considerably from country to country. Australia reports that Parliament has felt a loss of influence since the introduction of the budget reforms. As well, it indicates that cash basis information is important for Parliament: the questions asked by Parliament during the debate on the budget and the accounts are mainly about cash outlays and cash income. The same view is expressed by the United States. Both the United States and Australia find that cash basis information and accrual basis information complement each other for the performance of the authorization function by Parliament. The United Kingdom and New Zealand state that the authorization function is performed better under an accrual basis accounting system. Parliament receives better, more targeted information that clearly indicates the link with the objectives. The Parliament in Switzerland indicates that the type of budgetary system does not have a great deal of impact on decision-making. France, Germany and Norway prefer cash basis accounting for Parliament's authorization function. In Germany, the budget process has changed little over the past few decades. Parliament has gained an affinity with the budget process over the years and is cautious about suddenly discarding all of the experience and knowledge that has been built up. The Canadian Parliament has recommended to the government that the budgets of the ministries also be prepared on an accrual basis. Sweden differs in arguing that the difference between the two systems is minimal, but it does deliberately choose to prepare the budget on a cash basis.

1.2. Academic research

As many scholars have commented, it is naive to assume that a bookkeeping system is a system without value judgments – a system that simply provides information on the financial reality of organizations. Bookkeeping systems do have corporate and normative role. They provide information on the financial status of an organization as seen through its (financial) value. Cash and accrual basis accounting systems represent two different bookkeeping traditions, each with their own normative basis, and several variations of the two systems are used. In contrast to a pure cash basis system, a pure accrual basis system originates in the business sector, with the underlying principle of this system being to facilitate the maximization of profits.

Although experience with the use of accrual basis accounting in the central governments dates back as much as 20 years in some countries, academic research on accrual basis accounting is meager. Until now, the emphasis in academic research has been on transparency and costs, on the impact on decision-making, and on the accessibility and use of information.

Scholarly research shows that using an accrual basis accounting system makes it more difficult to compare financial performance from year to year. The reason for this is the continuous change in the unit of measurement of product groups and therefore the costs allocated to them. Accrual basis accounting encourages investment in the financial information system and training, for example. The research also shows that additional financial staff must be engaged, and that there are also costs involved in setting up and maintaining the information system. The academic research also emphasizes the limited importance that management assigns to accrual basis information. It appears that accrual basis data is often compiled by financial staff outside the organization itself and, as a result, this information has little effect on the organization's corporate processes and is therefore of little use to management. Finally, the extent to which Members of Parliament understand and use accrual basis data is unclear.

Although considerable empirical research must still be done, there is little doubt among academics that accrual basis accounting does not live up to the ambitious expectations of its advocates. A report by the Office of the Auditor General of New Zealand reports that the results of accrual basis accounting are disappointing in terms of the quality of the current financial accounting standards and a lack of experience of users in the public sector. The Australian Parliament recently submitted a report to the OECD that notes a number of deficiencies of accrual basis accounting for the purposes of the Members of Parliament. The Australian Department of Finance states in the Operation Sunlight report that more than 10 years of accrual basis accounting in the central government has not led to better information on policy costs.

The foregoing means that caution is warranted in the implementation of accrual accounting by central governments – caution not only because the existing international standards are directly based on the experience of the private sector, but also because the application of these standards to the public sector is driven by a naive conviction of the superiority of the financial tools used by the private sector. In the English-speaking countries this conviction is expressed in the willingness to adopt accrual basis accounting without a robust understanding of its effects. With the collapse of Enron and the debate about the causes of the current financial crisis, more and more objections are being raised about the professional standards applied in the financial system, in terms the role of the accounting profession, the oversight role, and the valuation methodology. For the public sector, these objections provide an opportunity to further develop the existing public sector accounting systems, in a way that does justice to the unique nature of the central government.

2. Cost of government-wide implementation of accrual basis accounting

Based on the experience in other countries, it is not possible to say a great deal about the real cost of implementing accrual basis accounting across the government. No country that uses accrual basis accounting has kept systematic records of its cost. Countries that do give an amount base it on a rough, limited estimate of the investment in the financial information system. Moreover, the estimates vary so much that no general conclusion can be drawn.

Therefore, for the above reasons, the quantitative data shown in the international research was not used to estimate the cost. Use was made of the qualitative information, however. Also,

literature on accrual basis accounting has been consulted, and the experience with accrual basis accounting within the Netherlands was looked at.

The research was coordinated with the Center of Expertise (Het Expertise Centrum–HEC). During the period from mid-January to end-February 2010, drafts and the final version of the report were reviewed by the HEC. The HEC tested the assumptions and cost estimates as shown in the final report and found them to be realistic. Any comments made have been included in the final report (see Attachment 3).

The implementation costs are divided into incidental, or one-off, costs and structural costs. The incidental costs can be divided into five categories: (1) the IT systems; (2) personnel; (3) the valuation of existing assets; (4) the implementation process; and (5) legislation and regulations. The structural costs are divided into three categories: (1) personnel; (2) the maintenance of the IT systems; and (3) the annual valuation of assets.

