

UNIVERSITY OF BIRMINGHAM

BIRMINGHAM BUSINESS SCHOOL

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ACCRUALS BASIS IN CHINESE GOVERNMENT

ACCOUNTING

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Abstract

Since 20th century 90's, most of OECD countries have introduced accrual basis into government accounting through series accounting reform. As the result, visible effect in strengthening government financial control and management in those countries has attracted the concern from other countries which have not involved in this trend.

For Chinese government, cash basis has dominated in the area of government accounting for a long period. Chinese government accounting has very tight relationship with state-budget; and it behaves as foundation of entire financial and budget management, therefore, the accounting basis acts as the fundamental guarantee of sound financial and budget management system. For the comparable lower requirements on accounting information in the past, cash basis of government accounting could satisfy users' demands. But with the changes in government accounting environment, its inherent weaknesses make it quit the stage and give the way to accruals accounting---a new power in government accounting.

From the start, accruals accounting has revealed its benefit on improving financial control and management in government. With it, government could has better performance on accountability, and provide more transparent report on its

financial performance to information users including the investors. After some academic researches on its inherent characteristics and implementation experience, Chinese government has confirmed the implementation of accruals accounting as the key factor in the process of establishing effective modern government.

For current Chinese government, accrual accounting have not been applied in all departments, Chinese government is experiencing the accounting reform which aims at changing the cash basis to accrual basis. Combined the successful reform experience from some OECD countries (like UK, U.S, New Zealand and Australia) with local environment, Chinese government accounting reform followed the step-by- step way with “Chinese characteristics” which begin from completing/creating reform environment to achieve full accruals accounting in final stage.

Chinese government accounting reform definitely is a well planned arrangement. But the unpredictable changes will exist within the reform process. Certain timely adjustment is essential for Chinese government within reform process. Frankly speaking, there is no perfect accounting system in the world. For public financial management, even accruals accounting which has better performance in most fields than others, its inherent weaknesses would bring potential issues to government. And some issues have been existed in developed countries like

UK, U.S. Australia and New Zealand. Chinese government has responsibility to pay more attention on those issues within reform process, and Chinese government need to do some analysis and prediction work on the problems which have high possibility to occur in future accruals accounting application. In China, completing the whole plan and apply accruals accounting in all levels of government would be long time process.

Key words: Accruals Accounting

Cash Accounting

Government Accounting

Government Accounting Reform

Financial management

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Introduction

Within the research area of government accounting, China is described as “a fertile ground for a country study” by Professor Chan L. James (1995). He represented China as good research object “could trace the extent of foreign and ideological influence” and “could compare government accounting during the socialist era with its role in the emerging market economy” ¹(Chan L. James, 1995). Current years, a large number of European and extra-European countries have implemented series reform to their government accounting system. With these reforms, accrual accounting is introduced and behaved as new norm of government accounting. China is also influenced by this trend.

Accrual accounting has excellent performance record in Business Accounting area, its outstanding ability in dealing with wider accounting information make it acceptable by most of accounting information producers and users including the government administrators.

Acting as the foundation of public financial management, accrual accounting promotes further New Public sector Management reform to be a trend which covers most of “blank area”. Chinese government has designed detailed plan to

¹ Chan L. James. 2000. “China could be a fertile ground for a country study in many ways. For example, one could trace the extent of foreign and ideological influences (Chan, 1995); one could compare government accounting during the socialist era with its role in the emerging market economy (Chan, 1996). A Sino-American comparison of budget and accounting coverage.

involve in this trend. Because of the significant changes in government financial environment, Chinese government begins to implement reform plan in advance recently. Since different countries have different politics and economy, the exact reform process would vary from country to country. Chinese government has combined the analysis on external experience and investigation on internal environment to design a “step-by-step” reform plan which different from thorough and fast government accounting reform taken in New Zealand. And based on this main framework, Chinese government set associated application model of accrual accounting. This government accounting reform plan is long-term process, and Chinese government has the responsibility to create perfect environment for accrual accounting application (like setting associated law and incentive regulations, training accounting staff). This paper first reviewed the international background of government accounting reform and the current government accounting environment in China. And then paper analyzed the reason why accrual accounting is the essential demand for Chinese government within this general background. In this part, paper compared the cash accounting which has dominated in Chinese government accounting with accrual accounting, paper first introduced the general situation of current government accounting in China as the background knowledge of following analysis. Then, paper analyzed the weakness of cash accounting for comparison with accrual accounting. This analysis has been represented in two aspects: the inherent weaknesses of cash accounting; and the insufficiency of

cash accounting in adapting changing government environment. Following is the analysis on accrual accounting. This analysis is represented in two aspects also: the inherent merits of accrual accounting; and the main reasons why Chinese government needs accrual accounting. This part is the focus of whole paper.

After the analysis, paper introduced the current activities of Chinese government in making some preparation for accrual accounting implementation. Paper uses the flow chart and related explanation to represent the general arrangement of reform which begin at creating perfect environment. To let readers have further knowledge on the situation of accrual accounting implementation in China, paper introduced the application model of accrual accounting as well.

This paper is not the pure literature review and analysis; it puts forward the predicted problems which have higher possibility to occur in future process to apply accrual accounting in Chinese government. This prediction work is based on the consolidation of above analysis, experience and current issues from certain countries. The whole paper aims at providing the comprehensive description on current and future status of accrual accounting in Chinese government within complicated international and internal environment. This paper also brings forward some potential issues needed further research in this field.

CHAPTER 1 : GENERAL BACKGROUND OF ACCRUAL ACCOUNTING APPLICATION

Cash accounting has dominated in government accounting area as the traditional method in most of countries including China. It is applied widely in the field of government financial management as simple technology to control cash movement. But the situation has been changed from end of 20th century; accrual basis becomes the main topic of New Public management especially within the process of government accounting reform. (Chan L. James. 2003)

1.1 The worldwide general situation of Accrual Basis application in Government Accounting through reform

Lots of countries should face a problem in government financial reporting which is how the government and associated departments provide a financial report to effectively support budget arrangement of next financial year. And this financial report should reflect the actual and comprehensive financial activities of government. (CIGAR Conference Paper, 2003) The system to produce such financial report would be the dreaming financial tool for government. When we review the performance of traditional cash accounting which has dominate position in government accounting for long period, we realized that traditional cash accounting is based on the cash received or paid; it ignores the recognition of income, depreciation and liabilities which have important economic sense for accounting (Perrin, J, 1998). Judged by its general performance, cash accounting is not powerful technique to improve the efficiency of financial

management and strengthen policy control of government. These weaknesses of cash accounting push government to implement thorough reform in government accounting. These reforms focus on changing accounting basis from cash basis to accrual basis to satisfy higher requirement on government financial management. The related budgeting system is changed to accrual basis as well. (Manzurual Alam, Ruvendra Nandan, 2005)

There are 15 countries which have applied or are practicing accrual based government accounting in primary government departments in 29 OECD countries. (Account for 51.7% in OECD countries) and 12 countries have applied financial reporting system on accrual basis in all government departments (Account for 41.1% in OECD countries). 20 countries have experienced the government accounting reform to apply accrual accounting in certain government departments. (Cheng, S, Hong, 2001) Australia, New Zealand have completed the reform and have adopted full accrual accounting in government. Canada, Iceland, Finland and Italy are involving in setting associated legislation to support the application of accrual accounting in government. Denmark and United States are experiencing accounting reform in certain part of government. (Zhao, J, Yong, 1998)

Except OECD countries, some countries in Asia, Africa and South America also have applied Accrual accounting and budgeting in government.

Furthermore, these countries have adopted the modified accrual accounting instead of full accrual accounting more or less. (Cheng, S, Hong, 2001)

The general situation of 19 countries which have experienced accrual accounting reform are presented in Table1.1²

² This table source form Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002. The analysis on the process of government accounting reform on accrual basis. *Government accounting and management*. 2002 (5); 33-35

Attached1: Apply cash based reporting but providing supplementary information on accrual basis

Attached 2: Interest charge and pension are recognized on accrual basis

Attached 3: Interest charge and other certain items are recognized on accrual basis and in the process of transferring to full accrual accounting

Attached 4: 1998 modified budgeting legislation was published, financial report is still on cash basis but providing supplementary information on accrual basis.

Attached 5: Implemented in 1992, but Iceland have not completed the accounting reform in the field of assets

Attached 6: Pension is recognized on accrual basis

Attached 7: UK central government have provided consolidated financial report in whole government from 1999--2000

Attached 7: UK local government still applies cash basis in compiling report, but it plans to apply accrual accounting completely from 2005/2006.

