



**ACCRUAL BUDGETING –
Experiences of Other Nations and Implications
for the United States**

UNITED STATES GENERAL ACCOUNTING OFFICE (GAO)

Amennyiben a teljesítmény-alapú finanszírozás érdekében a különböző szervezetek kibocsátási szintjét és minőségét kívánjuk finanszírozni, akkor azt is biztosítani kell, hogy megismerhessük ezeknek a kibocsátásoknak, teljesítményeknek a valós költségeit. Különösen fontos ez abban az esetben, ha több egymással versenyben álló szervezet nyújt hasonló szolgáltatást, és közöttük az „ár” vagy összehasonlító vizsgálatok (például benchmarking) alapján kívánunk választani. A pénzforgalmi szemlélet alapján azokkal a kiadásokkal számol a költségvetés, amelyek az adott évben felmerülnek. Ez azonban nem azonos a költségekkel. A költség-alapú költségvetés (ún. accrual budgeting vagy cost-based budgeting, szemben az ún. cash-based budgetinggel) minden kiadást és bevételt annak az évnek a teljesítményéhez kell kötni, azzal kell szembeállítani, amely miatt az felmerült. Ennek kezelésére szolgál a számvitelben az amortizáció: a tőkeköltségeket nem egyben számolják el a beszerzés évében, hanem az amortizáción keresztül annak az évnek a költségei között, amely évben az adott eszközt „fogyasztják”. Ez vagyis az amortizáció költségvetési elszámolása a költség-alapú költségvetés alapja.

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1. INTRODUCTION

In recent years, the United States and several other countries have made changes—some more sweeping than others—aimed at improving public sector financial and performance management. Although differences exist, the reforms have converged around the common objective of establishing more business-like practices with the aim of improving the performance, sustainability, and transparency of government activities and ensuring accountability for results. In a number of countries, these reform efforts have challenged traditional thinking about cash-based accounting and budgeting systems and stimulated interest in the potential for accrual-based information to contribute to improved public sector management. Accrual measurement is generally viewed as a better means of matching cost recognition with the consumption of resources.

At least 11 of 29 Organization for Economic Cooperation and Development (OECD) member countries, including the United States, have incorporated accrual-based measures to some degree into their financial management systems, and four – Australia, New Zealand, Iceland, and the United Kingdom¹ – have extended or plan to extend the use of accruals directly into the budget

for most items. Others, such as the United States, Canada, and the Netherlands, have adopted more limited accrual budgeting approaches, applying accrual budgeting to a limited number of budget items or specific departments. Other countries' early experiences with accrual budgeting may be useful to the United States as it continues down the path toward improving the way the government budgets for and manages its operations and programs and considers whether to extend its use of accrual budgeting.

Background

Method of Budget Reporting Reflects Choices About the Uses and Functions of the Budget

The U.S. federal budget serves as the primary financial plan of the federal government and thus plays a critical role in the decision-making process. Policymakers, managers, and the American people rely on it to frame their understanding of significant choices about the role of the government and to provide them with information to make decisions about individual programs and overall fiscal policy. While budgetary decisions are inherently based on political choice, the method of budget reporting² plays an important role

*A cikk a GAO/AMID-00-57 számú GAO jelentés első három fejezetét tartalmazza, az Objectives, Scope, and Methodology című alfejezet és a nem közölt fejezetekre történő hivatkozások kivételével. A teljes jelentés elérhető a www.gao.gov honlapon.

¹As discussed in more detail in the report, Iceland has adopted

accrual budgeting with the notable exception of capital spending. The United Kingdom does not accrue revenues.

²In this report, the method of budget reporting refers to the criteria used to determine how and when transactions are recognized and measured in the budget.



by shaping difficult choices and highlighting what trade-offs are brought to the forefront. Further, because the budget process serves as a key point of accountability between policymakers and managers, the way costs are measured and reported in the budget can have significant consequences for managerial incentives. The three bases of measurement discussed in this report—cash, obligations, and accrual— represent much more than technical means of cost measurement; they reflect fundamental choices about the uses and functions of the budget.

Cash and accrual represent two different bases for measuring budgetary costs. Cash-based measurement records receipts and outlays when cash is received or paid, without regard to when the activity occurs that results in revenue being earned, resources being consumed, or liabilities increased. Accrual-based measurement, on the other hand, records revenues and expenses in the period the activity generating revenues, increasing liabilities or consuming resources occurs, regardless of when associated cash is actually received or paid. Accrual measurement is useful in accommodating situations where transactions are not completed in one period. In the financial accounting context, accrual measurement places an emphasis on contractual duties. For example, revenues are recognized to the extent that goods or services have been delivered and expenses are recognized for assets used and liabilities incurred in generating the revenue. In an accrual accounting system, a corollary of revenue and expense recognition is the simultaneous recognition of changes in assets and liabilities.

In comparison, obligation-based budgeting focuses on the legal obligations entered into during a period regardless of when cash is paid or received and regardless of when resources acquired are to be received or consumed. The obligations basis is used in the United States for controlling federal government obligations and outlays. Obligation-based budgeting involves three stages:

(1) the Congress must enact budget authority³ before government officials may obligate the government to make outlays,⁴ (2) government officials commit—obligate—the government to make outlays by entering into legally binding agreements, and (3) outlays are made to liquidate obligations. Obligation-based budgeting, as currently used in the United States, provides an additional level of control over pure cash budgeting by requiring that entities have authority to enter into obligations to make outlays of government funds. Budget authority, obligations, outlays, and receipts are generally measured in cash or cash-equivalent terms.⁵ Further, with limited exceptions, the unified budget deficit/surplus—the key focus of the policy debate—is the difference between cash receipts and cash outlays. As a result, the U.S. budget is often referred to as cash-based as well as obligation-based.

In contrast to cash- and obligation-based budgeting, accrual budgeting generally involves aligning budget recognition with the period in which resources are consumed or liabilities increased, rather than when obligations are made or cash flows occur. Although accruals can be measured in a variety of ways, the term accrual budgeting typically has been used in case study countries to refer to the recording of budgetary costs based on financial accounting standards. Thus, accrual-based appropriations, by reflecting costs incurred during a fiscal year, generally provide information similar to that found in a private sector operating statement. Table 1 provides an overview of the three methods of budget reporting—cash-based, obligation-based, and accrual-based—and uses two hypothetical transactions to illustrate how the budgetary information provided to decisionmakers may differ based on the method used.

Choices about the appropriate method of budget reporting are complicated by the multiplicity of the budget's uses and users. The federal budget is simultaneously asked to provide

³In the U.S. federal budget system, budget authority refers to authority provided by law to enter into financial obligations that will result in immediate or future outlays of government funds.

⁴In the U.S. federal budget system, outlays refer to the disbursement of government funds in order to liquidate an obligation.

⁵Theoretically, transactions within an obligation-based budget

could be measured on either a cash/cash-equivalent basis or an accrual basis. With limited exceptions, the U.S. obligation-based budget measures transactions on a cash or cash-equivalent basis. One exception is the treatment of credit programs for which budget authority, obligations, and outlays are measured on an accrual basis. Certain interest payments are also measured on an accrual basis.



Table 1: *Comparison of Methods of Budget Reporting*

Method	General description	Budgetary treatment of hypothetical transactions relating to capital and inventories	
		Purchase and 1st year's use of building	Purchase and use of supplies
		Total equipment cost = \$10m Cash payments during fiscal year = \$5m Depreciation expense for fiscal year = \$1m	Total supplies ordered and received = \$3m Total payments for supplies = \$2m Total supplies used = \$1m
Cash	Budget authority ^a would equal estimated cash payments for the fiscal year. No appropriation required for outstanding contract costs or depreciation expense. Prior legislative budget approval may not be required before entering into legally binding contracts whose cash consequences do not occur during the fiscal year. Outlays ^b and receipts are recognized in the budget only in year cash flows take place	\$5m included in budget authority \$5m included in outlays and in deficit/surplus calculation	\$2m included in budget authority \$2m included in outlays and in deficit/surplus calculation
Accrual	Budget authority is the estimated amount of resources consumed, irrespective of when commitment is made or cash flows take place. Outlays/receipts are recognized in period resources are budget in the period consumed, liabilities increased, or receipts earned.	\$1m included in budget authority \$1m included in outlays in the deficit/surplus calculation (assuming net operating amount used as measure of deficit/surplus) \$5m included in financing requirement (cash flows), which may or may not require approval depending on approach used	\$1m included in budget authority \$1m included in outlays and in deficit/surplus calculation to cover supplies consumed during the period \$2m included in financing requirement (cash flows), which may or may not require approval depending on approach used
Current United States obligation-based budget	Budget authority is the authority provided by law to enter into financial obligations that will result in immediate or future outlays involving federal government funds. This authority is required before officials can enter into legal commitments on behalf of the government. Obligations are recorded primarily when goods and services are ordered, regardless of when resources acquired are to be received or consumed.	\$10m included in budget authority and obligations \$5m included in outlays and in deficit/surplus calculation	\$3m included in budget authority and obligations \$2m included in outlays and in deficit/surplus calculation

Notes:

^aIn this table, the term "budget authority" is used as a proxy for whatever term a government uses to imply legislative approval of amounts in its budget. In case study countries, authority to enter obligations is generally dealt with through executive controls. In the United States, congressional approval is required to enter into financial obligations.

^bIn this table, the term "outlay" is used as a proxy for whatever term a government uses to signify the use of resources.

^cAs will be discussed in detail in the report, accrual budgeting approaches vary significantly across countries. These examples are to provide general understanding of the accrual budgeting concept in its simplest form.



full information and appropriate incentives for resource allocation, control over cash, recognition of future commitments,⁶ and the monitoring of performance. Given the multiple and potentially competing objectives, choices about the method of budget reporting involve trade-offs. For example, control over spending is greatest if the budget recognizes the complete cost at the time the decision is made while assessing performance and its cost is generally best supported by recognizing resources as they are used to produce goods and services. As demonstrated in table 1, the up-front funding requirement under an obligation-based budget helps ensure control over the acquisition of a new building but does not align its cost with its use. Conversely, accrual budgeting better aligns the cost of the building with the periods that benefit from its use, but in its simplest form it does not provide for up-front control over entering a legally binding commitment to purchase the building. Given these trade-offs, a budget reporting approach should be selected based on the primary decision-making and accountability needs of a governmental system while balancing the needs of multiple users.

Cash-Based Measurement Traditionally Used for Public Sector Budgeting

Historically, countries have maintained central government budgets on a cash basis. The use of cash-based measurement in public sector budgeting has several advantages. Perhaps most notably, cash is a widely used and traditionally accepted measure of the government's impact on the economy since the cash-based deficit closely approximates the government's borrowing needs.⁷ Further, because it can be easily tracked, cash fits well with the traditional focus of public sector budgeting on control and on ensuring compliance with spending limits. In addition, for

most government activities, such as salaries or grant payments, the time between the occurrence of the underlying transaction and the cash flows is relatively short. Therefore, cash-based measurement generally provides both adequate information and control.

There are some activities, however, for which cash measurement is misleading. For programs such as credit, pensions, other postemployment benefits, and insurance, the current-year government obligations can involve cash flows to and from the government for many years. Other programs involve implied commitments or claims on future budgetary resources for social insurance programs such as Social Security and Medicare. Cash-based reporting also does not adequately reflect the cost of other decisions that can have a long-term impact, such as the cost of some tax expenditures, regulations, or government liabilities for environmental cleanup. As a result, cash-based measurement may not recognize the government's ultimate costs at the time the commitment is made. In other cases, such as for capital assets and inventories, the actual use or consumption of the asset may be spread over a period of time. As a result, cash-based measurement may not properly align costs with the provision of government goods or services. Thus, the true cost to the government as a whole and the specific cost of particular goods or services may be overstated in some periods and understated in others. These issues have led analysts and researchers in the United States and other countries to raise concerns over the past several decades that cash-based budgeting does not provide adequate information or appropriate incentives for some government activities. While the United States budgeted on an obligations basis and garnered its control benefits, most other case study countries were budgeting solely on a cash basis prior to their shift to accrual budgeting.

