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# *Which Way Now?*

## *A Theoretical Programme for the Transition to Accrual-Based Accounting*

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**SUMMARY:** Today in Hungary, cash-based accounting dominates all areas related to the accounting settlement of public sector expenditures and revenues, which represents significant problems from planning through implementation to auditing. The greatest disadvantage of the system currently in place is that it is impossible either to exactly assess the financial situation, or to determine precisely what anything truly costs. The European Commission and the OECD have been soliciting for and recommending the application of accrual-based accounting for several years, as it increases the transparency of financial statements, ensures accountability and establishes a better, more secure foundation for the implementation of planning, including revenue collection and cost-cutting, and in particular the achievement of management objectives. Accrual-based accounting is a modern system that books economic transactions as they are originated. It manages the problem of the wear and tear of tangible assets, improves resource allocation, provides up-to-date information about trade payables, shows current and future commitments and helps audit activity. The changes are necessary; therefore, it would be reasonable to create a new piece of complex legislation to regulate the financial management of the public sector. Creating such new legislation would enable a Hungarian model to be developed that could ensure long-term good governance that is based on prudent social consensus, and could make keeping public finances secure, while ensuring efficient performance of public functions. Through a fundamental change in financial management culture, by way of ensuring that revenue and expenditure can be efficiently planned and controlled, the deficit can be reduced and so can the volume of national debt.

**KEYWORDS:** cash-based approach, public sector, accrual-based accounting, unique Hungarian model

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There is a substantial body of Hungarian and international literature addressing the transition to accrual-based accounting. All analyses agree that transition is time-consuming and requires serious preparatory work. Analysts examine whose interests are served by transition, whether the political conditions are available, how well the country is prepared for transition, and whether its financial and accounting culture is adequate. This overview is looking to answer these questions.

The mission of entities managing and operating public finances with an interest in implementation

is to promote the transparency and regularity of public finances through value creating work, performed on a solid professional basis, thus contributing to 'good governance'.

Transparency, accountability, reliability, economical and well-balanced financial management require accounting in the public sector that is in line with Hungarian and international requirements alike. Moreover, they primarily serve the establishment of public finance equilibrium, curbing indebtedness and ultimately leading to a reduction in public dues. Of course, this recognition is not the product of our modern age, but comes from *Cicero* from 55 B.C.:

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*“The budget should be balanced, The Treasury should be refilled, Public debt should be reduced, The arrogance of officialdom should be tempered and controlled, And the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance.”*

## THE ROOT OF PROBLEMS

The current planning and implementation system of public finances reflects a cash-based approach. This is also how fiscal documents, local government plans and accounts submitted to the Parliament are prepared. These are what audits examine and qualify. Depending on public finance regulations – in given periods – certain non cash-basis items may also feature in cash accounting statements, making temporal comparisons difficult.

In certain fields, the current system of public finances – derived from the the Act on Public Finances and the system of regulations of the corresponding implementation decree – allows for the application of so-called ‘creative’ accounting techniques. As a result, an opportunity is created to show the financial standing of a given sub-system, institution or foundation in a more favourable light than it actually is. This is made possible through the incomplete recording of accounts payable, accounts receivable and assets, and off-balance sheet arrangements made by the reporting entity.

In a study published after the outbreak of the 2008 crisis, the IMF calls attention to the fact that in such tense periods, ‘creativity’ has significant breeding ground in budgetary accounts. Governments, therefore, must be urged to prepare financial statements that are audited by the given country’s audit offices in adherence with international rules (Irwing, 2012).

The study, praising the necessity of accrual-based accounting, points out that even though

greater ‘expertise’ is required to perform ‘tricks’ with such accounts, the opportunities to do so are significantly fewer than in the case of cash-based systems.

Council Directive 2011/85/EU, which regulates the requirements for budgetary frameworks of the Member States, points out, *inter alia*, that in the case of the account systems of Member States, accounting should be distinguished from the statistical methodology-based system which provides information on the results and condition of government finances. Complete and reliable public accounting practices for all sub-sectors of public finances are a precondition for the production of statistics.

At a macro-budgetary level, international organisations require comparability and the application of a standard methodology in connection with government balance, debt indicators and other statistics. (Convergence programmes are also prepared this way; forecasts should be prepared using the same methodology as that applied to statistics on actual data.) Accounts are prepared in accordance with the ESA 95 or the methodology of the Excessive Deficit Procedure (EDP). In statistical accounts, building on payments data, the transition system of the so-called ‘ESA-bridges’ should be used, which are unreliable in many cases as a result of institutional settlements (for example: changes in accounts receivable and accounts payable volumes, deferred items, counting investments, etc.). The supplementary information necessary for the transfer is insufficient, and its reliability is doubtful. The methodology – according to the content of the ‘bridge’ – now includes accrual-based revenue, expenditure, financial transactions and a different organisational scope, while several other adjustments also need to be included in the system. The system of the ESA-bridges, the carry-overs hinder transparency, and put people familiar with budgeting in a difficult position, not to ment-

ion experts, who work in this field specifically. The Budgetary Frameworks Directive requires the preparation and publication of a transfer-adjustment methodology.

