

# EURO PEAN

**PUBLIC SECTOR ACCOUNTING**

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## **CHAPTER 3**

### **BUDGETS AND BUDGETARY ACCOUNTING**

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#### **Summary**

This chapter describes various approaches to budgeting, which is the traditional essence of public sector accounting. This includes budget planning and budget-linked accounting. The roles and functions of budgets are presented as well as the ideas and practices of both traditional budgets and modern variants such as output- and performance-based budgets.

#### **Keywords**

Budget planning, budgetary accounting, budget models, types of appropriations

## **1. Introduction**

In the public sector, the traditional core area of financial decision-making and management is related to budgeting and budget implementation. Elected representative bodies are the ultimate

decision-makers in a democracy. One elementary part of this role is the budget power of the representative body.

The duty to be publicly accountable is more significant in government than in business financial reporting. As a consequence of the accountability of public administration to citizens and to their representative bodies (parliaments, councils, etc.), the principles of publicity and transparency are important in budgetary and financial reporting. This includes the lawful and regular behaviour of budget entities, compliance with the approved budget and striving to provide as much value as possible with the entrusted collective resources. Instead of the narrower profitability assessment in the private sector, in the public sector, the many-sided performance and value- for-money assessments are crucial.

Public sector budget structures and accounting conventions have been shaped by national practices. It is just lately that harmonisation pressures have emerged. Public sector accounting (PSA) is nowadays shaped more than ever before by international accounting standards, in addition to domestically developed accounting conventions. However, this international standardisation is more targeted to general-purpose financial statements than to budgets, and even this phenomenon is at an early stage in many countries.

In this Chapter 3 we first explain in Section 2 the budgetary accounting as one part of PSA. Section 3 is devoted to functions and principles of budgets such as the publicity and transparency principle. This is followed with a description of traditional annual budgets and modern variants such as performance-based budgets, and budget appropriations in Section 4 and budget-linked budgetary accounting in Section 5. The last section gives a conclusion.

## **2. Budgetary accounting in the family of PSA systems**

The **budgetary accounting** approach emerges from the agreed budget in the public sector. Bookkeeping must follow the logic and

structure of the budget regarding the allocation of income and expenditure to the correct budget codes. If the budget is cash-based, then the follow-up bookkeeping must also be cash-based. If the budget is accrual-based, then the follow-up bookkeeping must also be accrual-based.

Cash-based budgeting and accounting can achieve money control purposes in the public sector. Accrual budgeting means spending measured on a cost basis rather than on a cash basis.<sup>1</sup> Accrual budgeting and accrual accounting also serve the need for management information with their steering and control functions.

### **Link between budgeting and accounting**

The chart of accounts for budgetary accounting is derived from the budget structure. Budget entities may establish more detailed accounts as subaccounts to those accounts derived from the budget for management accounting and intra-organisational steering and control purposes.

If budgetary accounting and financial accounting are on the same basis, these two accounting systems can be merged into one serving both budget reporting and financial statement reporting purposes. For instance, if the budget is on an accrual basis, the entries made during the year into the ledger make up a double-entry system that generates both the budget outturn reports (budget statements) and accrual based financial statements.

## **3. The functions and principles of budgets**

Budgets in the public sector have several purposes. Annual legal budgets are normally supplemented with medium- to long-term

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<sup>1</sup> Schick (2007), p. 118.

strategic multi-year plans. These are typically less legally binding, but more proactive and forward-thinking than annual budgets. They contain policy decisions regarding financing priorities, service provision priorities, etc.

Annual budget plans involve short-term planning by nature: they are financing and resource allocation tools for public sector entities. Available financing and resources are allocated to each department, unit and activity inside the organisation. Budgets contain not only allowed amounts of expenditure, but often also the amount and maybe also the quality standards of the services that are to be provided.

Annual budgets have a financial control function because the approved budget is used as a control tool during the budget year. Appropriations are authorisations to use money according to budget rules, and unauthorised use of resources should be prevented with budget control. Control should guarantee the compliance of activities and spending using the budget, budget laws, regulations and rules. In addition, counterproductive and wasteful use may be prevented with proper budget control. Auditors have the responsibility to report on any essential breaches that they may identify.

The reporting function is fulfilled by publishing budget plans, but also ex-post budget reports (budget outturn statements). Reporting may include both interim reports and final reports. Actual figures are compared to both the first approved and the final adjusted budget figures. Published final budget statements should be audited by professional and independent auditors.