⁶In this report, the term "commitment" is used to mean a promise to provide a good or service. It does not necessarily mean a legally binding obligation, although it may be, in the case of a contract to purchase an asset, for example.

⁷A cash-based budget is not the only measure available to assess the impact of government activities on the economy. In the United States, for example, the official national income and product accounts (NIPAs) provide a picture of government activities in terms of production, distribution, and use of output. There are a number of major differences in the treatment of federal receipts

and expenditures in the NIPAs from their treatment in the unified budget, including adjustments for timing of payments. For example, the unified budget counts receipts for corporate taxes when they are received, whereas NIPA counts them when the liability is accrued. NIPA and the unified budget also differ in their treatment of investment and capital consumption. The unified budget reflects all expenditures of the federal government including investment while the NIPA budget shows current expenditures and thus excludes investments and includes the consumption of fixed capital (depreciation).



**Public Management Reforms Have Renewed
Interest in Accrual Reporting and Budgeting**

In recent years, public sector reforms emphasizing improving transparency, cost effectiveness, and managerial flexibility have served to further highlight the limitations of cash-based reporting and budgeting. For example, it has been recognized that adequately assessing performance under more result-oriented management systems requires information beyond the cash flows in a given period and more consistent and credible cost data across programs and accounts. At the same time, there has been a growing recognition that information on the long-term cost consequences of today’s commitments is important for policymakers as they consider making those commitments.

Faced with concerns about the sustainability of government activities and the demands of more result-oriented management systems, some countries have begun moving towards accrual-based measurement for financial reporting and, in some cases, budgeting. To date, at least 11 OECD countries, including the United States, had incorporated accrual measures to some degree for financial accounting purposes, and four—New Zealand, Australia, Iceland, and the United Kingdom—had extended or plan to extend accruals directly into their budgets for

most budget items. Other countries, such as the United States, Canada, and the Netherlands, have adopted accrual budgeting approaches only for specific budget items or departments. Table 2 provides a snapshot of the use of accrual reporting and budgeting by the United States and the other countries included in our review.

**Recent U.S. Reform Has Taken Significant
Steps to Improve Financial and Performance
Management**

Like many of its OECD counterparts, the United States has taken significant steps in recent years to improve public sector financial and performance management. Recognizing the need to improve effectiveness while at the same time limiting costs, the Congress established a statutory framework, outlined in table 3, which provides a powerful framework for instilling a more performance-driven approach to management and accountability.⁸ These reforms have served to highlight the need for more complete and reliable cost and performance information. In doing so, questions have been raised about whether the current U.S. cash- and obligation-based budget provides (1) a complete picture of the government’s financial condition to assess the long-term sustainability of government activities such as Social Security and (2) matches

Table 2: Use of Accrual Reporting and Budgeting by Country Reviewed

	Accrual financial statements		Budgets on accrual basis
	Department-level	National (core) government	
United States	Yes	Yes, subject to audit since FY 1997	No, with limited exceptions ^a
New Zealand	Yes, since FY 1991-92	Yes, since FY1991-92	Yes, since FY 1994-95
Australia	Yes, since FY 1995-96	Yes, since FY 1997-98	Yes, since FY 1999-2000
United Kingdom	Yes, started in 1993; all by FY 1999-2000	Yes, estimated for FY 1999-2000 ^b	Proposed. First accrual budget to be presented for FY 2001-02
Iceland	Yes, since FY 1992	Yes, since FY 1992	Yes, since FY 1998. Also presented on cash basis
Canada	No	Yes, modified accrual; full accrual for FY 2001-02	No, modified accrual including pensions and accounts payable
Netherlands	No, except for select agencies ^d	No	No, except for select agencies

Notes:

^aAccrual measurement used for credit programs and some interest.

^bThis involves the whole-of-government, including local authorities proposed for FY 2005-06.

^cDepartmental financial statements will be produced on a full accrual basis in FY 2001-02.

^dTwenty-two agencies produce accrual-based financial statements and receive appropriations for the “price” of outputs based on accrued costs.

⁸See Managing for Results: The Statutory Framework for Performance-Based Management and Accountability (GAO/GGD/AIMD-98-52, January 28, 1998).



cost to government performance in ways which effectively support management reform efforts.

At the heart of this framework are two significant reforms of the 1990s: the Chief Financial Officers (CFO) Act of 1990 and the Government Performance and Results Act of 1993 (the Results Act). The CFO Act—as expanded by the Government Management Reform Act of 1994 and amended by the Federal Financial Management Improvement Act of 1996— was designed to remedy decades of serious neglect in federal financial management by establishing chief financial officers across the government and requiring the preparation of audited annual

financial statements. It requires the preparation and audit of agencywide financial statements for 24 specified agencies beginning with fiscal year 1996 and for the preparation and audit of consolidated financial statements for the federal government beginning with fiscal year 1997. While the CFO Act established the foundation for improving management and financial accountability among agencies, the Results Act aims more directly at improving program performance. Under the Results Act, agencies are required to set multiyear strategic goals and corresponding annual goals, measure performance toward achievement of those goals, and report on their progress.

Table 3: *Statutory Framework^a for Performance-Based Management and Accountability Reform Efforts in the United States*

Title of act	Purpose
Government Performance and Results Act of 1993, P.L. 103-62	The purposes of the Results Act include holding federal agencies accountable for achieving program results and requiring federal agencies to clarify their missions, set program goals, and measure performance toward achieving those goals.
Chief Financial Officers Act of 1990, P.L. 101-576, and Government Management Reform Act of 1994, P.L. 103-356	The objective of the Chief Financial Officers (CFO) Act is to greatly improve and strengthen financial management and accountability in the federal government. The Government Management Reform Act expanded the CFO Act by, among other things, establishing requirements for the preparation and audit of 24 agencywide financial statements beginning with fiscal year 1996 and for the preparation and audit of consolidated financial statements for the federal government beginning with fiscal year 1997.
Federal Financial Management Improvement Act of 1996, P.L. 104-208, Div. A, Title I, sec. 101(f) [Title VIII], 110 Stat. 3009-389	The purpose of the Federal Financial Management Improvement Act is to ensure that agency financial management systems comply with federal financial management system requirements, applicable federal accounting standards, and the U.S. Government Standard General Ledger ^b in order to provide uniform, reliable, and more useful financial information.
Clinger-Cohen Act of 1996, P.L. 104-208	The purpose of the Clinger-Cohen Act is to improve the productivity, efficiency, and effectiveness of federal programs through the improved acquisition, use, and disposal of information technology resources.
Federal Managers' Financial Integrity Act of 1982, P.L. 97-255, 31 U.S.C. secs. 1105, 1113, and 3512	The purpose of the Federal Managers' Financial Integrity Act is to establish a framework for ongoing evaluations of agency systems for internal accounting and administrative control.
Federal Credit Reform Act of 1990, as amended, P.L. 101-508, 104 Stat. 1388-609 (1990), and as amended by P.L. 105-33, 111 Stat. 692 (1997)	The purpose of the Federal Credit Reform Act is to accurately measure the costs of federal credit programs by placing the cost of credit programs on a budgetary basis equivalent to other federal spending and to improve the allocation of resources among credit programs and between credit and other spending programs.

Notes:

^aThe framework also includes: *Paperwork Reduction Act of 1995*, P.L. 104-13; *Debt Collection Act of 1982*, as amended, P.L. 97-365; *Debt Collection Improvement Act of 1996*, P.L. 104-134, sec. 31001; *Prompt Payment Act* P.L. 97-177, 96 Stat. 85 (1982), Codified at 31 U.S.C. secs. 3901-3906; *Inspector General Act*, as amended P.L. 95-452; and *Computer Security Act of 1987*, as amended, P.L. 100-235, 101 Stat. 1724 (1988), as amended by P.L. 104-106, 110 Stat. 701 (1996).

^bThe U.S. Government Standard General Ledger provides a standard chart of accounts and standardized transactions that agencies are to use in all their financial systems.

^cThe *Omnibus Consolidated Appropriations Act of 1997* (P.L. 104-208) renamed both the *Federal Acquisition Reform Act of 1996* (P.L. 104-106, Div. D) and the *Information Technology Management Reform Act of 1996* (P.L. 104-106, Div. E) as the "Clinger-Cohen Act of 1996."



These reform objectives have been supported by the development of financial and cost accounting standards suitable for the federal environment.⁹ Under these federal financial accounting standards, the financial statements required by the CFO Act are prepared on an accrual basis unless otherwise noted. In contrast, the federal budget is based on budgetary concepts and policies adopted by the Congress and the executive branch, generally on an annual cash and obligation basis.

The United States has, however, also recognized the contribution accrual-based measurement can make to budgeting. In a series of reports in the 1980s on managing the cost of government, we advocated the use of some accrual cost measures in the budget. Specifically, we reported that the budget's exclusive focus on cash transactions meant that the costs of some programs, including retirement, insurance, and credit, were not accurately reflected in the budget. Since then, the budget has been modified gradually with the use of accrual measures to recognize the government's costs for certain programs. For example, in 1985, budgeting for military retirement costs was moved to an accrual basis at the program level by reflecting the government's expected costs for retirement benefits as they are earned. Similarly, since 1987, accruing retirement costs not covered by employee contributions have been charged to employing agencies for civilian employees covered by the Federal Employees Retirement System. In both cases, these program costs are offset within the budget because each agency's outlays for the accrued cost are paid to and recorded as receipts by the military and civilian retirement systems, respectively. As a result, the allocation of costs across agencies is improved. However, because the retirement systems themselves are within the

budget, total outlays, and thus the deficit/surplus, include only cash outlays to current retirees.

More recently, the Federal Credit Reform Act of 1990 changed the method of controlling and accounting for credit programs to an accrual basis and uses these accrued costs in the deficit and surplus. Prior to credit reform, outlays for credit programs were reflected in the budget only when cash was disbursed. Thus, the full amount of direct loans was reported as an outlay, ignoring that many would in fact be repaid. For loan guarantees, no outlays were reported when guarantees were made, thus ignoring the fact that some of the guaranteed loans would eventually default and require governmental cash outlays. Cash-based measurement thus overstated the cost of direct loans and understated the cost of loan guarantees in the year they were made. This not only skewed the cost comparisons between these two similar programs but also misrepresented their relative costs in comparison with other federal spending and led to disadvantageous patterns of funding loan guarantees rather than direct loan programs. Credit reform addressed the shortfalls of cash-based budget measurement for credit programs by requiring the budget to include before the credit is extended the estimated net present value¹⁰ of the cost¹¹ to the federal government over the entire lives of loans or loan guarantees.

There has been continued interest in the potential for accrual-based measurement to overcome the limitations of cash-based measurement for specific programs. Several years ago, the Chairman of the House Committee on the Budget asked us to review the budget treatment of federal insurance programs to assess whether cash-based budgeting provides complete information and whether accrual-based information could be used to improve budgeting for these programs. In 1997, we concluded that for

⁹The Federal Accounting Standards Advisory Board (FASAB) was established in October 1990 to consider and recommend accounting standards to address the financial and budgetary information needs of the Congress, executive agencies, and other users of federal financial information. When the Board has developed a proposed concept or standard, it is submitted to the Secretary of the Treasury, the Director of OMB, and the Comptroller General for their review. If, within 90 days after its submission, any one of these officials objects to the proposed concept or standard, then it is returned to the Board for further consideration. If, within 90 days after its submission, none of these officials objects to the proposed concept or standard, it becomes final. Cost accounting standards developed by FASAB require agencies to develop and implement cost accounting

systems that can be used to relate the full costs of various programs and activities to performance outputs.