*Note:* Apart from the fact that the accounting and budgetary systems operated by both Hungary and the EU are in need of considerable improvement, the indicator systems viewed as initial standards are also problematic. Certain elements of the Maastricht criteria – 3 per cent deficit, 60 per cent debt – require updating due to the following.

These criteria – as life today illustrates so well – cannot handle crises, and a de facto debt decrease would require significantly lower deficits. The criteria are not sensitive to economic changes, as they do not measure any of the economic or financial indicators that are relevant to public finances. Tangible asset investments are treated as expenditure even though total assets do not change; however, the transactions related to financial assets are treated differently than those of tangible assets, etc. (Bathó et al., 2004).

Consequently, in terms of accounting technique, the indicators themselves could be modified as well if all Member States were to use the same statistical methods for the treatment of consistent and economically equivalent transactions that also represent the quality of their budgets.

This would allow the system to be arbitrage-free. (Arbitrage transactions may be defined as transactions that can earn relatively risk-free profit by taking advantage of the price, exchange rate and interest rate differences present on geographically distinct markets).

It is not a coincidence that in addition to the methodologies used in statistics and in convergence/stability programmes, the direction of European thought in this area is that core data should be generated in accordance with a set of uniform standards in Member States, and that national budgets should be comparable.

Most of the problems related to comparability and quality assessment lie in country differences. The variety in public accounting methods make it very difficult to compare the indicators and standards applied.

In addition to the macro-level accounting problems, one must also accommodate with micro-level problems. The vast majority of accounting problems today result from the fact that the budgetary system currently used by institutions can only partly comply with the fundamental function and purpose of certified accounting. The most important goal at any given time is to supply information that provides a true and fair view of the assets, financial standing and income of the owners, and of the changes therein, in the interest of providing a sound foundation for economic – in the case of the state, economic policy – decisions, and to ensure that the processes can be controlled and monitored (Csonka – Bathó, 2009). The current regulations are contained in Government Decree No. 249/2000 (XII. 24.) on the Specificities of the reporting and book-keeping requirements applicable to general government organisations, as amended.

In practice, many problems are encountered in connection with statements, balance sheet items and financial analyses. Some of the data required and supplied are unnecessary for decision-making. The resource requirement of public functions cannot be easily determined, the need for depreciation/asset replacement does not figure into the accounts, and the inventory and valuation accounts of assets are not reliable, the expenditure related to the specific tasks cannot be used to compare the public functions, etc. These are only the most important problems.

The current system does not really answer the questions that follow from the features specific to the public sector. Decision-makers at different levels need summaries and data (economic analyses, presentation of consolidated government functions, what the

actual cost of each item is, etc.) necessary for holding the relevant players accountable, to prepare for decisions and to make analyses, to different extents and with different contents. The sets of data included in itemised reports and final accounts laws are not suited to be used for purposes of analysis, nor do they satisfy any of the related professional requirements.

The problem is rooted in the fact that cash-based accounting only reports data about the past, can reflect the internal content of the processes only partially, while it does not encourage reasonable resource use and does not take real liabilities, benefits, etc. into account (Szakács, 2012). The controlling systems have difficulty identifying the determinations of budgetary appropriations, and can utilise the data only in part to audit financial management in the interest of finding more cost-efficient solutions.

The financial monitoring systems that form the basis of the budget information and control systems cannot present the appropriations, accrued expenditure, any eventual sureties and other liabilities in an administrative, economic, and functional break-down, nor can they present actual performance and historical values in an exact manner.

## INTERNATIONAL PRACTICE

The European Commission and the OECD have been soliciting for and recommending the application of accrual-based accounting in Europe for several years. Most European countries have adopted or are in the progress of adopting the new system (Csonka, 2012). The public accounting approaches employed in the various EU Member States, as well as the changes in public accounting approach are explained in detail in *Annex 1* based the work international experts at the State Audit Office of Hungary.

*Note:* The view expressed by the Commissioner for Financial Programming and Budget is that “[h]igh quality financial information is essential to effective management in the public sector.” Taking this as a starting point, we can derive that the accounting reform started in 2005 will be applied in an increasing number of countries. According to the cited EU document, this is not merely a technical change: through a profound change in management culture, it allows deficit to be reduced by means of the consistent collection of outstanding revenues and the effective control of expenditure, whereby the debt of each Member State can also be reduced (European Commission, 2012).

