# PUBLIC SECTOR ACCOUNTING

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throughout the year and therefore the profile would be £6250 (one quarter of £25,000). For the fuel and other costs, the expected cash payments by the end of the first quarter might, because of the normal delay in paying suppliers invoices, be only £2500, which is significantly less than one quarter of the annual budget. If the actual payments for the first quarter are now compared with the budgetary profile for the first quarter, this indicates an overspend of £1250 for employee costs and an underspend of £500 for fuel and other costs.

The second distinct point is the earliest one for each transaction: when the transaction is ordered from the supplier or employee. There are three names that can broadly be used for this point: commitment to spend (common in the UK); the encumbrance (common in US state and local government); and the obligation (used in the US federal government). The idea behind this distinct point is that, while control of the government depends on controlling cash payments, it also depends on controlling the transactions that the government commits itself to. This idea is particularly strong in budgetary accounting, where the focus is on using the budget to control what is spent against the budget. The cash payment is part of that control, but, if the government is already committed to making a given cash payment, even if it leads to a budget being overspent, the payment itself becomes a formality that cannot be varied. This has added emphasis given that an official order from a government to a supplier or employee, while it may not be a legal liability to accept the goods or services, can usually be taken by the supplier or employee to mean that the order will not be withdrawn or varied to their disadvantage.

This second distinct point can be applied in a government in two broad ways, which can be identified in this example by distinguishing between the transactions with the supplier and those with the employee. The commitment basis or encumbrance basis is typically used only for those line items that authorise large numbers of purchases made daily or weekly – in this example, for the fuel transactions with the supplier. The budgetary control it provides is primarily for the budgetholder's own purposes. The budgetholder needs the accounting system to keep a record of the initiation and completion of every transaction so that he or she continuously knows the amount of the budget not yet committed. The final accounting for the year against the annual budget is based on cash payments, so the budgetholder also needs to know the amount of the budget not yet paid out. Exhibit 3.3 gives a budgetary control report for the commitment and cash bases.

**Exhibit 3.3 Commitment basis and cash basis budgetary control report for the Minibus Service, Social Services Department, City of Eutopia, for first quarter 20x2**

Minibus Service
Social Services Department, City of Eutopia
Budgetary Control Report
First quarter, 20x2

| £ | *Annual budget* | *Orders issued to date* | *Uncommitted balance of annual budget* | *Cash payments to date* | *Under-(over-) spending against budget* |
|---|---|---|---|---|---|
| [1] | [2] | [3] | [4] | [5] | [6] |
| Transport | | | | | |
| Fuel | 15,000 | 8,000 | 7,000 | 3,000 | 12,000 |

The two amounts of the uncommitted budget (Column 4) and of the cash balance for the budget (Column 6) are viewed differently by the budgetholder, even though his or her initiation of the transaction will lead to the payment for it. That is because of the segregation of duties in internal control – those who order goods and services do not make the payments for them. The budgetholder will actually issue orders, but the payments will be made by a payments office in the Finance Department, to reduce the risk that budgetholders will collude with suppliers in fraudulent or uneconomic transactions.

The crucial aspect of this segregation is that the budgetholder does not know when the payment will be made and therefore does not know when the budget will be charged with the payment. If the normal delay between the order issued and payment made for these kinds of purchases is a month or so, for most of the year the delay is not relevant in controlling spending for an annual budget as all orders issued in the year will lead to cash payments within the same year. Because of this, during the year it is the amount of the budget not yet committed that will be of most interest (Column 4), to ensure that the annual budget is not overcommitted. That means the need for a profile of expected cash payments by the end of the first quarter is less relevant here because the focus for control purposes is on the relationship between the annual budget, the commitments (the orders issued to date) and the uncommitted balance.

Towards the end of the year, the delay between an order and payment can mean that orders issued in one year lead to payments in the next. Therefore, towards the end of the year, the budgetholder's focus on Column 4 will be shared with actual payments to date (Columns 5 and 6). The focus on Column 4 during the year is because the budgetholder does not want to overspend against the annual budget; the focus on Column 6 is because the budgetholder does not want to underspend against it. The budgetholder's focus, then, while ensuring that the annual budget is not overspent, is on predicting how many orders can be issued to ensure that all the associated payments will be made by year end.

As a practical matter, because commitment systems most usefully relate to line items that authorise large numbers of purchases made often, the accounting can be complicated. There are many reasons for the financial amount of an order being different from the final payment. For example, the quantity and quality of goods delivered may not be what were ordered, prices may have changed, orders may be varied before delivery. The accounting basis, in practice, needs to be continually monitored to remain useful to the budgetholder.

The logic of commitment accounting follows from focusing on the earliest point of a given transaction, particularly a transaction with a supplier, but there is a second broad way in which that point can logically lead to a related accounting basis – the obligation basis. It can be identified in this example by focusing on all the transactions, including those with the employee. The budgetary control that the obligation basis provides is primarily for those who authorise the budget and for the top management who control the budget on their immediate behalf.