¹⁰Present value is the worth of a future stream of returns or costs in terms of money paid today. A dollar today is worth more than a dollar at some date in the future because today's dollar could be invested and earn interest in the interim.

¹¹Under the Federal Credit Reform Act, the estimated cost of a direct loan or loan guarantee is now the sum of all expected costs—including interest rate subsidies and estimated default losses—and all expected payments received by the government over the life of the commitment, discounted by the interest rate on Treasury securities of similar maturity to the loan or guarantee. Reestimation of the cost of loans disbursed or guaranteed in a given year is required over the life of the commitment.



federal insurance programs cash-based measurement may provide incomplete or misleading information because the annual net cash flows currently reported in the budget may not adequately match premium collections with the expected costs of insurance commitments. We recommended that the Director of the Office of Management and Budget (OMB) develop accrual-based cost estimation models for federal insurance programs and encourage similar efforts at agencies with insurance programs. Further, we recommended that, as estimates become available, they should be reported annually in a standardized format as supplemental information along with the cash-based estimates.¹² Building on these recommendations, legislation was introduced in the 106th Congress calling for the development of accrual-based cost estimates for federal insurance programs, with the eventual aim of incorporating these estimates into the budget. In addition, there has been increasing attention paid to the solvency of the Social Security program, which has generated interest in whether accrual-based information could serve to highlight long-term issues in the annual budget process.

Two concerns in particular have prompted interest in the use of accrual budgeting: (1) a desire to improve the budget treatment of commitments which extend over many years and (2) a growing recognition that to be most useful the improved cost and performance information provided by recent reforms must be closely linked to the federal government's budget and appropriations process. As a result, there has been interest in what lessons may be learned from other countries that have chosen to adopt accrual-based budgeting. These countries' early experiences with the benefits, problems, and feasibility of incorporating accrual-based measurement into the budget may provide insights as the United States continues its own financial and performance management reform efforts.

Countries Face Common Reform Objectives But Different Institutional Frameworks

Although commonalities in recent public sector reform agendas pursued by the United

States and other countries provide a valuable opportunity for shared learning, consideration must be given to significant differences that exist among countries. Specifically, key differences exist between the role legislative bodies in a parliamentary system of government and the Congress of the United States play in the budget process. In the United States, the legislature and executive are independently elected and have different constituencies and roles. In a parliamentary system, governments are formed by the political party, or coalition of parties, that have the support of a majority of Parliament. As a result, the line between the executive and the legislative functions is not as clear as it is in the United States. Many important budget decisions that are debated during the annual appropriations process in the United States occur before the budget is presented for parliamentary approval in the parliamentary system. Parliament's duty is to satisfy itself on behalf of its constituency that the current government has the Parliament's full confidence to continue governing. In fulfilling this duty, case study countries' parliaments regularly enact the government's budget without amendment. In Westminster systems a failure to do so may be viewed as a lack of confidence in the government and signal a need for new elections, including for a new Parliament.

Another difference between the United States and other countries is the method of budget reporting to which accrual is compared. While most of the countries in our study previously had budgeted on a cash basis, the United States has an obligation-based budget that permits greater legislative control than a cash-based budget. This difference is significant for evaluating the implications of a shift to accrual budgeting. As discussed later in this report, the use of an obligation-based budget provides additional recognition and control beyond that in either a pure cash budget or an accrual budget and thus has additional implications for assessing what would be gained and/or lost were the United States to move to accrual budgeting.

¹²See Budget Issues: Budgeting for Federal Insurance Programs (GAO-AIMD-97-16, September 30, 1997).



2. AN OVERVIEW OF NATIONS' ACCRUAL BUDGETING INITIATIVES

In the countries we reviewed, the use of accrual budgeting has been linked intrinsically with broader public management reforms driven by concerns about the size, role, and effectiveness of the public sector. While proponents attributed improvements in fiscal policy and managerial decision-making to the adoption of accrual budgeting, others have expressed skepticism about the usefulness and feasibility of accrual measurement for public sector budgeting. Further, because accrual budgeting was just one part of broader reform efforts, it is difficult to isolate the direct benefits and limitations of accrual budgeting from those resulting from other aspects of the comprehensive changes.

Although countries that have chosen to adopt accrual budgeting tend to use a common language in articulating their objectives, they have taken significantly different approaches in designing and implementing their accrual budgeting frameworks. These approaches generally reflect each individual country's reform environment and objectives. Thus, while "accrual budgeting" is often used as a generic term, it has been applied in different forms to address a variety of budgeting challenges.

Accrual Budgeting Adopted as Part of Broader Reform Efforts

Case study countries generally adopted accrual budgeting and reporting as part of broader reform efforts. In general, these efforts sought to improve the effectiveness and efficiency of public sector operations through improved transparency and more decentralized performance-oriented management. However, the impetus for and the magnitude of change varied. Some countries, such as New Zealand and Iceland, were motivated by large deficits and/or concerns over the sustainability of a large public sector. Others, such as the United Kingdom and Australia, undertook change as part of more general improvements in

public sector management. Further, the situation is dynamic as some countries continue to refine and expand their reforms, including the role of accrual budgeting.

As countries pursued these broader reform agendas, officials increasingly realized the limitations of purely cash-based budgeting systems. For example, by focusing budget decisions on cash flows within a particular year, cash-based budgeting did not include crucial information on assets, liabilities, and other commitments necessary to assess the sustainability of government activities or to provide incentives for a longer-range policy and management focus. Further, because cash-based budgeting did not always capture the full costs incurred in a period, it was viewed as hampering full understanding of and accountability for the relationship between performance and cost, a cornerstone of the performance-oriented management paradigm. According to officials in several countries, these concerns were heightened by the general belief that cash-based budgeting allowed manipulation of spending across years simply by delaying or accelerating cash payments. In addition, they expressed concerns that cash-based budgeting misstated the annual cost of using capital by failing to spread the purchase costs of capital projects over their useful lives and by ignoring the opportunity cost of tying up capital in the form of physical assets.

Proponents described accrual budgeting as an integral tool within broader reform efforts. In New Zealand, accrual budgeting was adopted as a part of a systematic program of sweeping changes that, beginning in 1984, sought to transform the country's economy and public management system in response to several years of serious economic difficulties. These reforms comprehensively and fundamentally restructured the role of the national government in the economy by corporatizing and privatizing government entities and enhancing efficiency and accountability in the remaining public sector.¹³ In addition, the reforms radically changed the accountability relationship between the government and departmental executives by establishing 5-year contracts with departmental executives and holding them accountable for

¹³Budget Issues: Privatization/Divestiture Practices in Other Nations (GAO/AIMD-96-23, December 15, 1995).



achieving discrete and measurable performance outputs included in the terms of purchase agreements¹⁴ signed with their respective ministers. Accrual budgeting was described as an essential tool in supporting this new model of devolution of responsibility by reflecting the full costs of resources used in achieving those outputs.

Australia's adoption of an integrated accrual budgeting and reporting framework built on numerous reforms previously undertaken to improve the effectiveness and efficiency of government operations and increase the transparency of budget and fiscal policy decisions. Following a comprehensive review of the government's operations in 1996, a reform agenda was developed which, according to the National Commission on Audits, was intended to (1) put the public sector on a more business-like footing, (2) foster a more competitive environment, and (3) build a culture that values high performance. Along these lines, the Financial Management and Accountability Act of 1997 devolved responsibility for financial management to agencies and established mechanisms to help hold chief executives accountable for the results of exercising their management prerogatives. As in New Zealand, some Australian officials described the adoption of an integrated accrual budgeting and reporting framework as key to advancing these efforts. It was generally believed that improving the consistency and comparability of financial, budget, and performance information would increase its use in the decision-making process.

Similarly, the United Kingdom's proposed adoption of accrual budgeting emerged from long-standing efforts aimed at improving public sector performance. Throughout the 1980s the United Kingdom embarked on a series of reforms aimed at improving public sector performance, including the Financial Management Initiative (FMI), which emphasized the devolution of responsibility for budget and financial management. At the beginning of these performance reforms, it became clear that a cash-based system would fail

to account completely for all costs necessary to deliver a specific result, thus making it difficult to adequately assess and compare performance within the public sector, and between the public and private sectors. As a result, attention turned to developing an accrual-based integrated system that would better support reform efforts by improving the quality and consistency of the cost information and incentives provided to decisionmakers. Given this, the United Kingdom's accrual-based system was described by one Treasury official as an extension of earlier reform efforts rather than a "new" direction.

Canada also is considering expanding its use of accrual measurement in budgeting as part of an ongoing effort to improve government financial management and establish more business-like practices. The Financial Information Strategy (FIS) first announced in 1989 sought to decentralize many financial reporting responsibilities to departments and to use accrual accounting and new reporting structures to provide departmental managers with better tools for financial management. Through FIS, Canadian officials hope both to achieve improvements in the government's accountability framework and to increase efficiencies in program and service delivery. The Canadian Auditor General opined that efforts to integrate improved financial management into day-to-day decision-making may be impeded if this information is not used for appropriations and budgeting, traditionally the means by which managers are held accountable. Because of these concerns, in December 1998, the government was asked by Parliament to study how best to incorporate accrual concepts more fully in the budget and appropriations.

Although Iceland's adoption of accrual budgeting also was only one small part of broader reforms, the driving factor in Iceland's decision to adopt accrual-based budgeting and reporting was concern over the sustainability of the government financial commitments. According to senior officials with the Ministry of Finance, the overarching theme behind the reforms was to recognize the full costs of central government

¹⁴The purchase agreements between ministers and departments specify individual outputs in terms and conditions similar to private sector contracts.



obligations when they are made rather than when they are paid. In particular, there were concerns over the large accumulated pension liability for public sector employees. Under the prior cash system, these costs were reflected in the budget when paid, not when earned. As a result, there were concerns that the costs of the government's underlying commitments were understated.

The Netherlands' efforts in this area have focused on rebalancing the role of the public sector through privatization, deregulation, and decentralization. Since 1992, the Netherlands increasingly has adopted performance management initiatives to achieve these objectives and to improve the efficiency of the public sector. The government viewed accrual budgeting and financial statement reporting as providing the framework necessary to manage for results. To date, an accrual framework is being applied only in agencies where it was deemed useful in promoting results-oriented management, such as those engaged in providing specific, definable services like correctional facilities. In 1992, the Netherlands amended its Government Accounts Act to create agencies—a new subunit of government—and allow them to operate on a private sector management model which included accrual budgeting and financial reporting.

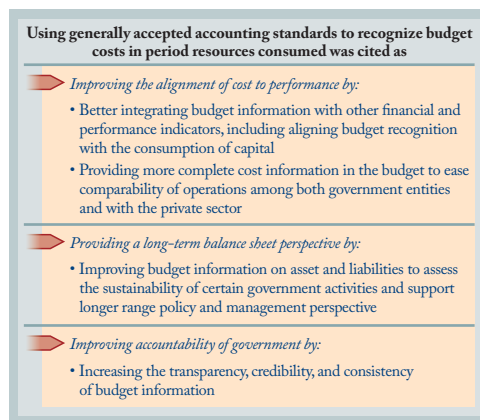
Accrual-Based Budgeting Credited with Improving Completeness and Usefulness of Budget Information for Decision-making

The difficulties in isolating the benefits of accrual budgeting from those resulting from other elements in broader reform efforts have not stopped proponents of accrual budgeting from claiming benefits from accrual budgeting. This chapter provides a brief introduction to some of the general benefits and concerns these countries associated with the use of accrual budgeting. The next chapter more fully discusses the role of accrual budgeting in addressing issues of performance, sustainability, and accountability within the public sector.

As outlined in figure 1, proponents credited accrual budgeting with improving the completeness and usefulness of the budget for decision-making by:

- better aligning cost with performance,
- providing information on all costs to encourage a longer-term management and policy focus, and
- improving the consistency and credibility of budget reporting.