The European Federation of Accountants is recommending that governments and public sector entities use accrual-based accounting, as it increases the accountability and transparency of financial statements, provides better information for planning, including revenue collection and cost-cutting, and in particular for the achievement of management objectives. An overview of countries also suggests that countries that have not made the transition to accrual-based accounting have had considerably greater difficulty handling financial crises than those that have (see Greece, Ireland, Italy, Portugal).

In France, the accounting rules approved in 2001 and introduced as of 2006 stipulate accrual-based accounting for the central government in accordance with the issued standard. The audit office audits statements and as of 2007 and 2009 audits have been extended to universities and hospitals, respectively. Accrual-based accounting is regarded as an important tool in terms of financial performance and management, as a structured audit report helps feedback, thereby improving transparency significantly.

The system used in the United Kingdom is somewhat different, but has a number of elements that could be adopted. As part of the Whole of Government Accounts project, similarly to the

private sector, the financial statements of around 1,500 organisations are consolidated according to the standards adopted by the EU, but customised to suit the needs of the public sector. The system was published for the first time in November 2011. As supplementary information to the report, a forecast is included on the long-term budgetary effect.

Apart from the EU, such systems are employed in five countries in the world (Australia, Canada, New Zealand, Switzerland, United States). Of the above, the practices of three countries are certainly noteworthy.

In the Australian system, the fiscal balance is the most important aggregate used in the financial statement, which is the accrual-based equivalent of the cash-based balance. In the interest of evaluating the activity of financial management, quality assurance certificates must be drawn up, and the contracts as well as the grants received must also be made public. There are certain internal and external audit systems that are at work, the governmental bodies regularly evaluate the strategic programmes.

The practice of the United States diverges in several respects. In the states, presenting the data of accrual-based book-keeping, budgetary information, and budgetary forecasts in one integrated reporting system is a great challenge. Recommendations are issued within the framework of the government specific financial statement about governmental performance, a task the implementation of which is further complicated by the fact the states within the United States have independent budgets as well to carry out their own specific governmental functions.

New Zealand is the furthest ahead in the areas of application. This question first came up during the eighties in order to solve financial management problems. The legislature passed two pieces of legislation in which it regulated the introduction of the performance target system and the accrual-based approach to public finances. The acts are the 1988 State

Sector Act and the 1989 Public Finance Act. Approximately 4 years after its launch and after the necessary fine-tuning, the system was operating efficiently (Barton, 1999).

## ACCRUAL-BASED OR CASH-BASED APPROACH

Accrual-based accounting is defined as a modern accounting system that books economic transactions when they are originated and not at the time of the receipt or payment of the amounts in question (as is the case under traditional cash-based accounting). Thanks to accrual-based accounting, accountability can improve, transparency can increase for financial reports prepared in the public sector as well, and there is better quality information available for financial management and the preparation of policy decisions. The practical advantages of the accrual-based approach are the following.

- ▶ The system handles the issues represented by the wear and tear of tangible assets. It does not behave as though tangible assets cost nothing. Accounting based on the principle of revenue recognition records the changes in the assets, financial standing and income of the business organisation in full.

- ▶ It provides up-to-date information on trade payables and trade receivables, because the economic events are booked well before payments. (As a result of the fact that financial revenue and financial expenditure may be recognised at a time that is different from period where the revenue and expenditure belongs economically speaking, it is simply impossible to assess the 'actual' economic performance of the budgetary institutions and it is impossible to compare performance in individual periods.) This problem is eliminated by the immediate booking of the economic event.

- ▶ It improves resource allocation, helps support decisions on investments, and with

the help of accruals and deferred items it shows existing and future liabilities as well.

▶ The general ledger provides more timely information on the costs of and the resources consumed during the activity, because there is no need to wait for financial settlement. By using accounting based on the principle of revenue recognition, there is a more realistic chance of comparing the performance of the various periods. All of this is made possible by the enforcement of the matching principle through the application of the principle of accrual. The revenues are linked to the period in which the organisation earned the given revenue by performing an activity, regardless of its financial settlement. At the same time, the items that are charged to profit and loss comprise the expenditures that were incurred in order to realise the revenues of the given period, regardless of when consideration is paid for the resources.

▶ It is a stricter form of accounting, because managers are expected to give account not only of cash movements, but also of all resources and of changes in assets.

▶ Data supply is more accurate and faster, and events can be handled better.

▶ It makes it possible to measure the results and performance of individual periods.

▶ It allows for precise planning for the coming periods, for monthly periods at the micro level and yearly periods at the macro level. Operating a cash-based accounting system requires large amounts of related analytical records that are not integrated with the books, which are indispensable for accounts (financial statements) to be drawn up. That is, the analytical records related to the statements are not integrated with the self-contained book-keeping system, resulting in a much greater chance of making a mistake while drawing up the statements. (For example, analytical records on accounts receivable and accounts payable, analytical records on tangible assets, analytical records related to tax types, etc.) Given its

unique features, accrual-based accounting is able to handle this difficulty in a systemic manner.

