



Enhancing Transparency and Sustainability in Financial Reporting via Accrual-Based Accounting

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Topics covered

1 Accrual Based Accounting VS Cash Based Accounting

- Concept and Differences
- Information and Transparency

2 Main Conversion Challenges and Impact

3 “Towards Transparency” - *A study conducted by Ernst & Young and the Institute of Public Management at Zurich University of Applied Sciences*

Transparency of Financial Reporting reduces the likelihood of unexpected surprises...

Essence of a Financial Crisis:

1. Unexpected
2. Default (or near/partial)
3. Debt (likely to spill over in a connected world)

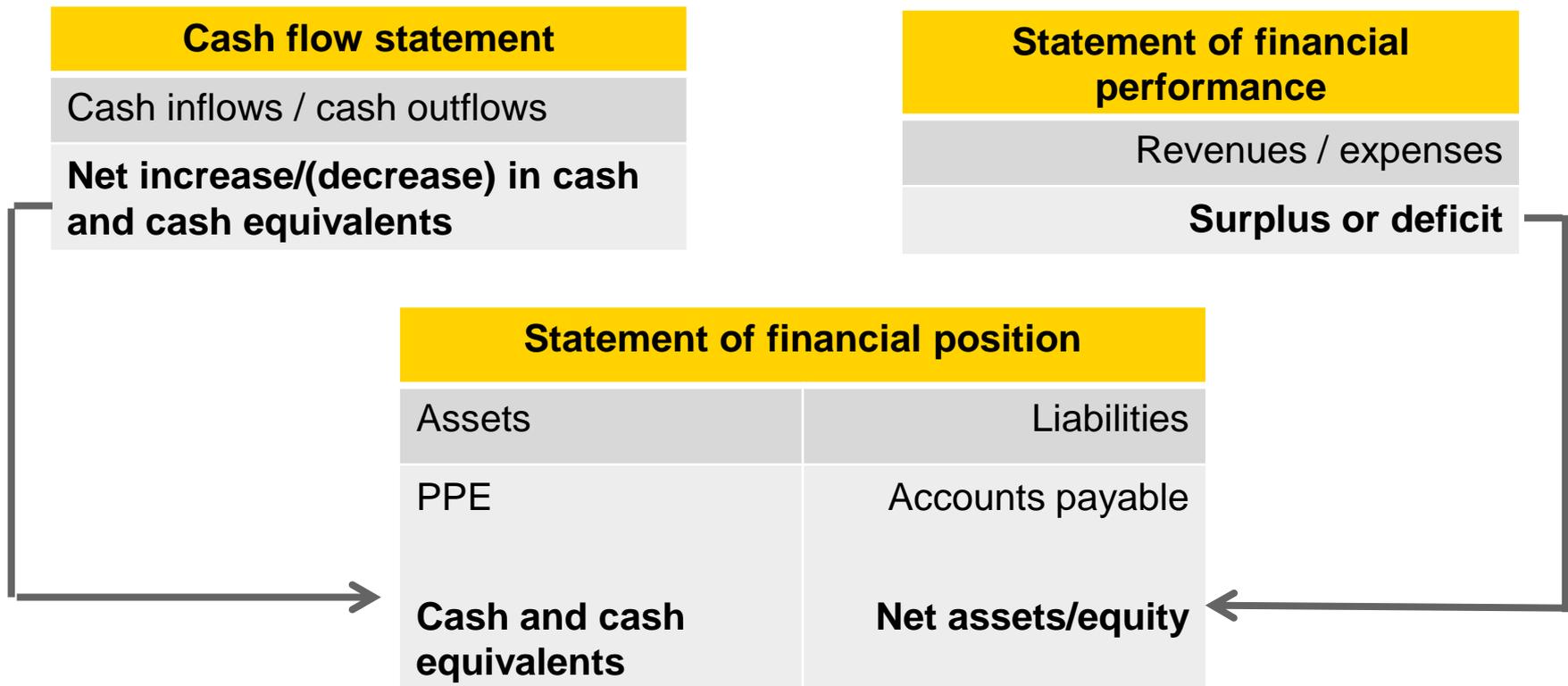


A closer look...

- ▶ The subprime-debt crisis: Securitization obscured quality of underlying debt
- ▶ The government interventions: Financial guarantees are often not disclosed, nationalized entities often not consolidated, toxic assets are not tracked in cash basis of accounting

Meaning – What is accrual accounting?

