

**PRIMER
ON
ACCRUAL ACCOUNTING**

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Accrual Accounting

It is a system of accounting in which transactions are entered in the books of accounts, when they become due. The transactions are recognised as soon as a right to receive revenue and/or an obligation to pay a liability is created. The expenses are recognised when the resources are consumed and incomes are booked when they are earned. Therefore, the focus is on the recording of flow of resources i.e. labour, goods, services and capital., the related cash flow may take place after some time (of event) or it may or may not take place in the same accounting period.

Cash Accounting

In this system of accounting transactions are recorded when there is actual flow of cash. Revenue is recognised only when it is actually received. Expenditure is recognised only on the outflow of cash. No consideration is given to the “due” fact of the transaction. This system of accounting is simple to understand and as such needs less skill on the part of the accountant. Its whole focus is on cash management. The recognition trigger is simply the flow of cash. Budgetary and legislative compliance is easier under this system.

Limitations of cash system of accounting

The limitations of cash based accounting are:

- It does not provide the complete picture of the financial position i.e. information on assets and liabilities are not available for fixed assets (land, building, machineries, defence, heritage assets etc.)
- No information about capital work-in-progress like dams, power plants, roads and bridges etc. is available.
- It does not give the full information on current assets e.g. accrued income like outstanding royalty, fees, service charges, tax arrears etc.
- Comprehensive information is not available about government liabilities (pensionary commitments, interest due, bills payable, depreciation for replacement of assets etc.)
- Unit cost and total cost of services provided by the Government departments like health, education, water supply, transportation etc. is not ascertainable (as depreciation, interest etc. are not apportionable)
- It ignores certain transactions by not recording expenditure already incurred but payment not made e.g. supplies made, salary, telephone charges, overdue interest etc. and also revenue earned but cash not received e.g. licence fees, services delivered (electricity, water etc.)
- It gives a wrong picture of income received, as advance tax receipts are recognised as income.
- No weightage is given to the concept of ‘matching’ i.e. expenses of a specific period should be set off against the revenue of the same period.
- No disclosure is made about contingent assets and contingent liabilities which may turn into committed ones on account of guarantees given or letter of comforts issued by the government.

- No information is provided about existing net liabilities of public enterprises and agencies outside the government, although the latter cannot escape such liabilities.
- No disclosures are made about Accounting Policies on the basis of which Financial Statements are prepared.
- It provides room for fiscal opportunism e.g. tax revenues can be collected in excess during a particular period followed by high incidence of refunds together with interest, payments can be easily deferred and passed on to the next financial year, revenue due in the future could be compromised by providing for one time payments.

Due to the above disadvantages, it is not possible to get the real picture of the government financial performance and position.

Advantages of the Accrual System of Accounting

The system of Accrual Accounting while retaining the advantages of the Cash Accounting System overcomes its limitations by inclusion of Cash Flow Statement in the Financial Statement of the entity. The major advantages are as under:

- It helps in the assessment of financial performance by correctly reflecting surplus/deficit as all expenses whether paid or not and all incomes whether received or not are duly accounted for.
- It gives information on whether income streams are adequate to meet short and long term liabilities so that their early payment keeping in view their payment period (short term and long term) and nature (cheap or costly loan) can be better managed.
- It provides comprehensive information on expenses which helps in knowing the cost consequences of policies and enables comparison with alternative policies. Also, information about calculation of subsidy can be extracted from the accounts, which helps in its rationalisation. This ensures the adoption of best policy, which in turn assures optimal use of scarce resources. It also helps in ascertaining the future sustainability of programmes.
- Liquidity position of the government can be better assessed
- It gives comprehensive information on the Financial Position i.e. assets and liabilities of government. In this system of accounting the financial decisions are not seen merely from the point of view of cash outgo or inflow but also from their impact on the asset- liability position of the government, future funding requirements of assets enabling planning of their timely maintenance and replacement.
- It gives disclosures on account of contingent assets and contingent liabilities so that risk associated with the guarantees issued and letters of comfort given can be better assessed by the user of the financial statements.
- It bridges the gap leftover by cash accounting by inclusion of accrued expenses and revenues (receivables and payables), physical assets, capital work-in-progress and depreciation, pension liabilities and provisions etc. in the accounting system.
- It discloses the Accounting Policies used in the preparation of Financial Statements for better understanding and appreciation of the Financial Statements.