▶ Comparisons of financial management in previous periods and any analysis of changes will also be precise only if based on accrual-based accounts. (The comparison of cash-based accounts leads to wrong conclusions in virtually all cases.) It is impossible to assess the actual performance of the economic entity in the given period with cash-based accounting, which is becoming increasingly important in the case of entities operating on the basis of budgets, in particular because during recent years or decades, these organisations have been performing increasingly widespread quasi-entrepreneurial activities.

▶ The accuracy of forecasts as well as of short and long-term projections improves considerably. It facilitates audit processes and makes controlling systems traceable. In the case of combined systems, however, through cash-based accounting, we lose one of the greatest strengths of the double entry system that is based on the principle of revenue recognition, namely the ‘controlled status’ provided by a self-contained system.

▶ Within a short time, it is able to transform the thinking of mid and top-level managers, helping them to make sound economic decisions.

*Note:* In international practice, accrual-based accounting systems operate on the basis of consistent principles. Both the public and the business sectors utilise the so-called international accounting standards (Polyák, 2008).

The International Federation of Accountants (IFAC) plays a leading role in this work. A separate committee deals with the public sector within the organisation. The committee sets individual standards for the various fields of the public sector. These documents are known as IPSAS (International Public Sector Accounting Standards). The fact that they are all accrual-

based is a common characteristic of IPSAS, and while their adoption is not mandatory, they are recommended by the EU.

The practical disadvantage of accrual-based accounting is that the systems in place today can only be changed gradually and over a relatively long time. The transition requires considerable budgetary expenditure. Training and the preparation of training materials require great care and competence; however, it is also true that general accounting education does not need to be complemented with public finance accounting of a fundamentally different approach.

The arguments for maintaining the cash-based system are the following.

- ▶ The budget of public finances is cash-based, and the accounting regulation of entities operating on the basis of budgets conforms to this. It is easy to integrate with the system of the central budget.

- ▶ ‘Custom’ is another argument for the cash-based approach. Changes are always met with resistance, and if the situation can be kept unchanged, the conflicts and the violations of interest arising from the transition can be avoided. This is the system that employees and managers of budgetary institutions know; this is the field in which they have professional experience.

- ▶ Having the changes accepted in professional terms would not be easy with all stakeholders. In every profession, changes that appear to be drastic are taken hard, therefore significant resistance should be expected from professionals who use cash-based accounting systems, to the extent they are unfamiliar with or have limited expertise in operating accounting systems based on the principle of revenue recognition.

- ▶ People working in the field of accounting have become thoroughly familiar with the use of accounting information systems that have been in place for years, or even decades.

- ▶ The replacement of the accounting infor-

mation systems and training process related to replacement would involve substantial costs. Professional re-training would be very costly. (It must be noted, however, that experts well-versed in budgetary accounting are familiar with the basic principles of accounting based on the principle of revenue recognition, even if they have less professional experience in this field, since they have been active in the budgetary sector for a considerable time.)

## TASKS RELATED TO THE TRANSFORMATION OF THE SUBSYSTEMS OF PUBLIC FINANCES

The preparation of budgets and final accounts is regulated by Act CXCIV of 2011 on Public Finances. These documents are submitted to the Parliament on a cash basis. Starting from the micro-level, planning and implementation are audited on a cash basis. The fields dealing with public finances, however, also prepare public finance balance sheets on an accruals basis in accordance with EU statistical requirements.

This, however, is not what the chapters of the budget follow. Appropriations under the various chapters are made on a cash basis. The first phase of the task aims to determine the methodology of accrual-based macro-budgetary appropriations. The main differences on the revenue side include value added tax, excise duty, energy tax, personal income tax, the deferral of interest revenues, central budget, loan repayment, stock sales, concession deals, international financial relations, EU refunds, loan repayments of separated state funds, social contribution tax, other contributions, sales privatisation revenues, debt transactions, revenues of government sector organisations classified as ESA.

The main differences on the expenditure side include corporate funding, consumer price supplements, financial accruals, loan provisions, MNB compensations, share purchases, loan

provision at various subsystems of public finances, interest costs to the so-called ESA circle, and expenditures of government sector entities.

Also depending on the date of transition, the two systems must both be present in Parliament presentations for a relatively long period for purposes of financing and comparability (Lantos, 2010). The practices of several countries prove that this duality can be maintained at the level of parliamentary decision-making: a vote is passed on the accrual-based – typically multi-year, rolling – budget, while the use of funds as a resource is limited through the specification of an annual cash-based envelope. This solution creates a cross-over between medium-term budgetary frameworks undertaken as part of medium-term EU economic coordination, the convergence/stability programmes and traditional cash-based budgets. The latter is still being voted on, but decision-making is already in progress regarding the multi-year sectoral ratios and the results to be achieved through the programmes.