“Under the **accrual basis of accounting**, transactions and other events are recognized in financial statements when they **occur** (and not only when cash or its equivalent is received or paid)..” (*Conceptual Framework, Introduction, 2013*)



Differences – Accrual accounting vs. Cash accounting

Areas	Accrual Basis	Cash Basis
Revenues	Recorded when they are <u>earned</u> , which may be before or after they are received	Recorded when they are <u>received</u> , which may be before or after they are earned
Expenses	Recorded when they are <u>incurred</u> , which may be before or after they are paid	Recorded when they are <u>paid</u> , which may be before or after they are incurred
Financial Statements	<u>Match</u> revenues to the expenses incurred in earning them, and more accurately reflect the results of operations	Financial statements reflect revenues and expenses based on when <u>transactions</u> were entered rather than when revenues were earned or expenses incurred
Receivables	A receivable is recorded when payment is <u>not received</u> at the point of sale	No receivables are recorded
Payables	Payables are recorded when payment is <u>not made</u> at the time of purchase	No payables are recorded
Payments	Revenues and expenses are recorded in <u>full</u> , even though partial payments may be made over extended time periods	No method of tracking partial payments is available

Information required in adoption of Accrual accounting

Financial Position

- ▶ Maintain **complete records** of assets and liabilities
- ▶ A **consistent framework** to identify, depreciate and amortize assets
- ▶ A **consistent framework** to identify existing liabilities, and potential or contingent liabilities
- ▶ **Residual** figure, net assets/equity comprising of:
 - ▶ Contributed capital
 - ▶ Accumulated surpluses and deficits
 - ▶ Reserves (e.g revaluation reserve; foreign currency translation reserve)

Financial Performance

- ▶ **Revenues and expenses**, including the impact of transactions where cash has not yet been received or paid
- ▶ Recognition of the **total costs**, including depreciation of physical assets and amortization of intangible assets
- ▶ Recognition of all **employee-related** costs

Cash Flow

- ▶ Comprehensive information on current cash flows and certain projected cash flows, including the cash flows associated with **debtors and creditors**

Accrual accounting enhances transparency, accountability and ease of audit

Financial Position

- ▶ Demonstrate accountability to the public for their **management of assets and liabilities** recognized in the financial statements
- ▶ Plan for future **funding requirements** of asset maintenance and replacement
- ▶ Plan for the **repayment** of, or satisfaction of, existing liabilities
- ▶ Make decisions about the **level of assets** and debt held in the context of financing the services they wish to provide

Financial Performance

- ▶ Consider the **cost consequences** of particular policy objectives and the cost of alternative mechanisms for meeting these objectives
- ▶ Decide whether to **fund** the production of services within sub-entities, or whether to purchase goods and services directly from third party entities
- ▶ Consider the **costs** of particular services in relation to user fees
- ▶ Allocate **responsibility** for managing particular costs

Cash Flow

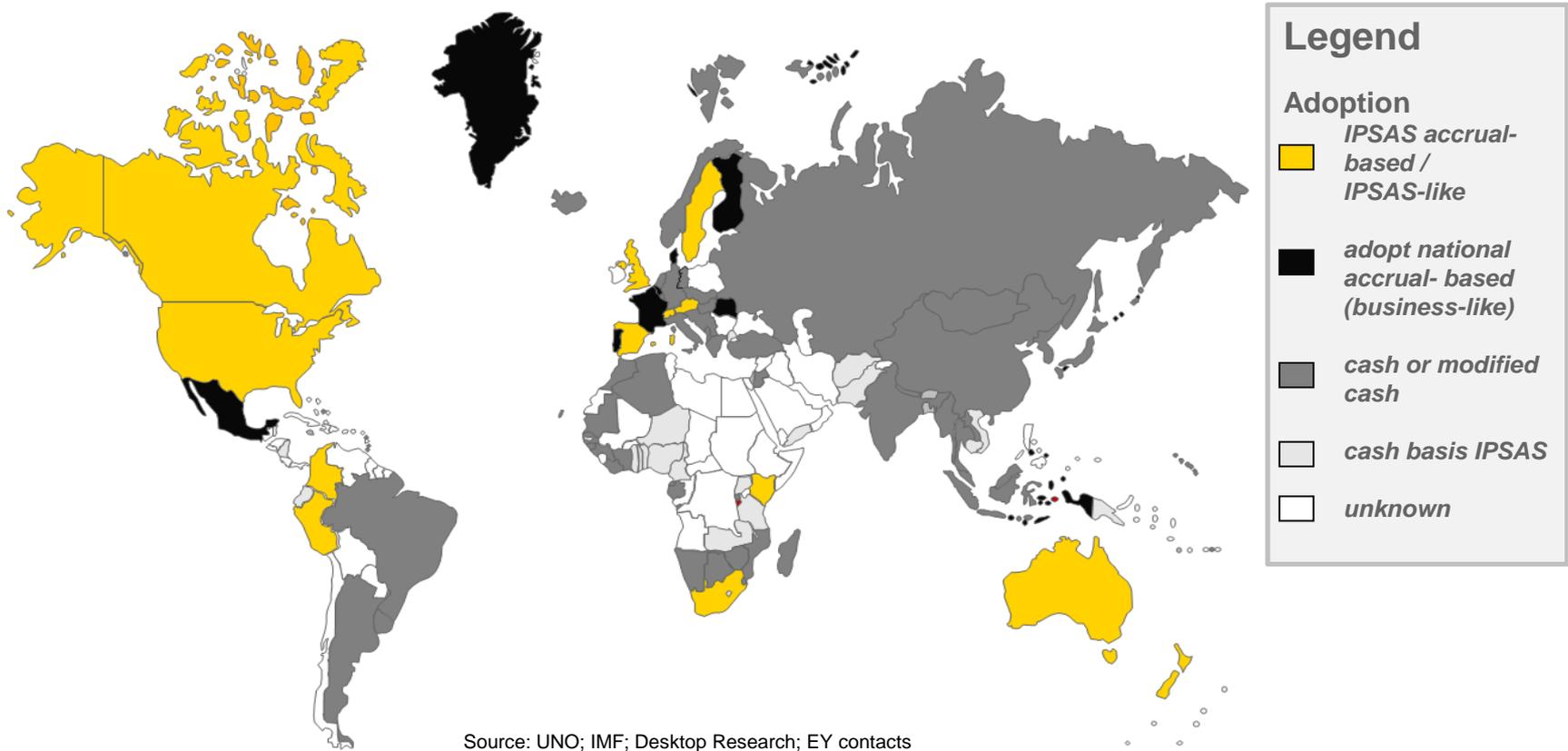
- ▶ Better **cash management** and may assist in the preparation of more accurate cash budgets

