

Issues of Implementation of Accruals-Based Accounting in Public Sector (The Case of Ukraine)

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Abstract

The article stresses that the general trend in public sector accounting reform consists of alignment of its methodology to corporate accounting approaches. In this case the implementation of accruals-based accounting is crucial. The following issues of implementation of accruals-based accounting in public sector are studied: the absence of proper measurement and recognition in accounting and reporting of all assets and liabilities of state (including all rights owned by the state, all natural resources that make a state asset and property, pension liabilities of state, etc.); uncertainty about the moment of recognition and measurement of revenue from paid taxes. The authors prove the necessity for development and implementation of IPSAS “Expenses” as the methodological guidance for accounting for public entities expenses, including expenses from exchange transactions, in particular for the providing of public services.

Accrual Accounting Implementation: Ukraine Experience

The reform in public sector accounting is the element of general reform process of Public Finance Management system (PFM) according to the Strategy of Reforming of Public Finance Management till 2020 adopted by the Cabinet of Ministers of Ukraine this February (Cabinet of Ministers of Ukraine, 2017).

One of the innovations of this reform is the application of accruals-based accounting by budget entities, state and local budgets execution. Despite the advantages of this accounting method, its application at the budget execution level is a difficult process.

The general trend in public sector accounting reform consists of alignment of its methodology to corporate accounting approaches. This is caused, on the one hand, by the progress and development of conceptual approaches and methodological techniques developed in corporate accounting methodology, and, on the other hand – by the willingness to provide users of financial and budget reporting with the information, which can become the efficient basis for decision-making process on the state level.

There are two accounting models for recognition of revenue and estimation of financial performance (results) in international and national practice. The first model is cash-based accounting (revenue is recognised when cash from sale of goods and services is received). The second model is accruals-based accounting (revenue is recognised after transfer of ownership on goods and services). The financial result according to accruals-based accounting is recognised on the basis of matching costs and revenues regardless of the receipt of proceeds from sales.

Historically, the cash-based accounting preceded the accruals-based accounting. Its absolute advantages relate to full correspondence of recognised revenue with its cash equivalent on the bank's current account. In terms of private individual property, the profit indicator, estimated with the cash-based method, is absolutely relevant (in this context it is informative and useful for financial decision-making).

Joint-stock ownership requires accounting the profit indicator that reflects the efficiency of the entity's activity. The profit of joint-stock company, on the one hand, characterizes the investment attractiveness of entity; on the other hand, it is a part of revenue distributed between owners. In this case it is important to remember that this indicator has to be published. It can be calculated only with the help of accrual method.

It should be noted that the accruals-based accounting is one of the principles on which the contemporary accounting system is based. This provision is declared in the international standards as well as in the national (Ukrainian) and in the Law of Ukraine "On Accounting and Financial Reporting in Ukraine" (the Law of Ukraine, 1999). It is formulated as the principle of accrual and matching costs and revenues (accrual basis of accounting). In accordance with this principle, financial result is estimated by comparing of annual revenues with expenses, incurred while obtaining revenues. Revenues and expenses are recorded at the moment of their recognition regardless of the cash receipt. Thus, the consequence of the application of this principle is the separation of cash flows from the process of generating of financial results. From the point of view of economic nature of reproduction of capital, such approach is justified, since it enables to identify changes in the structure and amount of equity during the reporting period. At the same time, in order to enforce the real value indicator of financial result in terms of its separation from cash flows, the accounting system was enriched by other principles that serve as certain limitations for accrual accounting. In particular, these principles include prudence (conservatism) and substance over form (materiality).

Let's consider the issues of implementation of accruals-based accounting in public sector.

The application of accruals-based accounting in public sector envisages the measurement, recognition and presentation in reporting of all assets and liabilities of the state. Not only property, plant and equipment, tangible and other current and non-current assets are the objects now, but also all intangible assets. These intangible assets include all rights owned by the state, all natural resources that make state asset and property, pension liabilities of the state. This information is of great importance for decision-making process at state level.

At present, not all assets and long-term liabilities of budget entities are subject to real assessment. In particular, the cost acquiring fixed assets is written off on appropriate funding resources without further depreciation.

In addition, there are problems with the transition of the formation of budget revenues accounting from paying taxes to accruals-based accounting. The state requirements to taxpayers may arise at the moment of receipt of tax return by the State Fiscal Service or when the taxpayer committed the action, the result of which is the obligation to pay tax. The assessment of such transactions makes the difficulty of accruals-based accounting. The general advantage of this method is the reliability of reporting from the point of view of the economic content of its indicators/items.

The abovementioned problems lead to the use of the modified cash-based and modified accruals-based accounting in public sector.