The budgetary institutions performing state tasks are extremely diverse due to their roles in task performance. Among them, some entities operate purely using budget resources, and some use only their own funds (Vigvári, 2002). As a result, they are faced with different accounting problems. For example, the accounting of items such as taxes, owners' income, or fee income collected by another organisation but recognised as chapter-managed appropriation is a recurring problem for the chapters on the revenue side.

Items are often recognised as funds within public finances, which are subsequently not carried by any of the government organisations as tax, owners' or fee income, because of the transient accounting. Therefore, when working out the transition, as presented in the micro-budget example, timing differentiations must be made for the organisations that have their

own revenues, are allowed to or are engaged in business activities regulated by law, and have a large volume of assets. They carry significant investment debts in their balance sheets; they implement large-scale EU programmes and execute financial transactions to the given chapter upon instructions from owners. Examples of such organisations include universities, large central hospitals, and foundations performing public functions (Veress, 2011). Obviously, transition must begin with these entities.

At the local level of public finances, increasing financial management problems in the local government subsystem, debt problems and the difficulties of financing have directed attention to tasks related to the transformation of accounting, including the problems of the financial management of majority-owned business associations. The problems of the current cash-based accounting system are more apparent in the case of this particular subsystem than in the central subsystem due to the unique features of operation. (The financial situation of local governments, the fair market value of assets, development of profitability, etc.) The transition of the local government subsystem must follow that of central systems as preparation in that particular field requires significantly more time. Accounting differences and the development of versions that can be taken into account is expected to be a highly complex task.

*Note:* A few tasks of great significance to resolve during the transition: to prepare the balance sheet for the opening of the accrual-based fiscal year; to prepare the accrual-based chart of accounts; to prepare a detailed internal policy on book-keeping and accounting records; to prepare new notes to the accounts; to reorganise the usual balance groups; to prepare new types of business reports and inventories; to organise audits; to create regulations regarding the contents of balance sheet items, etc. In order to implement the transition, the following must be prepared:



the specified breakdown of the balance sheet, the specified breakdown of the profit and loss statement, the accrual-based chart of accounts per account class, etc. (Vigvári, 2006).

In order to make the transition, a review of the legal background is required as at the moment accounting regulations are engrained in close to all facets of legislature, therefore, laws currently in force should be reviewed whether they show any relationship between the budget and the broadly interpreted operational systems of public finances.

▶ The acts and implementing regulations that definitely have to be reviewed are the following. Act CXCV of 2011 on Public Finances. The following regulations must be reviewed in particular: the structure of the Act on the Central Budget; the budgetary decrees of local governments; the rules of the implementation of the budget; the specific rules of financial management; the control system of public finances; the order of financing and account keeping for the subsystems of public finances; residual accounting; reporting and the information system of public finances.

▶ Act CLXXXIX of 2011 on the Local Governments of Hungary. It would be appropriate to examine the necessity of amending the following regulations: local government assets, local government financial management, the task financing system of local governments, the internal control system of local governments, debt settlement.

▶ Act CXCVI of 2011 on National Assets. With regard to the transition, certain sections of the Act must be examined in connection with financial management. In particular the basic principles of asset management, the management of national assets, and the exclusive economic activities of the state and local governments.

▶ Act C of 2000 on Accounting. When reviewing the Act, all sections containing provisions for the organisations of public finances must be reviewed.

The transition to accrual-based accounting takes several years. One possible implementation of the transition is contained in *Annex 2*.

The transition to accrual-based accounting systems should basically commence in four distinct phases. The first phase should focus on preparation, with the State Audit Office and the National Assembly acting as flag-bearers (2012–2013). The National Assembly would announce the transition in a resolution. The second phase involves decision-making, where the government and the Parliament take the leading roles (2014–2015). The third, and most complex, phase is that of implementation, where the entire public administration takes interest in performing the task (2016–2017). In the fourth phase, when feedback is given and audits are conducted, the State Audit Office again takes centre stage (2018–2019).

## THE ROAD TO REAL BENEFITS

After a review of the statutory background, the main issue is to clarify whether there is a need for an independent new act that covers the whole of the financial management system of public finances from planning and public accounting to amendments to accounting regulations on implementation, or it is sufficient to simply amend the system currently in place. Can the current financial systems of public finances be modified by leaving the foundations untouched and only adjusting implementation?

A number of experts addressing the issue agree that there is no need for a separate act; the system, derived from the frameworks ensuring executive power – reviewing the issue of exercising budgetary right – could be made operational and may be adapted to accrual-based requirements with only slight amendments (regulations regarding budgetary planning, final accounts, changes in the manner of the performance of public duties, etc.) (Kassó, 2006).

It is clear, however, that creating the legal background for the transition to accrual-based accounting is more than a simple accounting matter; it also includes the enactment of the areas of the budget, fiscal management, accounting and auditing.