Benefits of Accrual accounting vs. Cash accounting in enhancing transparency

- ▶ **Full view** of assets and liabilities – the countries’ “net financial position”
- ▶ Shows **service potential** embodied in public infrastructure
- ▶ Provides a complete **financial overview** of an entity through consolidated financial statements
- ▶ Forms the **basis** for the General Purpose Financial Statements (GPFS) analytical framework
- ▶ Fair presentation of assets and liabilities **enhances transparency** in reporting and better represents debt capacity
- ▶ Enables measurement of **efficiency** in operating and maintaining pools of assets
- ▶ Enhances management of and **accountability** for capital expenditures and related assets
- ▶ **Recognition** of borrowings and other liabilities, e.g. pensions, places focus on measuring and managing all financial obligations
- ▶ Allows for more **control** over financial management processes (e.g. Accounts Receivable/Payable accounting)
- ▶ **Exposure** of governments to guarantees and other obligations will be detected earlier rather than when default occurs
- ▶ Transparent reporting assists in debt ratings and can lead to **lower** borrowing costs



Overview of countries which plan or already adopt IPSASs



Cash Basis IPSASs	National cash basis	Accrual basis IPSASs	IPSAS-like/National accrual basis	Unclear
22	8	22	23	8

IFAC Study, April 2012, not published

Overview of supranational organisations using IPSAS

- ▶ Major supranational organisations which plan or already adopt IPSAS.

 <p>The Commonwealth Secretariat</p>	 <p>International Federation of Accountants</p>
 <p>COUNCIL OF EUROPE CONSEIL DE L'EUROPE</p> <p>Council of Europe</p>	 <p>INTERPOL</p>
 <p>European Union</p>	 <p>NATO</p> <p>North Atlantic Treaty Organisation</p>
 <p>EUMETSAT</p> <p>European Organisation for the Exploitation of Meteorological Satellites</p>	 <p>ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT OECD</p> <p>Organisation for Economic Cooperation and Development</p>
 <p>esa</p> <p>European Space Agency</p>	 <p>United Nation</p>