Nowadays, more and more developed countries try to push the application of accrual basis to most of government departments and they are willing to make this trend cover more "blank area". This trend has influenced more developing countries (Cheng, S, Hong, 2001). In those developing countries, by reviewing the successful reform experience from above countries, government administrator and academic researchers realized that implementing accrual basis in government accounting is significant for financial management improvement and establishing efficient government. (Zhao, J, Yong, 1998)

1.2 The background of government accounting reform in China

The international trend of government accounting reform which changes

accounting basis to accrual basis attracts the attention of Chinese Government and academic field. The budget department in Ministry of Finance in China has taken some researches on the cause, method and legislations of such government accounting reform. Those research projects are the leading research topic in the field of public financial management in China recently. The researches aim at combing above experiences with problems together which exist in current government accounting in China. (Lou, J, W. 2002) After several year hard work, Chinese government have practiced accrual accounting in limited area. Hong Kong government, as first one to apply accrual accounting, have announced in its 2002-2003 budgeting reports that it will apply accrual accounting further step by step from 2005. (Lou, J, W.2001) Before to analyze the situation of applying accrual accounting in Chinese government and related governments, there is a need to know more about the general background in China. Why Chinese government requires a reform to change accounting basis to accrual basis?

1.2.1 The local background of government accounting reform in China

With planned and centralized economy, the control of Chinese government covers every field; the financial support to realize government objectives is allocated directly by Ministry of Finance. But with the complementation of market economy in China, the definition of government and market within macro-economy is much more different. Government changes its focus to

provide public service and product, not just the financial control through direct allocation. The responsibilities of Chinese government are not the simple “allocation and control”, it acts as the “administrator” of state economy (You, L, Lian, 2003). Sufficient accounting information is the basis of economic decision for government administration. These information include the ones reflect the movement of financial capital (not just the budgeted capital) and other non-financial information related to above movement, like government guarantee and commitments. These changes require government accounting basis should have ability to provide user more accurate and comprehensive records on capital movement (Hassan A. G. Ouda. 2005). When current accounting basis can't satisfy those higher demands, adopting another suitable accounting basis through reform inevitably becomes good choice for Chinese government.

1.2.2 The international background of government accounting reform in China.

Except the changes in internal environment, outside challenges also push Chinese government step on the road of reform. China has entered into the WTO (World Trade Organization). When review it, we normally just focus on the opportunities and challenges to Chinese economy. We ignore its impact to government. After be a member of WTO, Chinese government should face the clash from outside on government administration. (You, L, Lian, 2003) Most of developed countries had series reform to improve government ability to

administrative economy. Chinese government chose to be the member of this international group, which means it should follow international way including government accounting reform. To complete the connection to international trend on building new government financial management, applying accrual basis in government accounting would be the current task for China. (Zhao, J, Yong, 1998)

1.2.3 The political background of government accounting reform in China.

Since series problems on effectiveness and efficiency of government financial management appeared in China, Chinese government has paid more attention on its performance. In 27th of July, 2001, Ministry of Finance published the 《The Regulation of Project Expenditure In Central Government》. There are 3 primary principles in this regulation: standardization principle; different treatment principle; efficiency and effectiveness principle. This is first time that Chinese government put forward its focus on performance in legislation. Obviously, it becomes the legal requirements for efficiency and effectiveness in government from that day. And accounting information with higher quality to evaluate the government performance is recognized as the key point for Chinese government to achieve that goal (Zhao, J, Yong, 1998).

The current popular technique applied in government accounting ---Accrual basis is definitely a good choice for government performance evaluation. It can

provide more accurate and sufficient information about income, expenditure and give public comprehensive record on government capital and liabilities. As the result, it can make reasonable cost evaluation of economic activities in government. After analyzing and comparing the profit with above result from cost evaluation, the outcome is the powerful foundation to judge government performance. (Jian , F, Li, 2001)

Within those backgrounds, adopting suitable government accounting basis which could produce more accurate, transparent and integrated information is urgent task for Chinese government. Therefore, accrual accounting naturally becomes the leading actor in this competition because of its outstanding performance in dealing with accounting information.

CHAPTER 2: THE NEED FOR ACCRUAL ACCOUNTING IN CHINESE GOVERNMENT

In despite of how strong the trend of reform in the field of government accounting, the need to change accounting basis for a country is determined by the current situation of government accounting.

2.1 The general introduction of government accounting in China

The government accounting system in China is based on associated government budget system. But it is not the real “budgetary accounting” applied in most western countries. Professor Rowan Jones ³ defined “budgetary accounting in <<public sector accounting>>as:” the phrase ‘ budgetary accounting’ refers to the practice of including budgeted amounts and actual amounts within the double-entry. And namely, this account should present a systematic and continuous way the comparison of budgeted amounts and actual spending.” (Rowan Jones, 1992)The real budgetary accounting should include both budgeted and actual amounts in report, and the comparison of them in same format.

Chinese government accounting has close relationship with government budget like the” budgetary accounting”, but Chinese government account just records the actual movement of budgeted capital, not the budgeted amount. Strictly

³ Rowan Jones, Maurice Pendlebury.1992. Public sector accounting 5th “strictly speaking, the phrase ‘ budgetary accounting’ refers to the practice of including budgeted amounts and actual amounts within the double-entry..... Namely, this account should present a systematic and continuous way the comparison of budgeted amounts and actual spending.”

speaking, Chinese government accounting is not the real budgetary accounting (Lou, J, Wei. Zhang, H, Li. And Li Ping. 2002). In all professional publications from China Ministry of Finance, Chinese government defined its government accounting as “an important tool for government budget management. It is the professional accounting to recognize, calculate and supervise the operation situation of budgeted revenues and expenses in central government, local government and associated departments.” And the framework of the whole system is determined by the framework of government budget system. (Zhao, J, Yong, 2001)

2.1.1 Framework of current government accounting system in China

The government accounting system in China has legal responsibility to serve for the budget management; and the framework of government accounting system is determined by the framework of budget management system which based on the regionalism. There are two types of budget branch systems: general budget and department budget. According to the above framework of budget management system, the government accounting system framework is composed of the Ministry of Finance general accounting and department accounting. The department accounting has further two components: accounting for administration department and accounting for state-owned enterprises. Within these two accounting systems, information users put forward the increased demands on high quality accounting information (Lou, J, Wei.

Zhang, H, Li. And Li Ping. 2002).

2.1.2. The budgeted capital movement and related financial activities are the objects of government accounting in China

The objects in government accounting are the budgeted capital movement and related financial activities, which are calculated, reflected and supervised by government accounting. Since the functions and financial tasks of financial departments, administration departments and state-owned enterprises are totally different; the objects of government accounting in those fields have significant distinction as well. (Zhao, J, Yong, 1998)

The object of government accounting in financial departments is the budgeted capital movement in central government and local governments. It is centralized and allocated in the process to achieve all budgeted tasks. But the object of government accounting in administration departments is the capital movement process. Within this movement process, capital is used and appropriated from budgeted capital in administration departments. The object of government accounting in state-owned enterprises is the capital movement process also. But the capital within this process is used and appropriated from budgeted capital or the revenues, cost and expenses. (Zhao, J, Yong, 1998)

The framework and object of government accounting system in China are the

fundamental knowledge to analyze the current situation of government accounting. For the further analysis about the existing problems in Chinese government accounting, we should focus on the accounting basis applied in current Chinese government accounting.

Chinese government have adopted cash basis in government accounting for a long period. Cash basis have brought unaccountable benefits to government accounting development. Under this accounting basis, Chinese government accounting system has good performance in cash flow management (Zhao, J, Yong, 2001). Since cash basis is a simple accounting technique, the financial reports on cash basis are easy to understand for public users. Even for accountants, cash accounting is simple to handle. Cash basis has been the user's favorite with its lower cost in administration and accounting expertise. But with the emergence of more new public service and products in government, the inherent weakness and external higher requirements have brought more doubts on the performance of cash basis in current government accounting in China. (Cheng, S, Hong, 2001)

2.2 The weakness of cash basis applied in Chinese government accounting

Cash basis is based on the recognition of only cash inflows and outflows. (Rowan Jones, Maurice Pendlebury. 1992) The final account on cash basis is the summarized cash books. The narrow scope of recognition on cash basis

would cause its unsatisfactory performance in government accounting.

2.2.1 The inherent weakness of cash accounting

Cash basis have undoubtedly dominated in government accounting for a long time; the primary reason is cash basis can satisfy requirements in that period with low cost. Under cash basis, the way to make record is simple, and the accounting statement does not need the record of assets and liabilities. Therefore, the accounting report is not so complicated and far more easy to understand. (Rowan Jones, Maurice Pendlebury.1992) Because it is easy to handle, the administration cost must be lower, and it is possible to let the staff with less training to operate cash accounting system and provide financial report.

However, with the development of market economy and expansion of government functions, Chinese government is involved in market-economy more, and the more complicated accounting information is demanded by government itself and external information users for further decision and evaluation. (Zhao, J, Yong, 2000) Cash accounting definitely could not satisfy requirements from government financial management; its weaknesses are revealed inevitably.

