

# ALTERNATIVE FINANCIAL ACCOUNTING AND REPORTING SYSTEMS IN NIGERIAN LOCAL GOVERNMENT COUNCILS

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## **Abstract**

*The aim of this paper is to analyse the various forms of accounting systems that can be applied in the local government. Over the years, local government has placed more reliance on preparation of accounting information on cash accounting bases without having recourse to its disadvantages among which includes its narrow informational contents which also limit the bases of evaluating local government performance. Alternatives to local government cash base accounting technique are: budget accounting, accrual accounting, commitment accounting and fund accounting all with their merit and demerit. In order to have fair objective of evaluating the performance of local government, an effective and efficient accounting system need to be put in place.*

**Key Words:** *Cash accounting, Budget accounting, accrual accounting, commitment accounting, fund accounting*

## **Introduction**

Local government accounting, like all other accounting, focuses on the needs of specific organizations at particular times. It is an increasingly demanded part of the accounting

discipline (Tanzi and Prakash, 2003). Its distinctive problem is how to account for local governments that provide services free at the point of delivery, financed primarily by taxation and grants. Ultimate responsibility is usually held by politicians endowed with finite, and short, time horizons - to the next election.

In the crucial but narrow sense of accounting as a control that ensures financial probity and guards against corruption, accounting in local governments has been as influential as in any other kind of organization. However, private sector accounting has, since the beginnings of the profession, become systematically associated with a much wider sense of accounting—the use of money to measure the performance of businesses. In a business, the value of services provided is given by the money the business collects from the sales it makes; because money is also used to measure the cost of services provided, money provides a universal measure of performance.

The cost of services provided by local governments is also measured in terms of money, because governments have to buy in the same markets in which businesses buy. But the effect of financing governments by taxation is that the recipients of governmental services do not express

their satisfaction in money terms. That universal measure of performance is not available. The traditional response to this problem has been to limit the role of accounting in government to matters of financial probity: the proper recording of transactions, the control of spending against the budget, and the minimization of spending. Matters relating to the quantity and quality of services provided were left to service professionals and politicians.

Generally, local government accounting has been reformed before national government accounting, and reformed gradually. The most abrupt transformation came at the national level, in theory and increasingly in practice, during the 1990s. Previously, cash-based budgetary accounting systems developed for the purpose of control by the sovereign government were the norm and were largely unquestioned. Now, every such system is being questioned, and in significant cases radically changed toward accrual based systems.

Thus far, the clearest triggers for change toward accrual-based accounting have been financial distress and fraud. Financial distress usually means that government spending has become too high to be borne by lenders or by taxpayers. Financial distress and fraud are not necessarily a function of accounting, although accounting is usually implicated either directly or indirectly (Jones, 2002). When accounting systems do change, it is often as a result of wider changes in management. The case for accrual accounting is clear. Cash-based accounting, by its nature, ignores too many economic events; accrual accounting—necessarily in combination with cash accounting—is, in practice, the fullest method available for recording, measuring, and communicating such economic events. Whether for internal management of a government or for external accountability, cash accounting is too parsimonious with the truth. The benefits of accrual accounting are not, of course, free. Providing more, high-quality information involves increased processing expense; it also requires training to understand fully its benefits. Moreover, accrual accounting, while addressing the unacceptable ease with which cash flows can be manipulated, introduces significant reliability

problems of its own, necessitating additional audit resources. Cash-based accounting is, by its nature, more reliable than accrual-based accounting, other things being equal, but is much less relevant.

### **1.2 Cash-Based Accounting**

Cash-based accounting exclusively emphasizes accounting for transactions—what matters are the individual records of each transaction. Periodically, these records are summarized (weekly, monthly, and annual receipts and payments) and classified (monthly salary payments, monthly running expenses, monthly tax receipts), often to compare against budgets. These records are the foundation of all accounting systems, for all kinds of organizations (and individuals). They emphasize an accounting that is based on verification—fact-based verifiable transactions. An important part of this verification is reconciliation of the accounting with the local government's bank accounts. Cash accounting provides operating statements (payments minus receipts) and very simple balance sheets (cash balance).