Objectives

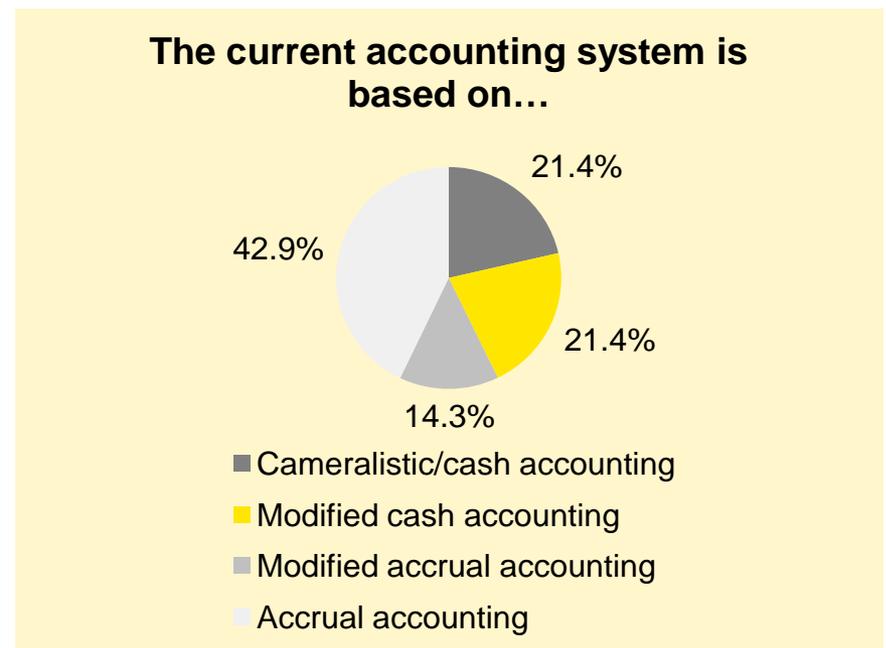
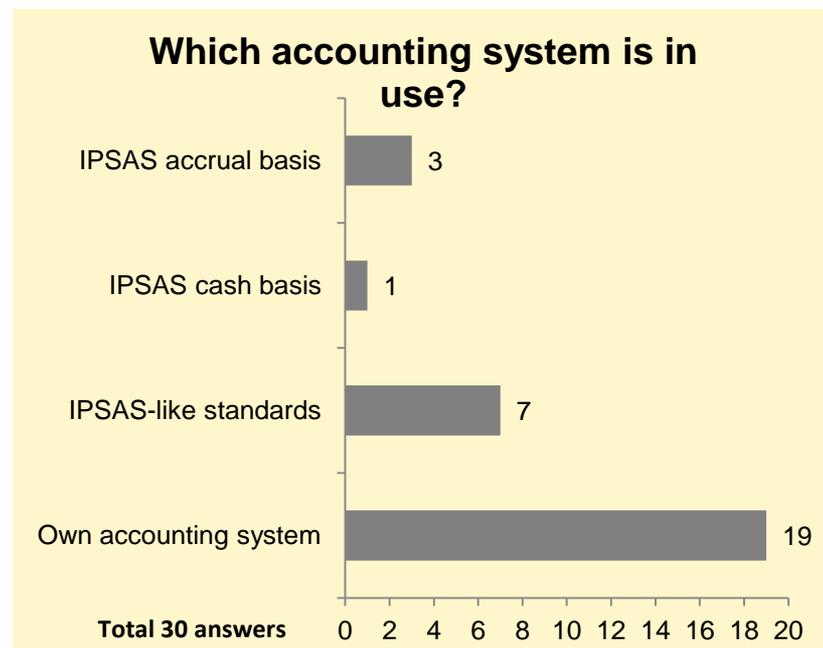
The main objectives of this study are:

- ▶ Get a picture of the current status of worldwide public sector accounting
- ▶ Identify trends and developments in public sector accounting
- ▶ Evaluate awareness and acceptance of IPSAS
- ▶ Reveal main obstacles in implementing new accounting systems
- ▶ Results shall contribute to the further development of public sector accounting



Country-specific accounting systems on (Modified) Accrual basis are common

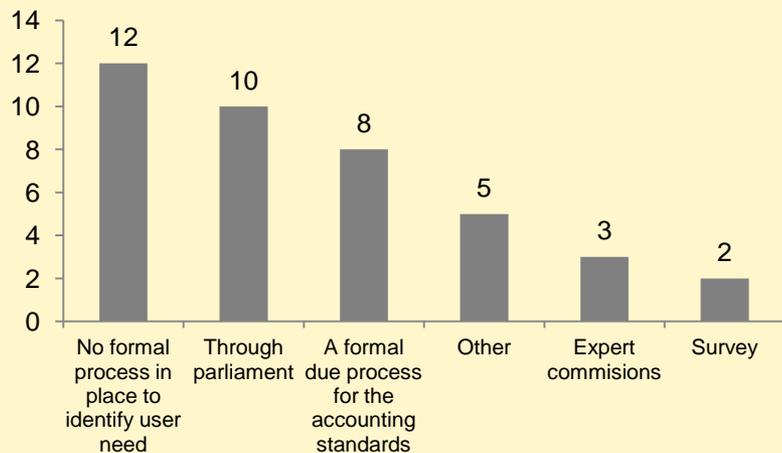
- ▶ In most of the countries the government (or a ministry) is the legal authority that issues the national standards
- ▶ Using an own national accounting system is common
- ▶ Accrual accounting is used by the majority of the countries



