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SUBJECT The central government accounting system: government's response to the report entitled *Revenues and expenses revaluated*.

Madam President,

On 23 February 2018 the Minister of Finance sent you the government's response to the report entitled *Revenues and expenses revaluated*, as issued by the Advisory Committee regarding the Central Government Accounting System in March 2017. The Netherlands Court of Audit had responded to the report on 8 May 2017.¹ We now present our opinion on the government's response.

The Netherlands Court of Audit is pleased the government has announced certain measures to improve the financial information provided by the central government. The government's response, however, does not make a clear choice to introduce an accrual system in due course as a structural solution to the weaknesses inherent in the current system. In two years, in 2020, the government intends to evaluate the need for *possible* further steps towards an accrual system. We think this intention lacks commitment and ambition.

Accruals is the most appropriate system

The government's reluctance to make a definite choice and name an introduction date is striking. The government had announced it would introduce an accrual

¹ Parliamentary Paper 31 865, no. 97.

budget and accounting system for the whole of central government as long ago as the Budget Memorandum 2001. It wrote at the time, *'The current budget system – an obligations-cash accounting system – is inappropriate for a (...) result-oriented environment. An accrual system – as used by the private sector, local authorities and many parts of central government, would be more appropriate. (...) The main benefit of an accrual system is that it considers the total cost of an investment when decisions are taken. In the obligations-cash system, by contrast, investments are financed as a lump sum from the budget and there is therefore little incentive to consider future costs (e.g. maintenance and replacement costs) when decisions are taken in the budget process. The accrual system includes such an incentive because the total cost (the life cycle cost, both the cost of production or acquisition and the cost of replacement and maintenance) is included in the estimates and decisions. This improves insight into the efficiency of government expenditure'.²*

The government subsequently decided not to introduce an accrual accounting system and in the years that followed opted for the less than satisfactory route of making improvements to the 'inappropriate' system.

The Advisory Committee regarding the Central Government Accounting System and the government itself have now again come to the conclusion that the current obligation-cash system has significant shortcomings. It does not generate all relevant financial information, is not transparent in certain areas and its content, form and terminology are not comparable with the systems in use elsewhere in the public sector in the Netherlands and abroad. Improvements in the current system are of course welcome but they cannot resolve these inherent problems.

We wonder why an evaluation would be necessary in 2020 if it has been acknowledged since 2000 that a government-wide accrual system is the most appropriate system. Only a government-wide accrual system can generate financial information that systematically tells the whole financial story for each budget chapter and the annual report. Apart from obligations and cash flows, the whole financial story includes costs and revenues and assets and liabilities, accompanied by clear explanatory notes, analyses and clarifications. Such information is necessary for both decision-making and accountability purposes. It strengthens parliament's right to approve the budget and thus the democratic process. It does so both when adopting and modifying the budget and when granting discharge to ministers at the end of the financial year. In our response to

² Budget Memorandum 2001, pp. 83-85. The proposed system was considered in more detail in the Budget Memorandum 2002.

the Advisory Committee's report we therefore specifically called for focus on the ultimate goal of introducing an accrual system. As the Advisory Committee noted, an accrual system produces the greatest coherence and consistency when it is applied to both budgets and accounts.

Permanent importance of cash

We agree with the Advisory Committee that appropriate budgetary control requires permanent cash management. Furthermore, parliament's authorisation of expenditure is anchored in the constitution.³ Expenditure by budget article must therefore also be a prominent feature of an accrual accounting system.

Accrual system is necessary for effective financial decision-making on the budget

In recent audits of the main roads, the main waterway network and the main water system in the Netherlands, the Court of Audit found that lack of insight into the total cost made it difficult to take well-considered decisions on these assets.⁴ We observed that an accrual system would structurally improve the situation.

An accrual system would enhance insight into the total cost of other assets, too, such as the life cycle cost of weapons systems and ICT projects.⁵ These costs must also be known for effective internal management.

Under an accrual system, this insight is laid down in the budget regulations and embedded in the budget information. This strengthens the clarity, consistency and robustness of the figures used in, for example, a societal cost/benefit analysis or business case. The figures can also be generated more efficiently partly because financial and administrative IT systems are designed for the accrual system.

If the budgets systematically included multiannual estimates not only of obligations and expenditures for current and future assets⁶ but also of all the costs relating to their acquisition, use and maintenance, the basis for dialogue and decision-making

³ Art. 105 of the Constitution.

⁴ Netherlands Court of Audit, *Maintaining the Main Road Network* (10 October 2014), *The Cost of Maintaining the Dutch Waterway Network* (14 October 2015) and *Maintenance of the Main Water System* (15 December 2016).

⁵ See, for example, Netherlands Court of Audit, *Audit of Central Government Accounts 2014*, *Ministry of Defence*, and *Final Report of the Parliamentary Enquiry into ICT Projects in Central Government* (House of Representatives 2014-2015, Parliamentary Paper 33 326 number 5).

⁶ According to the most recent state balance sheet, the government held assets worth approximately €90 billion as at 31 December 2012, of which approximately €69 billion related to the physical infrastructure managed by the former Ministry of Transport, Public Works and Water Management. See http://www.rijksbegroting.nl/2012/kamerstukken,2013/5/16/kst812050_7.html.

on investments,⁷ maintenance and divestments would be considerably stronger. In the current system, there is a very real risk that, for example, an inexpensive road with higher maintenance and/or replacement costs will be preferred to a more expensive road with lower maintenance and/or replacement costs. An accrual system might lead to a different decision as it would take the total cost into account rather than just the one-off cash outlay. This would increase the efficiency of public funds and the economic management of assets and equipment.

