Public Sector Accounting and Accountability: The Usefulness of Accrual Accounting- Where from and Where to?

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Abstract

The adoption of accrual accounting in the 1990s by the Commonwealth and various State Governments was intended to improve the efficiency and effectiveness of operations through improved decision making information and subsequently enhance the accountability of the public sector. This study examines the role of the government and public sector; the reason and importance for its intervention in particular markets, the degree of accountability required by this role and the financial information required in order to discharge this accountability and manage the resources under its control. This study investigates the applicability and usefulness business accounting concepts in the public sector by reviewing existing literature, examining current reporting requirements and obtaining sector opinion through the distribution of a survey.

Explanation of Topic Area

The adoption of accrual accounting in the 1990’s by the Commonwealth and various State Governments was intended to improve the efficiency and effectiveness of operations through improved decision making information and subsequently enhance the accountability of the government and the public sector (Barton, 2003, pg. 10).

However the ability of a commercially-based framework to adequately provide quality information\(^1\) for decision making in relation to the non-commercial activities and resources of the public sector and improve the accountability of the government to parliament and the public has been questioned. As such, nearly a decade on from its inception, the accrual accounting system adopted by the public sector is now subject to proposed refinements and harmonisation.

The objective of my thesis is to investigate the usefulness of accrual accounting based on generally accepted accounting principles (GAAP) in the public sector.

The aim of the paper is not to “reinvent” accrual accounting but rather to examine the reporting requirements of the public sector as they have, do, and may exist, and whether such requirements favourably or adversely effect the decision-making process and the discharge of accountability within the public sector. Much literature already exists as to whether the adoption of accrual accounting in the Australian public sector throughout the 1990s aided or hindered such processes, and it is the aim of this paper firstly to examine and review such literature, and then apply it as a basis for an investigation into the current environment to determine where the sector could proceed in the future.

The study firstly reviews the nature and role of the government and public sector; how it operates, its importance and what financial management information is required to promote the efficient and effective operations of the public sector and fulfil accountability to parliament and the public. The need for accrual accounting in the public sector to enhance resource management and cost control is then investigated and involves a review of how the public sector adopted accrual accounting as part of the New Public Management (NPM) reforms throughout the 1980s and 1990s. The application of a business model of accounting

\(^1\) Quality information as prescribed by SAC 3: relevance, reliability, comparability and understandability
is then investigated, examining the usefulness of such information in achieving the objectives of financial reporting (SAC 2, paras. 43-45) and thus assisting decision making and accountability. It is here that the study seeks its contribution, advancing prior research on the ability of a business model of accounting to provide quality information for public sector reporting.

Motivation and Importance

The study is motivated by the importance attached to the adequate discharge of accountability in a democratic system of government, where the essential role of the government is to coordinate the activities of the community to ensure the efficient and certain operation of a nation’s major functions, where individuals, namely a nation’s citizens, relinquish certain freedoms in the expectation of receiving something greater in return.

Granting such a government the right to exist and requiring citizens to contribute involuntarily to the programs of government are not unconditional; systems of accountability beyond the exclusive control of the government are needed to ensure citizens are not subject to abuses of power by the government.

The motivating concern of this study is therefore; given the position of government and the presumed greater accountability requirements necessitated by this position and the size of resources at its disposal; has the adoption of accrual accounting improved the efficiency and effectiveness of the decision-making processes of the public sector in relation to the management of these resources and are governments adequately accountable for their activities to their citizens.

The Government and Public Sector of Australia

Modern democratic governments are created when individuals surrender some of their freedoms to elected representatives in the expectation of receiving something greater in return. In modern democratic capitalist countries such as Australia, the essential role of the government is to coordinate the activities of the community to ensure the efficient and certain operation of the nation’s major functions (Funnell and Cooper, 1998; Carnegie and Wolnizer, 1995; Barton, 2003a).

The Nature and Role of the Australian Government and Public Sector

Government intervention, either through departments or non-department structures (statutory authorities or government business enterprises), is appropriate where the market has failed to provide the goods and services demanded by the community. These include, but are not limited to (Barton, 2003a); the provision of public goods and services to citizens (Barton, 1999, 2001, 2000; Carnegie and Wolnizer, 1995, 1999; Mulgan, 2000), the provision of social welfare goods and services, conservation of the natural environment and the management of government resources. Commercial markets exist for the supply of private goods and services. Consumers voluntarily bid for the items they wish to purchase and firms endeavour to supply them at a price which at least covers their full average cost. The primary objective of firms is always a financial one of earning at least sufficient profit (Barton, 1999, pg. 23). Private markets are based on the “exclusion principle”2 and given competitive market conditions, high level of knowledge and mobility of all producers and consumers, and the

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2 “A’s purchase of a good denies B’s purchase of it, and on private property rights. A obtains exclusive title or property rights to use the good as he pleases”- Barton, 1999, pg. 24
absence of externalities, private markets efficiently and effectively operate, and social and economic welfare is optimised (id. at pg. 24).