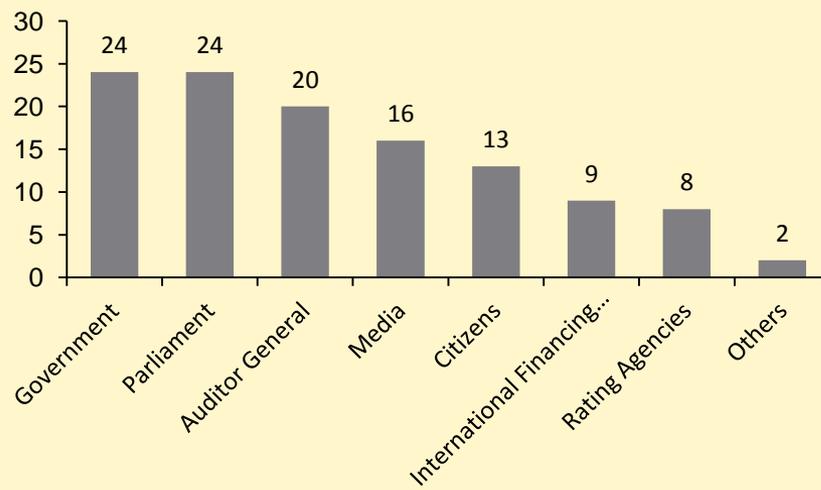
Public consultation, but not focused on identification of user needs

- ▶ Although a majority of countries claim to have a “public consultation process” before new regulations are issued, there is generally no formal process to identify user needs
- ▶ Citizens and rating agencies are not seen as main users

Identification of the different user needs regarding governmental financial reporting

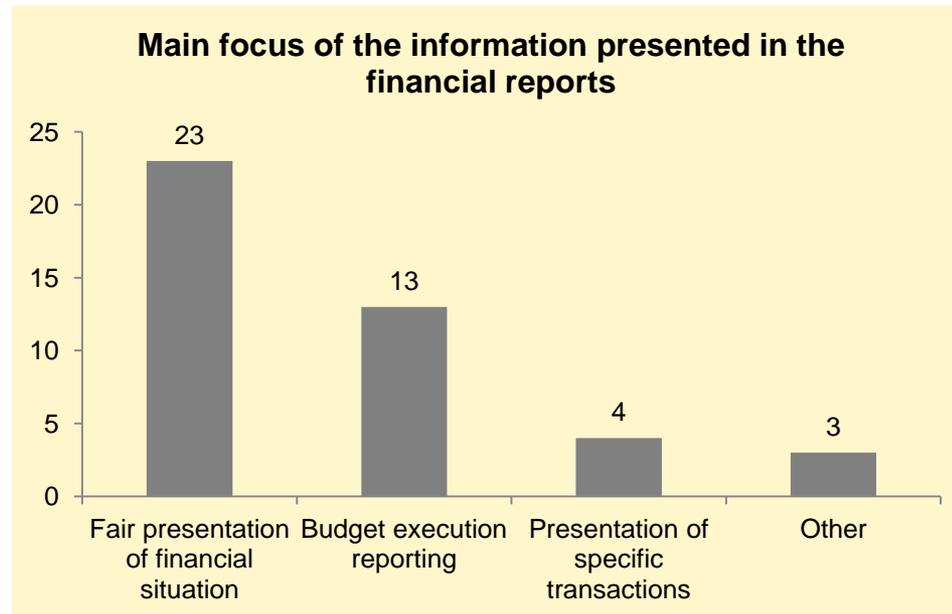


Main users of governmental financial statements



Fair presentation is seen as the leading principle – irrespective of the accounting system

- ▶ No common understanding of “fair presentation”
 - ▶ Even countries still on cash (or modified cash) basis accept fair presentation as being the leading accounting principle
 - ▶ But: the same countries doubt whether balance sheet / income statement is necessary in the public sector

