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Accrual accounting in government: Is fund accounting still relevant?

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Abstract

The main purpose of public sector accounting is to act as the trustee to protect and manage public moneys and discharge accountability. Fund Accounting is used as the rational response to serve as a reliable control technique for such purposes. With the emphasis of accrual accounting which is more reliable than cash accounting in measuring financial performance of government activities, this study therefore attempts to evaluate the relevance of the Fund Accounting in the planned adoption of accrual accounting by the Federal Government in Malaysia. Thus, the objective of this paper is to provide literature evidence to support on the relevance of Fund Accounting for the adoption of accrual basis of financial reporting in the Federal Government of Malaysia.

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1. Introduction

Traditionally, input-based budgeting systems and cash-based accounting systems are used by government in United States of America (USA) for accounting and financial reporting with the purpose to protect and manage public money and discharge accountability. However, these traditional systems do not provide the accounting information that is necessary for a government to operate efficiently and effectively. There are a growing number

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of countries, such as Australia, New Zealand, and the United Kingdom that have already transformed from input based to outcome based budgeting system and from cash-based accounting to some form of accrual accounting system.

The main purpose of public sector accounting in the early days was to demonstrate the legal and contractual provision of the government. The government acts as the trustee to protect/manage public moneys and discharge accountability and Fund Accounting is therefore used to serve as a reliable control technique for such purposes. A Fund Accounting is an accounting system emphasizing accountability rather than profitability used by governments and non-profit organizations. It is a self-balancing set of accounts, segregated for specific purposes in accordance with laws and regulations or special restrictions and limitations (Wikipedia, 2013).

The fast growing establishment of business types of government agencies and public sector financial reforms, the need for the adoption of accrual accounting in the public sector is required for performance measurement, financial information on the operating results and effective fiscal management (Freeman & Shoulders, 1999 and Accountants Today, 2011). Among the numerous changes in government accounting in recent years is the adoption of accrual accounting based on the International Public Sector Accounting Standards (IPSAS). Financial statements prepared on the accrual basis inform users of past transactions involving the payment and receipt of cash. They also show obligations to pay cash in the future and of resources that represent cash to be received in the future (Chan, 2003).

In evaluating the relevance concept of Fund Accounting for the Malaysian Federal Government in the accrual accounting environment, an extensive literature review and fact findings approach are used as the research methodological supports to achieve the following two objectives of this study:

1. To examine whether Fund Accounting is still relevant in the transformation journey of Federal Government in Malaysia for accrual accounting environment.
2. To review literature on the relevance of Fund Accounting in the Federal Government's accrual basis of financial reporting system in the two developed countries i.e. USA and New Zealand.

It is hoped that the research findings through extensive literature review shall contribute for future empirical study to be conducted. This study can provide literature evidence to support on the relevance of Fund Accounting concept in the Malaysian context for the Federal Government's planned adoption of accrual accounting basis for its financial reporting system. The fact findings approach for this study might also help to support the strategic trust and policy of the Accountant General's Department (AGD) towards the accrual accounting transformation.

2. Literature review and research background

Fund Accounting was used to promote control and accountability over restricted resources. Government had established separate resources into multiple types of funds to ensure that they complied with the restrictions placed upon them by legislators, grantors, donors and other outside parties (Lynn & Freemann, 1983). Fund Accounting recognizes the political, economic and legal differences that exist between the services provided and the activities carried on within public sector organization (cited in Kalsom, Rozainun, & Y. Nurli, 2012). Being as an accounting entity, each fund has its own self-balancing sets of accounts from which separate financial statements can be prepared. Fund Accounting is a self-contained accounting entity with its own assets, liabilities, revenues, expenditures and fund balance. Several funds are commonly used by the government and non-profit organizations to account for their resources and activities.

The objectives of Fund Accounting are to show the financial condition and its changes in the organization, the results of operations of the organization and its compliance with legal restrictions. According to Razek and Hosch (1995), the practical effects of adopting Fund Accounting depend upon the extent to which different funds are utilized and the form and extent to which the individual fund accounts are consolidated in the final accounts.