Pure cash-based accounting recognizes transactions only when cash flows out of, or into, the local government. However, in all but the very simplest of transactions, an accounting system could usefully recognize other events in the life of a transaction. Three events commonly used for purchases are goods or services ordered, goods or services received with invoice, and cash paid. Usually only two events for income earned are recognized: goods or services provided with invoice and cash received. Recognition of goods and services ordered is called commitment accounting. Recognition of goods and services received or provided is usually judged necessary in any credit economy, in which all but the simplest transactions are based on credit given or received. A cash-based accounting of purchase transactions on credit might recognize that, along with cash payments, debts have been incurred by receiving goods and services with an invoice. In such an accounting, the operating statement records goods and services received (made up of cash payments plus or minus the change between opening and closing payables [creditors]), minus receipts; and

the balance sheet records closing payables as well as cash balance.

Cash-based accounting might also recognize income transactions on credit, in which case the operating statement would also record income earned from goods and services provided (made up of cash receipts plus or minus the change between opening and closing receivables [debtors]) and the balance sheet would be extended to record closing receivables. In cases in which the local government "earns" income from goods and services, such an accounting would be useful.

However, significant proportions of a local government's income tend to consist of grants from other governments, including the national government, and taxation. Cash accounting for these kinds of income is useful and straightforward; recognition of receivables and payables might be useful but is also usually difficult. The general sense of the word "transaction" suggests the difficulties. A transaction implies at least two parties, each one having received something and given something up. When a local government receives grants or taxes, what is given up and when? And the corollary, when a government, other organization, or individual pays grants or taxes to a local government, what is received and when? There are three aspects to these difficulties.

First, the point at which a grant or tax becomes due is much less verifiable, because it is much more a matter of opinion than with goods and services sold. One might argue that this point is totally verifiable because it is the point at which an invoice is issued, but the obvious response is that the point at which the invoice is issued is also a matter of opinion. Second, the accounting system has to confront the additional uncertainty involved in judging whether the grant or tax "due" will be received in cash. Even in cash accounting, uncertainty arises because the receipt of cash does not necessarily mean that the transaction is complete: there could be adjustments subsequent to, and sometimes distantly subsequent to, the receipt. Third, in settings in which politicians, service providers, and service recipients often have insatiable demands for more services, accounting systems typically have a bias

toward prudence, so that expenses are overestimated and income underestimated. For most elements of a typical local government accounting system, it would be prudent to recognize goods and services when received and before payments are made but to recognize income only when cash is received.

Discussion of cash-based accounting raises the question, even in large contemporary governments, of bookkeeping systems, and specifically whether double-entry bookkeeping systems are necessary. The increasing dominance of IT systems will render this question irrelevant, but in practice there are settings in which the question is important. In principle, pure cash accounting can be efficiently and effectively carried out with a single entry system. However, recognition of invoices received necessitates double-entry bookkeeping, at a minimum to harness its undoubted benefits of self-balancing.

### **1.3 Commitment Accounting**

An accounting system that recognizes goods and services ordered by the local government is called commitment accounting. In principle, an accounting system could be devised that recognizes goods and services ordered from the local government but such a system is unlikely to be useful. The main purpose of commitment accounting is in budgetary control; indeed, one of its main difficulties is its relationship to financial reporting.

Commitment accounting provides a more useful record of "spending" against a budget, for both the budget holder and those with higher responsibility for budgetary control, than either records of goods and services received (which are strictly unnecessary for commitment accounting), or of cash paid (which are necessary for all accounting systems). It records spending at the earlier point at which an official order is issued for the supply of goods or services, thereby recording a commitment by the budget holder and therefore by the local government to receive the goods or services in the stated quantity, at the stated price. Because commitment accounting depends on orders being issued, it applies only to parts of a local

government budget, though it can relate to many small transactions: the parts to which it generally does not apply are employee expenses, financing expenses, and those running costs (such as gas, electricity, telephones) that are supplied without recurring orders.