Budgets are also a means of empowerment and delegation inside each public sector organisation. Along with the allocation of resources, the budget also aligns with the division of tasks to responsible budget entities inside the organisation. Furthermore, it is a communication device inside the organisation, and the budget and budget processes deliver information through the organisation. Budgeting also has behavioural aspects and effects on the budget entity's performance.

It serves at best as a motivation tool for personnel: for instance, it may reward good performance. It has an impact on budget entity managers' and all employees' motivation and behaviour.<sup>2</sup>

### **Accountability and transparency principles**

International Public Sector Accounting Standard (IPSAS) 24 does not require budgets to be published. From the democracy, accountability and transparency point of view, it is self-evident that public sector budgets should be published. Published budgets, budget out-turn reports and the associated audit reports are key elements of public sector accountability.

Budgets, budget out-turn statements and audit reports of budget compliance and performance should be easily accessible to any addressee via up-to-date kept web pages. A very important factor here is that governments have established professional and independent public audit institutions.

In addition, one method of enhanced budget accountability and responsiveness to people living in the jurisdiction is to create public involvement in budgetary process through participatory budgeting practices.<sup>3</sup>

### **Other budget principles**

In addition to publicity and transparency, some other important budget principles are explained below.<sup>4</sup>

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<sup>2</sup> Coombs and Jenkins (2002), pp. 83-86; Bergmann (2009), pp. 44-48; Prowle (2010), pp. 189-191.

<sup>3</sup> Yilmaz and Beris 2008, pp. 16-41.

<sup>4</sup> Jones (1996), pp. 56-59; Coombs and Jenkins (2002); PSC (2004); Prowle (2010).

Budget preparers have the responsibility to anticipate and estimate all expenditure and revenue for the budget period. The completeness principle in budgeting means that all expenditures and revenues (gross) should be included and not be offset or netted off against each other.

Extra budgetary funds not included in the approved budget should be avoided. Furthermore, use of “off-budget” fiscal mechanisms should be very constrained. We may refer here to the OECD (Organisation for Economic Cooperation and Development) recommendation (2015):

“Governments should include and explain public programs that are funded through non-traditional means – e.g. PPPs – in the context of the budget documentation, even where (for accounting reasons) they may not directly affect the public finances within the time frame of the budget document.”<sup>5</sup>

PPP refers to Public-Private Partnership. This is a cooperative arrangement between at least one public and private sector actor typically of a long-term nature.<sup>6</sup> These PPP arrangements should be transparently explained in reporting.

The prudence principle in budget planning means deliberate avoidance of exaggerating revenues or understating expenses. However, this may be a disputed principle if its practice goes against the principle of unbiased information, which requires that preparers must not adjust figures to achieve certain predetermined results. The reasonable balance principle means that budgets should not lead to unsustainable indebtedness. We may also talk about a formal

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<sup>5</sup> OECD (2015).

<sup>6</sup> Jones (1996), pp. 56-59; Coombs and Jenkins (2002); PSC (2004); Khan (2013); Prowle (2010); IPSAS 24.

budget financial balance rule that means that all budget expenditure must have corresponding budget financing. Public sector entities must plan budgets so that expenditures can be paid from incomes, loan income included. If their own revenues are not enough, public sector entities must borrow money (or use donations) to meet their obligations.

#### **4. Traditional annual budgets and modern variants**

Traditionally, local government budgets were split into recurrent budgets and capital budgets. In central government, it has been more usual to have only one comprehensive budget without splitting it.

Capital budgets include investments that the government is planning

- their timescale is often more than one year (for instance, infrastructure projects such as constructing highways, railways, tunnels, airports, harbours, universities, hospitals and so on).

Modern budgeting has been developed from detailed and strictly limited use of money to lump-sum budgets, one-line item allocations and the delegation of budgetary power to separate budget entities. This leaves more flexibility for the managers of budget entities to manage their entities

- when connected to performance-related rewards, this should lead to appropriate and productive behaviour in the budget entities.

Furthermore, one-line item budgets have often been connected to activity performance goals. This means that the counterpart to the added decision-making powers regarding budget entities operations is the added responsibility to produce outputs of defined quality and with desirable impacts on society.

Strategy-linked budgets are drawn up so that the annual budget functions as a tool to implement longer-term strategic goals. A new



budget strand is the phenomenon-based budgeting, in which the budget decision-makers allocate earmarked resources, for instance, to carbon neutrality actions mitigating climate change, or to actions enhancing gender equality or the position of children in the budget allocation.

