

## Fund Accounting For Federal Government: Is It Still Relevant?

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### Abstract

In the early days, the main purpose of public sector accounting was to demonstrate the legal and contractual provision of the government. It acts as the trustee to protect and manage public moneys and discharge accountability. Fund Accounting is used and defined as the rational resource to serve as a reliable control technique for those purposes. However, developments in governmental activities in recent years have raised concerns over whether the cash basis of accounting is sufficient and whether fund accounting is still relevant for present government accounting and financial reporting in the accrual accounting environment. Thus, the main objective of this paper is to provide an extensive review of literature for current developments in governmental fund accounting. The findings of this study, through extensive literature review, shall contribute to the empirical study to be conducted in order to support the revised fund accounting model for the Federal Government in Malaysia. This is done to achieve the control mechanisms of resource management and performance evaluation.

### Keywords:

Government Funds, Fund Accounting, Accrual Accounting, Federal Government, Malaysia

### Introduction

Traditionally, Government in United States of America (USA) uses input-based budgeting systems and cash-based accounting systems for accounting and financial reporting with the aim to protect and manage public money and discharge accountability. However, these systems do not provide the information that is necessary for a government to operate efficiently and effectively. Therefore, a growing number of countries, such as Australia, New Zealand, and the United Kingdom, are already shifting, or are planning to shift, from input based to outcome based budgeting system and from cash-based to some form of accrual accounting system.

The main purpose of public sector accounting in the early days was to demonstrate legal and contractual provisions of the Federal Government that is chosen by its people to carry out the duties of managing the country according to the Federal Constitution (Rayegan, Parveizi, Nazari, and Emami, 2012.) Fund accounting is used and defined as the rational response to serve as a reliable control technique for that purpose. However, due to the growing establishment of business types of government agencies, the need for the adoption of accrual accounting in the public sector is required for measuring performance and providing information on the operating results (Freeman & Shoulders, 1999).

Among the numerous changes in government accounting in recent years is the emergence of accrual basis of accounting based on the International Public Sector Accounting Standards (IPSAS). Financial statements prepared on the accrual basis inform users of past transactions involving the payment and receipt of cash. They also show obligations to pay cash in the future and of resources that represent cash to be received in the future (Chan, 2003).

According to the International Public Sector Accounting Standards Board (IPSAS), accrual based financial reporting by the public sector provides the following advantages (Chan, 2003):

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

In addition, the purposes of government accounting and the nature of public goods and tax financing also give rise to differences of public sector accounting with commercial accounting (Chan, 2003). According to Chan, government accounting has three purposes listed as follows:

1. Its basic purpose is to safeguard the public treasury by preventing and detecting corruption and graft.
2. The intermediate purpose of government accounting is to facilitate sound financial management which includes activities such as collecting taxes and other revenues, paying bills, borrowing and repaying debts. In a well run government, these activities

are budgeted and their execution through authorised transactions are recorded in the financial accounting system.

3. The advanced purpose of government accounting is to help government discharge its public accountability.

In order to serve the three identified purposes and to prepare financial statements that comply with the generally accepted accounting principles (GAAPs), fund accounting was used to account for government type activities. Fund Accounting is a self-contained accounting entity with its own assets, liabilities, revenues, expenditures and fund balance. Fund Accounting is the financial accounting techniques adopted and reported in terms of funds in the operating statements and balance sheet of public sector organizations.

The objectives of fund accounting are to show the financial condition and its changes in the organization, the results of operations of the organization and its compliance with legal restrictions. According to Razek and Hosch (1995), the practical effects of adopting fund accounting depend upon the extent to which different funds are utilized and the form and extent to which the individual fund accounts are consolidated in the final accounts. Fund accounting explicitly requires the political, economic and legal differences that exist between the services provided, and the activities carried on, within public sector organizations.

Based on previous articles reviewed by Ingram (1986), the following are some arguments against fund accounting:

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

Procedures and practices of accounting and reporting in Malaysia are governed by a set of rules. Among the regulations governing the accounting procedures for the government are Federal Constitutions (Revised 1972), the Financial Procedures Act, 1957 (Revised 1972) and the Audit Act 1957 (Revised 1972). These Acts provide limited and general provisions on financial, budgeting, accounting and auditing aspects of the government. The Federal Constitution, for example, sets out the rules regarding financial provisions. Specific requirements concerning the control and management of public finance as well as the financial and accounting procedures are provided by the Financial Procedure Act 1957.