The following are some arguments against Fund Accounting based on literature review (cited in Ingram, 1986):

1. It fails to describe the operating results of the government as a whole.
2. It is too complicated for external users to understand.
3. It focuses too much on legal compliance and too little on efficiency evaluation.
4. It does not permit taxpayers to determine the need for taxes.

5. It permits managers to distort performance and thereby misappropriate resources and abuse of funds. However with the emergence of accrual basis of accounting based on the International Public Sector Accounting Standards (IPSAS), financial statements prepared on the accrual basis provides the following advantages (Chan, 2003 and Rayegan, Parveizi, Nazari & Emami, 2012):

1. It shows how an entity financed its activities and met its cash requirements.
2. It allows users to evaluate an entity's ongoing ability to finance its activities and to meet its liabilities and commitments.
3. It shows the financial position of an entity and changes in financial position.
4. It provides an entity with the opportunity to demonstrate successful management of its resources.
5. It is useful in evaluating an entity's performance in terms of its service costs, efficiency, and accomplishments.

Government types of funds are defined as those funds in which the accounting emphasis (measurement focus) is placed on spending activities. The measurement basis used for the government accounting system depends on the fund or funds involved and are guided by sound financial judgement (Hepworth, 2003). In the United States of America (USA), government fund such as the General Fund, Special Revenue Funds, Debt Service Funds, and Capital Projects Funds use the modified accrual basis of accounting with a measurement focus on current financial resources (Governmental Accounting Standards Board (GASB), 1998). For modified accrual accounting basis, revenues are recognized if they are measurable and available for use during the year whilst expenditures are recognized in the period the liabilities are incurred if measurable, except for accrued interest on general long term debt which is recognized when payment is due to bondholders. The full accrual basis of accounting is used for proprietary funds such as enterprise funds and internal service funds. Under this accounting basis, revenues are recognized in the period earned and expenses are recognized in the period that the liabilities are incurred. GASB 34 in US requires government to continue to publish governmental funds statements prepared on a modified accrual basis and government-wide statements prepared on an accrual basis. In revising the Fund Accounting in US, the GASB No 34-Governmental Financial Reporting Model requires the following preparation of government funds statements:

1. Government Funds Statement focuses on a government's fiscal accountability, budgetary compliance and short term financial health using the modified accrual accounting.
2. Government-Wide Statement requires two new financial reports: 1) statement of net assets (balance sheet) and 2) statement of activities (income statement) using accrual accounting for all of the government's activities
3. Separate financial statements are provided for government funds, proprietary funds and fiduciary funds. Major individual governmental funds and major individual enterprise funds are reported as separate columns in the fund financial statements
4. Reconciliation Statements of governmental funds' fund balance to statement of Net Assets and Reconciliation of the statement of the Revenues, Expenditure and changes in Fund Balances of governmental funds to the statement of Activities

The Federal and State Governments in Malaysia have adopted a modified cash basis of accounting in the preparation of the annual financial statements. Under modified cash basis of accounting, expenditures which are incurred in the prior financial year will be paid in January of the new financial year and are reported as expenses for the prior financial year. As for Local Government, Statutory Bodies and Government Linked Companies in Malaysia, they have adopted an accrual basis of accounting in preparation of their general purpose of financial statements. The planned adoption of accrual accounting by Malaysian Government in 2015 shall create more government financial commitments as compared to cash accounting system where full disclosure of liabilities and contingent liabilities are required to be reported in assessing the true economic implications of public sector financial management (Accountants Today, 2011).

In the context of Malaysian Government, the financial provisions of Federal Constitution 1957 and the Financial Procedure Act 1957 describes in detail the financial provisions with regards to the accountability and

enforcement matters (Zakiah, 2007 and Zauwiyah, Junaini & Aziz, 2009). The objectives of the Financial Procedure Act 1957 are stated as follows:

1. To provide guidance for the control & management of public finance for the whole nation:
2. To provide financial and accounting procedure
3. To provide guideline for collection, custody and payment of public monies
4. To provide procedure for purchase, custody & disposal of public properties
5. To provide authority for the investment of money standing in the consolidated funds
6. To define and explain the three accounts of the consolidated funds
7. To enforce provisions of Federal Constitution relating to finance.