### **Budget appropriations**

Decision rules connected to the budget are important. One vital aspect is how the budget money usage is authorised. An appropriation is an authorisation granted by a legislative body to allocate funds for purposes specified by the legislature or similar authority (IPSAS 24.7, definitions).

The timing basis of appropriations can be divided to three classes:

- 1) cash-based appropriations;
- 2) commitment-based appropriations; and
- 3) accrual-based appropriations.

Furthermore, another trait, the particularity of appropriations, is connected to how detailed or less detailed the appropriations are. Budget appropriations may be strictly detailed line item appropriations or, at the other end of the continuum, one-line (lump-sum) general appropriations.

Virement rules are a process of controlling the transfer of funds from one budget head to another. Virement rules may be stricter or more flexible from the point of view of the budget entities.

In addition, budget appropriations may be either fixed (restricted to the current year) or transferable (some ability to carry-forward part of the funds to the next year). The possibility to transfer usage of unspent appropriations to the next year is one factor that demotivates waste of public money before the end of the budget year.

<b>Budget year:</b>	<b>X</b>	<b>X+1</b>
<b>Appropriation transactions</b>	<b>€</b>	<b>€</b>
Appropriation – transferable	1,000	0
Spent part of the appropriation	700	
Unspent and transferred part	300	
Spending of the transferred part		300
<b>Note:</b> A two-year transferable appropriation for the whole expenditure is included in the budget for Year X (usable during X or X+1 years). €300 is not included in the budget for Year X+1, but is transferred from the appropriation for Year X.		

Table 3.1: Wholly transferable appropriations - example

If the government is using the carry-forward option, this prohibits waste in the end of the budget year. However, it may lead to excessive liquidity because all appropriations must have full cover on the financing side (the formal balancing requirement).

Another at least equally important factor is the choice between gross and net appropriations. Traditionally, public sector entities have had gross budgets. Nowadays, it is quite common for budget entities to have net appropriations. Net appropriations have both a spending portion and a revenue portion. They encourage budget entities to be active and creative in generating their own additional revenues.<sup>7</sup>

If net budgeted revenues are more than estimated in the budget, the entity may by its own decision increase its expenditure, as long as it does not exceed the net appropriation. In our example in Table 3.2, the net expenditure is fixed at 600 €.

Not all government revenues are suitable for net budgeting: tax incomes should not be earmarked for the tax agency's own

<sup>7</sup> Khan (2013), pp. 342-345, Brusca et al. (2015), OECD (2017), p. 19.

spending, neither should fines be earmarked for a police station's own spending.

Net budgeting is an incentive to innovate on the revenue side because revenues earned can be kept inside the budget entity for incurred expenditures as long as the net sum approved in the budget is not exceeded. There is also a risk to the net budget entity that the revenues fall below the estimate used in the approved budget. In that case, the budget entity will be required to reduce its expenditures to achieve the agreed level of net expenditure.

<b>A) Gross budget entity</b>	<b>Budget €</b>	<b>Actual €</b>
Expenditure	1,000	1,000
Income	400	500
<b>B) Net budget entity</b>	<b>Budget</b>	<b>Actual</b>
Expenditure	1,000	1,100
Income	400	500
Difference/ Net expenditure (=net appropriation)	600	600

Table 3.2: Gross versus net budgeting – an example

Innovativeness and improvements on the revenue side may thus be encouraged in budget entities when additional revenues earned are not lost to the Treasury or central financing office.

Traditionally public sector budgets have been prepared on a cash or modified cash basis. For these bases, the focus is on the money transfers and money control. Table 3.3 gives an example of a cash-based budget. The approved budgets allow cash outlays of 600 € during the first budget year and 400 € during the next budget year.

	<b>Budget</b>			
Cash basis	Budget year	X	X+1	Total
	Cash-based expenditure	600	400	1,000
	Actual payments	600	400	1,000
	Difference	0	0	0

Table 3.3: A cash-based budget – an example

There is a misunderstanding that governments have been using only a pure cash basis, while many governments have in reality been using not a pure but a modified cash basis. The short-term commitment basis in budgeting is an example of a modified cash basis. In this case, if goods or services are planned to be received in budget Year X, they may be paid in the first few months in Year X+1 and still belong to the budget Year X expenditure.

Budget planning should also take into consideration contracts, including goods or services that are received in later budget years that result in equivalent longer-term payment commitment. These payments should be included in the approved budgets for later years unless the government is using transferable appropriations that extend the usage of such appropriations beyond the current budget year.