The logic of commitment accounting is that the budget holder wants to spend the budget, neither under spending nor overspending. Although not always rational, typically more severe penalties apply to overspending than to under spending. Given that the practical imperative is not to overspend, an accounting system more prudent than cash-based accounting recognizes spending when orders are issued, rather than later when goods or services are received and paid for.

Three main problems trouble commitment accounting: under certain circumstances it can be costly and unreliable, and its usefulness can be questioned. It clearly adds to the complexity of accounting given that it must always be in addition to cash accounting; when it is also used in conjunction with a system that records goods and services received, the complexity is even greater. Not only must there be additional records for each transaction but also the record of goods issued would not necessarily be the same as the record of goods received, simply because the quantity of goods that arrive may not be what was ordered—and the price may be different. Any given transaction may begin at one cost when the goods are ordered, have to be adjusted to another when the goods are received, and end with yet another when the goods are paid for. Because commitment accounting tends to reflect numerous relatively small transactions, the additional entries and corrections can produce significant complexity.

Commitment accounting can be less reliable than cash-based accounting in budgetary control. If a budget holder sees that the budget for a period—especially for a year—is going to be underspent (measured by orders issued), commitment accounting provides easy opportunities to spend up to the budget merely by issuing orders. In principle, the term “merely” is inappropriate because issuing an official order is not a trivial

matter; it would normally mean committing the local government to receiving the goods and paying for them. In practice, however, the uncertainty naturally occurring between the order and the payment can be exploited in different ways to spend a budget artificially. These ways range from the reasonably acceptable (ordering slightly before the goods are required) to the unacceptable (ordering goods that are not going to be received or paid for). This potential weakness of commitment accounting is overcome by increased monitoring by the controllers of the budget and by auditors, but at additional cost.

Commitment accounting becomes less useful from the perspective of financial reporting. A local government could not issue an annual external financial report for general use that defined its spending against its budget to include goods and services ordered but not received, simply because “spending” would be too easy to manipulate. The consequence is that internal financial reports monitoring spending against budgets would record goods and services ordered but not received, but the reports would have to be taken out of the definition of spending for an external financial report. As a result, the local government reports two measures of spending, one for internal and one for external use. Because the imperative of the one for internal use is to spend as nearly as possible to the budget, the one for external use (using the altered measure of spending) is likely to show under spending. Budget holders who want to increase their budgets might want to use this anomaly in negotiating subsequent budgets.

#### **1.4 Fund Accounting**

A central issue in accounting is the definition of the “reporting entity.” This term is most commonly used in the context of external financial reporting and, while it has always been significant, it has taken on greater importance as organizations have, legally and managerially, become more complex aggregations.

The term does, however, have significance in the internal accounting for any organization. In business, the main issues relating to the reporting entity for external financial reporting contrast

reporting for one company with reporting consolidated financial statements for a group of companies; within companies or groups of companies, debates would center on the adoption of cost centers, profit centers, and investment centers. In government accounting, the more common issue relates to the use of funds and any subsequent consolidation of those funds, in either internal or external accounting. In this sense, a fund is a pool of resources assigned to a particular purpose and initially kept separate from other pools of resources; fund accounting then provides, in the pure case, a self-contained set of financial statements for each fund. Fund accounting is a consequence of the traditional focus on financial control and is a technical response to the instinct to designate money for specific purposes. It satisfies a demand for separate accounting for separate kinds of resources.

In local government, distinguishing between different kinds of income, with consequent distinctions between how each kind can be spent, is common—distinctions are made between income from a general property tax and a dedicated tax (the tax is assigned to be spent in a particular way before it is collected), between taxes and grants, between different kinds of grants, between loans and other income, between user charges and other income. It is common for the provider of a loan or grant to impose the distinction explicitly, or for the general law to impose the distinction on general or specific taxes. It is also common for local governments themselves to want to make distinctions, perhaps between resources that can be used only in the long term and those that can be used in the short term. In some contexts, those distinctions that are externally imposed are called restrictions; internally imposed are called designations. Both distinctions are natural but often introduce complexity. Although the source of income may be clear, many functions of a particular local government are carried out jointly, requiring difficult and arbitrary allocations of costs between funds, as well as other transfers between funds.