2.2.1.1 Cash basis cannot provide sufficient information to satisfy the need of

users

Cash basis can provide the information on cash inflows and cash outflows. (Rowan Jones, Maurice Pendlebury.1992) But general information about government financial performance and operation status should include the assets, liabilities and incomes, especially the information about the situation and efficiency of using state-owned assets, the future payable liabilities and depreciation of state-owned assets. (Prodjoharjono Soepomo1999)The information on these aspects likes the mirror to reflect general operation situation of government. Unfortunately, cash accounting does not include the records on assets and liabilities. Since there is no any record of assets, there must be no any record about depreciation and income. Lacking those three important factors (assets, liabilities and income), financial report cannot give user sufficient information to have the comprehensive knowledge on government financial status. That must be the barrier of further development for the government. (Adeyemo, Margaret Folashade, 1997) For instance, when potential investors of government project cannot get the information about government's capability to payoff its liabilities, they will give up this project because of potential high risks.

2.2.1.2 Cash basis cannot provide information with strong pertinence to make proper decision for government

Cash accounting just records the cash flows and ignores the movement of other financial resources, like assets, liabilities, depreciation and closing stock figure. (Rowan Jones, Maurice Pendlebury.1992) But these financial items have significant influence on government potential capability to provide public service and product. Without any record of liability, government may not realize its actual liabilities and its capability to payoff them. It must reduce the ability to provide budgeted public service and product. Under cash basis, whether the asset is still used, expired or sold, the public does not know and they cannot have a true assessment on government performance. For government itself, it cannot achieve the effective asset management without any detail. Due to this reason, government administrator realized cash accounting couldn't provide accounting information with strong pertinence to make proper decision. (Maria Antonia Jorge de Jesus,2005)

Except the weakness on providing sufficient information to evaluate financial status, cash accounting have another weakness on measuring performance. It can provide administrator possibility to manipulate time to create "good performance". The performance of government could be measured narrowly by comparing budget with the actual, bad performance briefly means over-spending or under-spending (Rowan Jones, Maurice Pendlebury.1992). Therefore, under cash basis, the administrators have the chance to manipulate their financial report to achieve the match between budget and actual. They can

manipulate their “good performance” using the time (When a department realized it is going to over-spend budget, administrator postpones cash payment to match budget, not reduce spending). (Public Audit Forum, 2002)

Inherent weaknesses have made cash basis loss its supports gradually. For Chinese government, the special economic background and changing government environment make this situation more visible.

2.2.2 The challenges for cash basis in Chinese government accounting

By the end of 20th century, the Chinese government accounting environment has significant changes. More doubts have been put forward about the performance of cash basis in government accounting. The challenges for cash basis mainly focus on the three aspects. First is cash basis can't satisfy the users' demand in providing more comprehensive accounting information. Second is cash basis can't adapt the changes in financial field of government. The last challenge is it is not good at providing sufficient compared information to make performance evaluation (Jian , F, Li, 2001)

2.2.2.1 Weakness of cash basis in providing comprehensive and intact accounting information

This weakness of cash basis is revealed after the emergence of new service and various investment entities for government project. After Chinese

government published new legislation on government purchase, there exist many new accounting items. For instance, during the process of purchasing, the products and invoice may not arrive at same time or the payment is paid by installments. How to deal with the recognition is a problem for cash basis. For above items, the demand on accurate and intact accounting information is beyond the capability of cash basis. (Zhao, J, Yong, 2001)

Chinese government is involved in market economy; the way it provides public service and product also follows this trend. Now Chinese government prefers to absorb more external capital to support its projects on building fundamental facilities. Various investors ask government to provide comprehensive and intact accounting information for consideration before investment. They have higher requirements on transparency and accuracy of information. And they need the compared accounting information or sufficient information for comparing to evaluate the performance of government. (Cheng, S, Hong, 2001)

Except above investors, more external accounting information users (like taxpayer, purchaser of national Treasury bond) expect to know the situation of state-owned assets and situation of government liabilities. For government administrator, they must know more comprehensive information to convenient financial management. (Oly harimino, 2005) Even for international market, it put forward higher requirements on quality of Chinese government accounting

information as well.

Unfortunately, the inherent weakness of cash basis restricts its capability on producing intact and comprehensive accounting information to satisfy user's needs.

Chinese government has not a set of consolidated accounting statement, which includes comprehensive records on assets, liabilities and cash flows. (Wang, Y, Jun. 2002) Just with the insufficient accounting information, Chinese government is hard to make proper decision and performance evaluation. That is biggest barrier which blocks the way cash basis keeps its position.

2.2.2.2 Cash accounting cannot adapt to the significant change in government financial field

To satisfy the need on developing market economy, Chinese government has completed a series of reform on budget management. Those reforms include the application of Department budgeting and Zero-based Budgeting, operation centralized payment by state treasury and government purchase legislation. (Cheng, S, Hong, 2001)

In the field of capital source, significant change has brought challenge to cash basis. In the past, the capital source of administration department and

state-owned enterprises depend on national budgeted appropriation. Recently, part of public services and products are open to private, and the capital source channel is wider than before. For current state-owned enterprises, biggest part of its capital source is from economic activities profit. Therefore, the capital source of them does not need to fully depend on state budgeted appropriation. (Wang, Y, Jun. 2002) Various capital sources ask for the associated wider provision of accounting information. The changes on accounting calculation and recognition have become the urgent task, which has significant impact on accounting process. But cash basis make users disappointed. Cash basis can't afford that task with limited capability. (Wang, Y, Jun. 2002)

Cash basis as government accounting basis had its thriving period, but with the inherent shortcoming and changed accounting environment, information users realized the need to apply another accounting basis more effective to replace cash basis. Accrual basis definitely attracts the attention of information users.

2.3 The need to apply accrual basis in government accounting

For millennium, the main objective of accounting was concerned with the stewardship of resource. For this purpose, the fundamental need was for a reliable record of those receipts and expenditure which are within responsibility of the steward. (Public Audit Forum, 2002) In early times, simple record of expenditure and revenue in cash were sufficient. As business developed, the information users in public found that greater sophistication was necessary.

They need the records of sum owing to them (debtors) and sums due to others (creditors/liabilities). (Public Audit Forum, 2002) So, accrual accounting and valuations were required. After the successful application in commercial accounting practice, accrual accounting is introduced to government gradually as the main focus of government financial management reform. Accrual basis as the replacer of cash basis, it should prove its capability on satisfying above need better according to those changes. (Bernardino Benito, 2005) Accrual basis has total different recognition basis compared to cash basis. From the characteristics of accrual basis, we could get the general knowledge on accrual basis application.

2.3.1 The inherent merits of accrual accounting

Accrual basis and cash basis are totally different receipt and payment recognition standard, the accounting information produced by accrual accounting has wider scope over cash accounting to adapt the current government financial management development in China. Under accrual accounting, fixed assets began to be recorded and then depreciated, spreading the cost over the lifetime of the asset. It was found to be useful to compare one year with another, which meant that stock is recorded and only counted as expenditure when it was used, rather than when it was paid for. (Rowan Jones, Maurice Pendlebury.1992)

There is a table to generally compare the performance of those two accounting basis in seven main aspects.

Table 2.3 ⁴Comparison of the ability to satisfy following accounting objectives between accrual accounting and cash accounting

Objectives	Cash accounting	Accrual accounting
according to legal budget	Yes	Yes
according to contract requirement including expenditure limitation	Cash demand and limitation	Cash and economic resource demand and limitation
Use of resource, allocation and financial support	Cash resource	Cash and economic resource
Ability to provide fund for activities and pay liabilities	Source form cash	Source from economic resource
Financial situation and related changes	Cash situation	Financial and economic resource
Provide fund and cash support	Cash resource	Cash and other financial demands
Record financial performance according to cost	No record of information	Provide essential information to evaluate the performance

From the comparison above, we could have simple knowledge about some merits of accrual accounting over cash accounting. For more detailed merits, the ⁵“Guideline for governmental financial reporting, 1998” has mentioned the benefits of accrual accounting more clearly as list:

Financial Position:

- Better decisions on feasibility of providing services
- Better planning for future funding requirements

⁴ This table source from You, L, Lian, 2003. The research on Chinese government accounting and accrual basis. *Chinese Public Accounting*.

⁵ The public Sector Committee of the International Federation of Accountants (IFAC) published a Guideline for Governmental Financial Reporting in 1998.

- Better planning for asset maintenance and replacement
- Better management of cash point, repayment of liabilities, etc
- Forces full records of assets, so enhance management of them
- Raises questions on use and disposal of assets

Financial performance:

- Makes clear the total cost of services provided
- Reveals if current activities are funded by running down net worth
- Includes the cost of using up assets
- Allows assessment of revenue requirements
- Improves resource allocation
- Helps with make/buy or rent/buy decision
- Enables delegation of the management of costs
- Recognizes the cost of delayed payments, e. g. pension
- Improves comparisons with the private sector

(IFAC: Guideline for governmental financial reporting.1998)

Based on this list, the benefits of accrual accounting would be presented and analyzed in following four aspects.