Government Accounting Standard (GAS) No: 3, 4 & 5 set up by the AGD in Malaysia also explains the three types of Consolidated Fund (Consolidated Revenue, Trust and Loan Account) in compliance with Federal and State Government in preparing their Public Accounts. Public sector organizations are producing financial statements as regulated under Section 16 (1) of the Financial Procedure Act 1957 (Revised 1972). This is known as Public Accounts. The Federal Public Accounts contain the Balance Sheet, Statement of Cash Receipts and Payments, Statement of Memorandum Accounts and Notes to the Accounts. The Balance Sheet comprises of a Statement of Cash, Statement of Investments, the Statement of Consolidated Revenue Account, the Statement of Consolidated Loan Account and the Statement of Consolidated Trust Account.

3. Research methodology

An extensive literature review and fact findings approach are used as the research methodological supports to achieve the two objectives of this study. Extensive review of literature along with a series of discussion with key participants at the AGD were conducted to collect data for the purpose of analytical review of literature and fact-finding approach of preliminary investigation.

In the literature review perspective, the author(s) compare various methods adopted by selected developed countries relating to Fund Accounting in their respective accrual basis of financial reporting system.

In the research context of the AGD, the research method of this study takes the following forms:

1. Content Analysis for the identified two trust accounts from the Consolidated Trust Account of Federal Government
2. Interviews with key officers in-charge of the identified consolidated trust accounts at the AGD government officers

4. Findings and discussion

This section is organised in two parts to present the literature review and the fact-finding results with recommendations in response to the two (2) research objectives of this study.

4.1 Findings from the perspective of Federal Government in Malaysia

Research Objective No: 1

Examine whether Fund Accounting is still relevant in the transformation process for accrual accounting adoption by the Federal Government in Malaysia.

Research Question No: 1

1. Should Fund Accounting continue?
2. Should Fund Accounting be reported in cash or accrual basis for more reliable consolidated accounts?

Firstly, the planned adoption of accrual accounting in 2015 for Federal Government in Malaysia (Accountants today, 2011) are indicated by the setting up of Accrual Accounting Implementation Team in the AGD to formulate the Malaysian Public Accounting Standards (MPSASs) by adopting IPSAS with amendments. The Fund Accounting is found to remain relevant in the transformation journey of Federal Government in Malaysia for

accrual accounting environment. The issue of relevance of Fund Accounting in the Federal Government's accrual basis of financial reporting is mainly due to the following reasons:

1. Fund Accounting is still relevant in terms of legal requirements and financial procedures (Art 97 (1) of Federal Constitution, Section 7, 9 and 10 of Financial Procedure Act 1957; Development Fund Act 1965, Housing Loan Fund Act 1971 (revised) and Trust Deed.
2. There is no rules and procedures stated in Federal Constitution 1957 (amended) and Financial Procedure Act 1957 (amended) for the specific accounting basis to be used for the presentation of fund financial statements
3. For trust accounts and consolidated trust account, the Fund Accounting should be continuously maintained and it is still legally required by Federal Constitution 1957 (amended) and section 7, 9 and 10 of Financial Procedure Act 1957 (amended) even if Federal Government has to adopt accrual accounting basis in the preparation of annual public accounts. The consolidated trust account is an account in which all trust accounts contained therein such as public trust fund and government trust fund to keep all trust moneys received which have to be applied in accordance with the terms of the trust. The Fund Accounting in cash basis for consolidated trust account can possibly be transformed into accrual basis to be in line with the planned adoption of accrual accounting by the Federal Government in 2015 and it can still be used for the reliable control mechanism for resource management and performance evaluation.