However, where any one of these market conditions does not exist, market failure occurs and results (social and economic welfare) are not optimised. Externalities are the basis for government or public sector provision of goods or services in a “modern democratic society with a mixed public/private sector economy” (ibid). Externalities occur when all the costs and all the benefits of a good or service are not confined to the transaction parties. With public goods it is inefficient to exclude a consumer from sharing the benefit of a particular good or service, such as defence, law and order, basic education and health services, community, heritage and environmental facilities. The non-competitive nature of such markets that is often a result of such externalities causes goods and services to be non-self-funding3, requiring the intervention of the government and public sector to supply the good or service and fund its provision from the budget (ibid).

The expropriation of resources from the private sector through taxation and other levies to fund such provision in conjunction with the nature of the above listed goods and services, has implications for the appropriate level of disclosure in relation to the provision of public market goods and services.

The Importance of Government Intervention

Thus in the presence of externalities, the intervention of the government/public sector becomes essential to the provision of certain goods and services. The objectives of providing these goods and services are not necessarily financial; rather they involve protecting freedom and maintaining law and order, enhancing knowledge and social relationships, improving general economic welfare and enhancing the health of the community (Barton, 1999, pg. 26; 2000).

The Accountability of the Government and Public Sector

Until the New Public Management reforms of the latter decades of the twentieth century, the overriding concern imposed by Westminster constitutional conventions was for the accurate and regular accounting of cash receipts and cash payments as required by the Commonwealth of Australia Constitution Act 19004 (Funnell and Cooper, 1998, pg. 11). However with persisting and progressive reforms throughout the 1980s and 1990s at the Commonwealth and State levels of government, the government/public sector is now accountable also for the results achieved by the use of these resources. The “efficient, effective and ethical use” (Financial Management and Accountability Act 1997, s. 44(1) (3)) of resources is assisted by the “chain of accountability” (Funnell and Cooper, 1998. pp. 32-39), which promotes efficient and economic government operations but not at the expense of reduced services (ibid).

Comparing Accountability in the Public and Private Sectors

Government is very different from the private sector in both form and function (Funnell and Cooper, 1998; Barton, 1999, 2000, 2001, 2003a; Carnegie and Wolnizer, 1995; Mulgan, 2000). Public goods markets are much more complex than commercial markets because of the range of social, educational, recreational, scientific and political matters in addition to

3 Given the high fixed costs and price equaling a negligible or zero marginal cost being unable to recover such costs
4 Sec 81- All revenues or moneys raised or received by the Executive Government of the Commonwealth shall come from one Consolidated Revenue Fund, to be appropriated for the purposes of the Commonwealth in the manner and subject to charges and liabilities imposed by this Constitution
financial matters of ordinary private markets (Barton, 2000, pg. 232). As such managers of these entities can be accountable for their performance with respect to matters not exclusive to financial performance (Barton, 2000, 2003a; Carnegie and Wolnizer, 1995; Funnell and Cooper, 1998; Sutcliffe, 1985) and thus the success or performance of such entities must be measured in other than financial terms.

In the public sector, as competition and market choice are unusual, greater reliance has been placed on accountability as the otherwise weak and defenceless principles (citizens) seek to impose some curbs on the powerful organisations and individuals (government, ministers) who are supposed to be serving their interests (Mulgan, 2000, pg. 88). Accountability requirements in the public sector are therefore generally more stringent, particularly with regard to process and general policy as citizens are far more than consumers of either public or private sector goods or services provided by an “efficient” public sector (Mulgan, 2000; Funnell and Cooper, 1998). Citizenship carries with it a broad range of privileges and responsibilities, of which the consumption of goods and services is only one small part. Therefore, the treating of citizens predominately as consumers (Barton, 2003b; Shergold, 2003; Pallot, 2001), for whom cost considerations are construed as uppermost importance only considers one aspect of their identity as citizens (Funnell and Cooper, 1998, pg. 40). Civil, political and social rights of citizens also exist which necessitate the greater accountability of the public sector to its citizens, in order to ensure; access to defence, law and order, community services and the proper functioning of government processes for which they were elected.