2.3.1.1 Benefits on Completeness

Accrual-based accounts are more comprehensive than cash accounts. Accrual accounting is based on the recognition of revenues earned and resources consumed in a period, rather than cash received and paid, assets and liabilities

have to be counted for; and the owner's interest (and changes in it) becomes clear. (Rowan Jones, Maurice Pendlebury.1992) It provides a fuller picture of an entity's position than a simple cash statement. (Public Audit Forum, 1998) In cash based budgetary accounting, Good performance just means the match between government budget and actual use. But in empirical practice, performing well means efficient and effectively use, not just the match to budget. The information in measuring good performance should include the ones reflecting the assets, capital, income, and liability. (Rowan Jones, Maurice Pendlebury 1992)

Under accrual accounting, the assets can be recognized; related cost and depreciation can be recorded. Having had the record of government assets and put value on them, the capital can be recorded as well. On accrual basis, capital items have been stored separately in balance sheet leaving the operating items in the profit/loss accounts. (Allan P. 1988) Furthermore, the completed record of capital has economic significance on making the record of Income. Income is only recognized after capital has been maintained intact. Based on intact capital record, income figure could be recorded and provide further support on evaluation of performance. (Christensen, M. 2002) With accrual accounting, there are no hidden liabilities for administrator and external users. And it can make government hard to transfer the cost in its financial year to successive government. (Rowan Jones, Maurice Pendlebury, 1992)

For instance, for certain long-term guarantee like the staff pension in government and liabilities, government financial report should include those records as government liabilities under accrual basis. (Regan, E, V. 1987) Except it, some items can't be counted should be record in note of financial report. These characteristics of accrual accounting improved the transparency of information indeed. (Chan L.James.1988)

Even had the intact record on those items, information on cash is still the most important part in government accounting. As an effective method, accrual accounting provides sufficient accounting information on cash flows as well. This method is more informative than the sums received and paid in cash. (Egol, M. 1987)

2.3.1.2 Benefits on better planning, management and decision-making

There is increased demand on high quality services provided by government. The related requirements on better management, better decision-making and better planning and allocation are put forward. The foundation to achieve such objectives is the complete and accurate accounting information. (Evelyne Lande, 2002)

Accrual basis is the only one could recognize the real and intact cost of products and services. This "real cost" is a cost, which could be compared periodically

and compared with external competitor in financial period. Since accrual accounting could provide comparable, intact and real cost information, it improved the ability of government to make wise decision, and the administrator in government must transfer their focus from cash control to economic resource planning and allocation. (Tatsuhiko Kato. 2005) When planning and allocating resource especially scarce resource between government departments, the proper proposals based on measure of real cost will give administrator confidence that the financial implications of going ahead, or not going ahead, have been evaluated. (Public Audit Forum, 1998)

This enables them to evaluate the relative quality of competing bids and make sure that they have strong information support to decide which investment could bring greatest public gain. (Public Audit Forum, 1998)

Within government departments, accrual information makes possible a range of planning tools, including better option appraisal, whole life costing, sensitivity analysis and what-if analysis. These tools are particularly important in capital investment decisions. They enable revenue alternatives to be compared with capital, and the result could be considered to support decision. (Marwata and Manzurul Alam. 2005)

Accrual accounting provides intact information about asset, which benefits to

durative administration on assets and support wise decision on government assets purchase and disposal. For instance, with the sufficient records on stock assets, the unused assets could attract administrator's attention and find efficient way to be used, the administration of assets must be operated better.

Therefore, accrual accounting can be a financial language for planning, management, and decision-making (Public Audit Forum, 1998). Except those benefits on decision-making, basically, the record of income which is an important factor to measure performance, record of capital and record of liabilities in government account is the primary channel to provide essential information to investors. (Public Audit Forum, 1998)

2.3.1.3 Benefits on performance management

Good performance management needs effective performance measures.

And those effective performance measures should be calculated on the basis of comprehensive and consistent financial and operating data. Accrual accounting with intact information is therefore an essential component of better performance management. (Public Audit Forum, 1998)

Within competitive market, ignoring the influence of change in prices, the income figure provided under accrual basis is considered as the acceptable measure of performance. More profits imply more success. With relatively

comprehensive accounting information, accrual basis could make certain comparison between accounting items possible. These comparisons reveal the performance of government. For example, expressing profit as a percentage of capital employed is used to compare performance over time and to establish target rate of return (Rowan Jones, 1992).

Although the output of government is hard to measure, accrual accounting still can provide the measure of output to support performance measurement (Rowan Jones and Klaus Luder 2003). To provide a basis for the output measurement, accrual accounting can contribute to the measurement of progress towards the achievement of outcomes and of the relative costs or outcome targets according to different activities. (Public Audit Forum, 1998)

Units and activity data, which are based on accrual information, also enable reliable cost estimates to be made. Performance measures are often based upon them. They are suitable as performance measures for comparing over time or across units. (Public Audit Forum, 1998)

To sum up, performance measurement produced by accrual accounting is an essential need for internal government administrator and external supervision by public.

2.3.1.4 Benefits on prefiguring future cash flows and assessing financial risk

One of the purposes of published financial statements is to enable the user to prefigure future cash flows. The prediction of future cash flows should be based on sufficient information. Although the cash accounting also provides the record of cash flows, this work is beyond its ability. Compared to cash accounting, accrual accounting definitely has more comprehensive information to support the work on prefiguring future cash flows. However, no matter how well prepared or how detailed the information we obtain, giving the guarantee or complete certainty is beyond the ability of information producer. Therefore, except prefiguring future cash flows, good accounting basis should have ability to provide sufficient information to assess the potential financial risk. (Kenneth A. Smith. 2004) Accrual accounting has additional record on incomes, assets and capital compared to cash basis. The information in those items combined with the ones about liabilities reveals the ability of government to payoff liabilities and the ability to overcome the potential financial risk. (Public Audit Forum, 1998)

By the way, the ability of accrual accounting to provide information on transactions in the period in which they occur could reduce the potential for manipulation of accounts and improves comparability between periods and the departments too. (Rowan Jones, 1992)

Generally speaking, further benefits become evident when the accrual

accounting is applied in government: costing can be based on resource consumed rather than those purchased, assets may be better managed because they are recorded, and better investment decisions may be made because the present period can be seen more easily in the context of past and future. (Miekatrien Sterck, Bram Scheers, Veerle Conings. 2005)

2.3.2 The need of accrual accounting in Chinese government

Attracted by the inherent merits of accrual accounting, Chinese government starts to focus its attention on it. And the internal environment begins to appear the intense needs for this accounting basis as well.

2.3.2.1 The need for better financial control

Chinese government have adopted cash basis for a long time. Although it can control the capital appropriated by government within the budget, it can't make an effective financial expense control. And since this control is based on the "time" (e.g. the time that an invoice make the payment), which make it is impossible for administrator to manipulate the time and arrangement to achieve budgeted objectives. (Wang, Y, Jun. 2002)This situation has become the headache of Chinese government. Accrual accounting would be good medicine because the recognition is based on occurrence of financial activities. Administrator loses the power to change "time".

The Chinese government budgeted amount on cash basis juts like a “cake” for budgeted capital users, since the financial control focuses on expense, which should be controlled within budget. The users competed for getting more “cake”, under cash basis, they don’t care the output. But in practice, accrual basis has to be paid attention on the output. With accrual accounting, the effective financial control could be established.

2.3.2.2 The need for evaluating government performance

The primary requirement on government accountability is to reflect the implementation situation of budget by government and whether the expenses are in accordance with related law and legislation. Therefore, government accounting has the responsibility to provide information to support performance evaluation. (Isabel Brusca and Vicente Montesinos, 2005) As I analyzed, cash accounting has no such ability, but accrual accounting naturally can satisfy this demand.

Currently, National People’s Congress (Chinese Parliament) puts forward its requirement on government accountability that accounting information to public users should reflect comprehensive aspects to state government performance. (James Chan and Li Jianfa. 2005)

With the development of Market economy, external investors of public project

expect to have more information on government performance to consider before they invest their money in projects.

Therefore, under those increased demands, performance evaluation inevitably becomes the essential part of Chinese government accounting. It is the time for cash accounting to quit the stage.

2.3.2.3 The need to avoid financial risk for Chinese government

Cash accounting can't reflect the liability of government, amount of liability is hidden to be the "unseen corner". The real financial status of government can't be revealed, there will exist the magnification on financial resource, which could be allocated, and the fake balance between liability and assets. As a result, the misguidance for public and administrators on economic decision arises, the work on removing financial risk and protecting government from risk is much difficult. Threatened by rising possibility of financial risk, Chinese government is pushed to adopt an accounting basis, which has natural ability to overcome it.

(Lou, J, Wei. Zhang, H, Li. And Li Ping. 2002)

Accrual basis has been accepted by Chinese government with its merits, and will replace cash basis to be the leading accounting basis in Chinese government, a thorough accounting reform should be implemented.