Further guidelines and requirements concerning accounting procedures are issued by the Treasury through instructions and circulars (Zakiah Salleh, 2007).

For the Malaysian Government, all government revenues and monies received have to be accounted for into a fund, known as the Consolidated Fund. Article 97(1) of the Federal Constitution states that all revenues and monies howsoever raised or received by the Federation shall, subject to the provisions of this Constitution and of Federal law, be paid into and form one fund. This fund is known as the Federal Consolidated Fund. Article 97(2) states that all revenues and moneys howsoever raised or received by a State shall, subject to Clause (3) be paid into and form one fund. This fund is to be known as the Consolidated Fund of that State. Section 7 of the Financial Procedure Act, 1957 further explains that there are three separate accounts maintained by the financial authority in respect of the Consolidated Fund. These are the Consolidated Revenue, Trust and Loan Account. Government Accounting Standard (GAS) Nos 3, 4 & 5 set up by the Accountant General Department in Malaysia also explains the three types of Consolidated Fund in compliance with Federal and State Government in preparing their Public Accounts. Public sector organizations are producing financial statements as regulated under Section 16 (1) of the Financial Procedure Act 1957 (Revised 1972). This is known as Public Accounts. The Federal Public Accounts contain the Balance Sheet, Statement of Cash Receipts and Payments, Statement of Memorandum Accounts and notes to the Accounts. The Balance Sheet comprises of a Statement of Cash, Statement of Investments, the Statement of Consolidated Revenue Account, the Statement of Consolidated Loan Account and the Statement of Consolidated Trust Account.

The Federal and State Governments in Malaysia have adopted a modified cash basis of accounting in the preparation of the annual financial statements. Expenditures incurred in the prior financial year but not yet paid will be paid in January of the new financial year and are reported as expenses for the prior financial year. As for Local Government, Statutory Bodies and Government Linked Companies in Malaysia, they have adopted an accrual basis of accounting in preparation of the general purpose of financial statements.

For Federal Government in Malaysia, the planned adoption of accrual accounting in 2015 shall provide a broader measure of the burden of government financial commitments than does cash accounting. Full disclosure of liabilities and contingent liabilities is equally necessary in assessing the true economic implications of public sector financial management (Accountants Today, 2011).

Given that the emphasis of accrual accounting is more reliable than cash accounting in measuring financial performance, this study thus attempts to evaluate the relevance of the concept of fund accounting adopted by the Federal Government in Malaysia for its transformation process toward accrual basis of accounting. The main objective of this paper

is to provide extensive review of literature for the current developments in governmental fund accounting. It is hoped that this study can provide literature evidence on the relevance of fund accounting which can still be adopted by the Federal Government in Malaysia during its transformation process toward an accrual basis of government accounting and financial reporting. The findings of this study through extensive literature review shall contribute to the empirical study to be conducted. This is to support the revised fund accounting model for the Federal Government in Malaysia as it moves towards its accrual accounting implementation for the control mechanisms of resources management and performance evaluation.

### **Literature Review of Fund Accounting**

In business accounting, the term “funds” typically refers to working capital (current assets less current liabilities) or selected elements of it (such as cash and investments) (Lynn and Freemann, 1983). However, the term fund has a different meaning for government and not-for-profit accounting entities since they establish their accounting systems based on a fund basis (Lynn and Freemann, 1983). As an accounting entity, each fund has its own self-balancing sets of accounts from which separate financial statements can be prepared. Government and not-for-profits commonly use several funds to account for their resources and activities. For example a church may use one fund for general operations, another for resources set aside to construct a new building and a third for its religious schools.

A fund is defined as a fiscal and accounting entity with a self balancing set of accounts recording cash and other financial resources together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitation (Razek and Hosch, 1995; Governmental Accounting Standards Board, GASB, 1998). With term self-balancing for sets of accounts, each fund of a government or not-for-profit uses the accounting equation:  $\text{assets} = \text{liabilities} + \text{fund balance}$ . This is a variation of the business accounting equation ( $\text{assets} = \text{liabilities} + \text{owners' equity}$ ). The term fund balance like owners' equity is a residual and is often referred to as net assets. Fund balance or net assets is the amount left to the parties with rights to the assets after all other claims against those assets have been liquidated (Lynn and Freemann, 1983). Since the basic accounting equation is the same, funds can be accounted for by the same double-entry system of bookkeeping as the current status and past performance of businesses can be summarized by similar financial statements. For example, the balance sheet of a fund can detail the specific assets, liabilities and elements of the fund balance that underlies the accounting equation as at any point in time. A statement of revenues, expenditures and other changes in the fund balance can explain the reasons for changes in the fund balance during a specified period. A statement of cash flow can reconcile the changes in cash between the end and the beginning of a period (Lynn and Freemann, 1983).