The exact cost of government-wide implementation of accrual basis accounting is difficult to determine as there is still a great deal of uncertainty regarding the detailed requirements of the system and the wish list for the system functions. Therefore, in the calculation of the costs, a lower threshold and upper threshold were used. The lower threshold is based on adaptation of the current IT system and a low degree of risk. The upper threshold is based on replacement of the current IT system and a high degree of risk. The actual cost will most likely lie between the two.

The incidental costs are estimated at between € 129 million and € 261 million. The annual structural costs are estimated at between € 13 million and € 28 million. Table 1 provides an overview by category.

Table 1: Overview of the Cost of Government-Wide Implementation of Accrual Basis Accounting		
Incidental (one-off) costs	Lower Threshold	Upper Threshold
IT systems	€ 30 million	€ 71 million
Personnel	€ 16 million	€ 25 million
Valuation of assets	€ 11 million	€ 22 million
Change process	€ 72 million	€ 143 million
Total implementation	€ 129 million	€ 261 million
Structural costs		
Personnel	€ 6 million	€ 14 million
Maintenance of IT systems	€ 2 million	€ 4 million
Valuation of assets	€ 5 million	€ 11 million
Total structural costs per year	€ 13 million	€ 28 million

3. European reporting requirements and submission of the EMU balance

National Accounts

The CBS has prepared the national accounts of the Netherlands for more than 65 years. The national accounts provide information on developments in the Dutch economy. This information is important for economic policy making. The national accounts include key figures such as economic growth, inflation, unemployment, and the income and expenditure and financing of

sectors of the Dutch economy. The CBS publishes the national accounts annually. More recently, it has begun publishing the key national accounts figures on a quarterly basis.

Purpose of the ESA

Member states of the EU are required to use the European System of National and Regional Accounts 1995 (ESA 1995) to prepare their national accounts. Because use of the ESA is mandatory, economic data are comparable from country to country. In the ESA, it is not the cash transaction that is relevant, but rather the point in time when the underlying economic transaction takes place. The ESA belongs to the family of accrual basis accounting systems, and the fact that the ESA is referred to in English as “accrual accounting” does lead to misunderstandings as it can suggest that the ESA is equivalent to an accrual basis accounting system and vice versa, when in fact this is not entirely the case.

Reporting on Government Finances to the European Union and the IMF

The Netherlands is committed to reporting the EMU balance on a monthly basis to the IMF and on a quarterly and yearly basis to the European Union. Although the government uses a cash accounting system, the (statistical) information on the government – which is needed for these reports to Europe and the IMF on such things as the EMU balance and EMU debt – can in practice be generated relatively easily from the cash basis data in the government budget and government balance sheet. Naturally, corrections of the cash amounts are needed, but the number of corrections is actually quite small.

In an accrual basis accounting system, shadow cash basis records (such as cash flow statements) must be maintained. This is not just for monitoring and reporting on the key budget variables, but also because information on the amount of financing that must be obtained on the money and financial markets by the Funding Agency to cover the government’s actual deficit is and remains necessary. It is also useful to have cash basis figures on government finances available for the European Commission’s process of verification of the member countries’ EMU figures. The issue of the Greek statistics has demonstrated the importance of cash basis figures.

Local governments

It is also useful to look at the experience of local governments with reporting. Local governments use accrual basis accounting for their budgets. The experience to date has shown that the quarterly and yearly reporting (and for that matter monitoring) on the EMU balance on the basis of available accrual basis data of the local governments is complicated. Conversion of the accrual basis figures of the local governments to ESA 1995-compliant figures requires specialized knowledge, which is scarce in the local governments

Monitoring

It is not just the European Union that uses the key EMU balance and EMU debt variables. Other international organizations such as the IMF and OECD use these variables, which also form the basis of the Dutch budget policy. It has been possible to use information from the cash basis

system for the national and international monitoring of the EMU balance and EMU debt. In the government's budget policy, control of government finances via the expenditure frameworks and income indicators is the primary concern. These amounts are defined in cash terms. This means that information needed for monitoring purposes to test the expenditure frameworks and income indicators is directly available from the cash basis accounting system.

National control based on the expenditure frameworks

Controlling government expenditure via the expenditure frameworks and income indicators means that (relevant) information must be reported and available on a cash basis. In an accrual basis accounting system, expenditure frameworks and income indicators cannot be linked to the government budget individually; instead a fairly complicated conversion is needed.

Yours sincerely,

J.C. de Jager
Minister of Finance

Attachments

BZ10-330 Attachment 1: International Experience with Accrual Basis Accounting Systems
Parliamentary paper | 06-10-2010 | Finance

BZ10-330 Attachment 2: Cost of Government-Wide Implementation of a Full Accrual Basis Accounting System
Parliamentary paper | 06-10-2010 | Finance

BZ10-330 Attachment 3: European Reporting Requirements and Submission of the EMU Balance
Parliamentary paper | 06-10-2010 | Finance

BZ10-330 Attachment 4: Academic Research
Parliamentary paper | 06-10-2010 | Finance

BZ10-330 Attachment 5: Background Document
Parliamentary paper | 06-10-2010 | Finance