CHAPTER 3: THE ACCOUNTING REFORM AND APPLICATION MODEL OF ACCRUAL ACCOUNTING IN CHINESE GOVERNMENT

3.1 The government accounting reform which introduces accrual accounting to China

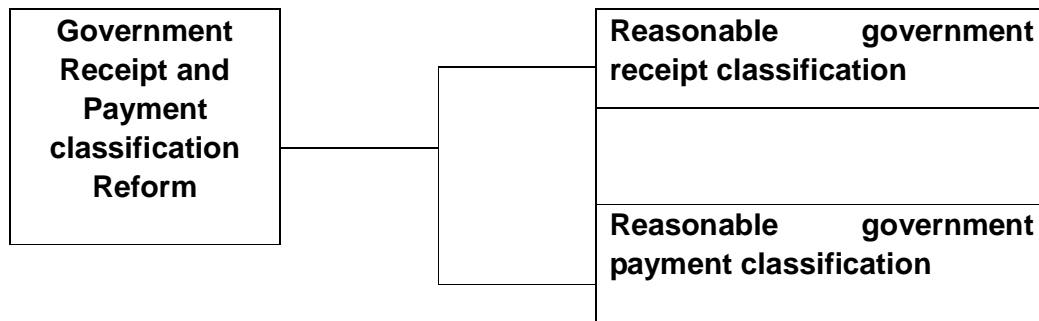
Chinese government has completed series reform on financial expenses, like the reform on Department Budgeting, Centralized payment by national Treasury, and government purchase. They are the start of series government financial management reform which includes the government accounting reform. (Ting Gang Lu .1988)In view of above benefits from accrual accounting, Chinese government decides to practice accrual basis in all government departments through accounting reform. This reform is not only the reform on government technique which deals with the information, but also the fundamental reform on public financial management of government.

For current Chinese government, that's not the right time to implement accrual basis in whole government, since there is no mature environment for implementing accrual accounting everywhere. The three main reasons are: *a.* China is in the changing period. Even recently, the legal system is not sound enough to act as safeguard. *b.* There are three coexistent accounting systems in Chinese government: the General Financial Accounting, Administration Department Accounting and State-owned Enterprises Accounting. Chinese

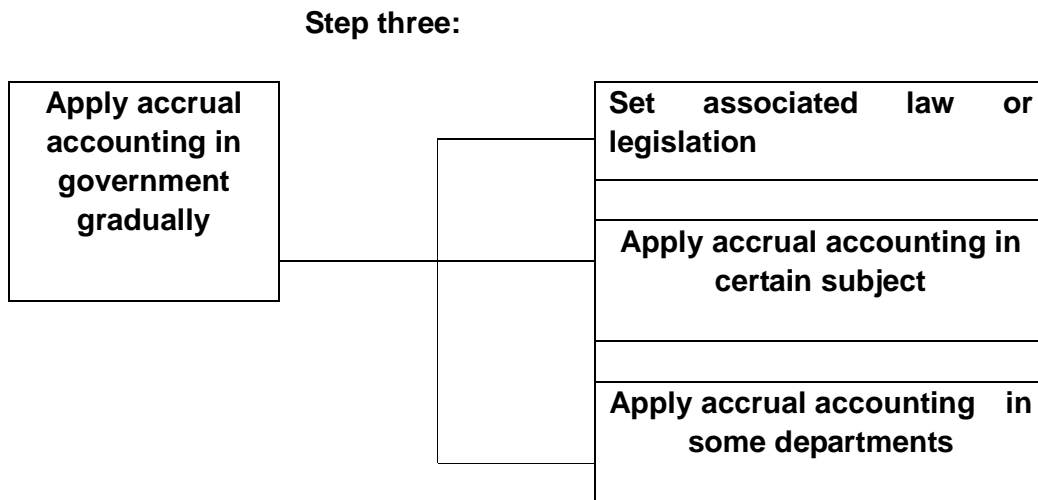
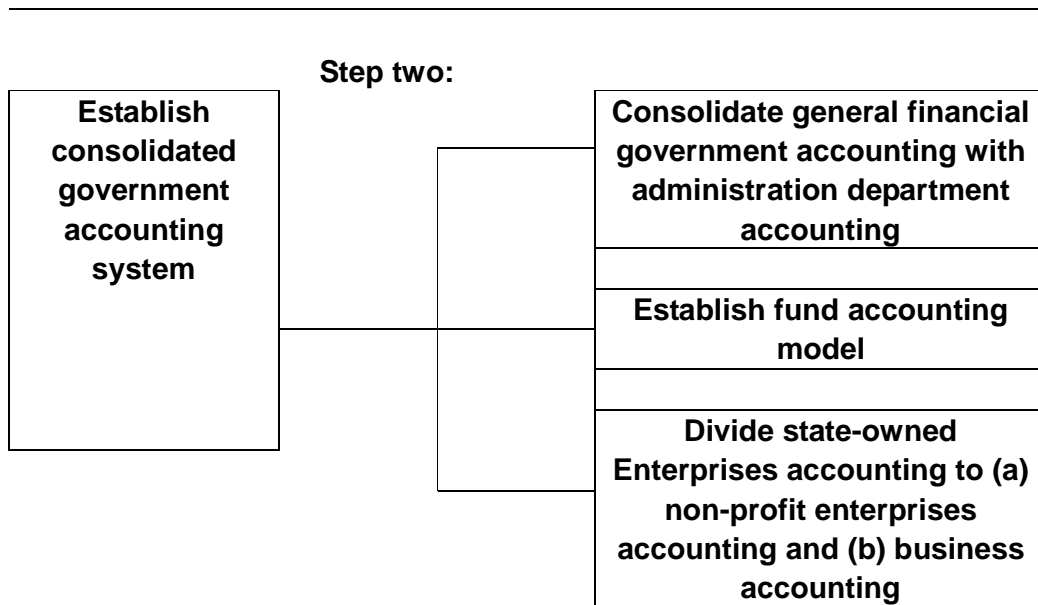
government is lack of consolidated accounting system as operation guideline to be the basis of accounting reform. C. Current accounting staff in Chinese government has no sufficient professional background as the staff in private organization (Wang, Y, Jun. 2002). Accrual accounting is a more complicated technique and it requires skilled accounting staff to handle. All of these are barriers which should be faced within government accounting reform. As demanded, Chinese government accounting reform should be comprehensive and well-planned. Combining the actual situation in China with successful experience from other countries, this reform is designed to follow the “step-by-step” way which begins at creating mature environment for reform. And the terminal is to establish reasonable and sound accounting recognition basis. (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002)

The detailed steps of Government Accounting Reform in China are represented in table 3.1 ⁶

Step one:



⁶This table source from You, L, Lian, 2003. The research on Chinese government accounting and accrual basis. *Chinese Public Accountin*



Step four:

Achieve final goal--- Apply accrual accounting in all government departments and state-owned enterprises.

There is no clear boundary between current receipt and expense classification in Chinese government accounting. The weaknesses are very obvious in the ability to reflect exact receipt and expense situation on budgeted capital, and to

reflect and evaluate the extent that government departments to implement their financial task. So, the first step to perfect reform environment is establishing basic receipt and expenses classification. And the following arrangements in consolidating general financial government accounting with administration department accounting and other two stages are the continued activities in perfecting environment. The key step within reform is step three, in step three, the final stage to perfect environment (set law and legislation) also behaves as the beginning of following empirical practice (practice in certain subject and departments). After complete all these arrangement, Chinese government would consider that whole government accounting system is on accrual basis theoretically. (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002)

Chinese Government plans to practice accrual accounting in two accounting subjects first (Social Security Expense and liabilities). And then, accrual accounting would be practiced in most primary subjects step by step. At the meantime, Chinese government chose some departments to implement accrual accounting. During practice process, conservative Chinese government adopt both of two accounting systems (cash accounting and accrual accounting), it thought that is a safe way to keep reform going straight without any suddenness in daily accounting work. (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002)

Accrual accounting has been practiced in all departments of Hongkong local

government. For other parts of China, accrual accounting just has been applied in “year-end balance” item in central government account. In 2001, the Ministry of Finance has published the supplementation of <<General Financial government Accounting System>> which states that accrual basis could be used in following items: unrealized expense in current financial year because of politics (even budget has been arranged); unrealized expense because of using process (even budget has been arranged); unrealized expense because of the need of balancing budget. (Wang, Y, Jun. 2002)

Chinese government accounting reform is still in the baby stage, some adjustment may be needed in further practice to satisfy the environment changes in the future. Except the introduction of government accounting reform, if we want to get the comprehensive knowledge about application of accrual accounting in Chinese government, the application model is the essential part we should refer to.

3.2 Application model of Accrual Government Accounting

The first step to have general knowledge on application model in China is the concrete meaning of five primary accounting items (Assets, liabilities, revenue, expense and equity) in accrual government accounting of China.