The annual budget authorises all the budgetholders to spend neither more nor less than the amounts authorised. The logic of the obligation basis is that, while

control of the government depends on controlling all cash payments, it also depends on controlling all the transactions that the government commits itself to – or, we can say, obligates itself to. Every transaction must have an earlier point than the payment of cash. That is so even for transactions where the delay is very short, perhaps almost instantaneous, between deciding to buy and paying cash. It is also so for transactions such as salary payments to employees, in which the obligation is made when each contract of employment is signed. The obligation basis holds every budgetholder to account for not just paying cash but also obligating the government at earlier points to subsequently paying cash. Exhibit 3.4 shows a budgetary control report using the obligation and cash bases.

**Exhibit 3.4 Obligation basis and cash basis budgetary control report for the Minibus Service, Social Services Department, City of Eutopia, for first quarter 20x2**

Department A Budgetary Control Report
Month ended [*date*], 20x2

| £ | *Annual budget* | *Obligations to date* | *Unobligated balance of annual budget* | *Cash payments to date* | *Under-(over-) spending against budget* |
|---|---|---|---|---|---|
| [1] | [2] | [3] | [4] | [5] | [6] |
| Operating: | | | | | |
| Employees | 25,000 | 7,500 | 17,500 | 7,500 | 17,500 |
| Transport | | | | | |
| Fuel and other | 22,000 | 10,000 | 12,000 | 2,000 | 20,000 |
| Capital: | | | | | |
| Vehicles | 50,000 | 50,000 | 0 | 50,000 | 0 |
| Total | 97,000 | 67,500 | 29,500 | 59,500 | 37,500 |

The exclusive use of the cash basis in a government restricts the budgetary control by that government as a whole to cash payments; all other aspects of control – including control of the obligations made by budgetholders on behalf of the government – are dealt with by the internal control system in other ways. Rules about the kinds of obligations, and the size of them, that can be entered into by a budgetholder without higher authorisation might be imposed in a variety of ways. Penalties for overspending cash budgets might be more severe, with explicit rules about how overspending is to be covered by other budgets within the year or beyond.

In contrast, the obligation basis, in conjunction with the cash basis, adds to the budgetary control itself the control of the obligations made by budgetholders on behalf of the government. In its extreme form, the obligation basis states that any obligations entered into by a budgetholder for which there is no remaining – unobligated – budget for the year are void. Orders issued to suppliers are cancelled, however much the supplier may already have done to satisfy an order. The orders cannot be applied to next year's budget because that budget, even if it has already been passed, only authorises obligations to be made in that subsequent year, not in the current year.

A fundamental problem that the obligation basis can have is best identified by comparing it with the commitment basis. The logic of the two bases is the same. The application of the logic is clearest under commitment accounting because all of the transactions it is applied to clearly begin with an official order that results in an associated cash payment. The recognition by the accounting basis of the earlier point of each transaction is clear and frequent. This clarity and frequency only applies to a small proportion of government budgets, however.

Most budgets are dominated by salaries, for which that earlier point is clear (the signing of each employment contract), but the point at which each decision is made not to terminate the contract or not to vary it is usually not frequent. For the obligation basis to be applied comprehensively, artificial points have to be imposed. For example, the total annual salaries payment is said to be obligated at the beginning of the year or, more likely, the monthly salaries payment is said to be obligated at the beginning of each month or else perhaps at the point during the month that the actual payment is certain. None of these points has any significance for the politicians who authorised the budget. The obligation basis in such cases becomes a formal one with no practical effect.

The obligation basis, with the cash basis, can distinguish between operating payments and capital payments, as in Exhibit 3.4 but otherwise operating and capital are accounted for in the same way. The budget authorises the full amount of each transaction, whether operating or capital, in terms of both the obligation to pay and the payment itself. The most unusual and significant aspect of this is that the budget scores the full amount of a capital project at the time of the obligation.

This is of great significance for the internal control of budgetholders, but also for the external control of the government as a whole. Under this basis, the politicians who ultimately adopt a budget are being forced to count all capital projects, for their full amount, at the time of the budget. How that budget is to be financed – particularly the proportions to be financed by taxation and borrowing – will mitigate the effects of this. When borrowing is allowed for capital projects (explicitly or implicitly), the politicians can immediately glean the benefits, in voters' eyes, of authorising capital projects while using borrowing to postpone the costs to taxpayers. At least the budget does immediately score the full amount for the capital projects. A balanced budget on the obligation basis, defined to prohibit borrowing, would additionally force the taxpayers to pay that full amount immediately.

The earliest and latest points when transactions might be recognised by accounting are the commitment/obligation and the cash payment. The third possible accounting basis lies between these two points: the accrual of the transaction – when the goods or services were delivered and an invoice issued. This point does not apply to many transactions in government budgets. The salaries line item is again a good example of transactions that are often large parts of budgets for which the cash payments are the only significant accounting basis as they are typically neither subject to 'orders' nor to invoices. For those line items that do relate to goods and services bought on credit, however, the accrual basis is of very great significance. The cash basis is always and everywhere necessary. The commitment basis and the obligation basis can be very relevant, but

they cannot record the cost of using the goods and services bought on credit. Only the accrual basis of the transactions can do that as it is the only basis that is comprehensively defined by the possibility of using the goods and services.