Figure 1: Improvements in Budget Information Attributed to Accrual Budgeting



Proponents from several countries suggested that accrual-based information was an important tool in understanding the full costs of government programs and activities. Because accrual measurement matches costs with the period resources are used in the provision of goods and services, it generally has been viewed as providing a more accurate and complete picture of the cost of government activities than the cash flows in a given period. For example, accrual budgeting recognizes costs which contribute to the provision of goods and services but do not require immediate cash distributions such as employees' deferred compensation (pensions to be paid in the future). It also spreads the costs of some cash spending over the periods that benefit from it. For example, in an accrual budget, the purchase cost of a capital asset would be spread over the life of the asset as it is used rather than having the full cash amount appearing as a cost in the period the asset is purchased as in a cash-based budget. Thus, accrual-based information is a better indicator of the actual resources consumed in performing government activities. However, whether it is also appropriate for resource allocation depends



in part on whether it represents the full cost of government's commitment at the time decisions are made. In some instances, such as pensions, accrual measurement recognizes the government's commitment earlier than obligations measured on a cash-basis; in other instances, particularly capital assets, accrual measurement does not reflect the government's full resource commitment at the time the decision is made.¹⁵

In addition, accrual budgeting was viewed as enhancing understanding of the cost of performance by making budget information more comparable to other financial and performance indicators. For example, proponents suggested that if both the budget and the financial statement are accrual-based, it is easier to compare the amount requested and appropriated in the budget to actual results reported in the financial statements and other performance reports. Thus, accrual budgeting was viewed as helping to improve understanding of the link between budgeted amounts and results achieved.

Further, proponents argue that by incorporating a balance sheet perspective,¹⁶ accrual budgeting improves the information and incentives to support a government's stewardship role. While countries that have enacted an accrual budget¹⁷ generally vote on items similar to expenses found in a projected operating statement, in doing so they incorporate balance sheet information into the budget debate. They do this by: (1) including expenses associated with changes in an entity's assets and liabilities in appropriation amounts and (2) requiring primary financial statements to be included as part of the budget presentation.¹⁸

Accrual-based appropriations generally reflect costs incurred during a fiscal year and thus provide information similar to that found in an operating statement. An operating statement

recognizes revenue and expenses of a period and reflects changes in the balance sheet. For example, an asset's value is reduced by depreciation on the balance sheet and a depreciation expense is recorded in the operating statement. Since they reflect information similar to that included in a projected operating statement, appropriations under accrual budgeting generally capture expenses for a period including those that reflect changes in the balance sheet such as depreciation or changes in the liability for pension benefits.

As a result, proponents generally view an accrual-based framework as encouraging a fuller assessment of the government's management of its assets and liabilities, and thus its longer-term financial health. However, it is important to note that none of the countries currently use, or plan to use, accrual budgeting to focus attention on the long-term fiscal pressures of social insurance and health programs that experts predict may have serious implications for many of the world's industrialized countries.¹⁹

In these countries, aligning the basis of budgetary measurement with financial reporting standards, in particular, standards that mirror generally accepted practices in the private sector, was seen as increasing the credibility and consistency of budget information for public sector decisionmakers, the financial markets, and the public. Some argued that the public has some familiarity with private sector accounting and so would find a budget based on it more understandable. Using the same measurement basis throughout the financial management cycle was viewed as increasing the credibility and consistency of information provided to decisionmakers and thus enhancing the relevance and usefulness of financial statements and other cost information for budgetary and managerial decision-making.

¹⁵Proponents note that case study countries have established compensating control for capital asset projects. Although treatment varies among case study countries, appropriations are generally required for annual cash requirements for asset purchases that exceed departmental reserves or are above a certain dollar amount. See chapter 3 for additional information.

¹⁶A balance sheet perspective refers to providing information on assets and liabilities of an entity.

¹⁷New Zealand, Australia, and Iceland.

¹⁸Primary financial statements include a Balance Sheet, an

Operating Statement, and a Cash Flow Statement. Iceland does not require a Balance Sheet in its budget presentation.

¹⁹Most countries use financial accounting standards as the basis of measurement for accrual budgeting. In order for a future cost to be recognized as a liability under most accounting standards, it must be considered both probable and reasonably estimable. Generally, government commitments such as social insurance have not been judged as meeting these criteria for recognition. Although not considered a liability, U.S. federal accounting standards do call for supplemental disclosures for social insurance programs.

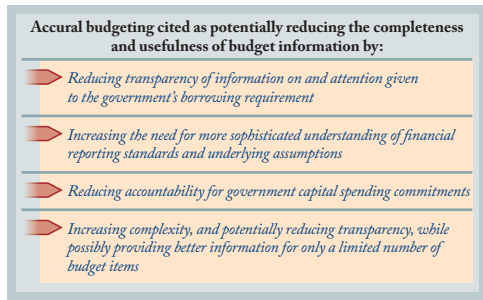


Proponents acknowledged that accrual-based information could be provided without changing the budget basis, but they suggested it might have little effect on management decisions and behavior unless it was the basis of accountability, i.e., budgeting. Proponents asserted that budgeting on one basis, i.e., cash, and reporting on another basis, i.e., accrual, would send conflicting signals and incentives. In the words of a former New Zealand official who championed the adoption of accrual budgeting, “accrual accounting will not amount to much more than an interesting accounting exercise unless the information is used for the purposes of economic management.”

Some Express Skepticism About Use of Accrual-Based Budgeting

Despite these perceived benefits, some officials and other experts expressed skepticism about the value or feasibility of accrual budgeting. Figure 2 lists some concerns raised about accrual budgeting with respect to a central government’s role in the economy and control over spending.

Figure 2: *Conceptual Concerns Raised About Accrual Budgeting*



A concern expressed by some experts was that accrual budgeting does not focus sufficient attention on the government’s borrowing requirement and thus fails to address adequately the central government’s role as partial custodian of the economy. For example, some economists in New Zealand told us that even though the cash flow statement provides information on the government’s borrowing requirements, it does not provide adequate information for

analyses of the effects of government policies. There was also some concern because decisionmakers have encountered difficulties understanding the complexities involved in the use of accruals for budgeting because of the technical issues and assumptions on which accrual measurement is based. As a result, in Australia and New Zealand, observers suggested that the opportunity may exist for manipulation in the inherently political budget environment. Because accrual measurement focuses on recognizing the financial effects of economic events, it is necessarily dependent on interpretations and judgments about both when those economic effects occur and what their ultimate cost will be. While cash-based budget estimates also require judgment and interpretation, the impact of a budget decision is known with more certainty at the end of the reporting period. In contrast, the impact of accrual-measured budget decisions may remain a matter of judgment. In our previous work on accrual budgeting we have explored the budgetary implications of uncertainty in estimates of risk assumed by federal insurance programs.²⁰

Finally, using the accrual basis to measure costs in the budget may, in some cases, provide less up-front budget control than does obligation-based budgeting, such as used in the United States. For example, obligation-based budgeting requires budget authority for the full cost of a building before the purchase obligation is made while accrual budgeting generally spreads cost recognition over the life of the building. Thus, for capital assets, obligation-based budgeting provides greater control over committing the government to future payments than does a pure cash or accrual basis. Thus, choices about the basis of budgeting depend in large part on the relative importance one places on recognizing and controlling the full costs at the time decisions are made versus the matching of recognition to the period resources are consumed. Methods could be developed to capture accrued costs, such as capital acquisition funds, so that costs can be matched with performance while still preserving up-front control.

For these reasons, some view accrual budgeting as potentially undermining the central government’s traditional roles in overseeing the economy and

²⁰Budget Issues: Budgeting for Federal Insurance Programs (GAO/AIMD-97-16, September 30, 1997).



ensuring accountability for taxpayer funds. In addition, some U.S. officials and budget experts have suggested that these potential risks of full accrual budgeting may not be warranted given that for most parts of the budget, the differences between cash (for obligations) and accrual measurement are not likely to be significant. Skepticism about the benefits of a change to accrual budgeting is increased by the fact that if accrual budgeting were implemented based on financial accounting standards as done by the case study countries, it would not fully address social insurance commitments.

Countries Vary Significantly in the Design and Implementation of Accrual-Based Budgeting Systems

Despite the use of common language in articulating their objectives, countries that have chosen to adopt accrual budgeting have taken

significantly different approaches in designing and implementing accrual budgeting frameworks. Four countries—New Zealand, Australia, Iceland and the United Kingdom²¹ – have chosen fairly inclusive approaches to implementing accrual budgeting. These approaches (1) use the same accrual-based²² accounting standards accepted by the government both for financial reporting and to measure budget items and (2) incorporate primary financial statements²³ roughly similar to those found in private sector financial reporting as part of the budget process. With two notable exceptions—Iceland’s exclusion of capital and centralization of pension costs and the United Kingdom’s exclusion of revenues—these countries apply accrual-based measurement to virtually all budget items at both the departmental level and the central government. The other two case study countries, Canada and the Netherlands, have applied accrual budgeting on a more limited basis to specific budget items or departments.

Table 4: Design Features of Case Study Countries’ Accrual Budgeting Approaches

Design feature	New Zealand	Australia	United Kingdom	Iceland	Canada (current system)	Netherlands (for select agencies only)
Same accrual-based standards for financial reporting and budgeting	X	X	X	X	X	X
Budget presentation includes primary financial statements	X	X	X	X		
Physical assets on an accrual basis in departmental budgets	X	X	X			X
Accrued pension expense for current employees included in departmental budgets	X	X	X		X	X
Output-based appropriations	X	X				X
Departments receive authority to draw cash for non-cash accruals, such as depreciation, as means of supporting decentralized management framework	X	X				X
Recognition of change in accrued pension liabilities in governmentwide deficit/surplus	X			X	X	
Accrual-based net operating balance used as governmentwide deficit/surplus measure	X			X		

²¹Adoption of the United Kingdom’s approach remains subject to parliamentary approval.

²²Some accounting standards are not fully accrual-based. For example, Iceland’s accounting standards require that physical assets be reported on a cash basis and the United Kingdom accounts for revenues on a cash basis.

²³Traditionally primary financial statements include (1) a

balance sheet which presents the total balances of assets, liabilities and net position of an organization as of a specific time, (2) a statement of operations which provides information on an organization’s flows of revenues and expenses and other changes in the organization’s net resources, during a period of time and (3) a statement of cash flows which presents the cash flows of an organization during a period of time.



Not surprisingly, these varied approaches are reflective of each individual country's reform objectives and budgetary needs. As shown in table 4, approaches varied with respect to:

- the extent to which accrual budgeting is used as part of an output budgeting framework in which the budget is intrinsically linked to performance;
- the scope of budget items measured on an accrual basis; and
- the organizational level to which accrual budgeting is applied.

New Zealand and Australia placed significant emphasis on directly linking the budget (including the basis of appropriation) with their overall performance and accountability structure. In these two countries, the shift to accrual measurement occurred concurrently with a shift to output-based appropriations.²⁴ In general terms, output-based appropriations provide funding for the total resources required to produce an “output” (a good or service produced by departments on behalf of the government) including costs that do not require a cash outlay, such as depreciation and pension expenses. Reflecting the desire for a business-like environment, the intent is that, where possible, appropriations will come to represent the “fair market price” the government intends to pay for the department's outputs. However, Australian officials we spoke with acknowledge that for the first few years, at least, appropriations will be based on the total accrued costs (inputs) used to produce an output. They suggested that the objective over time is to benchmark the prices of these services to the private sector or other government prices for similar services.

The United Kingdom has also proposed an accrual budgeting framework that aligns resources to performance, but it stops short of adopting output-based appropriations. Under its proposed approach, accrual-based “resource accounts” will replace appropriation accounts and become the main form of accountability to Parliament. Parliamentary approval for departmental funding is to operate on a dual cash and “resource” basis. Each budget estimate will be represented by both

an accrual request for resources—which includes noncash amounts such as depreciation—and a cash requirement for proposed cash withdrawals. However, in comparison to the New Zealand and Australia models, which provide cash to cover noncash amounts such as depreciation, the United Kingdom's resource budget would treat noncash items as “notional” entries, i.e., departments will not receive cash to cover these amounts. While stressing that a number of issues, such as the precise treatment of capital, were still unresolved, officials noted that a key objective in designing the system was to concentrate attention on resources without relinquishing control over cash.