	Budget year	X €	X+1 €	Total €
Commitment basis	Appropriation	700	300	1,000
	Account entries	700	300	1,000
	Spending margin	0	0	0
Note	Accounting for budget follow-up: 600 € was paid during Year X, and the budget entity has an obligation to pay a vendor 100 €. Accounts payable, credited with 100 € (expenses 700 €, bank account 600 € and accounts payables 100 €).			

Table 3.4: Commitment-based budget – an example

## Accrual budgeting

What is accrual budgeting? According to Khan's definition:

“Accrual budgeting means application of the accrual concept to the preparation and presentation of the budget. It entails planning that includes revenues and expenses in the budget of the year in which the underlying economic events are expected to occur, not necessarily in the year in which the related cash is expected to be received or paid.”<sup>8</sup>

Accrual budgeting requires the application of generally accepted accounting principles in the preparation of the budget. However, accrual is not an overriding concept in accrual budgeting. According to Khan, for instance, estimating budgeted tax revenue on a long-term accrual basis (predicting future accruing tax incomes caused by taxable realised events in the budget year) could be subject to strong uncertainty (for instance, because of delayed taxation decisions, uncollectable taxes, etc.). Therefore, the estimate may be considered unreliable. In such a case, the accrual-based estimate may have to be changed to a measure that is closer to a cash-based estimate.

The reliability concept may override the accrual concept in PSA and budgeting. The accrual budget may also recognise cash implications of budgetary decisions. For instance, in Britain departments have both an accrual based appropriation and a cash limit. The accrual budget structure implies the use of both prospective accrual operating statements and cash flow statements. The accrual budget may also contain a prospective balance sheet with projected assets, liabilities and net equity .

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<sup>8</sup> Khan (2013), p. 340.

In practice, accrual budgeting does not entail a systematic use of accrual appropriations in OECD countries. Many countries use a mix of accrual and cash appropriations. Examples of items that may not be included in budgetary appropriations include the following:

- Provisions;
- Depreciations, inventory value changes;
- Losses arising from changes in market values of assets and liabilities.

Examples of budgetary appropriations/revenue estimates kept on a cash basis in (modified) accrual budgets include:

- Repayment of debts – cash basis;
- Tax revenues – cash basis.

Capital expenditures may require both accrual- and cash-based approval and legal control. Furthermore, accrual budgets may be combined with commitment appropriations – a government can have an accrual budget but exercise legislative control at the commitment stage. Usually, in practice, governments exercise controls over both cash items and accrual items.<sup>9</sup>

Proponents of accrual budgeting argue that it provides incentives to better manage capital assets, especially the acquisition, disposal and maintenance of fixed assets.

Planning and recording only cash movements may give too late information about the impacts of policy decisions. Accrual budgeting facilitates the better planning of investments and maintenance and also provides incentives for public sector or-

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<sup>9</sup> Khan (2013), pp. 342-345; Brusca et al. (2015); OECD (2017), p. 19.

ganisations to dispose of assets that are unnecessary. It provides (and compels the planning of) more fiscal indicators than cash budgeting.<sup>10</sup>

However, presenting accrual budget information in a user-friendly manner is challenging. Scope for manipulation and creative accounting is increased because adjustments in discount rates, changing ways of capitalising expenses and revaluing assets and so on can be manipulated. Personnel, Information and Communication Technology capacity requirements may hinder accrual budgeting – it requires skilled staff and sophisticated information technology facilities.

New public financial management (NPFM) generally favours and promotes accrual-based budgeting. However, in practice, modified accrual-based budgeting is more realistic and popular than full accrual-based budgets. One reason for this is that full accrual-based budgeting requires high maturity in a country's accounting resources, information systems and accounting skills. In many countries, not all the preconditions of fully-fledged accrual basis are available in practice.

According to Schick, accrual budgeting is not ready for widespread application as a budget decision rule because of its complexity. However, for most countries it suffices rather as an analytical tool than a decision rule in budgeting. Without appropriate discretion, managers are likely to regard accruals as technical entries that have no bearing on the resources available for expenditures.<sup>11</sup>

A full accrual-based government budget structure is illustrated in Figure 3.1 below. After the budget year, the annual actual figures are reported in budget statements. Budget statements con-

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<sup>10</sup> Based on Khan (2013), pp. 349-358.

<sup>11</sup> Schick (2007), pp. 131, 137-138.

tain comparisons between the approved budget plans and actual realised budget figures.