The accounting bases of transactions have been illustrated so far in budgetary control. The accrual basis can be similarly illustrated, but budgets are, in practice, likely to be cash-based, with or without the commitment or obligation basis. The accrual basis is, therefore, more likely to be restricted to the financial statements. Once we have illustrated the accrual basis in the context of the financial statements, we can return to its implications for budgeting.

The accrual basis of transactions provides only the foundation for accrual accounting. What also needs to be defined is which other revenues, expenses, assets and liabilities are recognised and what measurement and valuation bases are then applied to all of the amounts so recognised. The term 'accrual accounting' is authoritatively used to refer to different definitions of all these aspects. Even when the term is used (implicitly or explicitly) to mean comprehensive accrual accounting, the definitions vary. It is useful, therefore, to refer to each of these not as 'the full accrual accounting basis' but 'a full accrual accounting basis'. Of equal significance, in government accounting, there are many variations in the use of partial accrual accounting bases – indeed, they are probably the norm. In some contexts, they are referred to as 'the modified cash basis' or 'the modified accrual basis' – the usefulness of both terms being that they identify a basis that is somewhere between a pure cash basis and a full accrual basis. The variety of detail underpinning these generalisations, again, suggests that it is more useful to refer to each of them as 'a modified accrual basis'.

Exhibit 3.5 provides a full accrual accounting example using the Minibus Service, with additional data.

**Exhibit 3.5 Full accrual basis financial statements for the Minibus Service, Social Services Department, City of Eutopia, for 20x2–20x5**

At the beginning of 20x2, the department bought a minibus for £50,000, financed by an earmarked loan for four years, repayable at the end of each year in equal instalments, at 3 per cent interest. The minibus had a four-year life and, at the end of 20x5, it had no scrap value; the depreciation policy is straight-line. The minibus carried external clients for a fee, set so as to break even for the service – a financial objective that the service did achieve each year. The annual cash payments, and the accrued expenses, for the vehicle service were £30,000 for the driver and £20,000 for fuel and other vehicle expenses. There were no inventories at any of the year ends. There was no working capital at any of the year ends; fees collected provided any necessary working capital within the years. All of these data are known, thus the example has no uncertainty in it and no changing prices over the four years.

Exhibit 3.6 provides the operating statement and balance sheet for the data in Exhibit 3.5.

**Exhibit 3.6 Full accrual basis financial statements for the Minibus Service, Social Services Department, City of Eutopia, for years ended [*date*], 20x2–20x5**

Minibus Service
Social Services Department, City of Eutopia
Years ended [*date*], 20x2–20x5

| £ | *20x2* | *20x3* | *20x4* | *20x5* |
|---|---|---|---|---|
| [1] | [2] | [3] | [4] | [5] |
| **Operating statement** | | | | |
| Operating revenues | | | | |
| Fees | 64,000 | 63,625 | 63,250 | 62,875 |
| Operating expenses | | | | |
| Employees | 30,000 | 30,000 | 30,000 | 30,000 |
| Transport | | | | |
| Fuel and other | 20,000 | 20,000 | 20,000 | 20,000 |
| Depreciation | 12,500 | 12,500 | 12,500 | 12,500 |
| Finance costs: | | | | |
| Interest on debt | 1,500 | 1,125 | 750 | 375 |
| Total expenses | 64,000 | 63,625 | 63,250 | 62,875 |
| Net surplus (deficit) for the year | 0 | 0 | 0 | 0 |
| **Statement of financial position** | | | | |
| ASSETS | | | | |
| Non-current assets | | | | |
| Vehicles | 37,500 | 25,000 | 12,500 | 0 |
| LIABILITIES | | | | |
| Current liabilities | | | | |
| Current portion of long-term borrowing | 12,500 | 12,500 | 12,500 | 0 |
| Non-current liabilities | | | | |
| Long-term borrowing | 25,000 | 12,500 | 0 | 0 |
| TOTAL NET ASSETS | 0 | 0 | 0 | 0 |
| NET ASSETS | | | | |
| Capital contributed by the government | 0 | 0 | 0 | 0 |
| Accumulated surpluses (deficits) | 0 | 0 | 0 | 0 |
| TOTAL NET ASSETS | 0 | 0 | 0 | 0 |

In this example, the cash basis and the accrual basis for the transactions is the same (because there are no receivables or payables or inventory at the end of the year). In practice, the difference between the two bases for transactions may or may not be materially different to a government's financial statements. The essential difference between the two bases in this example, as often in practice, is that the full accrual accounting recognises an additional expense – depreciation.

There are two fundamental points about the depreciation charge. First, it transforms the cash-based total costs of the service shown in Exhibit 3.4 from £97,000, of which £47,000 are operating costs and £50,000 capital costs, into a measure of the economic cost of the service provided in the year (usually shortened to 'cost of service provided'), by excluding unallocated costs of the vehicle and including a measure of the costs of the vehicle used up by operating it.

Second, it offers the possibility of using the financial statements to report on capital maintenance. By abstracting from price change, both the financial