It is insufficient to amend the Act on Public Finances; to adjust the decrees on implementation; to prepare the balance sheet for the opening of the accrual-based fiscal year; to prepare the accrual-based chart of accounts; to prepare a detailed internal policy on book-keeping and accounting records; to prepare new notes to the accounts; to reorganise the usual balance groups; to prepare new types of business reports and inventories; to organise audits; and to create regulations regarding the contents of balance sheet items.

A change in the public finance and financial management approach generated by the new act is necessary and essential.

According to analyses to date, it would be appropriate to draw up an act that takes the unique characteristics of Hungary into account, and which conforms to growth criteria and cost saving management by the state in the long-term.

In anticipation of the results of the review of the legislative background, it is the author's opinion that an act entitled "Act on accounting to ensure the transparency of financial management in the public sector and the accountability of public funds" should be drawn up.

In democratic countries with varied political structures the priorities of introducing the system are vastly different. There is, however, agreement on one thing in countries operating as presidential or parliamentary democracies alike, namely that transition without widespread political consensus is very slow and difficult.

With respect to the above, it would certainly

be appropriate to establish political consensus to clarify the commitment of political forces over the priority issue of whether the transition to the new system would be made. As a starting point, therefore, a document should be drawn up to settle the issue in a clear manner. This could take the form of a resolution by the National Assembly based on consensus. In that regard, determination and approval is needed of the main tasks that the government and the State Audit Office would have to perform in the short and long-term in connection with the transition.

The political benefits that could be achieved through the new system would have to be presented very clearly. If a transition is made to the new system, the benefits derived from the accrual-base approach in Europe or globally will become apparent. Resource allocation will improve, as will competitiveness as a result, while the transparency of the public finance system will also improve and become simpler.

Through these changes and the creation of a new law, it is possible to establish a Hungarian model that is unique in Europe and could ensure long-term good governance based on prudent social consensus. An invisible, yet very real social contract could be made between income owners – individuals, enterprises, and the state – that would allow for secure public finances and efficient task performance by the state.

High quality financial information is essential to effective management in the public sector. The accounting reform can be derived on that basis.

Based on our review of the issue, this is not merely a technical change, but serves the primary goal of reducing deficit and thus debt through a profound change in management culture and the effective scrutiny over spending.

**INFORMATION ON THE PUBLIC ACCOUNTING APPROACHES APPLIED IN VARIOUS EU MEMBER STATES AND OTHER DEVELOPED COUNTRIES, AND ON THE TRANSITION IN PUBLIC ACCOUNTING APPROACHES**

The international survey conducted by the State Audit Office of Hungary in April–May 2012 was prepared using the English language paper presenting the public internal control systems of EU Member States<sup>1</sup> as well as other materials.

Country	What system is employed in public accounting (central-level, local government-level, etc.)?	Information on the ‘transition’ (date, time requirement, etc.)
Austria	At the moment, a modified accrual-based approach is used for one part of accounting in the public sector, and a modified cash-based approach for the other part. In the near future, the federal level will become entirely accrual-based.	The transition of the federal level will be implemented in two phases in 2009–2013. 2011 was the pilot year. In 2012, the accounting system of the old and the new approaches are functioning parallel to one another at the federal level. 2013 will see full transition.
Belgium	At the federal level, accrual-based accounting is close to being introduced everywhere. Half of the provinces have already made the transition, to be completed in the rest in 2012–2013.	A law was passed in 2003 to make the transition to accrual-based accounting at the ‘central level’. However, transition only commenced in 2009 in 5 pilot projects. Full transition will be completed in 2012.
Bulgaria	The country’s public sector applies a modified cash-based approach.	There is no transition whatsoever in progress. Final accounts and all other accounting documents are cash-based. At the level of ministries and their institutions, accounts have both cash-based and accrual-based sections.
Cyprus	Public accounting uses a modified cash-based approach.	According to plans, the first accrual-based final accounts will be prepared for the 2015/2016 financial year. Gradual transition commenced a few years ago, and every year an increasing number of budget items are accounted for on an accruals basis.
Czech Republic	The central level employs accrual-based accounting.	In 2010, the central level has made the transition from modified cash-based to purely accrual-based accounting. Details are unknown, but there was a transition project between 2007 and 2010.
Denmark	Accrual-based accounting in the whole of the public sector.	The transition to accrual-based accounting was made in 2005, with a pilot programme running the preceding year at several institutions. The transition to accrual-based budgetary planning was made in 2007, i.e. budgetary planning has been accrual-based since the spring of 2006.

<sup>1</sup> “Compendium of the public internal control systems in the EU Member States”, prepared by the European Commission in 2012.