This figure shows some important influences from one part of a budget plan to another using the arrows. For instance, if the public sector entity invests in fixed assets (investment budget), this has ramifications for the operational recurrent budget because the asset in use typically creates depreciation expenses. It also has ramifications for the planned balance sheet and naturally for the cash flows during the budget period.

The annual margin before depreciations is the starting item in the cash flow budget. The net cash flow after operations and investments is an important balance ratio: if it is negative, it typically means that the local government must raise new debts. Net borrowing is shown in the funding cash flow section. After several adjustments that eliminate all non-cash items from the figures, the cash flow budget ends up showing the change in the liquid assets of the local government. If the local government has a buffer in its cash reserves, it may use also liquid assets to finance net investments.

A surplus or deficit in the income statement budget will show the anticipated influence on the net assets. Typically, a local government should aim to have an annual margin that covers its depreciations. If the result after depreciation is positive, the local government may earmark provisions for needed new investments or alternatively let the surplus accrue to the balance sheet. However, local governments should not accrue surpluses continuously because this would be a sign of collecting too much tax from local tax-payers.



**Example of a full accrual-based local government budget structure**

Recurrent budget impacts: maintenance costs, depreciations, etc.

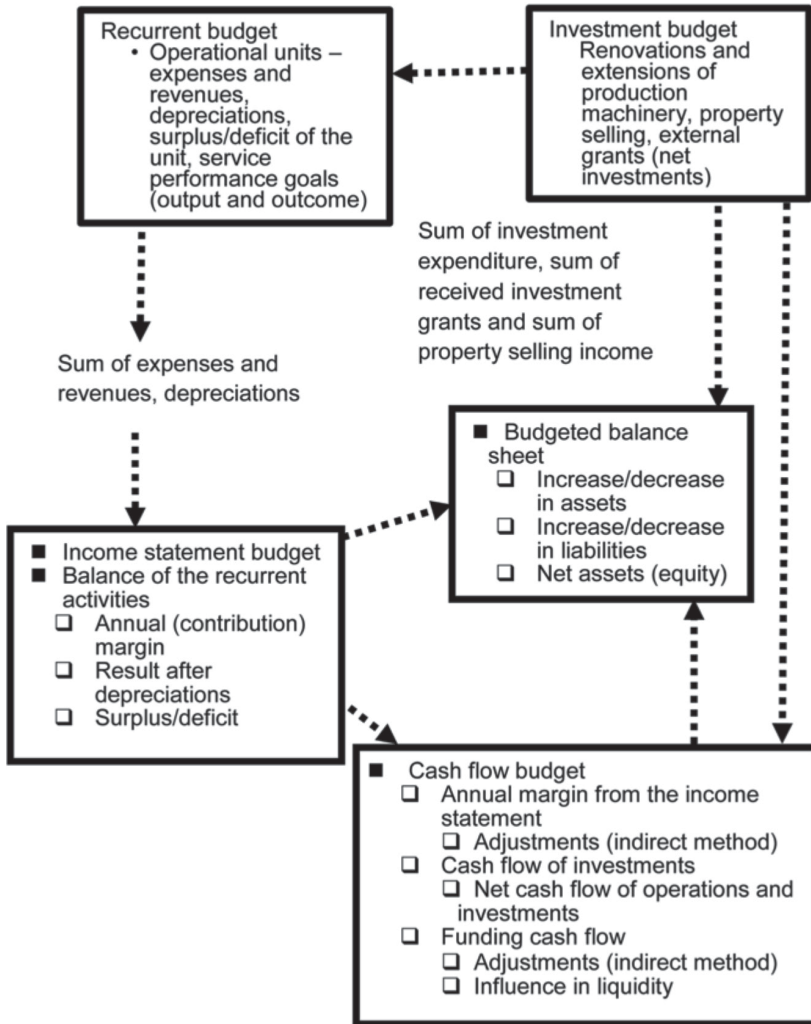


Figure 3.1: A full accrual-based budget with separate partial budget plans

In a fully-fledged accrual budget, the depreciation costs of fixed assets are included as appropriations. In addition, changes in the

inventory and other accruals must be recognised in the budget according to the rules of business accounting.

Table 3.5 gives, for the reason of simplicity, an example of only depreciation costs in an accrual-based budget. Usually, depreciation costs are not an appropriation, but rather an informative element in the budget. However, it affects the accrual financial performance and the balance sheet. Budgets that are on a cash basis or commitment basis do not have depreciation costs in the budget, or such allocation items as changes of inventory during the accounting period.