Accrual Accounting System generally adopts Double Entry Book Keeping System

One should not confuse between the terms “basis of accounting” and “system of bookkeeping”. “Basis of accounting” refers to the set of concepts and rules that determine when (the time) a transaction is recognised by the accounting system and recorded in the books. Accrual accounting and cash accounting are examples of basis of accounting while a “double-entry system” refers to

a type of book-keeping system where for every transaction two aspects are recorded in books of accounts. In cash-based accounting, transactions are recognised by the accounting system when cash is received or paid, while in an accrual accounting method, the accounting system records a transaction when the right to earn income is established or when expenditure is committed. A book-keeping system can either be single entry or double entry. In the single-entry system, income and expenses are recorded through a daily summary of cash receipts and disbursements. In the Double-entry system, daily transactions, including sales, purchases, cash receipts, accounts receivable and accounts payable, are recorded in journals. Every transaction has a debit in one account and a credit in another. While double-entry is more time-consuming, it is more accurate as it is self-balancing. Accrual basis accounting is best implemented using double entry method of book-keeping, while single entry method of book-keeping is normally predominant where cash basis accounting is adopted.

Major difference between Single entry and Double entry system of book keeping with reference to Government Accounting

Single entry system is a system of book-keeping in which transactions are recorded as a single entry, rather than as both a debit and a credit. When using single entry book-keeping, only cash payments and cash receipts are recorded. The receipts and payments accounts as above can also be maintained separately for capital and revenue. Single entry accounting tends to be suitable only for small entities with limited transactions. Double entry is an accounting technique, which records each transaction as both a credit and a debit. Credit entries represent the sources of financing, and the debit entries represent the uses of that financing. Since each credit has one or more corresponding debits (and vice versa), the system of double entry bookkeeping always leads to a set of balanced ledgers with credit and debit accounts. Selected entries from these ledger balances are then used to prepare the Income Statement and Balance Sheet.

Possibility of preparation of Government Balance Sheet within the Cash System

It is possible to prepare a Balance Sheet within the cash based system even though, it is not likely to be a complete and reliable Balance Sheet. In a single entry system, there is no provision to keep track of assets or liabilities within the accounting system. Information has to be kept separately, outside the accounts. Such a system cannot be reliable, unless all the sources of information are audited and the linkages to the accounting system are checked as well. Further, if some expenses are incurred in creating an asset but the bills have not been paid, these will not be reflected in the accounts. These expenses will not be included in the total cost and the resultant value recorded will not reflect the true cost of the asset. If a double entry book-keeping system as in place under the cash based system, then the Balance Sheet would be more reliable. However, even in this case, the accounts would not present a “true and fair view” as explained below:

- Income would tend to be overstated, as liabilities and expenditure would be understated. For e.g. an advance received for performing a service will be treated as income, irrespective of whether the service has been provided or not. (In contrast, under an accrual-based system, the same will be accounted as an advance and treated as income only when service is rendered).
- Another illustration: Consider a contractor who has completed the work as per agreement, but his payment is still to be made. In a cash-based accounting system, no expenditure would be recognised; neither would there be any acknowledgement of a liability. An accrual-based system would capture the liability in the Income and Expenditure account as well as in the accounting of assets and liabilities.

Budgeting on cash basis and accounts on accrual basis

It should be noted that the “basis of accounting” is independent of the Chart of Accounts. The basic Chart of Accounts can be similar for both bases of accounting - cash or accrual. The system based on accrual accounting would have some additional account heads. When the accounts are compiled, it will have certain account heads in addition to the budget heads. These account heads will relate to accrued transactions. For example, the Chart of Accounts will have the following heads for treating fixed assets:

- Fixed Assets
- Depreciation
- Accumulated Depreciation
- Profit or loss on sale of assets

Under the cash system of accounting only the purchase of asset is recorded. The budget heads will continue to show the asset acquisition as capital expenditure. In addition to showing the expenditure, accounts based on accrual concept will also show the extent of depreciation, the accumulated depreciation till date and the profit or loss, if any, when the asset is sold.