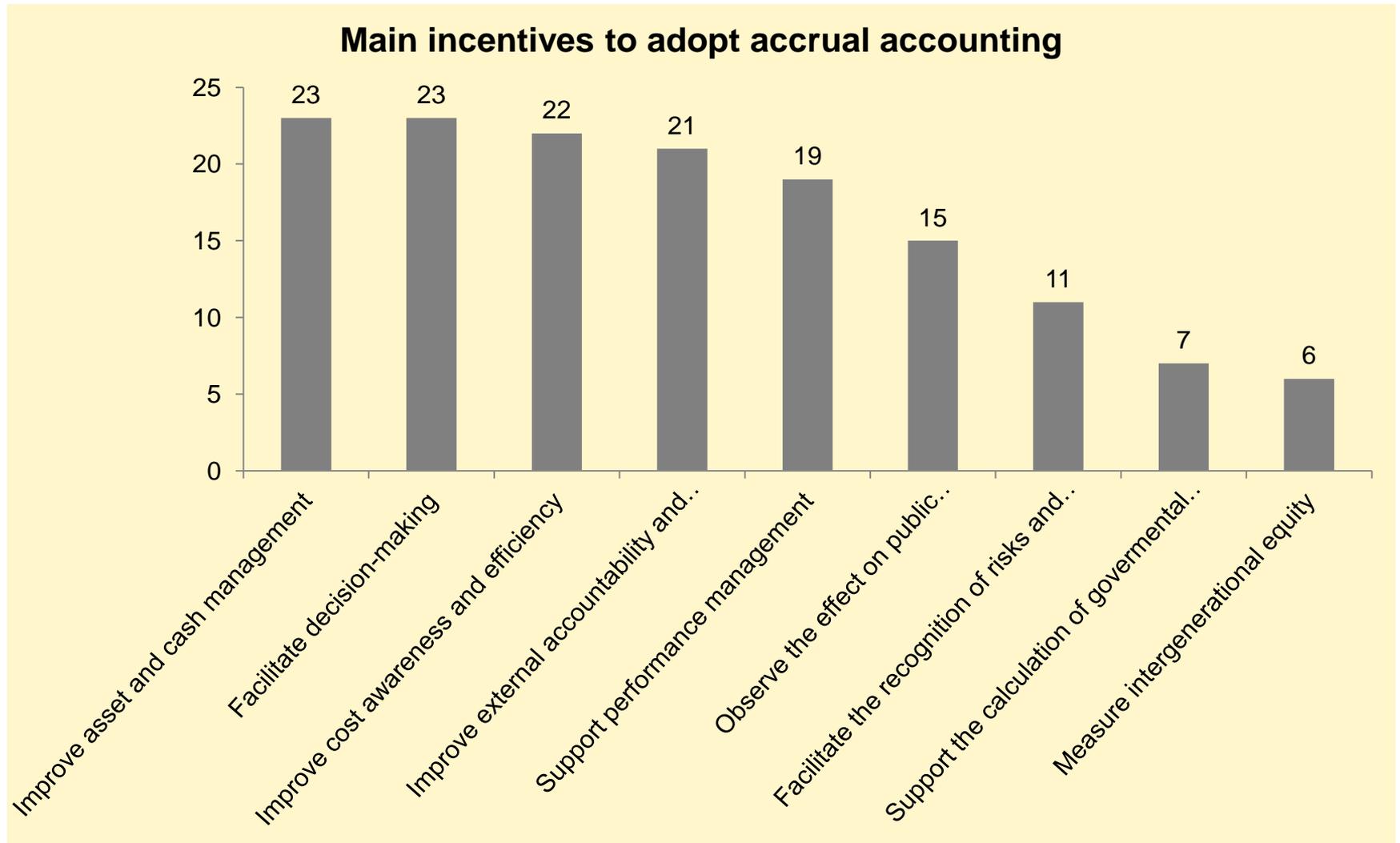


Better financial reporting and comparability are important reasons for new accounting systems

20 countries mentioned why they intend to implement a new accounting system or why they do not intend to do so

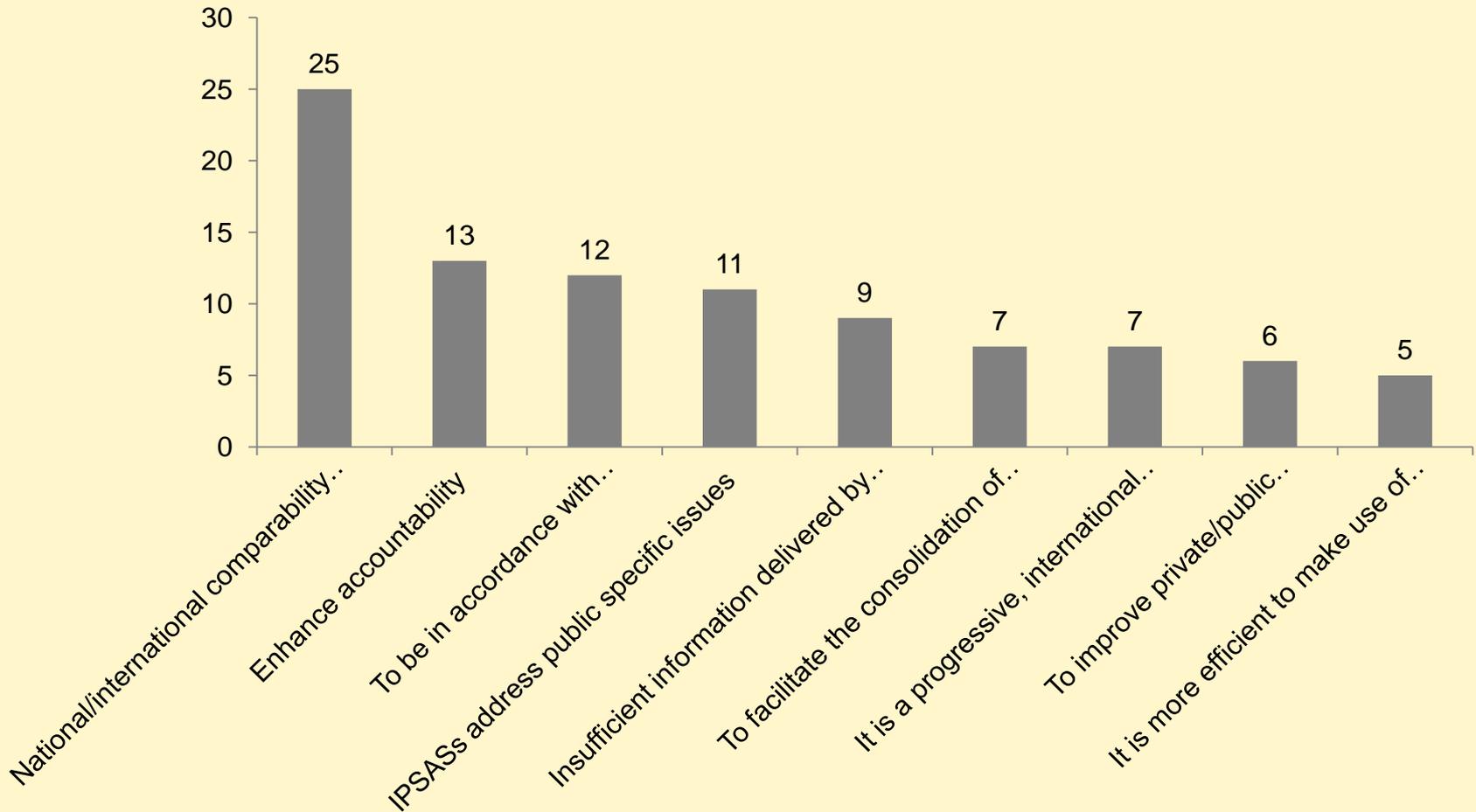
- ▶ Main reasons for a new accounting system are:
 - ▶ Improve financial reporting and accountability
 - ▶ Improve transparency of public finance
 - ▶ Achieve international comparability
- ▶ However, many countries described why they do not plan to implement a new accounting system:
 - ▶ Already on accrual basis
 - ▶ Transparency and true & fair presentation already ensured