	<b>Budget items</b>	<b>Budget year</b>	<b>X</b> €	<b>X+1</b> €	<b>Total</b> €
Accrual basis	Operation (recurrent) budget and income statement budget				
Item example:	Depreciation costs		0	50	50
Note	The investment is planned in the investment budget. Straight-line depreciations 100 per year, the construction is taken into use 1.7.X+1 (so only half a year of depreciation in this year).				

Table 3.5: An accrual-based budget – an example of budgeted depreciation costs

The allocation of expenditures, expenses, incomes and revenues to the budget should be defined clearly. Appropriate financial management must have a systematic and consistent manner for how to budget; it cannot be done in an undefined way. Legally binding appropriations must be clearly defined so that they can be distinguished from other non-binding budget information. Budget decision-makers have the right to know and understand how the budget information and authorisations have been allocated to the annual budgets.

## Performance-based budgeting

The so-called Planning – Programming – Budgeting System (PPBS) was invented in the 1960s based on the ideal rational planning and decision- making model that flows from overall goals to programmes and annual budgets all in perfect congruence with each other. This is a model that is closely related to the idea of strategy-linked budgeting.

Later the emphasis was laid on budgeting for results and for outcomes or performance-based budgeting. Input-based budgets have been transformed more or less into output- and outcome-based budgets (OBB) or performance-based budgets (PBB).

<b>Activity goals 2022 Strategic</b>	<b>Means of implementation</b>	<b>Indicators</b>
Promote care and welfare of the elderly Preventive treatment of the elderly A customer control system based on multi-agency service plans for those customers in need of personalized services.	Group-based services for old people increased, service group sizes decreased, recreational services increased in cooperation with non-profit organizations and volunteer operators.	Customers and customer visits in close daytime services have increased at least with 20 % compared to the level of 2020. Weekly cultural and physical exercised offered included in close daytime services for old people. A Service Barometer of customers satisfaction is collected and published at regular intervals.
Digitization of service supply	Digitalized service supply targeted to home care, sheltered nursing homes, family carers and rehabilitation service groups.	Customers of Remote Service of VideoVisit-increase during the year with 60 % compared to the year 2020. Usage of Remote Service will enlarge to customers using both home care and rehabilitation services, at least 10 customers participate yearly to remote rehabilitation.
Involvement of old people	Involvement of old people with the personal budget system.	The customers of the personal budget system (Hebu) during the first year of installment 2022 are at least three. Hebu-customers get multi-agency service, and their customer satisfaction is 4 in the measuring scale from 1 to 5.

Old people care 2022 (statistical data)	Number
Home care customers	175
Home care visits	77,340
Customers of support services (meal service, etc.)	260
Caring for close relatives, number of persons in dependent care	70
Residents in sheltered housing (outsourcing service)	90
Old people's home, bed days in long-term care	24,820

Table 3.6: Example of a performance budget (Finnish municipality of Lempäälä: Annual budget 2022, Old peoples' care service section of the annual budget).

The real-life example in Table 3.6 is from Finland. In Finland, output targets included in the approved budget are binding. Appropriations must be dimensioned in the original budget so that the output targets can be achieved. If it seems during the budget year that they cannot be achieved, either the goals, the appropriations or both must be changed by council decisions so that they are again compatible (the output targets must be achieved with the funding) in the final and executed budget.<sup>12</sup>

Generally, it is more difficult to calculate from qualitative outcome goals to costs than from quantitative output (product) goals to costs. Cost-effectiveness is in principle the ultimate key ratio in public sector activities, meaning that the budget money should be allocated and used in the best possible manner in providing outputs with desirable outcomes related to citizen needs and agreed activity goals. Economy alone is not a comprehensive yardstick, because it measures costs related to output – for instance, economy as euros/patient care operation – but not

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<sup>12</sup> In Finland, output goals decided in the council are as binding budget rules as financial budget rules. Section 110 § (4) of the Local Government Act of 2015: “The budget shall include the appropriations and revenue estimates required to fulfil the duties and meet the operating targets, and an indication of how the financing requirement will be covered. The appropriations and the revenue estimates may be stated in gross or net terms. Budgets and financial plans shall have a section covering operational finances and an income statement, and a section on investment and financing.”

effectiveness as euros/cured patient (outcome). In practice, it is many times easier to measure and report the cost per output figures than cost-effectiveness figures containing quality and impact assessments.