Accounting reforms vis-à-vis concomitant budgetary reforms

Budgeting and accounting systems are closely linked to each other. In the long run it is desirable to have concomitant reforms in the budgeting and accounting systems, if government were seeking the full benefit of reform in its accounting system. However, implementing reforms simultaneously in both accounting and budgeting systems is very complex, and the task of managing the change is extremely difficult. Most countries that embarked on reforms first undertook accounting reforms, followed by budgetary reforms within a few years. Examples include New Zealand, Canada and UK. Therefore, commencing by modifying the accounting system is a good way to start the reform process, but it needs to be continued to its logical conclusion.

Experience of other countries, which prepare Appropriation Accounts under the accrual system

In most countries, government needs funds for the purposes of the development from their respective consolidated funds. Accordingly their legislatures authorise the appropriations through according of approvals to the appropriations bills proposed by the concerned government. Once an appropriation is authorised, an appropriation account is established, which disclose expenditure at the same level of detail as in the estimates, to make amounts available for expenditure from the Treasury. Various countries follow different types of appropriation. The different types of appropriation accounts include:

- **Open Appropriation Account:** An open appropriation account is an account that has not had the balance transferred to a successor account or to surplus. The appropriation in the account may be expired or unexpired.
- **Closed appropriation account:** A closed appropriation account is an account that has had the balance transferred to a successor account or to surplus. The appropriation in the account is lapsed.
- **Successor Account:** A successor account is an account established for the payment of obligations applicable to appropriations for the same general purposes, but which have

either lapsed or been discontinued. A successor account is available indefinitely for the payment of obligations chargeable to any of its predecessor accounts. Further, appropriation accounts may include not only accounts to which money is directly appropriated, but also other funds. A fund, as used in connection with appropriations, is a sum of money or other resources, usually segregated, to be expended or used for specified purposes. Funds differ from appropriations in that they are usually permanent in nature and do not expire unless they are revoked by the Parliament. Thus, in USA, appropriation accounts are prepared for General Fund, Trust Fund and Revolving Fund. Nevertheless, appropriation accounts as prepares in India, are similar to the system followed in the Commonwealth countries like UK, Canada and Australia. Thus, in UK, the Resource Accounts for each financial year are prepared and laid before Parliament under the Government Resources and Accounts Act 2000. They show the extent to which the resources granted by Parliament through Consolidated Fund Acts (following voting by the House of Commons on Estimates presented to it) have been used, and are signed by senior civil servants from the departments concerned (Accounting Officers). They are audited by the Comptroller and Auditor General. In addition to giving his certificate that the financial statements give a true and fair view of the state of affairs of the audited department concerned and that expenditure has been applied for the purposes authorised by Parliament, he may make additional comments on the accounts.

Disadvantages in add-on statements of accrual transactions to Reports of cash accounting system

If accrual transactions are added to the annual accounts without accrual based information being integrally accounted for, the accuracy of the accounting statements would be suspect. As a system, this would not be robust and, therefore, somewhat suspect in its integrity. For instance, if a bill has not been paid under an accrual accounting system, the expense will be recorded and a corresponding entry for 'Creditors Bills payable' will be made. If these accounting entries are not integrally accounted for, it is likely the information may not be captured correctly. Further, any error in recording the entries will also not come to light. On the other hand when these accounting entries are passed under accrual system of accounting, the errors, if any, will be highlighted as the Trial Balance and Balance Sheet will throw up the difference. Accrual accounting is a complete, double entry and a self-balancing system with built-in checks, which substantially minimises errors and frauds.

Recording of assets and their depreciation in Government transactions/operations even when such transactions/operations are not undertaken for profit.