The main source of contention in fund accounting is not in the use of funds (although there has been debate about the number of funds one organization

needs given that funds can proliferate), but rather in whether there should be, or to what extent there should be, consolidation of those funds, especially in external financial reports for general use. The main problem with fund accounting is that it can conflict with a view of the local government as a whole. While a provider of a specific grant may have understandable needs to see clearly how that grant is spent, the taxpayer (whether local or national) has an equally understandable need to see how the grant is spent in relation to the local government as whole, especially because the taxpayer is bearing the ultimate risk of that local government. In fact, given the complexities of fund accounting, the provider of the grant also ought to understand how the grant is spent in the context of the other funds. The same is true of a lender, even when the loan has a specific charge on particular assets. A lender whose loans are secured by the taxable capacity of the local government obviously needs to see the local government as a whole.

However, consolidation of funds in financial statements, by its nature, obscures the individual funds and can mislead. Resources that the consolidated financial statements appear to suggest are available to be spent on any purpose (perhaps to the general benefit of the community) may be legally restricted to narrow purposes; or resources only available in the long term may appear to be available to be spent now. If there were no constraint on the length and complexity of financial statements, the solution would always be to provide both individual fund and consolidated financial statements.

There is a constraint, however, and the increasing tendency is for the external financial statements to be consolidated, if not wholly then in part, with the fund statement being provided separately for specific needs.

### 1.5 Accrual Accounting

The meaning of the term "accrual accounting" (sometimes called accruals accounting) can vary considerably, in theory and practice. In its fullest sense, accrual accounting is the comprehensive and continuous recording of all revenues,

expenses, assets, liabilities, and cash flows of the local government. Accrual accounting affects the recording of transactions, the periodic internal financial statements, and the published financial statements. A prerequisite of accrual accounting systems is a comprehensive record of assets owned (which usually does not exist in extant local government accounting systems) and of liabilities incurred (which probably does, except that contingent liabilities are usually not recorded).

The meaning of "comprehensive" is still controversial. The traditional basis of all accounting was historical cost. In business accounting practice, historical costs are changed to some form of current value (increasingly referred to as "fair value") in many ways; however, a comprehensive system of current-value accounting, while it has been experimented with in the past, is not part of extant practice. In some of the new government accounting systems that have adopted accrual accounting, a wider use of current-value accounting is in use, even if stopping short of being wholly comprehensive.

Cash accounting can be extended to recognize payables and receivables, increasing the number of items in the balance sheet with consequent effects on the operating statement. Accrual based accounting recognizes more items. Recognition of payables means that, in addition to the measurement of cash outflows, the accounting system provides a measure of goods and services received. The most obvious next step for accrual accounting is to recognize inventories, so that the accounting system provides a measure of goods and services used (by adjusting cost of goods and services received for changes in the opening and closing inventories); in this, the accounting system also provides a measure of inventories held. In many parts of a local government's budget, such adjustments might not produce material change in the measure of costs, in which case they would not be made. Inventory valuation is often not without measurement difficulties, but there have long been routine methods of dealing with them.

In the assets section of the balance sheet, another major item that a full accrual accounting would

recognize is depreciation on depreciable assets. This, as with inventories, is concerned with including in the cost of service provided a relevant measure of goods and services used. Clear examples of depreciable assets are equipment and vehicles. Accrual accounting provides a valuation of the depreciable assets for the balance sheet and a charge to the operating statement for the period's depreciation. However, other classes of assets are less clearly defined as depreciable.