Budget reforms often go hand-in-hand with lump-sum budgeting, which means that budget authorisations do not go to detailed single line items, but rather contain total revenues, total expenses and investments, or even only a total result figure. Budget entity managers have greater freedom, as long as they do not exceed the gross amounts and reach their performance targets.

These reform features mean that budget entity managers should have more flexibility and power to operate, for instance, regarding personnel policies, recruiting, outsourcing, etc. On the other hand, responsibilities regarding activity performance have increased in terms of output and outcomes with budget resources.

Budget reforms in the above-described style may have not only efficiency ramifications, but also problematic democracy and personal effects, often linked to reducing the powers of trade unions and general public sector staff. So such reforms may not increase the democratic culture of public sector entities, especially when they are linked to senior managers being paid what can be seen as grossly inflated salaries.

In addition, if the government entity managers lack operational decision-making power and the entity lacks reliable and sufficient data on outputs and outcomes, performance-based budgeting is not in practice a realistic budget model.<sup>13</sup>

### **Other planning and reporting modes**

If governments only prepared annual budgets, the planning horizon would be incomplete. That is why governments also make and

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<sup>13</sup> Schick (2007).

publish separate strategic plans, multi-year budgets, medium-term spending frameworks and long-term fiscal sustainability reports. It is important to align operative budget plans with government strategic plans. However, when a government has or is planning to have a wide array of plans and reports, it is often in practice so that they turn out to be more or less disconnected from one another, giving rise to confusion and reform fatigue.<sup>14</sup> The idea of purposive strategy-linked budgeting tries to reduce this risk.

From the point of view of the budget decision-maker, it would be ideal for them to be supplied not only with consistent information on yearly costs but also the total life-cycle costs of long-term liabilities caused by contracts, commitments and investments to which the government is planning to bind itself. If this information is not directly in the budget figures, it could be in budget overview text or in budget supplements. Furthermore, life-cycle calculations of significant investments or complicated PPP arrangements may be included and transparently explained in other plans and documents. In this case, the budget documents should make reference to these other sources of information.

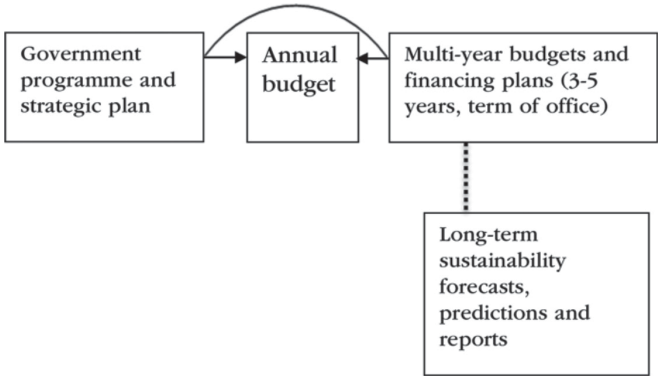


Figure 3.2: Government planning and reporting system

<sup>14</sup> Schick (2007), p. 121.

## **5. Budget-linked budgetary accounting**

As already mentioned, the link between budgeting and accounting forms the basic feature of governmental accounting. Allocation of expenses, revenues and capital expenditures into the budget may follow a cash basis, modified cash basis, commitments basis or accrual basis. Because budget accounting (budget bookkeeping) is budget-linked, the recognition principles of budgetary accounting must correspond to the allocation principles of the associated budgets. This should help to secure proper control during budget execution.

Financial management and budget surveillance require an account classification for budgetary accounting to be created. The chart of budgetary accounts should be derived from the legally binding budget. The main budgetary accounts may be further divided into subaccounts according into different management and reporting needs inside the organisation.

### **Parallel accounting systems**

Some countries have established accrual-based financial accounting besides the traditional budgetary accounting that has remained mainly on a modified cash basis. Recording financial information in both financial accounts and budgetary accounts may happen simultaneously inside one combined information system. Information technologies with sophisticated software allow the integration of these two subsystems. Alternatively, budget entities may carry out reconciliations between the accrual financial accounting and budgetary accounting systems.<sup>15</sup>

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<sup>15</sup> Brusca et al. (2015).

Below is what the IPSAS 24 requires:

“47. The actual amounts presented on a comparable basis to the budget in accordance with paragraph 31 shall, where the financial statements and the budget are not prepared on a comparable basis, be reconciled to the following actual amounts presented in the financial statements, identifying separately any basis, timing and entity differences:

(a) If the accrual basis is adopted for the budget, total revenues, total expenses and net cash flows from operating activities, investing activities and financing activities; or

(b) If a basis other than the accrual basis is adopted for the budget, net cash flows from operating activities, investing activities and financing activities.