The objectives of fund accounting are to show the financial condition, changes in the organization, the results of operations of the organization and its compliance with legal restrictions. Fund Accounting also recognizes the political, economic and legal differences that exist between the services provided and the activities carried on within public sector organization.

Fund accounting promotes control and accountability over restricted resources. Government and not-for-profits establish separate resources into multiple types of funds to ensure that they adhere to the restrictions placed upon them by legislators, grantors, donors and other outside parties.

Characteristics of fund accounting Fatimah Abd Rauf , Haslinda Yusof, Normahiran Yatim, Usha Rani Poobaalan, Saluana Che Salleh, Radiah Othman (2009) can be summarized as follows:

1. Fund accounting is the financial accounting techniques adopted and reported in terms of funds in the operating statements and balance sheets of public sector organizations.
2. Fund accounting explicitly recognizes the political, economic and legal differences that exist between the services provided and the activities carried on within public sector organization.
3. Most government bodies use fund accounting where each fund is an independent accounting entity.
4. The fund is the sum of money allocated for specific purposes.
5. Each fund has its own set of accounts with complete double-entry and financial statements.
6. It must be self balancing and autonomous (Total Assets = TotalLiabilities).

### **Current Developments of Fund Accounting**

In government accounting, the resources of the government are accounted for through funds. A fund is a separate fiscal and budgetary entity. Funds are set up to demonstrate stewardship and fiscal accountability for the resources entrusted to the government. Government types of funds are defined as those funds in which the accounting emphasis (measurement focus) is placed on spending activities. Within this group are the funds that primarily account for the receipt and disbursement of resources used to provide services (Razek & Hosch, 1995). In government accounting, the measurement basis used for the accounting system depends on the fund or funds involved and are guided by sound financial judgement (Hepworth, 2003).

In the United States of America (USA), governmental types of funds such as the General Fund, Special Revenue Funds, Debt Service Funds, and Capital Projects Funds use the modified accrual basis of accounting with a measurement focus on current financial resources (Governmental Accounting Standards Board, GASB, 1998). On this basis, revenues are recognized if they are measurable and available for use during the year. Expenditures are recognized in the period the liabilities are incurred if measurable, except for accrued interest on general long term debt which is recognized when payment is due to bondholders. For proprietary funds such as enterprise funds and internal service funds, the full accrual basis of accounting is used. Under this basis, revenues are recognized in the period earned and expenses are recognized in the period that the liabilities are incurred. To some extent, GAAP requires that the budget for certain funds be developed using the modified accrual accounting method for measuring and reporting purposes.

Funds are established mainly to ensure governments adhere to resource restrictions and a government fund structure rarely mirrors its organizational structure. A government should have only one general fund but it may have any number of the other types of funds. For example, a city may maintain a separate special revenue fund for each restricted revenue source, a separate capital projects fund for each major capital project and a separate debt service fund for each issue of outstanding bonds. In the USA, most general purpose governments engage in three broad categories of activities under the three different types of governmental fund with different basis of accounting and measurement focus. The following Table 1 shows the fund structure of State and Local Government in the United States of America.

**Table 1: Fund Structure of State and Local Government in the United States of America.**

Types of Fund	Government Funds	Proprietary Funds	Fiduciary Funds
Purpose	To account for and report government's operating and financial activities financed predominantly taxes and intergovernmental grants	To account for and report governments' activities that are similar to those carried out in the private sector and financed predominantly through user charges	To account for and report resources held by governments as trustees or agents for another party or parties
Basis of Accounting & Measurement Focus	Modified accrual and current financial resources	Full accrual and economic resources	Full accrual and economic resources

Examples	General fund, special revenue funds, debt service funds, capital projects funds, permanent funds (e.g. maintenance of a public park or cemetery)	Enterprise funds (e.g. electric utility) internal service funds (e.g. a centralized purchasing function or motor pool)	Trust funds (pension trusts, investment trusts and private purpose trusts) and Agency funds (taxes collected on behalf of another government)
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The Government Accounting Standards Board (GASB) is an independent organization that establishes and improves standards of accounting and financial reporting for State and Local Governments in the United States of America. The Government Accounting Standards Board in June 1999 issued GASB Statement No. 34, Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments. GASB No. 34 presents a new governmental financial reporting model that for the first time requires state and local governments to present consolidated government-wide financial statements prepared on an accrual basis.