Reference: The assessment of expenditures and revenues in accordance with accruals-based accounting also affects the assessment of assets and liabilities.

The modified cash-based method in accounting for state debt involves the fixing of cash flows, while recognizing the state debt and loans is carried out by accruals-based accounting. This method is also applied while recognizing other settlement, the need for which arises during the budget execution process. Some assets and liabilities, other than mentioned above, affect the liquidity and solvency of the state, therefore, they are assessed by the accrual-based accounting.

The modified accrual-based accounting is applied for assessment of assets and liabilities. At some point of its implementation it became clear that this method cannot provide the ability to assess the above mentioned accounting objects reasonably. The modified accruals-based accounting is applied as transitive, in order to create necessary conditions for implementation of full accruals-based accounting. For example, the implementation of accruals-based accounting of fixed assets depreciation requires the recognition by fair value, determination of useful life of such assets by groups. Taking into account the condition of fixed assets in the public sector, it can be concluded that this process requires a lot of organizational work, methodological preparation and time.

Comparison of accruals-based and cash-based accounting indicates the predominance of the first method. This method is more progressive. Under the accruals-based accounting the transactions are recognized at the moment of fulfillment or change in economic value of assets or liabilities.

The statement of budget execution in accordance with the budget legislation of Ukraine is prepared on cash basis. The content of this statement reflects cash flows: revenues and expenditures, funding sources for deficit. This reporting is public, in fact, that is the reporting on government transactions.

The research showed the lack of clarity and uniqueness of the theoretical substance and practical application of different methods of recognition of revenues and expenses in public sector of Ukraine. This also applies to legislative support of this issue. Unlike the "cash-based" and "accruals-based" accounting, terms "modified cash-based" and "modified accruals-based" accounting are not used either theoretically or in practice. The application of cash-based accounting is indicated only in one legislative act. The mechanism for its application is not specified.

The transition to accruals-based accounting cannot be the one-stage process and needs long period. For this period, it is necessary to apply the modified accruals-based accounting with the preservation of cash basis. This should be taken into account while carrying out the public sector accounting in budget entities of the state.

The gradual application of accruals-based accounting in public sector of Ukraine will allow the transition to medium-term budgeting, and control the flow of any assets and liabilities as well as take into account cash balances.

One of the reasons of the difficult way of implementation of accruals-based accounting into practice of public entities is a lack of methodological guidance provided by IPSAS on accounting for expenses (including expenses from exchange transactions, in particular, providing of public services). Actually, the IPSAS package doesn't include the Standard "Expenses" as well as it is not present in the IFRS package. However, the absence of IFRS "Expenses" is due to concept of determining of corporation's financial results and economic nature of non-governmental property: all spendings and outflows from the entity of resources are recognized as expenses.

In the public sector the state is an owner of capital that is the basis of formation of budget entity. Therefore, economic essence of public entities' expenses in these terms acquires a slightly different meaning. Thus, expenses of public entity arise from events, the settlement of which expected to result in an outflow from the entity of resources and increase of obligations. But because the financial resources of the state are spent, the purpose-oriented character of the resources use, social and economic effect of such use is important. The methodology of planning and accounting for expenses of providing public services and its cost calculation is of great importance. The reliable indicator of public services cost is a basis for substantiated defining of the amount of budget funding of public entity's activities.

We consider it relevant to discuss the development of a particular IPSAS “Expenses” or an appropriate consultative document. Such standard is developed in Ukraine: National Public Sector Accounting Standard (Provision) 135 “Expenses” (NPSAS(P)). Difficulties that arise while implementing this process emphasize its significance. Its structure and content can be taken as a basis for the development of relevant international standard.

NPSAS(P) 135 “Expenses” has the following structure:

1. General provisions
2. Classification of expenses
3. Recognition and measurement of expenses
4. Cost of products and services
5. Disclosure of information on expenses in Notes to Financial Statements (the Ministry of Finance of Ukraine, 2012).

At the same time taking into account the IPSASB initiative for the development of Consultation Paper “Accounting for Revenue and Non-Exchange Expenses” issued by IPSASB (the proposals on application of revenue recognition model proposed by IFRS 15 “The Revenue from Contracts with Customers”) and the outcomes of discussing it by the Ad Hoc Committee on International Accounting Standards ICGFM, we suggest the following structure of IPSAS “Expenses”:

1. General provisions
2. Classification of expenses in public sector
3. Recognition and measurement of expenses from non-exchange transactions
4. Recognition and measurement of expenses from exchange transactions
5. Cost of products and services
6. Disclosure of information on expenses in Notes to Financial Statements.

The mechanism of formation of public services cost on the example of state higher educational institutions is presented on figure 1.