Secondly, the exposure draft 1/2012 for Malaysian Public Sector Accounting Standard 1 (MPSAS 1) contains the information related to the relevance of Fund Accounting in accrual accounting basis of financial statements of the Federal Government. As stated by MPSAS 1 of the Federal Government's Accrual Accounting, Fund Accounting is still found relevant where the presentation for the summary balances of trust accounts (section 9 and 10 of the Financial Procedure Act 1957) is shown in the Statement of Changes in Net Assets/Equity. Para 118 of the exposure draft 1/2012 for MPSAS 1 states that an entity shall present a statement of changes in net assets/equity (also known as Consolidated Fund) showing on the face of the annual financial statements under the title name known as Summary of Trust Accounts balances.

The exposure draft 1/2012 for Malaysian Public Sector Accounting Standard 1 (MPSAS 1) has included the statement of changes in net assets/equity in the complete set of Federal Government's financial statements. A complete set of accrual based financial statements comprises the following (MPSAS 1 - Presentation of Financial Statements):

1. A statement of financial position;
2. A statement of financial performance;
3. A statement of changes in net assets/equity;
4. A cash flow statement;
5. When the entity makes publicly available its approved budget, a comparison of budget and actual amounts either as a separate additional financial statement or as a budget column in the financial statements; and
6. Notes, comprising a summary of significant accounting policies and other explanatory notes.

4.2 Findings from the analytical review of Literature

Research Objective No: 2

To review literature on the relevance of Fund Accounting in the Federal Government's accrual basis of financial reporting system in the two developed countries i.e. 1) United States of America and 2) New Zealand.

Research Question No: 2

1. The relevance of Fund Accounting in the selected of developed countries in their adoption of accrual basis of Financial Statements
2. Presentation format in the form of consolidated account or as a separate financial reporting (supplementary statement) as being reported in the Financial Statements of the selected developed countries

Most general purpose governments in USA engage in three broad categories of activities under the three different types of governmental fund with different basis of accounting and measurement focus. The following Table 4.1 shows the fund structure of Local and State Government in the USA.

Table 4.1. Fund Structure of Local and State Government in U.S. of America

Types of Fund	Government Funds	Proprietary Funds	Fiduciary Funds
Purpose	Accounting and reporting government's operating and financial activities financed predominantly by taxes and intergovernmental grants	Accounting and reporting governments' activities that are similar to those carried out in the private sector and financed predominantly through user charges	Accounting and reporting resources held by governments as trustees or agents for another party or parties
Basis of Accounting	Modified accrual	Full accrual	Full accrual
Measurement Focus	current financial resources	economic resources	economic resources
Examples	General fund, special revenue funds, debt service funds, capital projects funds, permanent funds (e.g. maintenance of a public park or cemetery)	Enterprise funds (e.g. electric utility), internal service funds (e.g. a centralized purchasing function or motor pool)	Trust funds (pension trusts, investment trusts and private purpose trusts) and Agency funds (taxes collected on behalf of another government)

GASB 34 requires government in the USA to continuously publish governmental funds statements prepared on a modified accrual basis and government-wide statements prepared on an accrual accounting basis. In revising the Fund Accounting, the GASB No 34 – Governmental Financial Reporting Model requires the following preparation of Fund Accounting in the accrual basis of financial reporting:

1. Requires government to continue publish Governmental Funds Statement prepared on a modified accrual basis and government-wide statements prepared on an accrual basis.
2. Government Funds Statement focuses on a government's budgetary compliance, fiscal accountability and short term financial health using the modified accrual accounting.
3. Government-Wide Statement requires two new financial reports: 1) statement of activities (income statement) and 2 statement of net assets (balance sheet) using accrual accounting for all of the government's activities

In addition, Revising the Fund Accounting under GASB No 34 – Governmental Financial Reporting Model also requires the following preparation format:

1. Separate financial statements are provided for government funds, fiduciary funds and proprietary fund. Separate columns in the fund financial statements are required to report the major individual governmental funds and major individual enterprise funds
2. Reconciliation Statements of the fund balance of governmental funds to statement of Net Assets and Reconciliation of the statement of the revenues, expenditure and changes in fund balances of governmental funds to the statement of Activities

In the government context of New Zealand, the annual financial statements had included the Statement of Trust Money to fairly reflect the trust monies managed by the government. Trust money in New Zealand is defined by sect 66 of Public Finance Act 1989 as follows:

1. Money that is deposited with the Crown pending the completion of a transaction or dispute and which may become repayable to the depositor or payable to the Crown or any other person
2. All money that is paid into Court for possible repayment to the payee or a third party or authority
3. All money that is paid to the Crown in trust for any purpose
4. Money that belongs to or is due to any person and is collected by the Crown pursuant to any agreement between Crown and that person
5. Unclaimed money that is due to or belongs to any person and is deposited with the Crown

Statement of Trust Money is included in the complete set of the audited financial statements of the New Zealand Government which comprise the following:

1. statement of financial performance
2. analysis of expenses by functional classification
3. statement of comprehensive income
4. statement of cash flows
5. statement of changes in net worth
6. statement of financial position
7. statement of segments
8. notes to the financial statements
9. supplementary statements
10. Statement of unappropriated expenditure
11. Statement of expenses or capital expenditure incurred in emergencies
12. Statement of trust money

The following Table 4.2 demonstrates supplementary statement presentation format for the New Zealand Government's Statement of Trust Money for which the trust monies are managed by the responsible ministries.

Table 4.2. New Zealand (NZ) – Statement of Trust Money

SUPPLEMENTARY STATEMENT PROFORMA						
Trust Dept	Opening Balance	Contributions	Distributions	Revenue	Expenses	Closing Balance
Ministry of Health	xx	xx	(xx)	xx	(xx)	xx
Ministry of Justice	xx	xx	(xx)	xx	(xx)	xx
Dept of Labour	xx	xx	(xx)	xx	(xx)	xx
NZ Police	xx	xx	(xx)	xx	(xx)	xx
Balance Carried Forward	xx	xx	(xx)	xx	(xx)	xx

5. Recommendations

Based on the research data obtained from the analytical review of literature and fact-findings approach, the following are few recommendations provided for the relevance of Fund Accounting in the accrual basis of Financial Statements of the Malaysian Federal Government:

1. Presentation of accrual-based fund financial statements of trust accounts in particular should be in line with MPSAS or IPSAS application.
2. To examine figures in receipts and payments account of trust accounts from cash basis to accrual basis for fund based financial statements and changes are made to the trust deed in relation with changes in accounting basis.
3. Summary of Trust Account balances (if accrual basis is adopted) should be shown in Statement of Changes in Net Assets/Equity (MPSAS Exposure Draft 1/2012 Presentation of Financial Statements : No 118)
4. Summary of Trust Account balances (if cash basis is adopted) should be shown in Statement of Changes in Net Assets/Equity (MPSAS Exposure Draft 1/2012 Presentation of Financial Statements : No 118)
5. Use Supplementary Statement – Statement of Trust Money (refer to Financial Statements of New Zealand Government)

6. Review the USA's application for its Revising The Fund Accounting under GASB No 34 – Governmental Financial Reporting Model for the preparation of Fund Accounting in the accrual basis of financial reporting:
7. Further Research for Gap Analysis Study and Data Conversion (Migration to Accrual Accounting)
8. Training and education programs for motivating factors to the implementators.

6. Conclusion

Malaysia's New Economic Model (NEM) recommended the adoption of accrual accounting for prudent fiscal management and performance measures in the public sector. With the planned adoption of accrual accounting for Federal Government in Malaysia is in 2015, it is hoped that the findings of this study can help the AGD to evaluate the relevance of Fund Accounting concept for its transformation process towards accrual basis of government accounting and financial reporting. Accrual accounting can effectively complement outcome based budgeting in the results framework to provide the relevant cost data and information to make public policy decisions that maximizes the outcome of scarce resources.

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