There are many incentives for adopting accrual accounting

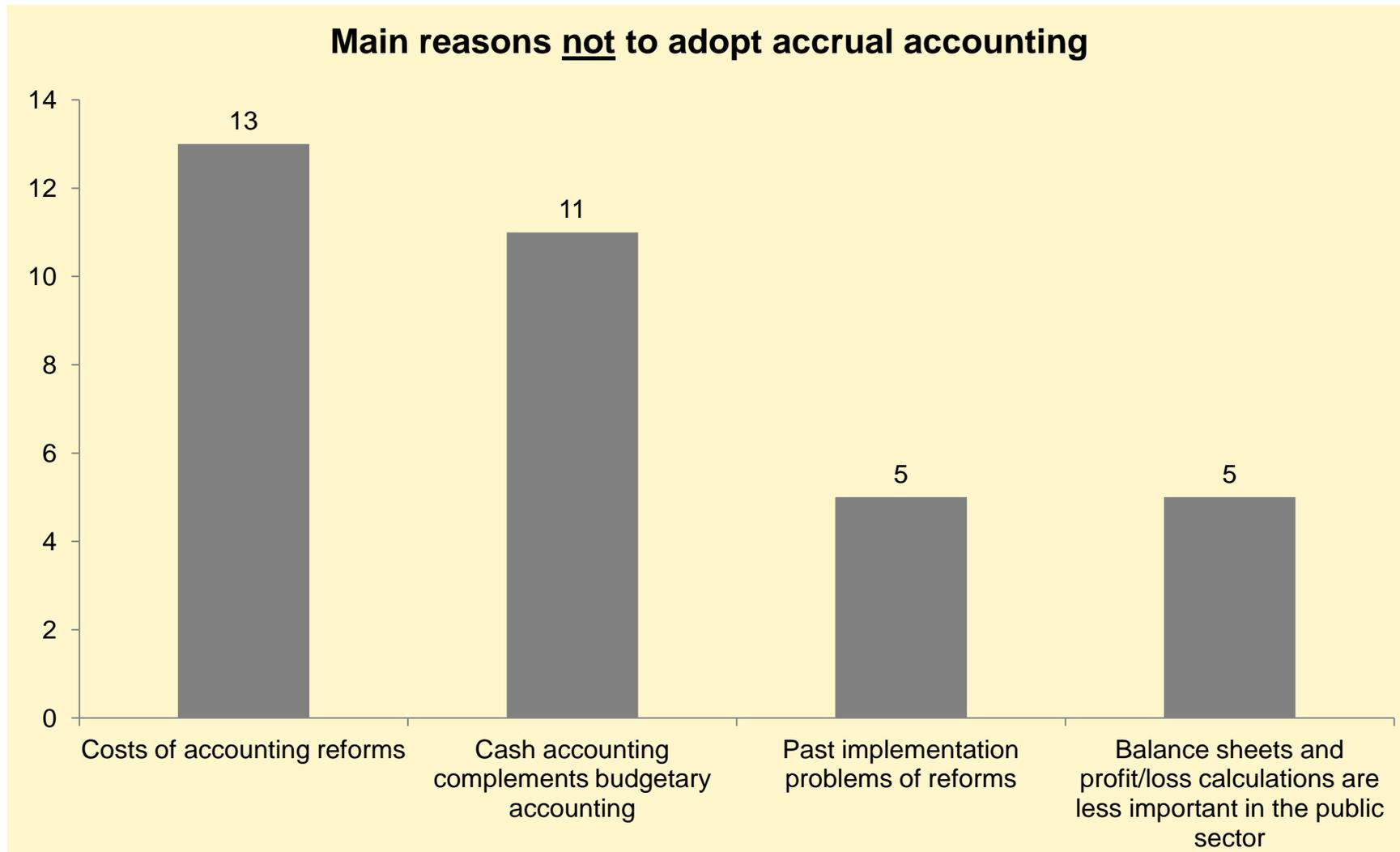


The most important reason to apply IPSAS is the comparability of financial information

Possible reasons to apply IPSAS/IPSAS-like standards



The costs of an accounting reform are the main reason not to adopt accrual accounting



Conclusions

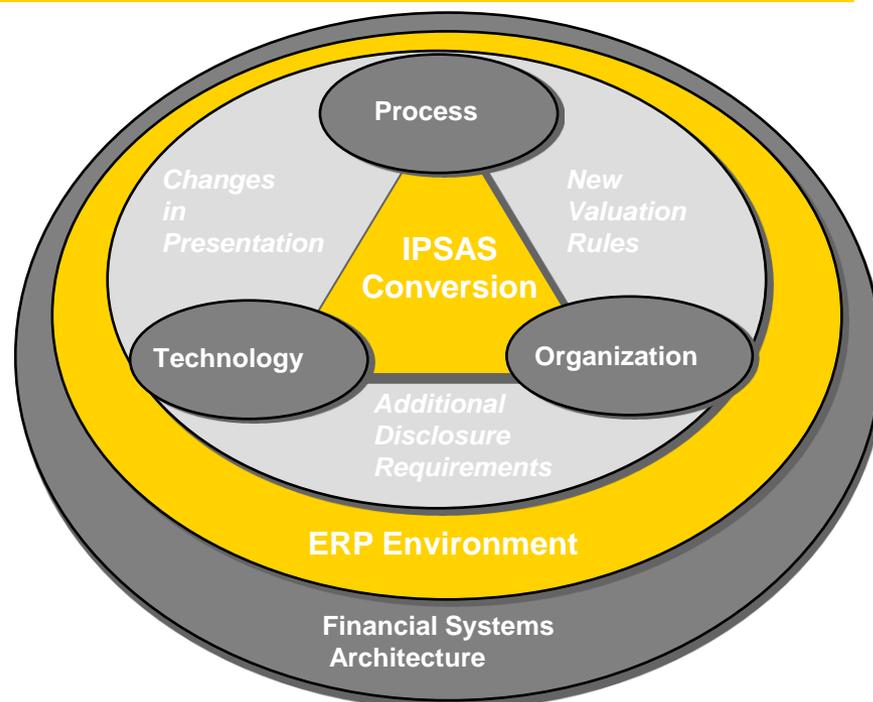
- ▶ IPSAS have arrived around the world – it is not a matter of lack of know-how or awareness
 - focused work on specific standards for the public sector as well as intensive communication is starting to pay off
- ▶ Main principles are known worldwide – but obviously not consistently understood
 - further dialogue between standard setters and accounting bodies seems to be required
- ▶ Additional momentum could result from GFS
 - even if interdependence seems to be globally accepted, further alignment of reliable and a unified set of data as well as harmonized accounting rules should be aspired to



Main IPSAS Conversion Challenges and Impact

Main Challenges

- ▶ Political/Executive support
- ▶ Legal framework
- ▶ Accrual accounting know how/capacity building
- ▶ Staff capacities for reform
- ▶ IT/ERP system implementation
- ▶ Impact of reform on organisation, i.e. changes to processes and systems
- ▶ Registration and measurement of assets and liabilities/opening balance sheet
- ▶ Focus on budgeting and reporting



1. IPSAS conversion will impact all levels of accounting in a government!
2. IPSAS conversions will impact several areas outside of the accounting function!
3. A top level conversion to IPSAS may not be sufficient!

A low-angle, night-time photograph of the Petronas Twin Towers in Kuala Lumpur, Malaysia. The towers are illuminated from within, with their windows glowing yellow and white. The sky is a deep, dark blue. The text "Thank You" is overlaid in a large, white, italicized sans-serif font across the center of the image. The base of the towers shows a brightly lit entrance area with glass panels and palm trees in the foreground.

Thank You