3. 2.1 Concrete meaning of accounting items in accrual accounting

“Assets”, in accrual accounting, it indicates the economic resource controlled or owned by government accounting entity which is predicted to have ability to obtain future profit and service potential. These assets in accrual accounting include cash, debtor, accrued income, physical assets and other long-term assets. Accrual accounting also requires purchase expense of all capital assets should be capitalized and depreciated when there exists loss or consumption related to assets. (Johan A.M de Kruijf.May 2005)

Under accrual basis, all assets represented in above definition of “Assets” should be revealed in Balance sheet. The normal measures of assets are the following two: when certain Assets have their active trading market, it could be priced reliably following the Market convention. The price of assets in private enterprises of same industry could be the benchmark of the price of government –owned assets; when there does not exist the records of cost or market prices; there is a need to evaluate the actual value of assets. Especially, the “unrecognized assets” should be revealed and explained periodically in Note with actual value. (“Unrecognized assets” indicates the assets can’t be recognized without reliable measure) (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002)

Liabilities indicate the economic obligation afforded by government which may cause the loss on economic revenue or resource. Liabilities include the creditor

and accrued liabilities, liabilities of pension or allowance, liabilities related to future revenue, loan and advance payment from other governments.

Revenue indicates the total flow in of economic profit or service potential which causes the increase of net assets or equities during financial year. This revenue doesn't include the flow in related to owners' devotion. The "revenue" in accrual accounting includes: tax revenue, revenue from sales or services: net revenues from sales of assets and other revenues. (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002)

Expenses in accrual accounting mean the reduction in economic revenues or services during financial year. It behaves as the assets flow out, increase of consumption and liabilities which cause the reduction of equity or net assets except the decrease in equity allocated to owners. (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002)

The expenses include the costs related to following items: payment of products and services, depreciation of physical assets, net loss on sales of assets, unprofitable government transfer payment, allowance and donations. The recognized expenses in accrual accounting are different from one in cash accounting. These expenses are the cost to obtain products and services during financial year (No matter whether such cost is paid or not). But they don't

include the expense on constructing physical assets, pay back of liabilities or the investments to other entities (No matter they are loan or supplement capital) and the flow out of trust capital when government acts as the agent or assignee. The cost of physical assets could be recognized in purchase. Except the lands, the costs of physical assets would be allocated as the depreciation when they are in use. (Wang, Y, Jun. 2002)

Net assets and equity in accrual accounting indicate the surplus equity which deducts all the liabilities from assets of government. When the surplus amount is positive, the equity/net assets behaved as the available net assets. When the surplus amount is negative, the equity/net assets behaved as the revenue which has been used in advance. The net assets /equity have following components: accumulated profits or accumulated deficit, provision (revaluation provision, foreign exchange provision) and turnover capital. (Wang, Y, Jun. 2002)

In the process of having knowledge about application model, the key content is step two----knowledge on recognition and measure principles in China.

3.2.2 The recognition and measure principles in Chinese government accounting on accrual basis

Under accrual basis, in China, the recognition and measure of assets should be based on historic cost. With reliable proof to state that book value is lower than

asset value at end of financial year, the asset provision should be counted according to this balance. Followed the accrual basis, government accounting should set the capitalization standard of assets, under this standard, the assets can't be capitalized and counted as current expenditure; over this standard, the assets must be capitalized. But there is an exception, when the value of sole asset is under this standard but with total value of them over the lowest standard, we should combine them together as sole asset to recognize. (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002) For certain assets needed to be renewed periodically; they should be recognized as fixed assets at first purchase, the all following renew could behave as cost, except the significant change in value of assets (normally means the expenditure of renew is accounted over 30% of original value), we need to adjust the book value of assets in above situation. The loss of service potential of assets should be recognized as cost in associated financial year. (Wang, Y, Jun. 2002)

In the process of dealing with assets, it needs to recognize balance between book value and the revenues coming from disposing assets as the loss or revenues.

Since accrual accounting recognizes liabilities by the basis of "payable". The contingent liabilities and commitments which might cause the flow out of economic revenues should be recognized as predictive liabilities. (The

possibility might be the 50%--95%) (Wang, Y, Jun. 2002). For instance, when the government guaranteed the related liabilities, the obligation arises from the update regulation about hygiene and security could cause the contingent liabilities.

The recognition standard of revenues in government accrual accounting is: the economic revenues related to the project have the possibility to follow in, as result, the cost and value of such project must be counted reliably. The revenues of government have its specialty compared to those from enterprises. These can be divided to two categories: reciprocity revenues and non-reciprocity revenues. The reciprocity revenues like the revenues from products and services sales, interest and dividend could follow the business accounting standard to be recognized. The non-reciprocity revenues mainly include the tax revenue, non-tax revenues and transfer payment. The tax revenues could be recognized according to associated tax payment regulation and realization of taxable revenues. (Gao ning, Cheng, S, Qun, Cheng, G. Meng, 2002) Since taxing the non-tax revenues is unstable, its recognition could be based on the receipt of payment. The transfer payment of government should follow the international regulation; and it can be recognized when exact transfer payment exists. Other revenues like donation, foreign exchange gain and so on could be recognized following the business accounting standard.

Under accrual accounting, the cost of a business or activity should be recognized as expense when it satisfies the recognition standard on definition and possibility of expenditure simultaneously. The expense types in financial report include: staff expenditure, cost of product sales, cost of services, the usage of physical assets (loss of depreciation and service potential), rental and cost of rent, maintenance and operation fee, Interest, government transfer payment , other expense or loss(assets value loss, foreign exchange loss and so no). (Wang, Y, Jun. 2002)

Above items except government transfer payment are similar as expenses in private business which could adopt the recognition standard of business accounting

3.2.3 The application case in accrual based government accounting of China

In Chinese government, accrual accounting mainly applied in following fields: endowment insurance, interest liabilities, tax revenues and capitalization and depreciation of assets. Accrual basis and cash basis have significant difference in above items. I provide the application cases of accrual accounting and compare it with cash accounting in table 3.1

Table 3.1 Application cases of accrual accounting and comparison with cash accounting

	Items	Cash accounting	Accrual accounting
1	Social security expense	Recognize current payment	Recognize future payment accounted in current financial year, no matter whether it is paid or not
2	Assets depreciation	Don't count depreciation	Depreciate fix assets in employment period
3	Long-term liability interest	Recognize current interest of payment	Count interest of long-term liability periodically
4	Tax revenue	Recognize current actual tax revenue	Recognize tax estimate of actual revenue as receivable tax revenue or accrued tax revenue
5	Divide regular and capital expense	Don't divide and count both of them into current expense	count regular expense into current expense, count capital expense into related assets, count cost as depreciation
6	Investment income	Recognize current received revenue	Recognize revenue based on revenue of investor
7	Expense of government guarantee	No disclosure	If coincide to liability definition, recognize as liability. If not, disclose in notes of balance sheet
8	Asset devaluation	No recognition	When have reliable proof to state the value loss of assets, count related assets reserve(bad debt reserve)

3.3 Accrual financial report in Chinese government

Government financial report is accounting method to show government financial status comprehensively and systematically. In China, accrual government financial report has its special focus and objectives compared to financial report on cash basis.

3.3.1 The objectives of government financial report

Government financial report on accrual basis should indicate the reliable

financial/non-financial information related to government financial performance and accountability.

IASC (International Accounting Standard Committee) published a bulletin about the objectives of government financial report: it should help government to accomplish its responsibility on disclosing financial information to public and ensure that the information users could measure its accountability, help information users to evaluate current government performance, help users to evaluate quality of service provided by government and government's ability to pay liabilities. (Cheng, S, Hong, 2001) According to above regulation, the financial report of Chinese government on accrual basis is responsible for providing following information:

It needs to provide the information whether capital used is within legal government budget. It could help information users to confirm the accounting responsibility of government. (Jian , F, Li, 2001)

It needs to provide the information about government financial status. It includes the information about source and type of revenues: information about resource allocation and use; the information about the extent that revenue compensates the business daily cost; cash flow and future cash requirement information; information about the ability to pay the liabilities; information which state the overall financial status of government. (Jian , F, Li, 2001)

It needs to provide the information to evaluate performance of government. Government information users need associated information to evaluate the operation performance of government using economic and efficiency standard (cost and output). Government financial report also needs to disclose the status that government completes their legal objective. (Jian , F, Li, 2001)

It needs to provide the information to indicate the economic impact of government activities. Such information could help public to know more about the nature, scope and extent of government activities even the relationship with macro-economy. For instance, the extent that the impact of proportion (government expense to total society outcome) to macro-economy. (Jian , F, Li, 2001)

3.3.2 The framework of government financial reporting system on accrual basis in China

The entity of government financial report is the one who afford the accountability solely. Under accrual basis, the government financial report could be divided to three levels: a. the fund as sole accounting entity should have its own fund financial report. For this fund, capital use should be restricted by law. (Zhao, J, Yong, 2001)

b. Government and associated departments establish the funds followed certain

regulation, and they gather all fund financial reports together, then make government departmental financial reports. Within this process, the entity of government accounting is the various departments in government. (Zhao, J, Yong, 2001)

c. Gathering all departmental financial reports together and make the general government financial report. (Zhao, J, Yong, 2001)

The departments in Chinese government are divided according to budget appropriation relationship and administration relationship. Financial budget management adopts the “centralized leadership, classified administration” system. Under the leading of central government, every department is administrated by upper departments. According to this administration classification, Chinese government should establish “pyramid” financial report structure on accrual basis: The general consolidated financial report; central government financial report; local government financial report (need to be consolidated upon the administration classification); departments consolidated financial report which is made according to the categories of funds; sole fund financial report. (Zhao, J, Yong, 2001)

Within above framework of government financial reporting system on accrual basis, Chinese government financial report should includes four basic

accounting statements: balance sheet; statement of financial performance;
statement of cash flow; notes of financial statements. (Zhao, J, Yong, 2001)

The concrete meaning of accounting items, recognition/measure principles, and characteristics of financial report form the primary content of accrual accounting application model in Chinese government which behaves as the heart of Chinese government accounting reform.