It is essential to record assets in the books of accounts and provide for depreciation not only in a commercial environment, but also for entities that do not operate for profit. Governments, particularly those that operate in a Parliamentary democracy, are custodians of the money raised from the citizens and other sources. They have a duty to ensure that assets created out of such borrowings are looked after properly, so that they are not frittered away or used inefficiently. This duty of the government is irrespective of whether the assets are put to use to generate profit or otherwise. Depreciation is the diminution in value of assets due to wear and tear and efflux of time. The value of an asset after depreciation reflects its "true value". It is essential to ascertain this value in order to evaluate whether the desired outputs and outcomes are obtained from the use of the asset. Irrespective of the nature of the entity (commercial or otherwise), it is important to know the true value of the asset and depreciation helps in assessing the correct value. To continue to show the assets at their original value will be to over-estimate the value of the assets.

Policy of provisioning for bad debts and its impact

Accounting for bad debts and provisioning are essentially prudent policies, and do not mean surrendering the claim to receive payment. Treating a debt as bad or provisioning for it does not mean that efforts need not be undertaken to recover the debt. The policy for providing for bad debts merely denotes the fact that recovery from such a receivable may not be certain, and to present a more accurate position (of assets in this case), a possible erosion in value of the assets is recognised in the books of accounts. The act of provisioning does not and should not change the right of government over the particular claim. If this principle is understood and practiced, there should be no issue of “encouraging defaulters”.

Use of IT/computerisation at transaction level for smooth flow of information and their compilation

Computerisation at transaction level is desirable for smooth flow of information and their compilation. Initially, the Treasury and District Treasury offices need to be computerised. The extent of computerisation will depend on user capabilities, extent of networks, availability of computers etc. A detailed study needs to be undertaken to ascertain the readiness of computerisation at a location before it can be recommended.

Impact of recognising expenses on accrual basis and income on more or less cash basis

- What is important to note is that the accounting treatment that best represents the actual situation (in other words the “true and fair” view) should be used. If revenue from tax is not measurable and is uncertain or difficult to realise, then the correct principle would be to recognise such income on cash basis. The accrual-based system that intrinsically follows the principles of conservatism and measurability, requires that we “anticipate no gains, but provide for losses”. In the context of government accounting, recognising expenditure on accrual basis meets the criteria of conservatism, measurability and practicability. Government should bring in place procedures to accrue expenditure. Information on expenses is to be compiled to assess the cost of mobilizing revenue and sustainability of existing programs. It is also required to know the likely cost of proposed activities and services or alternative proposals and to determine that whether to fund the production of services within government sub-entities or to purchase directly from non-government organizations. Generation of surplus or deficit is not as much an issue as is a transparent depiction of the underlying situation. It may be noted that banks (including public sector banks and the Reserve Bank of India) recognise all expenditure on accrual basis, and revenue from impaired assets on cash basis.

Experience of other countries

The following countries have moved over to accrual accounting and accrual budgeting:

- i. Australia
- ii. New Zealand
- iii. The Netherlands (in the process of introducing full accrual budgeting)
- iv. Sweden (in the process of introducing full accrual budgeting)
- v. Switzerland (in the process of introducing full accrual budgeting)

The following countries have adopted full accrual accounting but follow cash based budgeting:

- i. Canada (While the federal Government adopts cash budgets, several Canadian provinces have adopted accrual budgeting)
- ii. Japan
- iii. United States
- iv. Italy
- v. United Kingdom
- vi. Portugal (provides additional accrual information along with the budgets)
- vii. Azerbaijan
- viii. Uzbekistan

The following countries have set in motion the process of moving over to an accrual based accounting system:

- i. France
- ii. Fiji Islands
- iii. Indonesia
- iv. Marshall Islands
- v. People's Republic of China
- vi. Philippines
- vii. Republic of Korea
- viii. Sri Lanka
- ix. Mongolia

Members of the European Union are required to prepare their budgets in accordance with the European system of Accounts (ESA 95). It is not a full-fledged accrual system but is predominantly based on accrual concepts.