United Kingdom	<p>The whole of the public sector applies accrual-based accounting. The IFRS (International Financial Reporting Standards) were adapted and interpreted for the public sector.</p> <p>According to a study (see the section on New Zealand), the contents of the middle column only apply to institutional financial statements. The transition of final accounts as a whole was planned for 2006. The transition of the local government sector was performed in the 1990s.</p>	<p>The transition to accrual-based public accounting and budgetary planning began in 1995 and was completed by the 2001–2002 fiscal year. This had 3 dimensions:</p> <ul style="list-style-type: none"> <li>• the planning of budgetary expenditures in 2000 looking three fiscal years ahead (the so-called “2000 Spending Review” already used an accrual-based approach for the years 2001/2002, 2002/2003 and 2003/2004);</li> <li>• in March 2001, the expenditure budget for 2001/2002 (Estimates) was already submitted as an accrual-based document;</li> <li>• by the 2001–2002 fiscal year, accrual-based statements had completely replaced cash-based statements. In the two preceding fiscal years (1999/2000 and 2000/2001), however, the full range of accrual-based statements were also prepared and released at the same time as the cash-based statements.</li> </ul> <p>The accomplishment of this triple goal was set out for the government in a 1995 white paper. (There had been declarations of intent on transition prior to 1995, however, these were not binding.) The triple goal was accomplished fully and on time. July 2000 was a crucial month for political decision-making. Chronology: (1) 2000 spending review approved (= Point 1 above); (2) laws related to the old cash-based accounting system repealed; (3) two parliamentary committees authorise the Treasury on behalf of the Parliament to replace older format statements with the new format and to plan for 2001/2002 with the accrual-based approach.</p>
Finland	<p>The whole of the public sector employs accrual-based accounting.</p>	<p>(Early) transition was completed in the 1990s. Reporting (accounting) and budgetary planning are accrual-based in the whole of the public sector.</p>
France	<p>The whole of the public sector employs accrual-based accounting.</p>	<p>Central level transition was completed in 2007. Local government level transition was completed in the 1990s.</p>
Greece	<p>Public sector accounting uses a modified cash-based approach.</p>	<p>No transition.</p>
Netherlands	<p>The country has a mixed system.</p>	<p>Local governments and provinces have followed the accrual-based approach since the 1980s. There are, however, mixed solutions at the central level. Ministries employ a special cash-based approach. All subordinated institutions use the accrual-based approach. The planned transition of the central level to accrual-based accounting has been postponed.</p>

Ireland	The central level employs cash-based accounting.	There is a pilot project for the introduction of accrual-based accounting as well as proclaimed government intention, but no specific schedule.
Poland	Modified cash-based approach.	No transition. Only a few institutions (separated funds, paying authorities of EU funds) employ the accrual-based approach.
Latvia	The reporting and accounting of the public sector is accrual-based.	This was introduced in 2003 in the interest of complying with international accounting standards (IFRS/IAS, IPSAS).
Lithuania	The complete reporting and accounting of the public sector will soon become accrual-based.	The transition commenced in 2005, extended to the whole of the public sector and has now been completed. By the end of 2008, the accounting and reporting standards, the general ledger accounts and sample manuals for institutional accounting regulation had been prepared. By 2010, all institutions were preparing accrual-based statements. The first accrual-based national final accounts will be prepared for 2012.
Germany	Federal ('central') level reporting has stuck with cash-based accounting, however, certain provinces have made (or are in the progress of making) the transition to accrual-based accounting.	The federal level has not made the transition. The Ministry of Finance argues that the majority of federal expenditures are grants, welfare allowance or interest payments, therefore, the transition would not be beneficial. At the federal level, an intention was formulated to introduce the essential elements of accrual-based accounting midway through the federal asset report that is part of the final accounts. The German 'Act on Public Finances' allows free reign for states to apply any of the public accounting approaches, thus certain provinces have already made the transition to accrual-based accounting. Provinces that have not made the transition have to supplement their cash-based statements with certain elements of business sector reporting practice.
Italy	Public sector accounting uses the cash-based approach.	Central and local levels both employ the cash-based approach. There are reform ideas for the transition at both levels. Accrual-based approach to be enforced (integrated) in budgetary planning according to the 'Compendium'.
Portugal	For the most part, the cash-based approach is applied in the public sector, with the exception of state and local government-owned companies.	There has been no transition. A reform project was initiated in 1997 (Official Plan of Public Accounting) which has not been completed to date and has no deadline set. Several ministries and other institutions involved in the project, however, have made the transition. A few institutions apply the modified cash-based approach, but this is of marginal significance.