Iceland's approach to accrual budgeting reflects a greater emphasis on recognizing certain long-term commitments, such as employee pensions, as opposed to allocating costs to particular goods and services. Although significant realignment of the budget occurred as a result of the reforms, its goal was to bring more activities into the fiscal budget—creating links to the decision-making process—rather than aligning resources to programs and activities. For example, Iceland's approach to budget reform differs in two key ways from the approaches adopted in other case study countries: (1) capital is reported on a cash basis as work is completed and paid for, rather than on an accrual basis with depreciation to align its cost with its use in the production of goods and services and (2) public sector pensions are controlled and recognized centrally in the Ministry of Finance's budget rather than allocated to budgets of the various ministries that manage the associated programs and activities. Under Iceland's approach, the main focus of budget debate is on the Operating Statement that includes estimates of revenues and expenses on both an accrual and a cash basis. However, the operating result (deficit/surplus) is reported only on an accrual basis.

Canada and the Netherlands have taken more limited approaches to accrual budgeting, applying accruals only to specific departments or specific budget items. Canada currently uses accrual for public sector employee pensions and

²⁴Both New Zealand and Australia distinguish between items controlled by departments and items administered by

departments on the government's behalf such as social insurance. New Zealand has several types of appropriations.



accounts payable at both the department level and the governmentwide level. However, it is considering a change which would shift capital and other items to an accrual basis with the intent of better integrating the financial management system. Under the current system, Canada has two measures of fiscal position (deficit/surplus): (1) the financial balance, or cash requirement, which approximates the country's financing need and (2) the budgetary balance—its primary fiscal measure—that includes pensions, accounts payable, and other accrual-measured items even though cash is not needed immediately.

The Netherlands has applied accrual budgeting, using an approach similar to the New Zealand and Australia models, for a select number of agencies (subunits within ministries) but is still undecided about its application governmentwide. Under the Dutch approach, a ministry receives an appropriation to cover the price—including costs for which no cash outlay is required—of goods and services purchased from an agency under its control. For example, the Ministry of Justice would receive a cash appropriation to cover the price of goods and services it intends to purchase from the Prison Service. The Ministry of Justice would in turn give the Prison Service a cash amount that is intended to represent the “price” for the goods and services provided by that agency to the Ministry. Under this regime, Parliament must approve an agency's accrued costs—including noncash costs such as depreciation—and agencies can “save” funds in an account with the Ministry of Finance to fund future capital expenses. In addition, effective January 1, 2000, agencies are able to “borrow” funds from the Ministry of Finance as well. Both the use of “savings” and the “borrowing” of funds require approval by the Ministry of Finance and ultimately must be enacted into law by the Parliament. The governmentwide deficit/surplus is reported on a cash basis.

Each of the case study countries turned to some form of accrual budgeting as part of a broader reform effort. Chapter 3 discusses how they use accrual budgeting to address some key issues.

3. PERSPECTIVES ON ACCRUAL BUDGETING FOR DECISION-MAKING

As suggested in the previous chapter, the case study countries, to varying degrees, have turned to accrual budgeting to address concerns about public sector performance, sustainability, and accountability. Similar concerns have also been the focus of recent reform efforts within the United States. In several countries, accrual budgeting has been used as a tool to support wider performance management reforms including, in some cases, more decentralized, performance-driven accountability systems. Accrual budgeting is also viewed as improving the recognition of the future costs of current decisions and so increasing the attention paid to the sustainability of government activities. Further, accrual budgeting was viewed as improving accountability by enhancing consistency and transparency of budget information, even though it raises some new control issues. However, the extent to which accrual budgeting has, or is expected to, influence decision-making varies with the approach chosen by each country. This chapter discusses more fully the various perspectives on implications of accrual budgeting for decision-making.

Performance, Sustainability, and Accountability Issues Central to Reform Efforts

The case study countries and the United States share the common objective of improving public sector financial management and performance while enhancing transparency and accountability. As described in the previous chapter, these issues came to the forefront as the countries undertook broader reform efforts to address significant fiscal stress and/or to improve government operations. In the United States, there has been a similar move to improve government performance and financial management, leading to the enactment of a series of reforms.²⁵ At the same time, changing demographics and other factors have brought to the forefront questions about the sustainability of the government's long-term commitments such as Social Security and Medicare.

²⁵For further discussion of reform efforts see chapter 1.



To varying degrees countries in our review have used, or plan to use, accrual budgeting to help address similar concerns about public sector performance, sustainability, and accountability. Proponents of accrual budgeting argue that the only way to really affect decision-making is to move beyond financial statement and performance reporting to using accrual information as the basis of resource allocation. However, most countries have limited experience with their accrual-based frameworks and provided only a few specific examples of decisions attributable to its use. Further, since in general case study countries moved from a system of cash-based accounting and cash-based budgeting to accrual accounting and accrual budgeting, it is often difficult to distinguish the benefits of accrual budgeting from those that would have been achieved with accrual accounting alone. This is particularly true for such one-time benefits as the development of financial systems or the identification of assets. Finally, as noted earlier, the comprehensive nature of some of the reform efforts makes it difficult to isolate the benefits of accrual budgeting from those stemming from other changes. For example, New Zealand—the country with the most experience with accrual budgeting—implemented accrual budgeting as only one part of sweeping and radical reforms that restructured the role of government and its financial and performance management system.

Accrual Budgeting as a Tool in Addressing Performance Management Challenges

Country officials and other proponents saw accrual budgeting as a useful, if not critical, tool in addressing performance management challenges. In particular, accrual budgeting has been used to provide more timely recognition of the complete costs of government activities, an important factor in assessing performance. However, the design of each country's accrual budgeting system, which tends to reflect the country's overall management approach, shapes its role in addressing performance challenges.

In our case study countries, accrual budgeting is credited with supporting broader management reform efforts in several ways, such as

- reflecting and supporting more decentralized and performance-focused accountability systems,
- facilitating more competitive, businesslike approaches to providing government goods and services, and
- encouraging more efficient and effective resource management, particularly with respect to capital assets.

Accrual Budgeting Viewed as Supporting More Decentralized, Performance-Focused Accountability Systems

In some countries, accrual budgeting has been used to support more decentralized, performance-focused management. Most notably, in New Zealand and Australia, the adoption of accrual budgeting complemented a shift to systems that allow managers considerable autonomy, including increased freedom over the use of resources (inputs), while holding them accountable for delivering specified results within budgeted costs.²⁶ Officials and other reformers from both countries stressed that accrual measurement, by providing a tool to match costs with the provision of goods and services, was key to supporting these more decentralized management systems that emphasize managerial flexibility as a means of improving efficiency and effectiveness.

In both Australia and New Zealand performance management benefits were attributed to the union of output budgeting²⁷ and accrual budgeting, not a shift to accrual measurement alone. In general, output-based appropriations provide funding for the total resources used to produce an “output” (a good or service produced on behalf of the government), including costs that do not require an immediate cash outlay. Managers are then given significant discretion over the mix of inputs (spending on salaries, supplies, capital, etc.) used to produce

²⁶The Netherlands has applied a similar approach on a more limited basis to specific department activities.

²⁷Output generally refers to goods and services produced by

departments. For example, in New Zealand the quantity and price of outputs are agreed upon by the ministers and their departments' chief executives.



agreed upon outputs. This type of approach reflects and supports the philosophy that the public sector should operate as close to a private sector model as possible.

By structuring appropriations around outputs, these systems are intended to reduce the traditional budget focus on controlling inputs while increasing accountability for performance. Under New Zealand's approach, output-based appropriations are the result of purchase agreements between department executives and their ministers, with the ministers specifying the output to be provided in a given quantity and at a given quality. In Australia, appropriations for each department are for the full financial resources, measured on an accrual basis, required to produce outputs that contribute to the outcomes the government is trying to achieve. This output-outcome structure is determined during a strategic planning process in which departments and their ministers define desired outcomes, then define the outputs that, if delivered, would lead to these outcomes. Reflecting the desire for a more businesslike environment, the ultimate goal in both countries was for departments to be appropriated the fair market price of outputs.²⁸ Further, to provide additional incentives to continually seek efficiencies, the Australian system permits departments to retain a share of any operating surpluses.

Accrual budgeting was described as useful, if not critical, to developing accountability within these more decentralized, output-focused systems. In the view of one former official from New Zealand "a decentralized public management structure that focuses on output and performance could not be managed without accrual budgeting." Because an output-based system gives departments significant discretion over how funding is used to produce outputs, oversight is premised on the ability of policymakers, as the purchasers of goods and services, to adequately assess the price and quality of outputs. As a result, reliable information on the full costs of producing goods and services, rather than just

the immediate cash outlays, becomes increasingly important to ensuring accountability.

By better aligning budget recognition with the consumption of resources, proponents view accrual measurement as providing a better analytical base to assess the full costs associated with a given level of performance. For example, accrual measurement recognizes costs as they are incurred, such as employee pensions, which may not result in cash outlays for many years but nevertheless were earned within a budget year. Proponents also point out that accrual measurement helps mitigate some cost distortions inherent in cash-based budgeting. For example, the National Commission of Audit in Australia noted that, under its accrual budgeting framework, a department would no longer appear efficient in budgetary terms just because it used less cash in a year if, at the same time, it accumulated more liabilities. Conversely, it noted that a department would not automatically appear as a poor performer because it spent a large amount of cash in 1 year on capital assets that may in fact enable it to operate more efficiently over time. As a result, accrual budgeting is seen as enhancing accountability by, for example, facilitating comparisons of cost and performance among alternative suppliers, both public and private.

Proponents from both New Zealand and Australia stressed the importance of integrating accrual-based information directly into the budget. In their view, better cost information alone would be insufficient to influence managerial behavior; holding decisionmakers and managers accountable through the budget process for all the costs associated with a given level of performance would be more effective in creating incentives to ensure efficiency and effectiveness in the absence of input controls. Along these lines, a former New Zealand official involved with the reforms stressed that if performance is what drives reform, and accrual concepts are deemed most appropriate to assess the costs associated with performance, then it follows that one would budget on this basis.

²⁸New Zealand has used a staged approach to implementing accrual-based output appropriations. The final stage, to which no department has transitioned, assumes competition among suppliers of outputs. Australia's system is designed so that appropriations ultimately are to represent the "price" the

government intends to pay for each agency's contribution to the achievement of planned outcomes. Australian officials noted however that at least in the first few years, appropriations would be based on the total accrued costs (inputs) used to produce an output.



**Accrual Budgeting Viewed as Useful in
Facilitating More Competitive Approaches and
Fostering Cultural Change**

Whether combined with output budgeting or not, accrual budgeting was described as improving performance by fostering more competitive and businesslike approaches within the public sector. For example, accrual budgeting was described as making it easier to compare performance among alternative suppliers, both public and private. In addition, accrual budgeting was described as important to fostering cultural change that heightens awareness of financial and performance management issues.

***Accrual Budgeting Viewed as Supporting
Performance Reforms by Facilitating Comparisons***

Some proponents view accrual budgeting as supporting performance reforms by facilitating more valid comparisons among alternative sources of goods and services. As we have reported in the past, consistent and complete cost information is important to fostering better management by making it easier to more fully understand the implications of different decisions. Similarly, officials and proponents suggested that accrual measurement allows for more valid comparisons of performance and thus can help the government identify inefficient areas or determine the most efficient method of delivering government goods and services. Further, accrual budgeting was seen as fostering more performance-focused management and oversight by increasing the comparability of prospective budget information with actual financial and performance information.