CHAPTER 4: THE ISSUES SHOULD BE MENTIONED IN ACCRUAL ACCOUNTING OF CHINESE GOVERNMENT

The design of Chinese government accounting reform process has absorbed the successful experience from many countries, mainly from Australia, UK, U.S. and New Zealand. (Johan Christiaens and Vincent Van Peteghem, 2005) From the table 1.1, we could see that these four countries have walked in front of other countries; they are typical countries to implement full accrual accounting in all levels of government successfully. Therefore, the sum-up of some issues about accrual accounting arise in those countries after government accounting reform would provide Chinese government meaningful suggestions.

4.1 Current issues on accrual accounting in UK, New Zealand and the United States

Although these four countries implement their government accounting reform at the same period, the issues arise after reform focus on different areas. Consequently, the analysis would be taken country by country with certain comparison.

4.1.1 The issues in New Zealand

“By 1992, New Zealand became the first country in modern times to produce whole of government financial statements on full accrual basis, just as the United Kingdom, as part of its policy of modernizing the public sector, enters the

brave new world of Resource Accounting and Budgeting (RAB), The PFA (Public Finance Act) in New Zealand brought a shift from detailed centralized controls over input to ministerial control over output. New Zealand reaches a ten year milestone with its accrual accounting regime"⁷. This is a description of New Zealand Government Accounting Reform by June Pallot in 2001. Overall, the change to accrual accounting has been beneficial but it was not accomplished entirely without difficulties and there remain some issues to be resolved. (June Pallot, 2001)

First, there have been concerns about the time and cost involved in meeting the information requirements for monitoring reports. (Hepworth N. 2003) This concern would be more problematic for smaller departments. In response to this concern, a working party was set up in 1994 to review accountability requirements. It put forward that central agencies and the Audit Office should keep the demands for information at a reasonable level. (June Pallot, 2001) For small department, overfull demands would add the time, cost, passivity and reluctance to such departments, the risk on their work would be caused. For other two countries, they have that concern as well.

⁷ June Pallot, 2001. A decade in review: New Zealand's experience with resource accounting and Budgeting. *Financial Accountability & Management*, Nov. "By 1992, New Zealand became the first country in model rn times to produce whole of government financial statements on a full accrual basis, just as the United Kingdom, as part of its policy of model rnizing the public sector, enters the brave new world of Resource Accounting and Budgeting (RAB), The PFA (Public Finance Act) in New Zealand brought a shift from detailed centralized controls over input to ministerial control over output. New Zealand reaches a ten year milestone with its accrual accounting regime".

Second, there are a number of issues about the operation of financial management in incentives. Because of capital charge, there is a need for greater awareness of the capital charge outside head offices when it has the incentive effect on managers who use more assets. By the way, there is a problem on how government departments which provide services to low-incomes are to recover the charge. (June Pallot, 2001)

Third, there are concerns about the performance measures. Especially when refer to output, outcomes, and strategic result areas. There is just little dispute in New Zealand about the performance measures on output, since it is possible (although sometimes difficult) to assign costs to output. But it is normally impossible to assign costs to outcomes. Because outcomes normally are not as physical as output, they are more social and have further impact. However, there has been quite heated debate in New Zealand over whether performance measure in terms of output delivery is sufficient for accountability purposes. (June Pallot, 2001)

Except those three main issues, there is another issue in practice, which is attributed to the difficulties in implementation. The transparency problem, when the government could manipulate Accounting policies, obviously, the government accounting transparency would be diminished (Sheila Ellwood and Andy Wynne. 2005). But, we should admit that New Zealand government

benefits a lot through reform even above issues still need further attention.

4.1.2 The issues in UK

The government accounting reform in UK brought this country to a new period---full accrual accounting. As Professor Rowan Jones represented in 2003 CIGAR conference paper, ⁸“a fundamental change this makes is, in the case of all transactions(when relevant), to score both the cash flow and the earlier economic event of goods and services being received or provided.” This reform is successful, and accrual accounting system work well. But issues exist as well.

First, Rowan Jones states that⁹ “the financial statements of each department do not give a consolidated set of micro-based statements for the national government as whole”, although UK national government has legal requirements on providing whole-of-government financial statements, but a set of consolidated statements still does not come out. For the local government, they have legal responsibility to provide consolidated financial statements as whole entity as national government. But they seem have similar problem as national government. (Rowan Jones and Klaus Luder 2003)

Second is the issue on quality of accrual accounting. Even for a sound

⁸ Rowan Jones and Klaus Luder 2003. United Kingdom. *Reforming government accounting and budgeting in Europe*. “A fundamental change this makes is, in the case of all transactions (when relevant), to score both the cash flow and the earlier economic event of goods and services being received or provided.”

⁹ Rowan Jones and Klaus Luder 2003. United Kingdom. *Reforming government accounting and budgeting in Europe*. “the financial statements of each department do not give a consolidated set of micro-based statements for the national government as whole”,

accounting system, if the quality can't be promised, its products would be meaningless. In UK, the financial statements on accrual basis have problems in two areas. The information in statements sometimes is not sufficient to support further use. And parts of them are not audited and overdue. (Rowan Jones and Klaus Luder 2003)

Third issue is about the cost basis adopted in accrual accounting. Compared with US, UK government has departed from historical cost method of accounting, but the cost basis in UK is not consolidated, e. g. infrastructure and community assets at historical cost(net of any depreciation); operation assets at the lower of net current replacement costs or net realizable value, and investment properties at market value. The measure and compiling could be problematical for consolidated financial statements on accrual basis attributed to mixed asset valuation bases (Martin Evans. June 1995). By the way, UK accrual accounting application in government has the similar issues in cost as other countries as well.

4.1.3 The issues in U.S.

In the U.S. government—wide financial statements for both the federal government and state and local governments use the (full) accrual accounting. The accrual basis is also used to account for business activities of government. Governmental activities and funds use the modified accrual basis of accounting.

But this accounting system is not a perfect one without any concerns. Since the inherent weakness of accrual method, the problem in cost can't be avoided. And other issues also need attention. (James Chan and Li Jianfa. 2005)

First, accrual accounting is on historical basis. For certain area, historical cost basis is a little problematical for measuring. For the fixed assets on historical cost basis, the measure work is hard to operate with price change. (James Chan and Li Jianfa. 2005) When implementation of accrual basis to produce information on assets with historical cost base, even revaluation is required frequently, there is problem exist. The process would be costly with required accurate valuation.

Second, although the accrual accounting can produce the information for performance measurement, the signal is not so evident. Not like business, the poor performance of them would be evident in stock process fairly quickly and associated data. The accounting information can provide more obvious indication. (Kenneth A. Smith, 2004) The result of inefficient government performance becomes evident much more slowly and appears in the cost of real estate (via either high taxes or low property values due to poor quality of services). The performance measure on accrual basis can't work well as user's demand.

Third, U.S. should face the common issue in all countries, which adopted accrual basis. The accounting basis transfer is not simple process, in which more cost and time should be involved. Therefore, at the beginning stage of applying accrual basis, the net cost of its implementation exceeds its net benefits. The general negative comments would appear. (Kenneth A. Smith, 2004)

Although implementation of accrual accounting in government has received much support, but there are still opposition. They state that accrual accounting refers to much measure and valuation; the process would be more subjective. There is possibility for administrator to manipulate it. The quality of information is a little problematical. (Chan L. James. 2003) They are also worried about the cost of this system, and the complicated statements on accrual basis would be a barrier for public users to come close to government activities. Even though, there does not seem to be any support at any level for a return to cash accounting and input controls. (Chan L. James.. 2002)

4.2 Aspects need to be concerned in Chinese government accounting reform

Chinese government used the reform experience from other countries for reference to arrange its reform plan. The current issues in accrual accounting of those countries also cannot be ignored; they would be the sample of issues, which need to be concerned in Chinese government accounting reform.