Romania	Public sector accounting uses an accrual-based approach.	Accrual-based accounting was introduced at the central level in 2007. According to the document referred to in the section on New Zealand, this has been introduced for the whole of the public sector, actually in connection with the EU accession.
Spain	Public sector accounting uses an accrual-based approach. The budgetary statements are accrual-based.	The entire public sector has been using accrual-based accounting since the 1980s. (The reply regarding local governments was unclear, but completed transition can be assumed.) The accounting of state and local government companies was accrual-based to begin with as they follow the practice of the corporate sector.
Sweden	The entire public sector uses accrual-based accounting.	The transition was made at the central level in the early 1990s, and even earlier in the case of local government. The development was implemented by a specialised government body, the Swedish Financial Management Agency.
Slovakia	Public sector accounting uses an accrual-based approach.	The transition was made between 2005 and 2008. The general goal was to ensure the comparability of Slovakian statements with those of EU Member States. They also adopted the IPSAS standards.
Slovenia	Modified cash-based and accrual-based accounting are both present at the same time in the public sector, with the former in dominance.	The transition commenced in 2005, but has not been completed.
Australia	Public sector accounting uses an accrual-based approach.	Full accrual-based reporting at the national (federal) level was achieved by the year 1999/2000. Full-scale introduction took three years. According to the statements of two state audit offices, full transition was already implemented earlier at the state level, in 1992 and 1997. In both cases, transition time was four years.
Canada	The 'central level' employs accrual-based accounting.	Transition in 2002–2003. Before this, the country used a modified cash-based approach.
New Zealand	The whole of the public sector employs accrual-based accounting.	The relevant act was passed in 1989. The transition was first realised in the statement regarding the fiscal year ending on 30 June 1993. New Zealand was one of the first countries to make the transition to accrual-based public accounting.
Russia	The public sector has shifted towards accrual-based accounting. According to the material available online, there is actually a hybrid system in place.	Transition commenced based on a government plan approved in 2004, and the new accrual-based system was up and running in 2009.

Switzerland	All three levels of the public sector (federal, cantonal, local government) use accrual-based accounting only.	Cantons and local governments fully introduced accrual-based accounting at the beginning of the 1980s. In 2008, the implementation of the so-called 'harmonised accounting model' reform project commenced, the goal of which was to introduce advanced accrual-based methods and techniques. In certain places this reform project has already been completed, but is still in progress in others. Accrual-based accounting was fully implemented at the federal level in 2007. The so-called 'New Accounting Model' is based on IPSAS standards. For budgetary planning reasons, the federal level implemented a dual approach: it held on to cash-based budgetary planning, but at the same time also introduced accrual-based budgetary planning. This dual approach is efficiently handled by the integrated reporting and budgetary planning system, covering all levels of public administration in order to avoid data duplication. The implementation of the reform project began in the autumn of 2002 (with the development of the base model) and ended in the spring of 2008 when the first statements after the new model were released. (Transition thus took five years, from 2002 to 2007).
USA	The federal level uses an accrual-based approach. Only certain states have made the transition.	Transition was completed at the federal level in 1997.

*Compiled by:* State Audit Office of Hungary, Department of Quality Management and Methodology

**IMPLEMENTATION SCHEDULE  
2012–2019**

	National Assembly	Government	State Audit Office
Preparatory phase (2012–2013)	1.	Adoption of the National Assembly resolution.	
	2.		Preparation for the auditing of the new system – taking international practices into account – in accordance with the Rules of Organisation and Operation of the State Audit Office.
	3.		Social impact study (improvement of competitiveness, convergence, facilitation of sustainable development, impact on employment, administrative burdens).
	4.		Impact studies regarding budget (improvements and impairments to the balance, budgetary consequences of short-term and long-term benefits and disadvantages).
	5.		Impact study of the IT background of introduction (determination of software and hardware requirements, development opportunities).
Decision-making phase (2014–2015)	1.	Drafting of a new act on public accounting, “Act on accounting to ensure the transparency of financial management in the public sector and the accountability of public funds”.	
	2.	Adoption of required statutory amendments (Act C of 2000 on Accounting, Act CXCV of 2011 on Public Finances, Act CLXXXIX of 2011 on the Local Governments of Hungary, Act CXCVI of 2011 on National Assets).	
	3.		Drafting of the decrees to implement the new act and statutory amendments.



Implementation phase (2016–2017)	1.		Application of the accrual-based system of planning and budget implementation for 2016 in the case of a few central budgetary institutions that will serve as examples (universities, hospitals, government agencies, one ministerial chapter).	
	2.		Application of the accrual-based system during local government planning and local budget implementation for 2017 (for the local governments of one city, one district and one village).	
	3.			Audit of the system by the State Audit Office.
	4.	Approval of Hungary's accrual-based central budget for 2017 by the Parliament (treasury budget, institutional budgets, financial management according to the new system).		
	5.	Approval of the accrual-based budget of local governments for 2018.		
Audit and feedback phase (2018–2019)	1.			Audit of Hungary's 2017 budgetary statement (final accounts document).
	2.			Audit of local governments' 2018 financial statements (local government final accounts).
	3.	Report for the Parliament – with concurrent reporting to the European Union – on experiences from the introduction of the Act passed under the title “Act on accounting to ensure the transparency of financial management in the public sector and the accountability of public funds”.		

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