Experience of other countries in the use of multi-dimensional classification in terms of both economic and functional classification

New Zealand provides both functional (item of expenditure of various departments) and economic classification. Canada provides economic classification in the accounts while United Kingdom provides the details of expenditure under various expenditure heads such as staff costs administrative costs etc.

Classifying transactions as other than exchange and non-exchange given the fact that there could be transactions that represent a combination of both, e.g. cross - subsidisation

All transactions can be classified into two types - exchange and non-exchange transactions. In exchange transactions, there is a value exchanged between the two parties, namely, the government and the other entity that provides or receives the service (or money). On the other hand, in non-exchange transactions, a government gives (or receives) value without directly receiving (or giving) equal value (for example, taxes collected). There is no third way of classifying a transaction. A cross-subsidisation is essentially two transactions (or more) where one is over-charged and the other under-charged. Both of these can be classified as exchange or non-exchange transactions.

Cost-benefit analysis of implementing accrual accounting

It is difficult to conduct an accurate cost-benefit analysis before accrual accounting is actually implemented. However, countries that have implemented accrual accounting have gained from

improved governance, better control over assets, increasing the confidence of all stakeholders, and quite simply from availability of more accurate information for decision-making with all stakeholders. There is authentic and accurate information on government position, resulting in better flow of resources in the economy and generally better economic performance riding on more certainty. A couple of illustrations of benefits are:

- United Kingdom has been able to identify a number of idle assets that were hitherto not being put to any gainful use.
- New Zealand had been able to quantify the extent of fines and other charges levied by various departments of the government and follow-up on their collection (the cash based system of accounting will not be in a position to provide the amount of receivables).

Average time period required for transition to accrual accounting

Most of the countries, which have moved to accrual accounting, have taken a time period of 7-10 years for the transition. New Zealand, which has the most well developed and documented transition process, took nearly 7 years to come to a full accrual accounting stage. Canada is a country similar to India in terms of the federal structure and complexity and it took about 8 years for completing the transition. Considering the size and complexity in India it is estimated that the transition process may take about 10-12 years. India also has the advantage of learning from the experiences of other countries such as New Zealand, UK, USA and Canada.

Checks and balances and risks involved in accrual accounting

Before accrual accounting is implemented, accounting policies that determine principles of recognition, measurement and disclosure need to be defined. These policies will entail that discretion is not applied indiscriminately. Further, the role of Audit also needs to be strengthened to ensure compliance. Since every transaction will have a corresponding entry, Audit will assume a stronger role and responsibility and will ensure checks and balances. The risks involved in accrual accounting can be similar to the risks involved in the present cash accounting system – However, accrual accounting leads to greater transparency in accounts resulting in easier detection of frauds.

Possible method to arrive at figures of tax expenditure and its different components

Tax expenditure is a tax concession that provides a benefit to a specified activity or class of taxpayer. Tax expenditure also redistributes the tax burden between taxpayers. At tax concession results in less tax being collected from particular taxpayers and consequently taxes paid by individuals and businesses that do not benefit from the tax expenditure are higher in order to raise the same total revenue. Tax expenditure should be reported because of the following:

- To allow tax expenditure to receive a similar degree of scrutiny as direct expenditure
- To allow for a more comprehensive assessment of government activity
- To contribute towards design of the tax system, by promoting and assisting public debate on all elements of the tax system.

Components of Tax expenditure include Tax exemption, Tax deduction, Tax offset and Concessional tax rate or deferral of a tax liability.

Tax expenditure can be measured in any of the following three ways:

- *Revenue forgone approach*- measures how much tax revenue is reduced (relative to a benchmark) because tax expenditure exists. It compares the current and/or prospective treatment and the benchmark treatment, assuming taxpayer behavior is unchanged.
- *Revenue gain approach*- measures how much revenue could increase if a particular tax concession were removed. Accurate estimation of this cost would require estimates of the secondary or behavioural effects associated with such a change.
- *Outlay equivalence approach*- estimates how much direct expenditure would be needed to provide a benefit equivalent to the tax expenditure. This approach measures the expenditure required, in pre-tax rupees, to achieve the same after-tax rupee benefit as a tax expenditure where the direct expenditure receives the tax treatment appropriate to that type of income in the hands of the recipient.