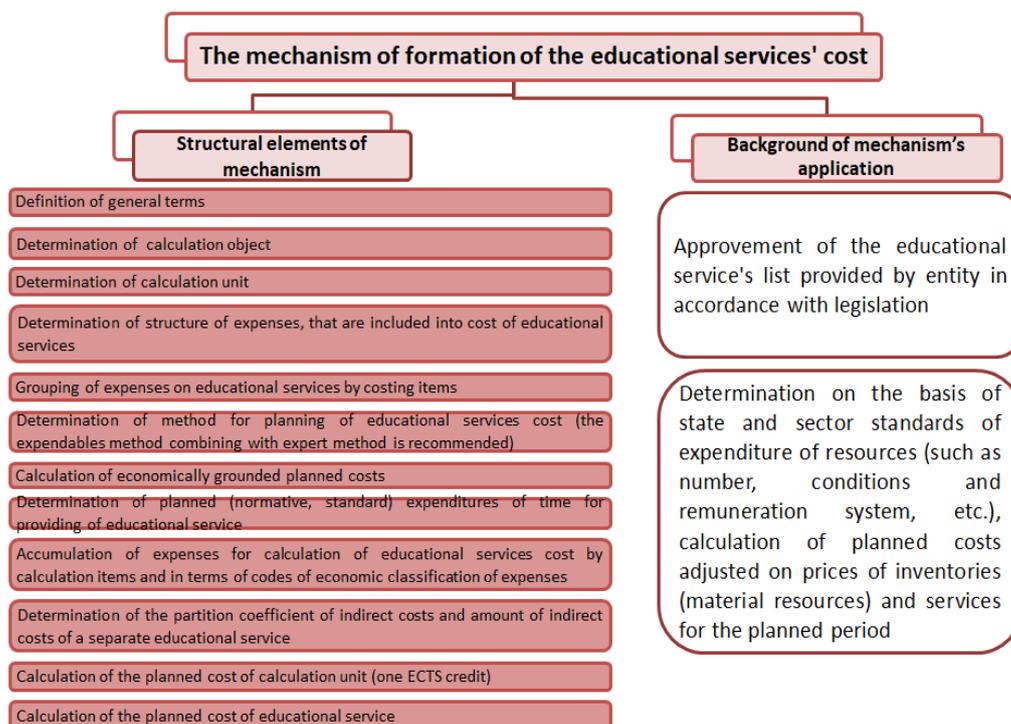


Figure 1. The mechanism of formation of the educational services' cost

In Ukraine, for a long period of time, there was no necessity to determine the cost of public services. Budget entities receive budget funding and spend it in accordance with approved cost estimate for the completion of relevant activity.

It is widely-known that when budget is allocated only on the basis of functional and economic classification of expenses then budget is a summary of data on general categories of expenses. In this case budget doesn't contain any information about target and potential impact of expenses. Thus, such a methodology doesn't establish the clarified link between spent resources and results received. Moreover, such allocation doesn't make it possible to determine the efficiency and successfulness of funded services.

In this case, the general purpose of funding is the maintenance of the net of historically formed institutions. In fact, the target for budgeting is to become the quantity and quality of the service obtained by the customer from the provider.

Taking into consideration the information mentioned above, it is topical to achieve a definite, usually long-term, result that meets the needs of society. Thus, financial results should be assessed in terms of delivery of services results. That is, budget entities need to calculate the cost of services provided by these institutions in accordance with legislation. The structural elements of mechanism and implementation precondition for the formation of public services' cost is presented on figure 1.

Definition of the general terms and approaches to formation of planned cost of educational service is presented on figure 2.