A senior budget official from the Netherlands used prison services to illustrate the discord between cash-based budgeting and performance assessment, including comparisons among alternative suppliers. He noted that, on a cash basis, a prison making capital improvements would appear more costly in the budget than another prison that is not making such improvements, regardless of the year-to-year relative efficiency of the prisons' operations. In his opinion, accrual budgeting, by spreading the budget recognition of the cost of capital improvements over the life of

the asset, would help to improve the information and facilitate more valid comparisons between the relative cost of operations. While this was an improvement over a cash-based budgeting system, it does not provide for the up-front control over capital purchase obligations that exists in an obligation-based system. One possible approach combining the benefits of both would be to compare accrual-based financial reports while retaining control over government commitments under an obligation-based budgeting system.

Proponents of accrual budgeting saw enhanced comparability with the private sector as beneficial. Full consideration of how a good or service can be provided most efficiently requires understanding its full costs including noncash items such as employee benefits earned but paid later. Under cash budgeting or obligation-based budgeting measured on a cash basis, these items tend to be excluded from a government's current budget decisions. However, they are incorporated into the price of private sector suppliers. Proponents envision that accrual budgeting, by providing more complete and comparable costs, could result in better choices about whether a good or service should be provided by a government department or by a private sector entity. New Zealand intended for departments to pay interest, taxes, and dividends so that their costs could be more readily compared to other suppliers (including private sector entities) providing similar goods and services.

With more complete cost information, accrual budgeting is seen by its proponents as a potential tool to encourage competition and facilitate mechanisms such as contracting-out, price benchmarking, and intra-agency charging. For example, New Zealand used accrual reports to determine the full cost of providing policy advice in various departments. It was also credited with helping to identify high and low cost areas, providing a clearer understanding of intradepartmental cost differentials and raising the possibility of achieving greater efficiencies and cost savings. As discussed above, some proponents see the ability to more readily make comparisons based on complete cost information as an essential component to ensuring accountability within decentralized management systems.



Accrual Budgeting Seen as Important Tool in Supporting “Cultural Change”

Proponents see accrual budgeting as an important tool in changing the public sector “culture” towards a more competitive, businesslike environment. As a general point, proponents argued that providing accrual-based information in financial statements or other supplemental reports was not likely to change behavior significantly if the accountability process, i.e., budgeting, remained on a cash basis. For example, the Australian National Commission of Audit (NCOA) expressed the view that a full accrual framework, including accrual budgeting, was an essential component of the structural and cultural change the government was seeking for a more competitive, efficient, and effective public sector. Observers in the United Kingdom also suggested that, although as a general rule generating interest in financial management issues is difficult, the use of accrual measurement in the budget appears to have increased the attention paid to implementing the recent accrual reforms. Similarly, Canada’s Auditor General emphasized the importance of changing the basis of appropriations to accrual to encourage the use of this information in day-to-day management.

Proponents generally held the view that accrual budgeting serves to enhance the prominence of performance management and oversight. Country officials and department managers we spoke with noted a greater focus on financial management as a result of the shift to an integrated accrual-based framework, including accrual budgeting. They suggested that, since the budget really matters to departmental managers, including accrual-based information in the budget greatly increases the stakes associated with its preparation and use. For example, officials from the Office of the Controller and Auditor General in New Zealand said that financial data under the accrual-based framework are more robust, consistent in quality, and timely. Departments now produce monthly accrual reports within 7 days of the end of the month. They attributed this in part to

the departments more closely monitoring their accounts on an accrual basis to avoid breaching appropriations. The view that accrual-based frameworks had improved, or were expected to improve, financial and cost data was held in most case study countries.

Accrual Budgeting Viewed as Encouraging More Efficient and Effective Resource Management

Advocates of accrual budgeting view it as a useful tool to encourage more efficient and effective resource management, particularly with respect to capital assets.²⁹ However, because most case study countries used predominately cash-based budgeting systems prior to changing to the accrual basis, their views of the trade-offs associated with a shift to accrual budgeting based on financial accounting standards are likely to differ from that of the United States. Shifting to accrual budgeting might not yield the same benefits in the United States, which already has accrual-based financial reporting. Moreover, compared to obligation-based budgeting in the United States accrual budgeting without compensating controls would delay the budget recognition of the government’s commitment for asset purchases.

Proponents and officials in most of the case study countries view accrual budgeting as encouraging the more efficient and effective use of resources by

- providing better information and incentives with respect to total resources consumed in the provision of goods and services, and
- better reflecting the cost of capital, thus encouraging better capital asset management.

Proponents see accrual budgeting as improving resource management by providing a better analytical base and incentives for assessing performance and managing costs. Managers from the United Kingdom and New Zealand expected that by providing more and better quality information, accrual-based frameworks would improve resource management by increasing the

²⁹Not all case study countries use accrual budgeting for capital assets. Iceland expenses assets as payments are made. Canada plans to report all assets on an accrual basis in its whole-of-government financial statements beginning in fiscal year 2001-2002. Canada

has not decided yet whether to budget on a full accrual basis. In the United Kingdom, the current proposal is for depreciation and capital charges to be “notional entries” which require a parliamentary vote but will not result in the departments receiving cash.



number and quality of questions asked about an organization and its performance. Although some other government officials view the increased agency discretion provided in systems that combined output budgeting with accrual budgeting with concern, proponents credited these systems with helping achieve fiscal constraint by better targeting spending cuts and, as discussed in the previous section, by encouraging efficiency gains. For example, according to a former New Zealand government official, under the old cash and input focused system, the government could arbitrarily impose an across-the-board budget squeeze but would not necessarily know the direct implications of this squeeze on performance. In contrast, improved availability and quality of performance and cost information under their accrual-based frameworks would enable officials to better understand the implication of budget decisions on performance. Specifically, under accrual-based output budgeting, the ability to translate a change in funding to a change in output was viewed by some proponents as improving the decision-making process. Some we spoke with, however, credited these benefits, at least in part, to the better linking of spending to specific results than to the shift from cash to accrual measurement.

In some countries accrual budgeting was used as a tool to support increased flexibility in asset management. In New Zealand, Australia, and the Netherlands, for example, department appropriations include funding for noncash items such as depreciation expense. Managers are expected to manage their asset base, which includes purchasing replacement assets with funds accumulated from this depreciation expense, although skeptics might worry that such funds would not be saved. Proponents say that this increased flexibility allows managers to make and implement more efficient decisions with respect

to their asset mix. In New Zealand, for example, managers could replace nonperforming telephone equipment more quickly rather than submitting to the previous lengthy approval process. In this approach, however, more than budgetary accounting has been changed. Agencies in some countries have been given a level of discretion with respect to asset purchases that is significantly different from the U. S. system.³⁰

Up-front control over contractual obligations is the focus of the U.S. obligation-based budget and including the cost of an asset in the budget before the government's commitment is made provides the Congress an opportunity to control spending. Recording the full cost for an asset purchase up front, as in the United States' obligation-based budget, also promotes fiscal control, an important objective in U.S. budgeting. By recording the costs up front, agencies and the Congress are encouraged to compare that cost with expected benefits when deciding whether to purchase the asset. Conversely, for capital assets, accrual measurement would delay cost recognition so as to spread the costs over the life of the asset.³¹ In this sense, choices about the basis of budgeting depend in part on the relative importance placed on recognizing and controlling the full costs at the time decisions are made versus the matching of budget recognition to the period resources are consumed.

Officials in several case study countries pointed to some compensating controls within their accrual frameworks. For example, if the cost of an asset exceeds accumulated depreciation, "capital injections"³² are required and these are subject to parliamentary approval in Australia and New Zealand and parliamentary notification in the Netherlands. In these cases, budget approval would be for the cash required in the budget year. In addition, in New Zealand, even if an agency had accumulated sufficient funds to replace an

³⁰Proponents point out that case study countries established a number of compensating controls in an attempt to alleviate control concerns. For example, in New Zealand, managers are not allowed to change the structure of their balance sheets without legislative approval; this is aimed at preventing managers from running down their asset bases to artificially lower the price of outputs. A number of case study countries also established supplemental approval processes for capital projects.

³¹Although treatment varies among case study countries,

appropriations are generally required for the annual cash required to purchase assets. However, these annual cash amounts may not represent the full cost of the assets. In some cases, legislative approval is not required for asset purchases below a certain amount if the department can fund them from depreciation reserves.

³²In general terms, a capital injection refers to the amount of additional funds required for a capital purchase beyond a department's available reserves. It represents an increased investment in a department's asset base.



asset without a capital injection, capital purchases above a specified amount require approval.³³ Further, Australia, New Zealand, and the United Kingdom require additional information on capital purchases under their accrual-based frameworks. For example, information such as (1) depreciation and capital charges resulting from the new asset and (2) the available cash reserves and capital injection needs may be required. This richer suite of information is perceived to help decisionmakers to make the proper trade-off between alternatives, e.g., whether to buy or lease a new asset, or simply to renovate an existing asset. Finally, some proponents pointed out that because depreciation and the capital charge would be included in future budgets, an asset no longer appeared as a “free good” after the initial purchase.

Improved alignment between budget recognition and the use of capital is another cited benefit of accrual budgeting. In Australia, New Zealand, the United Kingdom, and the Netherlands, the appropriation for a department’s operating budget or for specified outputs includes the annual cost of using capital, i.e., depreciation and the cost of capital charge.³⁴ This treatment was viewed as useful in (1) enabling comparisons among the relative costs of different operations and (2) distinguishing between current and capital spending.

Proponents believe that this approach improves decision-making by spreading the budget recognition of capital costs over the life of the asset. Specifically, it was viewed as improving both the information and the incentives to make more valid comparisons between the relative cost of operations. Further, some proponents suggested that by better aligning the budget recognition of capital with its use, accrual budgeting can be used to provide a better distinction between current spending and capital investment. For example, in New Zealand, the United Kingdom, and Australia, cash requirements for capital acquisitions are treated separately from the cost of using capital in departmental budgets. Some

proponents stated the view that this reduces a perceived bias against investment which may be created when the purchase cost of a capital asset must be recognized in the budget in the year of the purchase. The trade-off here is between aligning budget recognition of capital with its use and the greater fiscal control realized from up-front budgeting. In the United States, the purchase cost is recorded up front so that commitments for asset purchases can be controlled by the Congress before they are made. In the U.S. setting, information on the use of capital in providing services is available to the Congress in accrual-based financial reports for use in conjunction with obligation-based budgeting.

To further encourage the efficient use of assets, some countries also incorporated capital charges into their accrual budgeting frameworks. A capital charge, similar to an interest charge, generally is used to reflect the opportunity cost of capital invested. Several countries in our review— Australia, New Zealand, and the United Kingdom—have established a policy of levying a capital charge based on a percentage of a department’s net assets in order to recognize the cost of capital held by departments.³⁵ In New Zealand, this works as follows: departments are appropriated as part of the output price a capital charge based on their asset base at the beginning of the year; at the end of the year they must pay the government a capital charge based on their year-end asset base. If a department has a smaller asset base at the end of the year than the asset base for which the appropriation was made, the department is permitted to keep part of the appropriation made for the capital charge. New Zealand officials see this as providing an incentive to identify and dispose of underperforming assets; Department of Education officials stated that the capital charge spurred the department to sell a number of vacant sites that it had acquired in the 1960s and held although they were no longer needed.

Further, proponents credit accrual budgeting with improving the identification and valuation of

³³Asset purchases over NZ\$10 million require cabinet approval, whether or not departments need a cash injection.

³⁴Specifically, in New Zealand, Australia, and the Netherlands, departments receive cash funding to cover these noncash amounts. In the United Kingdom, the current proposal is for these amounts

to be “notional entries” which require a parliamentary vote but will not result in the departments receiving cash.