4.2.1 Law and associated regulations are the safeguards of successful reform

Law and associated regulations are the safeguards of government accounting reform in any countries. New Zealand, a country introduced accrual basis to government accounting very early. Every step within reform process, New Zealand government set associated law or regulations to support/ safeguard reform. In 1989, New Zealand stated in <<Public Finance Law>>that government and related departments should adopt accrual accounting. (June Pallot, 2001) UK, Australia and U.S. did the same work well. UK Parliament set <<Government Resource Accounting Law>>, which confirms the status of accrual basis in government accounting. (Evelyne Lande. 2005) In 1997, Australia government set <<1997 Financial Management and Accountability Law>> which states accrual basis should behave as the base of government budgeting, government accounting and financial reporting.(Guthrie, J.1998) U.S. also set series laws, e.g., <<Government Performance Regulation>>. The significant status of law in reform process is evident, Chinese government should pay attention on this area to ensure reform go well (Chan L.James. 2000).

4.2.2 Concern on incentive way to support further process

The current issue on incentives mentioned in New Zealand is also an aspect that Chinese government should concern. But they have different meaning in

incentives. Chinese government thinks the change on management concept is an incentive way to receive more support and push the process going further. Since Chinese government need to face the problem on higher cost involved with lower net benefit, the incentives could become the decisive factor for further reform. (Norvald Monsen. 2005)

4.2.3 Improve information disposal method and training higher quality accounting staff

Accrual method is more complicated compared with other accounting techniques. The wider information scope would add the difficulties in dealing with them. (Levi Garseth—Nesbakk. 2005) Chinese government cannot ignore the need on improving information disposal method, which is fundamental factor to determine whether accrual accounting system perform well. Since its complication, high quality staff is essential part. Series of training and sound staff selection rule are the guarantee of good performance for accrual accounting application. Chinese government should care about the quality of accounting staff. (Lou, J, Wei. Zhang, H, Li. And Li Ping. 2002)

4.2.4 Concern on measure

Chinese government adopted the historical cost basis in accrual accounting. Like New Zealand, Chinese government owned amount of infrastructure assets. If there are demands for accurate accounting information on assets, Chinese

government should reevaluate such assets periodically; this process could not be ignored even with more cost. In the process of assets measure, Chinese government need to concern more in dealing with the measure of a large amount of historical assets as well. For performance measure, Chinese government requires the report can provide good performance measure, but in practice, the result of performance measure can not be as evident as they demand. Chinese government needs to realize it. (Lou, J, Wei. Zhang, H, Li. And Li Ping. 2002)

4.2.5 Follow the suitable way

Although there is fundamental principle, every country has different political environment and economic situation. They cannot follow the same way to implement government accounting reform. The government accounting reform in New Zealand is more thorough--- it is completed just in seven years. Because of the sheer big size, it is impossible for Chinese government to implement reform with fast speed; Chinese government accounting reform should follow step-by-step arrangement all the time. (Chan L.James.1988)

The government also needs to concern on set consolidated financial statement within one set of accrual accounting system in China. The coexisting three accounting system (general financial accounting, administration accounting and state-owned enterprises accounting) should be replaced by one set of “pyramid”

system quickly to support accrual accounting application. (Lou, J, Wei. Zhang, H, Li. And Li Ping. 2002)

The above five aspects are main areas, to which Chinese government should pay much attention, except those, the issues on keeping transparent (government can not involve in manipulating the accounting policies more) are also in the scopes of government's concern.

4.3 Predicted problems exist in Chinese government accounting on accrual basis

Even Chinese government did well to avoid possible problems during the process of reform, attributed to the inherent weakness of accrual method and actual situation of Chinese policies and economy, series potential issues have high possibility to appear with accrual basis.

4.3.1 Potential issue on government accounting staff

The quality of accounting staff would be the decisive factor for the quality of accounting information. (Mark Christensen and Hiroshi Yoshimi.2005)

Chinese government adopted cash basis in government accounting for a very long period. Cash method is a more simple technique to deal with accounting information compared to accrual method. Correspondingly, the quality of accounting staff (we can not call them accountant, since they have poor

professional background in accounting) is lower. When accrual accounting is introduced to Chinese government, its complicated operation requires accounting staff with higher quality. More additional professional training in this field is urgent task for government accounting staff. During reform, the professional training must be given to staff, but that is just the essential part to improve quality. For the further development of accrual accounting in Chinese, there is a problem which can not be resolved easily. (A large amount of cost on training must be the first barrier) If the senior officer in Chinese government can have the right to hire or fire Junior accounting staff freely like New Zealand. More excellent accountant in private organization would be attracted to involve in government accounting work. But the reality is that is no possible to attract excellent accountant freely from Business accounting area in China. (Zhao, J, Yong, 2000)The issue in quality of accounting staff might become the primary potential problem for Chinese government.

4.3.2 Potential issue on assets revaluation with historical cost basis

Chinese government has adopted historical cost basis in government accounting in the past, and it prefers to apply historical cost basis in the future accrual accounting application as well. There is similar example; the fixed assets of U.S. government are on historical cost basis. And there is no obvious problems exist related to adopt this cost basis in U.S. (James Chan and Li Jianfa. 2005) But the situation is much different in China. For the long history,

Chinese government owned large amount of historical assets, the revaluation of them would be a complicated and costly process, and this process seems not so worthy for public. (Zhao, J, Yong, 2000)

Except historical assets, we know that the infrastructure assets of Chinese government are extended a lot those years, with higher demand on accurate information of fixed assets in accrual accounting; revaluation of infrastructure assets definitely is a large project for Chinese government. (Zhao, J, Yong, 2000)

By the way, for historical assets and defense assets, their revaluation needs professional staff to operate. But in China, there is no sufficient professional staff to complete it without any problem.

U.S government revaluates its fixed assets over a five-year cycle. Attributed to short of sufficient finance and staff, very frequent revaluation is less possible for Chinese government within recent years. (James Chan and Li Jianfa. 2005)

We should admit that series issues could appear on historical cost basis.

4.3.3 Series potential issues on financial report

Compared with cash accounting, accrual accounting is more complicated to handle. Correspondingly, this complicated accounting method must be problematical for information users. For the professional staff, there is no any trouble to understand the information they need from accrual financial report.

(Ryan C. 1998) But, most of accounting information users is public users without any accounting background including private investors. Understanding the indication of the information from accrual accounting financial report seems not easy to handle (especially, some information about government performance that users expect to know). (Chan J. L. Rowan Jones and K.G Luder, 1996) Although Chinese government expects to improve the transparency of its performance to public through accrual accounting financial report, this dream can not be come true so easily with the barrier in front of information users.

There is no any system (political or financial system) is perfect without any weakness and potential problems. Any potential or predicted issues can be overcome during the process of improvement as long as administrators put sufficient concern on them.

CHPATER 5: CONCLUSION

Forced by the trend of global economy, internationalization and significant changes on government administration model, most of countries in the world have implemented financial management reform especially in the field of government accounting. Accrual accounting is the first choice of governments to behave as new government accounting basis to satisfy current higher requirements on accounting information, especially the ones to state government performance. (Zhao, J, Yong, 2000)

Chinese government is practicing series financial management reform; government accounting reform which introduces accrual accounting to public area is the key factor to promote further financial management reform.

Compared to cash accounting, accrual accounting has absolute superiority in financial management. It can produce better report which indicates the government's accountability within more flexible environment. The information on accrual basis about government assets and liabilities offer a foundation to establish more effective and efficient resource management. (Frode Mellemvik, Levi Garseth-Nesbakk and Olov Olson. 2005) It could focus government's long term concern on financial decisions, which attributes to its ability on extending performance measure concept beyond the cash.

Adopting accrual accounting is a challenge on financial concept and techniques for Chinese government.

First, Since Chinese government applied planned economy for long period; the level of government accounting management is very low, even the concepts also have significant difference with the fundamental concepts of accrual accounting. In addition, current Chinese government still implement strong administration monopolization, it does not have strong consciousness on performance measure and public accountability. (Zhao, J, Yong, 2000) And because accrual accounting application is a profound reform on government internal profit allocation, the administrators in Chinese government should face large pressure.

Second, there are amount of barriers in practice when Chinese government adopt accrual accounting. In the past, Chinese government has no sufficient record on assets. With the cash accounting in historical cost basis, the record of assets in administration departments is not accurate and intact. (Zhao, J, Yong, 2000)As the result, in the beginning of accrual accounting practice, recognizing and revaluating large amount of assets is not an easy task for Chinese government.

Third, accrual accounting practice needs the support of completed and sound

treasury system. Sound treasury system could record payment situation accurately. And it also could provide the entire revenue and payment information feedback as the foundation of accrual accounting information used for making decision. But the reality is that Chinese government is experiencing the reform on treasury system; (Jian, F, Li, 2001) there is still long distance to establish sound treasury system demanded by accrual accounting practice.

This paper start from the analysis of worldwide situation of government accounting reform which provide the theoretical evidence. Combined with local environment, this paper provide general introduction on Chinese government accounting within flexible international environment. Then, paper focuses on analysis of inherent weaknesses of cash accounting and merits of accrual accounting, and then put forward the essential need for accrual accounting in Chinese government.

There is no end for any research in any field. Although this paper suggested Chinese government to concern certain aspects in the process of accounting reform and put forward some predicted problems in future accrual accounting practice at final part of paper, further researches in this area are demanded. Accrual accounting in Chinese government would be the hot topic for academics.

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