One such is often referred to as heritage assets (a site of historical importance, for example), meaning assets that are not normally going to be sold, cannot be replaced, and, while they may require conservation, do not depreciate in the normal sense; some would insist that such assets cannot and should not have a financial value assigned to them. Another is infrastructure assets (water pipes, for example) for which it has been argued that a systematic engineering plan to maintain the assets, with consequent maintenance costs at planned points in the future, provides a more relevant measure of cost than a depreciation charge would. In fact, this argument has more generally been applied to buildings: as long as the useful economic life of a building is maintained indefinitely, a depreciation charge is obviated. Also in the assets section are assets that are not depreciable and, therefore, that do not have a direct effect on operating costs, but that should be recorded in the balance sheet to provide a comprehensive account of assets owned. The clearest example is land, which under normal circumstances is not depreciated. Other examples would include those assets that in some circumstances might be depreciated, but that have been judged not to be depreciable.

In the liabilities section, all explicit liabilities would be recorded, in addition to the short-term payables that a cash-based system might recognize. The most significant effect on the operating statement would usually be any consequent charge for interest, on an accrual basis. Rather than recording the interest payments made, as the operating statement under cash-based accounting would, a full accrual accounting would record the interest due on all liabilities. Because of

the importance of cash in any organization, accrual-based financial statements are accompanied by a statement of cash flows. The ideal form of this statement draws the figures directly from the cash accounts.

Although a literal interpretation of the term "accrual accounting" does not necessarily require each organization to produce one set of consolidated financial statements, that production is the usual expectation. Because all but the smallest local governments are complex, this consolidation has to be based on a determination of which entities should be included in it and which should not. The typical dilemma is between adopting the criterion of "ownership," which might produce a legal determination, or the criterion of "control," which might produce a political or economic one.

Accrual accounting is often discussed in the context of the financial accounting and reporting system, which is where accrual adjustments would be made in the first instance. But the need for comprehensive measures of revenues, expenses, assets, liabilities, and cash flows is as important for the internal management accounts, so that managers have a complete accounting of their actions.

Accrual accounting in government is not without controversy but its benefits are obvious. Cash-based accounting systems provide a limited view even of the economic events affecting a government. Most important, they cannot provide measures of the cost of services provided in any meaningful economic sense—only accrual accounting can. In practice, accrual accounting may fall short of the ideal, especially when the accrual accounting is historic cost accounting. Notable examples of government accounting now adopt forms of current-value accounting.

Accrual accounting has an additional benefit over cash accounting: the latter is too easy to manipulate, in particular by postponing cash payments from one fiscal year to another. Furthermore, because any comprehensive system of accounting necessarily includes records of cash

flows, in principle a full accrual-accounting system only enhances any existing cash-based accounting system and takes nothing away.

Clear benefits always impose costs. Accrual accounting requires greater accounting sophistication, necessitating increased education and training, as well as more sophisticated hardware and software. Moreover, whether the accrual accounting is based on historic costs or current costs, it is by its nature replete with arbitrary judgments. Finally, although accounting standards and auditing limit the scope for producing diverse measures from the same data, they by no means eradicate it.

### **1.6 Budgetary Accounting**

Budgets are requests for money, in local government for public money: taxation and grants. In their definitive form, budgets are requests by the executive of a sovereign government for authority from the legislature to impose taxes. In the context of local governments, budgets may be seen as requests by officers for the authority of the council of politicians.

Thus, budgets are not the product of accounting systems at all but, once they have been approved, it is the chief financial officer's role to monitor actual spending against the budget, to provide a crucial form of financial control, internal or external. The form and content of the budget can significantly influence the possible extent of the financial control; thus, finance officials would always want, even if they do not always have, a central role in forming the budget request. Moreover, the requirement usually imposed on local governments to balance their budgets (budgeted spending is to be financed by taxation), even if the measurement rules are often vague, adds to the influence of the budget on accounting.