³⁵In the Netherlands, agencies will pay for the capital costs associated with loans used to finance asset purchases beginning in 2000.



assets. Although acknowledging that this benefit might have been achieved through a shift to accrual accounting alone without changing the basis of budgeting, proponents suggested that the link to budget improved incentives to take the reforms seriously and not simply treat accrual-based information as a paperwork exercise. Some officials and managers cited cases of finding assets that were poorly managed and even assets that they were unaware of owning. In New Zealand, the asset identification exercise led to the discovery that unpaid fines due to the Department of Justice were a significant asset on the department's balance sheet. Subsequent attention prompted the department to actively manage its accounts receivable by replacing traditional collection methods with direct payment systems at courthouses and using computerized call centers for tracking slow payers.

*Some Skepticism and Concerns Raised About
Implications of Accrual Budgeting on Resource
Management*

Some skepticism has been raised about the claims for accrual budgeting's beneficial impact on resource management. Some expressed concerns about the implications of the assumptions and judgments necessary for accrual measurement on transparency and thus on users' understanding. In addition, some we spoke with were uncertain about the extent to which the new information had influenced managerial decision-making. Several issues were noted with respect to asset management. For example, officials in New Zealand's Office of Controller and Auditor General were uncertain about the effectiveness of having a charge for capital in changing behavior significantly. Further, some officials noted that, while changes resulting from the shift to accrual were greatest for capital intensive departments, in New Zealand only a limited number of departments hold enough assets to make the change significant in the annual budget process. Along a different line, some analysts expressed the concern that capital

charging could drive department executives to decisions that are rational in the short term but damaging in the long term. For example, an audit official suggested that a department might have an incentive to try to operate with obsolete and fully depreciated assets in order to avoid a higher capital charge. In addition, while proponents thought that the increased discretion over asset purchases was key to supporting managerial efficiency and effectiveness, the increased discretion combined with cash funding for depreciation could result in the potential for departments to divert this funding for other purposes.

Additional concerns were raised that some forms of accrual budgeting could impede efficient asset management.³⁶ For example, some officials in New Zealand noted that in a technology-intensive environment, such as defense, asset prices tend to increase commensurate with improving technology. In such an environment, accumulated depreciation would be inadequate to fund asset replacement, thus requiring capital injections. Because capital injections are given heightened scrutiny during the budget process, some hypothesized that it could be harder to replace assets. Another concern about the New Zealand model of accrual budgeting was the possibility that requiring departments to maintain their asset bases³⁷ could serve to lock in the asset levels that existed when accrual budgeting was first implemented whether or not this reflects the optimal allocation of assets among departments. Further, the use of initial asset base levels to calculate future budgetary amounts, including the depreciation charge generally based on current value, could give departments that were asset rich an advantage over those that were asset poor. This latter group either must request a capital injection or operate with minimal assets. Although New Zealand officials told us that there had been no significant attempt to optimize asset levels prior to the shift to accrual budgeting, proponents suggested that accrual budgeting has increased the attention given to these issues.

In addition, the need to incorporate accrual measurement directly into the budget may be

³⁶As noted earlier, some forms of accrual budgeting provide appropriations for noncash expenses such as depreciation with the expectation that departments will use these funds to maintain their asset base.

³⁷In an accrual budgeting framework, maintaining the asset base generally refers to managing the value of assets on the balance sheet so that it does not decline from year to year except through the sale of excess assets.



questioned. Some of the benefits credited to accrual budgeting—improved asset identification and valuation, better information on the organization and its activities, or improved capital investment planning—might have been achieved without a shift in budgetary measurement by, for example, implementing accrual-based accounting and reporting alone. Some experts also noted that the cost of capital charges could be implemented within obligation- or cash-based budgeting systems. Proponents, however, expressed the strong belief that the link to the budget increased the incentives to take the reforms seriously and to ensure numbers were reasonable.

Asset identification and valuation were cumbersome and time-consuming efforts and the integration of accrual concepts such as depreciation created new budgetary control issues.

Sustainability of Government Activity Partially Addressed by Accrual Budgeting

Some countries that have incorporated accrual information in their financial management systems have done so, in part, with the expectation that it will help decisionmakers better understand long-term sustainability of government policies. This can be thought of as going beyond the longer-term management perspective for capital or more effectively targeting budget reductions to support fiscal constraints, as discussed in the preceding section, to the question of assessing the sustainability of government policies by providing

- better budget recognition of liabilities, and
- a more complete set of information to assess a country's financial health.

However, there are limits to using an accrual budget based on financial accounting standards in addressing long-term sustainability issues. A key limitation is that accrual budgeting as implemented by the case study countries does not capture social insurance commitments. The case study countries chose to largely mirror their financial accounting standards in their accrual budgets, but social insurance is not judged to be a liability under their accounting standards. Thus, none of them have budgeted for such

commitments on an accrual basis. This would also be the case if the United States adopted accrual budgeting strictly based on its federal accounting standards.

Accrual Budgeting's Better Recognition of Liabilities Credited With Leading to Program Changes

Although accrual budgeting does not deal with social insurance programs, proponents said it provides a fuller picture of other liabilities arising from past and current policy actions. For programs with long-term commitments, including public employee pensions, insurance, and credit, cash-based budgeting may not recognize a government's ultimate costs at the time the commitments are made. In these cases, accrual-based information on the government's liabilities could improve budgetary decision-making. Indeed, proponents from New Zealand and Iceland pointed to accrual budgeting as leading to changes to such programs.

In both countries the adoption of accrual budgeting highlighted issues with respect to public employee pension programs. In Iceland, accrual budgeting showed the consequences of wage negotiations on future public employee pension costs. Since a retiree receives a pension tied to the base salary of the person currently in the retiree's former job, wage renegotiations directly affect Iceland's pension liabilities. The full costs of these agreements were not fully realized by the public until the adoption of accrual budgeting led to the recognition of the liability in the budget estimates. Officials informed us that there is no longer public support for decisions that are so costly in the long term. Similarly, in New Zealand, recognizing pension liabilities on the balance sheet and accruing the annual change in that liability as an expense in the budget prompted greater fiscal caution about these long-term commitments. Under cash budgeting, the magnitude of future public sector pension costs was recalculated and reported to Parliament every 5 years, but this information generally did not play a significant role in the budget debate. According to a former minister, once the full liability for public sector pensions was brought onto the balance sheet and



the annual change in the liability was included in the budget as an expense, New Zealand made the difficult decision to close its defined benefit pension plan to new government employees.

As a result of recognizing the liability from providing accident coverage, the New Zealand government initiated efforts to reform the Accident Compensation Corporation (ACC) program. ACC is an insurance program comprising six accounts covering accidents ranging from motor vehicle to those occurring on the job. In the past, the value of future payments due to claimants was recorded only in the financial statement footnotes and had no impact on either the operating statement or balance sheet of either the ACC or the government. The accounting treatment recently changed, and the government recorded a liability for these programs for the first time in fiscal year 1999–2000. Consequently, the government booked on its balance sheet a liability of nearly NZ\$7 billion for previous accidents.³⁸ With accrual budgeting, this also reduced the estimated budget surpluses by NZ\$500 million since the estimated future cost of current accidents was booked as an operating expense. Officials attributed New Zealand's decision to raise premiums and add surcharges largely to this inclusion of program costs in the budget. The intention was to fully fund portions of ACC by 2014, thus helping to ensure that those programs are sustainable into the future.

Accrual budgeting was also credited with spurring changes in insurance claims management. Under the new accrual environment, ACC staff is dedicating more time to managing long-term disability cases with the highest projected costs. Through active management, ACC aims to reduce the severity of disability cases and thus program costs in the long run.

Some proponents also believe accrual budgeting helps improve decision-making by providing more complete information for understanding how budgetary decisions will affect a country's financial

health. Accrual budgeting frameworks were viewed as providing more complete information in at least two ways. The first way is by including actual and projected accrual-based financial statements in the budget presentation. For example, the accrual budget presentations in Australia, Iceland,³⁹ New Zealand, and the United Kingdom include the primary financial statements.⁴⁰ The second way is by reflecting annual balance sheet changes in the operating statement which is, in effect, the accrual budget. For example, an accrual-based appropriation would include the cost of pension benefits earned but not paid in the budget year, which represents the annual increase in the liability on the balance sheet. As a result, accrual-based appropriations capture changes to a government's net worth,⁴¹ which flow through the operating statement. Some view trends in net worth, if measured on a consistent basis, as one indication of whether a country's fiscal condition is improving or declining.

Some Experts Question Usefulness of Accrual Budgeting for Addressing Sustainability Issues

While proponents expressed the view that accrual budgeting was valuable in heightening awareness of sustainability issues, other experts were more cautious on this point. Two key concerns were:

- some significant government commitments are not captured in an accrual budget, and
- the meaning of “net worth” in the government context is unclear.

First, as noted above, accrual budgeting based on financial accounting standards does not capture some key fiscal pressures, such as future costs associated with social insurance programs. While some case study countries used modeling to estimate the future costs of these programs, none include them—or plan to include them—in the accrual-based budget.

Specifically, none of the case study countries recognize social insurance commitments as

³⁸The recognition was to be based on the estimated probable cost of claims existing at the end of the year, with minor adjustment for claims incurred but not reported based on historical experience.

³⁹Iceland does not include a projected balance sheet in its budget presentation.

⁴⁰Primary financial statements include an operating statement, a balance sheet, and a statement of cash flows.

⁴¹Net worth is the difference between balance sheet assets and liabilities. Case study countries that have capitalized assets included values for heritage assets and defense weapon systems as assets on their balance sheets. However, some exceptions are made due to valuation difficulties.



liabilities in their financial statements or record the expense in their accrual budgets. This is because these commitments do not meet financial accounting standards' criteria for recognition as a liability. Generally, the financial accounting standards adopted by most of the case study countries define liability recognition with three criteria: (1) an event has occurred, (2) a future payment is probable, and (3) the amount of the future payment is reasonably estimable. Using these standards, a differentiation generally is made between pension and insurance programs, which meet the recognition criteria as liabilities, and social insurance programs, which do not. For example, premium payments for insurance programs bring with them an expectation that claims will be paid—a probable and reasonably estimable future payment will be made once an insured event has occurred. On the other hand, the future payments for social insurance programs, which in the case study countries are funded on a pay-as-you-go basis, could be adjusted to fit within the fiscal policy objectives of the government at the time the payments need to be made.⁴² However, many of the case study countries use long-term cash forecasts, as does the United States, to recognize and present information on the imbalance between revenues and expected payment streams for social insurance programs.

Another argument made against recognizing social insurance as a liability is that a key factor in the government's ability to meet these social obligations, i.e., the power to tax, is not recognized as an asset. For example, according to officials in several case study countries, estimating future tax revenue is complicated and it may not be able to be reliably estimated. Since the power to tax is an asset that the government could call upon to meet the demand for social insurance, some experts suggested that accruing a liability for social insurance but not recognizing the power to tax as an asset would give an inaccurate picture of fiscal position.

This is one major reason why some accrual-based concepts such as net worth are

difficult to fit into the government context. As mentioned above, some important long-term commitments are not recognized as liabilities and do not appear on the balance sheet. Further, a government's "power to tax"—the means by which any government can pay its long-term commitments—is not recognized in government financial statements. In addition, there are numerous valuation issues created by the unique nature of many government assets and liabilities. Nevertheless, proponents maintain that the new framework provides more and better information than the previous cash-based framework. Further, New Zealand officials suggested that, although there are difficulties in measuring and interpreting some balance sheet items, this information may still provide useful trend information if measured using consistent standards from year to year. That is, while the measure may not necessarily be precise, changes from one year to the next may provide insights to decisionmakers on the implications of their decisions for the overall health of the nation.