**Accrual Accounting in the Australian Public Sector**

The adoption of accrual accounting in the public sector was to result in improved accountability of governments, better financial management by public service managers and greater comparability of management performance between jurisdictions. This would be achieved by recognising revenue during the period in which it was earned, regardless of when it would be received and the recognition of expenses during the period of consumption, allowing the matching principle to compare the cost of efforts with the value of results, regardless of the timing of cash flows (Guthrie, 1998; Henderson and Peirson, 2002). Further, the adoption of accrual accounting would assist the management of the significant amount of non-cash assets and liabilities of the public sector, allowing resources to be more efficiently and effectively employed throughout the sector. Rational decisions about the use and management of scarce resources, and the measurement and reporting of performance for accountability purposes could not be made or discharged in the absence of information pertaining to these resources.

By adopting accrual accounting information systems in place of Cash Accounting and Budgeting Systems (CABS) (Barton, 2003a), the public sector sought to “provide information useful to users for making and evaluating decisions about the allocation of scarce resources” (SAC 2, para. 43) and improve their discharge of accountability through the disclosure of “information relevant to the assessment of performance, financial position, and financing and investing, including information about compliance” (id. at para. 45). However, despite the unique role of government and the public sector in managing the affairs of the nation on the behalf of its citizens and the ensuing differences in its mode of operations from those of business as outlined above, a business model of accrual accounting for recording and measuring government transactions and events, and the results thereof, was adopted (Barton, 2003a, pg. 19, 1999, 2000, 2003b, 2003c; Carnegie and Wolnizer, 1995, 1999; McGregor, 5 Civil rights cover such things as freedom of thought and speech and access to the legal system, and political rights cover the right to have a say in the selection of governments. Social rights flow from a person’s membership of a community, entitling that person to services and assistance available to all the community- Funnell and Cooper, 1998, pg. 40
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1999; Newberry, 2001; Barton, Carnegie and Wolnizer, Newberry, 2002; Guthrie, Parker and English, 2003; Christensen, 2002, 2003; Guthrie, 1998; Sutcliffe, 1985). However in order to provide quality information for decision-making and accountability purposes, the Financial Management Information and Reporting System (FMIRS) adopted would need to be adjusted to reflect the unique nature and role of the government and public sector.

Literature exists as to the role private sector consulting firms performed in the development and implementation of accrual accounting in the public sector, and posits Public Choice Theory (PCT) (Barton, 2001, 2003a, 2003b) as a reason why many concerns raised in various reports (Department of Finance, 1994a, 1994b, National Commission of Audit, 1996) at the time of adoption about the applicability of a business model of accounting to the public sector were ignored.

The failure to create a new model of public sector accrual accounting has subsequently resulted in controversy and unresolved difficulties, the focus of which will be the remainder of this study.

The Application of Accrual Accounting in Government & the Public Sector

Good management cannot be based on irrelevant, biased and unreliable accounting information which does not purport to be what it actually is. Such information leads to poor decision-making and ineffectiveness and misleading performance and accountability information to parliament and the public (Barton, 2003a, pg. 39). Much of the information now provided by the public sector FMIRS is aimed at overcoming the perceived limitations of CABS by providing information pertaining to the efficient and effective management of all resources under the management of the government and public sector. As with private sector reporting entities, the prescribed financial reports are to be general purpose in nature and aimed at fulfilling the information needs of a wide range of users (Sutcliffe, 1985; Funnell and Cooper, 1998; Jones and Puglisi, 1997). What is of interest in this section and indeed this study, is whether given the nature and role of the government and public sector, do the current reporting requirements adopted by these bodies improve the efficiency and effectiveness of decision-making processes in relation to the management of resources and adequately discharge accountability.

The differing nature and objectives of the government and public sector and the requirement for greater accountability of processes questions whether a business model of accrual accounting based on GAAP can adequately satisfy the need for quality information of users of government and public sector information. The “so-called benefits of commercial business accounting” (Guthrie, 1998, pg. 138) are not so evident for some government agencies as a result of; the purpose of departments not including the making of a profit therefore not being a relevant measure of performance, financial structure not being relevant, nor solvency as the ability to continue “business” is determined by the policies adopted by government and the capacity for adaptation is not relevant as a department is unable to sell assets or change business (Guthrie, 1998; Funnell and Cooper, 1998). While financial information is important in the public sector, much public sector activity and performance cannot be adequately represented in financial terms alone, resulting in an increase in non-financial performance measures and indicators reported by public sector entities. In addition to the narrow dollar view of costs and efficiency, commercial/business accounting is “rife with problems which have in the past… (have been associated with) major financial misallocation

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6 Quality information as prescribed in SAC 3, para. 5 as being relevant, reliable, comparable and understandable. Definitions of relevance, reliability, comparability and understandability are provided in the Appendix- Key Terms
in the private sector” (Guthrie, 1998, pg. 140; Clarke, Dean and Oliver, 2003), which again questions the ability of business accounting concepts to improve the quality of information in the public sector.