The budget traditionally has been used to impose central financial control on all aspects of governments. Rules were developed, many of which are still in use, to provide control. Budgets that provide money for only a year, after which time they lapse (sometimes known as "annularity"), is one such rule. Another is the rule

that budgets are provided gross, so that any income earned by a budget holder must be surrendered to the central coffers (the "gross budget principle"). This emphasis on central financial control has also been associated with the idea that public money had to be spent on the cheapest that money could buy, especially for routine, recurrent spending.

The form that budgets physically take varies across organizations and countries, and over time, as does the form of all financial statements. Traditionally common features of budgets emerge. Over the past five or six decades, these features have been challenged, particularly by techniques that shift the emphasis from what is to be spent under the budget (inputs) to what is to be achieved from the spending of the budget (outputs and outcomes).

As comprehensive alternatives (program budgeting and zero-base budgeting are two major examples), these techniques failed to be accepted but elements of each continue to have relevance and be used. Traditional budgets are based on the organizational structure, more specifically, identification of those officers within the government who are held accountable for spending money against budgets. This feature of budgets applies whether budgets are highly aggregated or whether there is significant devolution of budgets—the organizational structure locates the budgets. Within each of the budgets thus identified, other common elements surface.

Budgets are usually lists of what is to be bought with the money being requested—inputs. These may be very broadly specified and may, in an extreme example, be a single amount. They are more typically specified in much detail. The one amount for the whole of the costs of employees might be broken down into detailed items, such as overtime pay for wage earners.

In sum, budgets are traditionally line-item, incremental requests that reflect the organizational structure. Being expressed in money terms, they are natural ways of requesting money. They are also very good at providing a crucial sort of financial control that finance officials demand, in that budgets specifically identify who is spending

money and what they are buying with it. This demand is not only in the interest of the finance officials themselves but is on behalf of the public, whose money is being spent. It is common for budgets to be enacted as law, in part to emphasize the importance of this kind of control. These traditional budgets are a natural part of the accountant's focus on financial probity.

An important part of budgetary control is the periodic, usually monthly, comparison of spending against the budget. This requires converting an annual budget into a profile of approximately how each budget is expected to be spent. Large parts of local government budgets can easily be profiled (salaries, financing charges, running expenses that are contracted to be paid for at specified dates), but for some items profiling can be difficult. Nevertheless, budget profiling is necessary to avoid what would otherwise be a continual questioning of budget holders about why their spending was not in a simple sense proportionate.

#### **1.7 Conclusion**

Management of other people's money is a heavy burden; managing public money even heavier. The traditional focus of local government accounting—on the proper recording of transactions and on control of spending against a budget—should not change. However, much more information can now be provided in a government accounting system without reducing its traditional focus, including economically relevant measures of cost of service provided, with clear segregation of capital and current costs, and comprehensive measures of indebtedness and of assets employed. Thus, substantially widened measures of government performance are facilitated. All of these can be provided in budgets as well as in financial statements.

Accrual budgeting and accounting, in their fullest sense, are the comprehensive and continuous recording of all revenues, expenses, assets, liabilities, and cash flows of the organization: they affect the recording of transactions, the internal financial statements, and the published financial statements. Moreover, while the traditional basis of all accounting is historical cost, current value is

gaining ever-wider use.

The costs of this additional information are not trivial. The necessary IT systems are becoming much more freely available but storing and retrieving data are only one part of the process. Understanding the subsequent information is also required, and this requires investment in education and training. The availability of IPSAS helps reduce the costs and provides a unique opportunity to further the cause of convergence in the government accounting systems of the world. Comprehensive, standardized accrual based accounting systems in local governments will emerge only in the distant future, but many of their additional elements are being developed by individual, and groups of, organizations.

One dominant theme in the sometimes bewildering changes in governmental accounting and budgeting over the past 50 years, as the size and complexity of the public sector have continued to grow, is the increasing reluctance of those at the center of each government to bear the financial risks of that government. This reluctance has led to increasing recognition of those risks, as well as to formal devolution of some of them from one level of government down to another, and from one level of government down to other entities. IT and accounting have made this recognition possible and will be central to its understanding.

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