Management of small savings by government

Government can use the money collected as small savings for meeting its fund requirements. However, a transparent system should be put in place to track the small savings maturity pattern year-wise and identify probable sources for meeting the maturity payments as and when they fall due. This would help in better fund management.

Concepts of ‘Public Account’ type fund in other countries

The public account, as maintained in India, is primarily to account for funds that the government receives and manages as a banker or trustee, rather than funding general expenditure. However, there are a number of funds which are not held in trust but included in the public account. For instance, the government maintains depreciation reserve funds and sinking funds under the Public Account. These are not funds held in trust. Similarly, security deposits and other deposits, short-term investments and some cash balances, which the government maintains under the Public Account are liabilities that the government has to repay or appropriate on completion of contracts. Like India, other countries like UK, USA, Canada and New Zealand also need to maintain public account. However, unlike in India where the public and consolidated accounts are separate and appropriation account prepared only for the consolidated fund, in other countries, appropriation accounts are prepared for even public account. Further, instead of being termed as public account, it may be defined as public fund or trust fund. Thus, in USA, the following types of funds are accounted for in the appropriation accounts:

General Fund: The general fund of the Treasury is the fund into which all receipts of the United States Government are deposited, except those from specific sources required by law to be deposited into other designated funds. Appropriations from the general fund are made by Congress to carry on the general and ordinary operations of the government.

Trust Fund: A trust fund is used to deposit amounts received or appropriated and held in trust according to an agreement or a legislative act. These amounts may only be used or expended according to the terms of the trust or act.

Revolving Fund: A revolving fund is established to finance a cycle of operations to which reimbursements and collections are returned for reuse in such a manner as to maintain the principal of the fund. The amount of the fund may be in the form of cash, inventory, receivables, or other assets.

Inclusion of defence, heritage and environmental assets as part of asset accounting

New Zealand is the only country, which recognises heritage, defence and environmental assets. United Kingdom follows a policy of valuing operational heritage assets. Non operational heritage assets such as art collections, archaeological sites, monuments and ruins are not valued. However, should some non-operational assets be valued, they are valued generally at the lower of depreciated replacement cost or net realisable value. In the United States, if a collection is held in furtherance of public service and not for gain; protected, preserved, cared for, and kept unencumbered; the same is not valued.

Differences between a receipt and payment statement under the cash system and cash flow statements/ Statement of Sources and Application of Funds under the accrual system.

The cash flow statement is similar to the receipt and payment statement under the cash system in terms of aggregate income and expenditure figures.

Impetus for adopting accrual concepts differently from private sector

The private sector focuses on commercial viability whereas the government plays a developmental and social role. Therefore, the need for economic and rural development might necessitate governments to adopt accrual concepts differently from private sector. The concept of 'true and fair' is different in government from that of the private sector. Further the concept of net worth in government is not as important as in the private sector. The focus of accrual accounting in government is to ensure that the output and outcome of the spending are commensurate with the inputs and the long term fiscal sustainability of government is captured appropriately.

Incorporation of the information on unpaid bills, subsidies, tax expenditure, tax arrears, etc, in the proposed system

State Government: The cash income and expenses will flow to the AG's office from the Treasury. It is proposed that every month end, the DDOs submit details of unpaid bills to the AG's office. Similarly, the Department of Revenue will furnish details of tax expenditure and tax arrears to the AG's office. The Department of Revenue has a statistical cell, which maintains trends in the same.

Central Government departments: The DDO of the concerned department at the end of the period, say a month, apart from the approved bills also sends copies of bills raised but not yet approved/paid to the Accounts Officers. The Accounts Officers enters the details of such bills under the relevant heads, which will appear as liabilities of the concerned department. The relevant heads to take into consideration such expenditure like accounts payable, subsidies etc.