The study employs a survey instrument which is founded on two previous survey studies, namely; Jones and Puglisi (1997) and the Public Sector Centre of Excellence (PSCOE) (2000).

Given the “experience effect” noted in the former and the relatively small sample size used by the latter, my study aims to contribute to this area of research by attempting to gather the opinion of government department CFOs when a certain amount of the experience effect noted in Jones and Puglisi (1997) has been overcome by a more representative sample size then that used by the PSCOE (2000).

Sought by the survey is the opinion of CFO representatives of the public sector about the perceived usefulness of accrual accounting concepts in the public sector and how they complement information reported under this system in their decision-making processes and discharge of accountability. Further the survey suggests areas of improvement in the current system, based on recommendations from reviewed literature, thereby facilitating the contribution of the study.

The study so far has examined the applicability of the conceptual framework, in terms of; the objectives of general purpose financial reporting (GPFR) (SAC 2, paras. 43-45), the quality of information (SAC 3) produced by applying business accounting concepts to the nature and role of public sector resources, and definitions applied to elements pertaining to the financial position and performance of public sector entities. The survey instrument has been developed to supplement the findings of prior literature and the examination undertaken by this study of the above. It has been hypothesised that the business model of accrual accounting applied to the public sector as it currently exists does not provide quality information for GPFR, resulting in objectives of financial reporting, namely the provision of information pertaining to the “financial position, performance, and financing and investing… and compliance” of the entity (SAC 2, para. 45) for decision making concerning resource allocation and the discharging of accountability, remaining unfulfilled.

The nature of markets in which goods and services are produced and provided has implications for accounting information systems. In private goods markets, assets must generate economic benefits sufficient to enable the firm to recover all costs from their product revenue (Barton, 1999, 2000, 2003a, 2003b; Carnegie and Wolnizer, 1995, 1999). It is therefore appropriate to define and value assets in terms of their cash generating capacity as outlined in SAC 4 (Barton, Carnegie and Wolnizer and Newberry, 2002, pg. 44). In the public sector however, as illustrated in prior sections, assets generate a wide range of social and community benefits, most of a non-cash nature. Literature reviewed (Barton, 1999, 2000, 2003a, 2003b; Carnegie and Wolnizer, 1995, 1999; Mulgan, 2000; Newberry, 2001; Jones and Puglisi, 1997; Sutcliffe, 1985) has demonstrated the difficulty of applying definitions and valuation methods derived from the business sector to these benefits produced by the public sector. It is therefore argued by this study that the reporting elements pertaining to the unique nature of public sector objectives be adequate distinguished from those pursuing a commercial end, and that the interpretation given to concepts such as financial position or performance, be adjusted, through definition and presentation, to reflect the objectives being pursued by the public sector. A number of recommendations, based on both prior literature and this examination of the conceptual framework and accounting standards (AAS 29), have been made in the study and have been included in the survey in order to obtain sector opinion as to whether such recommendations would assist in the improving the quality of information used for resource allocation decisions and discharging of accountability.
The interpretation of public sector financial information is argued to be assisted through the development and presentation of qualitative or non-financial measures incorporated in the GPFR of the public sector. Given existing literature on accrual output-based budgeting (AOBB) (Carlin and Guthrie, 2001a, 2001b; Carlin, 2003), the limitations of such an approach are to be examined. The disclosure of non-financial measures of performance or resources has implications for the interpretation of financial information presented by the public sector and is necessary for the adequate disclosure of the overall performance of the government and public sector.

**Conclusion**

Thus the study will contribute to existing literature on the adoption of accrual accounting in the public sector by examining the current reporting requirements pertaining to information used for resource allocation decisions and the discharge of accountability. The study follows the findings of a number of studies into the usefulness of accrual accounting information, however overcomes limitations of prior research; the experience effect and restricted population size, in obtaining sector opinion on the applicability of business accounting concepts to the public sector. As it is hypothesised that the accounting information system used by the public sector based on these concepts does not provide quality information to allow the objectives of GPFR to be attained, a number of recommendations have been put to the sector via the survey in an attempt to identify improvements in the current reporting environment. Again, it is not the purpose of this study to “re-invent” accrual accounting in the public sector. Accrual accounting has the potential to provide important and useful information to users of public sector financial information. However, the differing nature and objectives of the public sector require adjustments to make current practices in order to emphasise these differences and provide non-misleading information.

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