GASB 34 requires government to continue to publish governmental funds statements prepared on a modified accrual basis and government-wide statements prepared on an accrual basis. Government Funds Statements focus on a government’s fiscal accountability, budgetary compliance and short term financial health using the modified accrual accounting. Government-Wide Statements require two new financial reports: (a) statement of net assets (balance sheet) and (b) statement of activities (income statement) using accrual accounting for all of the government’s activities. The Statement of Net Assets reports not only current financial assets and liabilities as would be reported in governmental funds statements but also capital assets and long term liabilities. The Statement of Activities reports all revenues and all costs of providing government services during the year including items such as accrued interest expense and depreciation expense.

The government wide statements are consolidated and use the full accrual basis of accounting, thereby demonstrating whether current year revenues are sufficient to pay for current year services. The fund statements i.e. the present governmental funds - the activities of which are generally governed by a legally adopted budget use a modified accrual basis to facilitate budgetary comparison. The modified accrual basis is far more budget oriented than the full accrual basis in that the budgets of the government focus on either cash or cash plus selected short term financial resources. GASB 34 reaffirms that governmental funds should be accounted for on a modified accrual basis with a measurement focus on current financial resources. Current financial resources have been made operational as encompassing

expendable financial resources – cash and other items that can be expected to be transformed into cash in the normal course of operations. The “other items” include investments and receivables but not capital assets.

The new information contained in the government funds statements and the government-wide statements should permit much more meaningful comparisons among government organizations. The financial information will also be useful in developing service efforts and accomplishment measures. Citizens groups, policymakers and government officials can use the financial information to make better comparisons of performance among governments.

### **Proposed and On-Going Research Project**

Funds are established as a result of legal or statutory requirements for specific purposes. Thus, fund accounting ensures compliance of laws and regulations related to the money allocated. For all types of funds established, the funds can be discontinued should the need arise.

Developments in governmental activities in recent years have raised concerns over whether the cash basis of fund accounting is sufficient and appropriate for governmental accounting and reporting. Thus, accrual basis of fund accounting has now been seen to be an alternative for better reporting of government activities and resources with the planned adoption of accrual accounting in 2015 by Federal Government in Malaysia. Thus, the objective of this research project is to evaluate the relevance concept of fund accounting used by the Malaysian Federal Government for its consolidated trust account with its planned implementation of accrual accounting in 2015. There are six trust accounts for Federal Government in Malaysia which include development fund, housing loan fund, government trust fund, public trust fund, deposits and account payable (Zauwiyah Ahmad, Junaini Mohammad and Aziz Ahmad 2009). Therefore, this research project will investigate whether fund accounting report in terms of cash or accrual basis of accounting is still relevant for planned accrual basis of financial statements of Malaysian Federal Government in 2015. This study must be familiar with two key concepts of government accounting and reporting practices for a) fund accounting and b) the basis of accounting and measurement focus used by funds. The simple rule of thumb is that the basis of accounting determines when transactions will be recorded and the measurement focus determines what transactions will be recorded.

In evaluating the relevance concept of fund accounting for the Malaysian Federal Government in the accrual accounting environment, the methodological support of this research project would include the following to achieve the proposed objective:

1. Extensive review of literature for fund accounting based on accrual basis;

2. Expert opinion and review on fund accounting in accrual basis;
3. Content Analysis on the Audited Public Accounts of the selected consolidated trust account;
4. Interviews with the preparers of the selected consolidated trust account; and
5. Gap Analysis and Proposed Action Plans to justify the new approach and relevance concept of fund accounting of the selected consolidated trust account.

The quantitative analysis of data obtained from the content analysis of the audited public accounts and qualitative analysis of personal interviews shall provide the findings associated with the research objective. This study shall provide empirical evidence to support the revised fund accounting model in order to achieve the control mechanisms of resources management and reporting purposes for the Federal Government in Malaysia.

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