Accrual accounting as a tool for governments to take sound decisions of financial and managerial nature

By following accrual system of accounting, governments will be better positioned to assess their financial performance and financial position. Accrual system of accounting will help in preparing the position of assets and liabilities of the government, which is not possible under the current system. This would help in better fund management and evaluation of performance of various departments. Further, accrual system of accounting would help in estimating cost of services more appropriately, which could form a crucial input for managerial decision-making.

Sampling of peculiar government activities/functions/departments for pilot study for migration to accrual accounting

The transition to an accrual based system should be on the following lines. To start with Ministries/Departments with a commercial focus should implement the new accounting system. These departments (and the organisations under these departments) essentially provide commercial products/services, and compete with private sector entities. In these departments, there are tangible commercial benefits flowing from accounting reform which are essential for their competitiveness and economic viability. The next phase should cover departments with a social orientation. These departments fulfill the social responsibilities of the government. As opposed to the departments that have a certain amount of commercial and revenue focus, these are typically “spending” departments. The thrust here is on the delivery of services and ensuring that the output and outcome are commensurate with the inputs and targets. Transition to an improved system will provide these departments with better tools to monitor and evaluate service delivery and the costs. Finally, administrative/regulatory departments concerned with general administration and/or provision of regulatory functions should transit to accrual accounting. The accent of these departments is not as much on costs or revenues but on providing the necessary support and administrative services for overall running of the government and the economy. Select departments in each of the categories may be identified for pilot implementation. In the case of state governments, either an entire state government or a geographical unit such as a district or a set of districts, should be chosen for pilot implementation. If a district is chosen care should be to ensure that it is representative of all the major activities in the state.

Benefits of accrual accounting in social sector as the government mostly engage in such activities

A sound accounting system should assist the government in meeting its objectives. The information that the system disseminates should be of high quality in terms of the following parameters:-

- Accuracy
- Granularity (level of detail)
- Comparability (across periods)
- Appropriateness of metric(s). Such metric(s) should indicate the basic objectives of existence of the entity concerned (e.g. profit for a commercial entity, unit cost for a service centre, sustainability of operations as indicated by fiscal position and debt level, and so on)
- Adequacy of disclosures (of assumptions and financial position)
- Better control on resources and operations so as to be able to stand up to the scrutiny of stewardship - an essential element of democratic functioning Accomplishment of the above parameters is necessary for any sector including social sector.

Relation of performance evaluation/outcome to accrual accounting

The purpose of accrual concept is to make sure that all revenues and costs are recorded in the appropriate statement at the appropriate time period. Costs concerning a future period must be carried forward as a prepayment for that period and not charged in the current profit statement. For example, payments made in advance such as the prepayment of rent would be treated in this way. Therefore, accrual basis of accounting helps in reflecting true picture of expenditure in an accounting period. For example, one of the parameters in government for performance evaluation

of a department could be per unit cost of service. Accrual basis of accounting helps in quantifying the cost correctly, which is the key requirement for estimating per unit cost of service.

Flow of transaction and its capturing at various levels in accrual accounting

In the chain of processes mentioned as under, some would necessitate recording an accounting entry while some would be a matter of disclosure. For instance, when a commitment is made (step ii) it is not recorded in the books as an accounting entry, but is disclosed appropriately. Similarly, when service is received or rendered, the relevant accounting entry is passed. If the service received is not as per the terms of the contract (step iv), or requires modifications, it is disclosed appropriately. This has been explained below in terms of various steps:

- i) Appropriation - The legislature approves the spending of money.
- ii) Commitment - The government and its agencies make commitments to third parties to spend monies or to provide services.
- iii) Rendering of services - The government and its agencies provide or receive service.
- iv) Verification of delivery of services - The services provided or received are verified to ensure that these are in accordance with the terms of the contract.
- v) Preparation of payment order - The authorisation for the payment is made as per the laid down process.
- vi) Release of payment - The payment is affected.