Some Accountability and Control Issues Are Addressed by Accrual Budgeting but Others Are Raised

Proponents in all of the case study countries expected greater accountability from the adoption of accrual budgeting. Specifically, officials and other proponents credit the use of accounting standards for budgeting with increasing the transparency and credibility of budget estimates. Against the backdrop of their own budget history, they viewed the adoption of accounting standards as promoting greater accountability and transparency. Markets in particular were viewed as one audience for these reforms; for example, enhancing the credibility of budget information for financial market participants was viewed as a critical part of New Zealand's initiatives to enhance its market standing. In some cases, the adoption of accrual budgeting corresponded with the establishment of other new budget

⁴²The Canadian Pension Plan, broadly similar to the U.S. Social Security system, is a joint federal-provincial program.

It is separate from both federal and provincial budgets and its revenues and expenses are not included in Canada's budget.



planning and reporting procedures designed to institute forward looking budgetary frameworks and reports.⁴³

*Accrual Budgeting Adopted for Greater
Transparency and Accountability*

In general, the case study countries adopted accrual budgeting in reform environments which stressed the need to improve the “transparency” of the budget process and invite increased scrutiny of fiscal policy and specific spending initiatives. For example, Australia’s Charter of Budget Honesty and New Zealand’s Fiscal Responsibility Act each mandate the release, at the start of the budget process, of fiscal strategy statements setting the broad strategic goals of the government. Subsequently, the budget represents how the government intends to implement its strategy. These two countries viewed an accrual framework as important in supporting efforts to improve transparency. In particular, proponents in New Zealand informed us that cash-based budgeting followed inconsistent and complex practices understood by only a few practitioners. In contrast, private sector standards were viewed as generally accepted and understood. Consequently, proponents view applying these standards to the budget as helping to ensure that the budget is understood and subject to greater public scrutiny than was possible when the budget was cash-based.

Proponents stated the opinion that budgeting based on accounting standards increased the consistency and credibility of budget information because the accounting standards are independently developed, well documented, and may be more readily understood. For example, in New Zealand, applying private sector or other established accrual accounting standards was viewed as improving the credibility of government financial management in the credit markets. New Zealand had experienced loss of market confidence—partly attributable to government’s poor fiscal management—and faced the prospect of credit downgrades. Reform efforts including accrual budgeting were begun, at least in part, to

regain the trust of the credit markets. Officials in the United Kingdom and New Zealand told us that they believe the adoption of standards for budget development and presentation that mirror private sector accounting standards will enhance the credibility of budget estimates in the public debate. Officials told us that in their opinion, budgeting based on these standards provides consistency and reliability which can help instill confidence in the estimates and in the ability of the government to achieve its fiscal targets.

Improving the consistency between the budget estimates and the financial statements was also seen as important to enhancing parliamentary scrutiny. Proponents expressed the belief that lack of comparability between the information in the budget and the information decisionmakers receive on the actual results of their budget initiatives in accrual-based financial reports was problematic. For example, officials from New Zealand, Australia, and the United Kingdom all noted that differing budgeting and reporting standards generally provided conflicting signals to decisionmakers and could lead to the failure to adequately focus on results and performance. They viewed the alignment of the basis of budgetary measurement with that used in financial accounting standards, i.e., accrual, as providing a consistent basis with which to make comparisons.

*Accrual Budgeting Raised New Accountability
and Transparency Concerns*

Just as different budget structures highlight different issues, they can bring to the forefront different trade-offs. Budgetary accounting may hide or make transparent the implications of given choices and so confer an advantage or disadvantage. In some cases the trade-offs highlighted in an accrual budget are different than those that would have been presented for the same budget proposal under a cash budget. Although decisionmakers were expected to benefit from any new information that would be available as a result of accrual budgeting, its use—especially in support of more decentralized, performance-

⁴³In the United States, the Congressional Budget Office produces 10-year outlay-based projections for use in the budget process.



focused management philosophies—also raised some new accountability and control concerns.

Some forms of accrual budgeting may provide less control by top-level decisionmakers over some budget items. This is especially true for capital assets where, on an accrual basis, parliamentary decisionmakers may have less ability to control asset purchasing decisions than with a cash-based or obligation-based budget. As previously noted, in New Zealand, Australia, and the Netherlands cash is appropriated for noncash items, such as depreciation expense, and agencies will be allowed to save for asset renovation or replacement. Proponents in these countries argue that this discretion is key to encouraging effective management and that compensating controls can be established to alleviate these concerns. However, critics have raised concerns that delegating asset purchase authority to departments entails surrendering control over decisions that should be made in a governmentwide arena. This delegation could limit the government's ability to make trade-offs across agencies in the use of scarce resources. It also ties funding for new assets to existing assets through depreciation which fails to recognize changes in needs. For example, this process could provide too much for agencies with declining demands for assets and too little for agencies with expanding asset needs. It is unclear whether the compensating controls that were instituted to provide for parliamentary review of most asset purchases offset these problems.

Monitoring budget execution on an accrual basis presents new challenges. Under cash- and obligation-based budgeting, oversight of budget execution is relatively straightforward because managers usually do not have access to more cash than they are expected to use in a given period and obligations are closely monitored to avoid breaching the amount permitted by law. Under these types of budgeting systems, oversight of budget execution generally involves reviews of obligations incurred and cash disbursements to ensure that payments are made in accordance with authorized purposes.

Some we spoke with expressed concerns that the increased complexities associated with the use of accruals may lead to reduced transparency and control. These challenges arise because, depending

on the accrual approach used: (1) cash may be appropriated for noncash expenses, (2) some accrual-based amounts are based on assumptions and judgments which must be understood to reduce the potential for error or manipulation, and (3) when combined with output-based budgeting, wide discretion is provided over the use of resources. For example, parliamentary staff in the United Kingdom expressed concern about the ability to understand the reconciliation between cash requirements and accrued costs. Further, observers in New Zealand expressed concern that in the absence of truly competitive environments, the lack of detailed input information makes it difficult to judge departmental performance, especially the reasonableness of the output "prices" on which the system is premised. Under an accrual budgeting model, oversight may be grounded in financial management principles such as asset/liability management and the sustainability of projected cash flows. For example, in Australia, departmental performance will be monitored based on assessment of departmental operating statements. This is important in these systems because, as departments are given significant discretion over how funding is used to produce outputs, oversight is premised on the ability of policymakers, as the purchasers of goods and services, to adequately assess the price and quality of outputs. As a result, understanding the full costs of producing goods and services, rather than just the immediate cash outlays, becomes increasingly important to ensuring accountability.

Countries Developed Mechanisms to Cope With Budget Control Issues

Proponents noted various mechanisms which can help address control issues. For example, officials from several countries, including New Zealand, Australia, and the United Kingdom, pointed to corresponding enhancements such as alternative measures of fiscal performance, increased requirements for strategic and investment planning, and increased accountability for performance. For these reasons, proponents argued that it was important to consider a country's entire accrual-based management framework when considering issues of control and accountability. For example,



limits may be placed on managerial discretion by fiscal targets that govern key budgetary decisions and continue to be measured primarily on a cash basis. Officials argued that if total borrowing is constrained through fiscal policy objectives, such as debt-to-GDP targets, it may be more difficult for departments to justify capital injections (cash advances) for an asset purchase price even if only one year's depreciation expense would be recognized in the accrual-based budget.

All case study countries that adopted accrual budgeting continued to use some cash-based measures to monitor fiscal policy. For example, New Zealand uses an accrual-based operating balance as its primary deficit or surplus measure, but continues to monitor its debt-to-GDP ratio—a cash-based measure. Officials explained that the debt-to-GDP ratio is a key fiscal target which, used in conjunction with an accrual-based surplus or deficit, provides additional information for decisionmakers to undertake fiscally cautious decisions that contribute to improving the fiscal health of the country.⁴⁴ In fact, New Zealand officials and experts we interviewed explained that setting debt targets guides the determination of the accrual-based surplus or deficit target.

In the United Kingdom, the adoption of a fiscal framework which more clearly distinguishes between current and capital spending was intended in part to encourage capital investment. Nevertheless, the Parliament has asked that the new appropriations bills include a reconciliation at the departmental level between resources consumed (accrual amounts) and cash. Furthermore, they asked to vote on the departmental cash reconciliation as well as on the resources allocated at the activity level. These votes are intended to draw attention to the cash needs of the budget and demonstrate an interest in continuing parliamentary review of these cash resources.

In Australia, debate continues over whether the dominant measure of fiscal position should be accrual- or cash-based. Some who advocated that the primary measure of fiscal position be accrual-based stated that in order to most fully

influence behavior, the government should use as its primary measure the same measure to which departments are held accountable. Others expressed the view that that cash-based measures are a better indication of the government's role as steward of the economy and, additionally, are more familiar to the public. While Australia's budget is presented on an accrual basis, the budget balance—or bottom line—is adjusted to represent the cash financing requirements.

Aside from constraints imposed through cash-adjusted and cash-based fiscal targets, some case study countries imposed other controls at different levels in the budget process. For example, successive reforms in New Zealand—the State Sector Act of 1988 and the Public Finance Act of 1989—changed the locus of accountability in the public service by holding executives responsible for their performance through public service contracts. The new public service system is characterized by executive discretion over the hiring and firing of managers and other employees should performance not measure up to the expectations set forth in their contracts.

In addition, in some countries Cabinet scrutiny ensures that cash controls are still in place at an overall governmental and fiscal level. In Australia, for example, the Expenditure Review Committee, which is responsible for making budget decisions, retained its focus on incremental changes and cash requirements. Further, the Department of Finance and Administration (DoFA) will continue to review the monthly expenditure reports to ensure that departmental spending is in line with what has been budgeted and appropriated. Although ultimate accountability for any breach in budgeted appropriations lies at the department level, DoFA expects to review spending trends and advise senior decisionmakers if financial management is suspect. Similarly, in New Zealand, the timely availability of monthly financial statements was viewed as allowing analysts in the Department of Treasury to determine whether departments are on track to deliver outputs within the agreed upon price, or on the verge of breaching their appropriations.

⁴⁴For more detailed discussion of this topic see Budget Surpluses: Experiences of Other Nations and Implications for the United States (GAO/AIMD-00-23, November 2, 1999).



Conclusion

Case study countries expressed the view that accrual budgeting is a useful tool in addressing concerns about public performance, sustainability, and accountability. Some proponents view it as necessary to support more decentralized, performance-focused management by improving links between cost and performance. Accrual budgeting was viewed as providing decisionmakers with more complete information on sustainability of some government policies with long-term budgetary implications. Finally, proponents expressed the belief that accrual budgeting would improve accountability and control by enhancing the consistency and transparency of budget information. This last point was challenged by other observers who expressed concerns and skepticism that the increased complexities of accrual measurement and the decentralization of responsibility that accompanied most of the case study countries' budget reforms present difficult trade-offs that might offset the benefits proponents expect to achieve. Finally, some question the usefulness of accrual budgeting in addressing sustainability issues because it does not capture some key fiscal pressures—those associated with social insurance and health care programs.

The design of an accrual budgeting system shapes its role in addressing these challenges and tends to reflect a country's overall management approach and desired level of control. For example, the extent to which the adoption of

accrual budgeting reflected fundamental changes to core management philosophies and systems varied significantly. Some countries, such as New Zealand and Australia, integrated accrual budgeting with output-based appropriations to support decentralized, performance-focused management systems. The United Kingdom plans to use accrual budgeting to better recognize costs but to date has not chosen to shift to output-based appropriations. Conversely, Iceland's accrual budgeting system, which excludes capital and accrues pension costs only at the central level, better reflects aggregate costs to the government but places less emphasis on allocating full costs to particular goods and services. In general, the design of a country's accrual budgeting system tended to reflect its key concerns and reform objectives.

Abbreviations

ACC	Accident Compensation Corporation
CFO	Chief Financial Officers
DoFA	Department of Finance and Administration
FASAB	Federal Accounting Standards Advisory Board
FIS	Financial Information Strategy
FMI	Financial Management Initiative
GAAP	generally accepted accounting principles
GDP	gross domestic product
NAO	National Audit Office
NCOA	National Commission of Audit
OECD	Organization of Economic Cooperation and Development
OMB	Office of Management and Budget