The reconciliation shall be disclosed on the face of the statement of comparison of budget and actual amounts or in the notes to the financial statements.”<sup>16</sup>

A reconciliation between the budgetary results and the financial statements is provided, for instance, in the OECD financial statements.<sup>17</sup> The financial statements of the OECD are prepared on an accrual basis following the IPSAS. The OECD budget is prepared on a commitment basis for expenditures and an accrual basis for revenues. The most significant of the IPSAS adjustments relates to changes in employee- defined benefit liabilities. Another important difference lies in the treatment of investments.

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<sup>16</sup> IPSAS 24 Presentation of budget information in financial statements: Reconciliation of Actual Amounts on a Comparable Basis and Actual Amounts in the Financial Statements, paragraph 47.

<sup>17</sup> The Financial Statements of the Organisation for Economic Co-operation and Development as at 31 December 2020.



## 6. Conclusion

In the public sector, approved and authoritative budgets are the core area of PSA and accountability. The budget-based approach emerges from the authoritative budget and its execution, management and control.

The budget needs budgetary-linked accounting. This accounting must follow the logic of the budget, especially regarding the allocation of incomes and expenditures to the budget (budget codes). If the budget is cash-based, the associated bookkeeping must also be cash-based. If the budget is accrual-based, the bookkeeping must also be accrual-based.

At the same time, it must be understood that general accrual-based financial accounting and reporting may or may not be merged with the budgetary accounting and reporting. If they are not merged, a government will have to maintain a dual accounting system for different purposes with different reporting modes. In some countries, governments may account for and publish only budget-based statements.

It is crucial to note that public sector performance is only partly captured with financial figures and financial performance. That is why non-financial activity performance, accounting of outputs and outcomes are important for public accountability. These matters are planned and reported using performance-based budget systems.

With New Public Financial Management, a movement towards accrual-based budgets and performance-based budget has evolved. However, they face many practical obstacles that hinder their proper functioning and hence their ability to reach their ultimate goals of better information used in decision-making and better performance than before. Performance-based budgeting is easy to explain but difficult to implement on a strict basis (as a budget decision rule). Accrual-based budgeting is difficult to explain and even more difficult to implement.

Performance-based budgeting and accrual budgeting are very demanding regarding data quality and reliability. Their success is also dependent on politicians' and managers' willingness and ability to use the additional information provided by the budgeting and accounting systems.

The Table 3.7 summarizes the linkages between budget types, budget appropriations and accounting.

<b>Budget type dimensions</b>	<b>Budget appropriations</b>	<b>Type of budget-linked accounting</b>
<b>Timing basis</b>		
Cash-based	Cash-based	Cash accounting
Commitment-based	Short-term accrual-based	Weak modified accrual accounting
Accrual-based	Modified accrual-based	Modified accrual accounting
<b>Fixing of budget items (input-output dimension)</b>		
Strategy-based	Appropriations must be itemized to means in a way that the strategic goals can be achieved with the budget.	Chart of accounts and cost centers organized in a way that enable appropriate follow-up.
Phenomenon-based (subcategory of a strategy-based budget)	Appropriations must be itemized across sectors to meet the claims, for instance of combating climate change and proceeding to carbon neutrality.	Chart of accounts and cost centers organized in a way that enable appropriate follow-up.
Performance-based (output-based)	Appropriations must be dimensioned in the budget so that the output targets can be achieved.	Chart of accounts and cost centers organized in a way that enable appropriate follow-up.
Resource-based (input-based)	Appropriations are fixed to expenditure categories (factors of production)	Chart of accounts organized according to expenditure (revenue) categories

Table 3.7: Linkages between budget types, budget appropriations and accounting.

Lastly, we want to stress that it is necessary for governments to have reliable auditing institutions. Here we may refer to Schick's conclusions:

“For performance budgeting and accrual budgeting to take root, it is essential that governments have formal procedures for reviewing reported results, including accepted standards for measuring outputs and outcomes and for reporting costs and liabilities.”<sup>18</sup>

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<sup>18</sup> Schick (2007), p. 120.

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## **Additional readings**

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## **Discussion topics**

- What would you prefer as the best choice on the continuum from cash basis to accruals basis in public sector budgeting and why?
- Find some examples of different budget types from the web pages of local government budgets or state/central government budgets in your country or internationally and discuss how informative they are.

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