In a cash system of accounting only transactions i) and vi) mentioned above are recorded. However, from the perspective of a stakeholder of the entity in question, the information on the status of the entity at the intermediate stages is also important. The intermediate stages ii) through v) represent various stages of the transaction, when specific liabilities or obligations are contracted, or assets are acquired and revenues are earned. Failure to capture the essence of these steps will result in non-recognition of the liabilities and obligations or recognition of revenue. An accounting system based on accrual concepts can capture each stage of the transaction above, which materially affects the financial position of the entity, thereby ensuring a more comprehensive coverage and greater accuracy.

Extent of geographical data that will be covered by the proposed system

The geographical data that will be thrown up will be at the DDO level. While such information is captured now, they do not form an integral part of the Finance Accounts.

Inclusion of an Operating cost statement as a part of accounts in governments

Most countries that have adopted an accrual based system have operating cost statement forms as part of the accounts in government.

Treatment of various items in the Public Account

The balances under the Public Account will be part of the proposed statement of Assets and Liabilities. They will be shown under the following heads of account and will be grouped under the respective Asset and Liability accounts.

- (a) Small Savings, Provident Funds - These are monies held in trust by the government
- (b) Reserve Funds - These are ear-marked funds created with a specific purpose

- (c) Deposits and Advances - These represent the deposits and advances received and made by the Government
- (d) Suspense and Miscellaneous - These represent inter-department and inter-state transactions (in a State Government) and items pending final allocation
- (e) Remittances - Remittances made, un-encashed cheque, and cheque in transit are included under this head
- (f) Cash Balance - Cash balance of the government and short term investments made out of surpluses

Incorporation of all three parts of the Government Account namely Consolidated Fund, Contingency Fund and the Public Account in the Income and Expenditure Account in the proposed system

The proposed system covers all income and expenditure relating to the three funds.

Matter of subsidies in the proposed system

At present, the expenses of a department and cost recovery are shown at different parts in the budget, and the computation of subsidies is tedious and laborious. Further, there are no guiding principles provided in the budget that can educate the reader on the method of computing these subsidies, as a result of which different users tend to compute subsidies differently. The subsidies so calculated are not accurate, as complete information required for such computation is not available at one place. For instance, in a State budget the income from an economic service, e.g. Irrigation, is included under non-tax revenue. The expenses related to Irrigation are depicted under various heads. If a user desires to compute the subsidy provided by the Irrigation department, (s)he would find it difficult to identify the expenses specifically relating to the irrigation projects. Further, if a particular department provides both merit and non-merit goods/services, it is not easy to identify the extent of subsidy provided for non-merit goods. The proposed departmental accounts will help in identifying the overall extent of subsidy.

Basis of allocation of employee cost and material amount

The allocation of employee and other costs to various functions of the government should be made on the basis of a costing system. The accounting system only provides the necessary information for computing costs and by itself it is not a costing system.

Some issues to be addressed at the time of transition to accrual accounting

- *Preparation of the first Balance Sheet under accrual basis accounting:* The decision on the format of financial statements on migration to accrual accounting and generation of first set of financial statements is of key importance in transition. The format has to facilitate transparent, accurate and complete depiction of financial position. Checks and balances have to be in place to ensure appropriate measurement and recording of accounting data. Issues like preparation of Assets register and valuation of assets have to be addressed. Internationally the role of auditor has been significant in ensuring a smooth transition to accrual basis of accounting. Auditors may be helpful in framing the accounting policies on assets and liabilities, recognition of revenues and expenses, citizen's net worth, reporting period, measurement basis etc.

- *Accruing revenues:* Accurate information of revenues is essential for assessing the impact of taxation and other revenues on the Government's fiscal position, in assessing the need for borrowing in the long term and also to assess whether current revenues are sufficient to cover the costs of current programs and services. It is necessary to take a decision on the types of revenues that are capable of accruing with reasonable degree of certainty. In case there are few line items that are not suitable for accruing, they may be continued under cash basis accounting. The decision in this regard has to be taken by government.