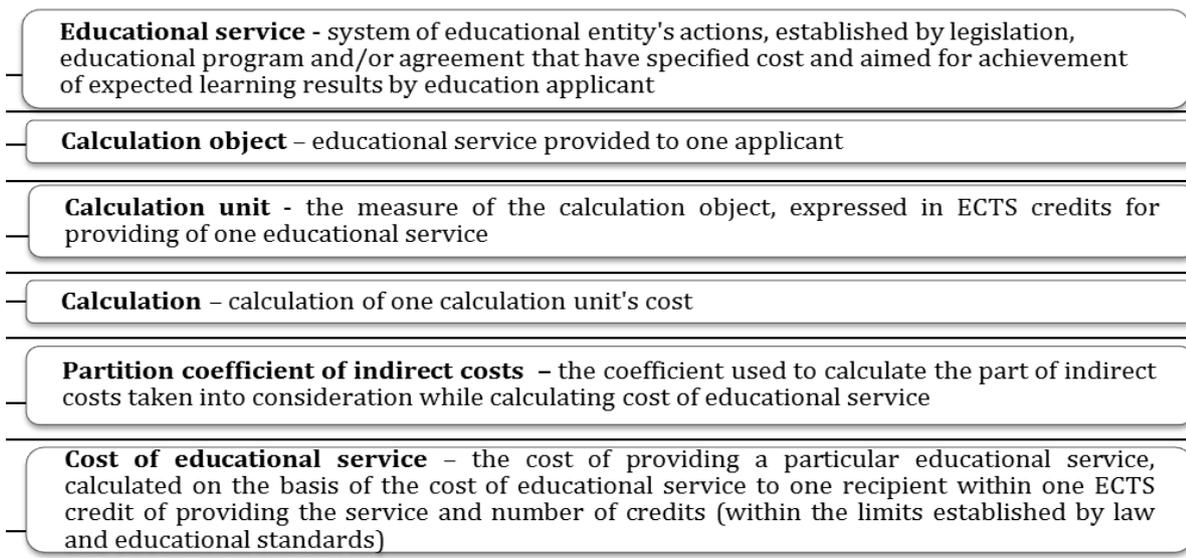


Figure 2. Definitions of the general terms and approaches to formation of planned cost of educational service

Under the cost of services it is necessary to understand the amount of spending of budget entity directly related to providing of public services. In accordance with the Law of Ukraine “On education” dated September 5, 2017 № 2145-VIII the definition of category “educational service” is the following: “educational service – system of educational entity's actions, established by legislation, educational program and/or agreement that have specified cost and aimed at achievement of expected learning results by education applicant”.

Cost is the basis of public services pricing. Estimation of the public service cost is calculation. The reliability of the calculation in many cases depends on choice of items of expenses, accounting for expenses object and calculation, calculation units, methods of distribution of indirect expenses.

Difficulty of determining of calculation items on providing of services by budget entities consists in multiple nature of activity of these entities. However, these issues can be solved at the level of sector ministries with the involvement of practitioners to methodological work.

The types of homogeneous services are the object of accounting for expenses. Calculation object is a separate type of public service provided in accordance with legislation.

The objects of calculation are closely related to the concept of calculation unit that is measure of product taken for estimation of the relevant calculation object.

In order to determine the cost the appropriate calculation of services method is used. That is a set of methods for mapping, grouping and aggregation of data on expenses for providing services in accounting that ensure the determination of actual product cost. Such methods can include direct-costing and standard-costing. However, unlike material production (issue of accounting for expenses of this production is developed in detail and reasoned way both from the theoretical and practical sides) the methodology of accounting for expenses and calculation of services of budget entities is at the initial stage of development.

In addition, there is a need for harmonization of calculation items with the codes of economic classification of expenses that are the general indicator for regulation and enforcement of planning and spending of budget entities.

The connection between calculation units of planned cost of educational service and codes of economic classification of expenses are presented on figure 3.

STRUCTURE OF EXPENSES	CALCULATION ITEMS	CODES OF ECONOMIC CLASSIFICATION OF EXPENSES	
DIRECT EXPENSES			
Direct expenses on wages and social contributions	Wages	2111	Wages
	Social contributions	2120	Social contributions
Direct material expense	Materials and services	2210	Inventories
		2240	Settlement for services (except utility services)
Other direct expenses	Other direct expenses	2210	Inventories
		2240	Settlement for services (except utility services)
		2250	Expenses on business trip
INDIRECT EXPENSES	Indirect manufacturing expenses		
Wages and social contributions of administrative, economic, managerial, service personnel		2111	Wages
		2120	Social contributions
Indirect material expense		2210	Inventories
Payment of business trips for those employees		2250	Expenses on business trip
Depreciation of fixed assets and intangible assets of general purpose			
Maintenance, operation and repair of fixed assets, other fixed assets of general purpose		2240	Settlement for services (except utility services)
Payment for heating, electricity, water, wastewater, natural gas and other energy		2270	Settlement for utility services and energy

Figure 3. The connection between calculation units of planned cost of educational service and codes of economic classification of expenses

In order to sum up, it should be noted that implementation of accruals-based accounting as the element of public finance system reform (in particular, the implementation of program-target method into the budget process) requires the restructuring not only the accounting and reporting areas, but also planning and management systems. This can be proved by the next argument. The grouping of expenses related to cost of services and, consequently, efficiency indicators of budget program (cost and product indicators) can be carried out in accordance with requirement of IPSAS “Expenses”.

Public sector financial reporting, prepared with accruals-based accounting, will enhance the level of public awareness of the realized economic policy and strengthen public confidence in Government.

The application while preparation of reporting with accruals-based accounting of understandable for users’ format (that is similar to those, provided by commercial sector) will

enhance the transparency of public sector activity, investments and commitments of public entities, changes in their financial position.

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