An accrual system also better explains that:

- maintenance costs are also incurred for assets in years when there is no cash outlay for maintenance or replacement;
- investment expenditure is not consumed in one year but is used for several years (depreciated over the life of the asset);
- postponement or cancellation of necessary maintenance expenditure comes at the cost of impairments in an asset's value – expressed in the form of accelerated depreciation – and/or higher maintenance costs in subsequent years;
- the postponement of a payment for a service rendered does not alter the fact that costs have been incurred;
- the disposal of assets not only generates cash but also entails a reduction in the value of the government's assets and can be accompanied by a book loss – and can therefore be a poor business deal (penny wise, pound foolish).

An accrual system strengthens decision-making by, for example, providing better insight into the funds available to build new infrastructure and the funds necessary to maintain existing infrastructure. It also provides more insight into the sustainable, structural financing that is a consequence of structural policy, versus one-off financing for temporary policy.

Insight into total cost generates added value in respect of more than just infrastructure and equipment. As long ago as the 1990s, the Minister of Finance noted in response to a Court of Audit report on the financial insight into peace-keeping missions that the explanatory memorandum to supplementary budget acts

⁷ Statistics Netherlands has estimated that the government invested approximately €6.3 billion in fixed assets in 2017, out of total expenditure of €178 billion (approximately 3.5%). The central government invested an estimated €13.2 billion out of a total of €186 billion (approximately 7%). <http://statline.cbs.nl/statweb/publication/?dm=sln&pa=82563ned>. With regard to current expenditures, such as salaries and grants, 'costs' and expenditures' are often the same although timing differences might arise on account of deferred items and provisions.

and ultimately the Final Budget Act should provide more insight into the full cost of peace-keeping operations. The Court of Audit believes such an improvement in the financial insight is necessary to make well-considered decisions on the deployment of peace-keeping missions and their priorities and to manage their cost in the longer term.⁸

We would note that the Advisory Committee does not refer in its cost/benefit analysis to the considerable financial benefits of improved decision-making that an accrual system would bring about.

Accrual system is necessary for good financial accountability in the annual reports

If the annual reports were to include costs incurred and a complete balance sheet with assets and liabilities in addition to obligations, expenditures, receipts and a trial balance, they would present a more complete view of budget execution. Furthermore, they would improve insight into the efficiency of public expenditure and the funds available at the end of the financial year to invest in necessary maintenance and acquisition. This would strengthen the basis for granting discharge to the ministers at the end of the financial year and strengthen the substantive link with the following year's budget. A coherent set of financial statements with a balance sheet (financial position), a statement of operations (costs and income) and a cash flow statement (receipts and expenditures) prepared using the universal double entry accounting system is generally regarded as the most basic building block of financial management – not only in the private sector but also in the public sector, except, that is, in central government.

Accrual system is necessary to increase consistency at home and to practise what you preach

In several important respects, the financial information provided by central government does not satisfy the standards it expects of other parties in the public sector. Provinces, municipalities and water authorities must all apply accrual accounting and thus provide complete financial information.⁹ So must hospitals, care institutions, schools, universities, etc.¹⁰ Private companies are required by law

⁸ House of Representatives, 1996-1997, Parliamentary Paper 25 250, no. 2.

⁹ See, for example, the Programme Budget 2018-2021 and annual reports and accounts for 2016 of The Hague municipality:

https://denhaag.raadsinformatie.nl/document/5664265/1/RIS297813_bijlage_Programmabegroting_2018-2021; <http://www.jaarstukken2016.denhaag.nl/>

¹⁰ See, for example, University of Leiden, Annual Report 2016:

<https://www.universiteitleiden.nl/binaries/content/assets/algemeen/over-ons/jaarverslag-2016-universiteit-leiden.pdf>

to keep accrual accounts. The elected executives running the provinces, municipalities and water authorities and the supervisors of the aforementioned institutions therefore have a better understanding of their financial position than the national parliament has. In our audit entitled *Maintaining the Main Road Network* of 2014, we found that the provincial authorities and municipal executives had a better understanding of the financial state of road maintenance than the House of Representatives had. If the central government brought its financial information into line with that of the rest of the Dutch public sector, it would be easier to follow the trail of public funds and to exchange information between the ministries and other public bodies.

Accrual system is necessary to increase consistency with other countries and to comply with international standards.

Virtually every country in the EU and the OECD has already introduced an accrual system at central government level or is currently doing so. The European Commission wants public organisations in the EU to use accrual accounting, partly because of the need for robust EMU figures and to increase the consistency of the organisations' financial reporting. The adoption of a government-wide accrual system would be in step with the international trend and would strengthen the Netherlands' position to influence the ongoing harmonisation initiatives within the EU. It would enhance transparency, enable comparisons and improve all the member states' ability to follow the implementation of the European Semester. The government's proposal does not explain how it will contribute to a uniform accrual accounting system (EPSAS)¹¹ in the EU.

Accrual system is necessary to improve the consistency and transparency of information in budgets and accounts

An accrual accounting system is a means to make the information in budgets and accounts considerably simpler and more transparent.

Two budget and accounting systems are currently being used within central government: the line ministries use an obligations-cash system and the agencies use an accrual system. Rijkswaterstaat actually uses both systems: accruals for 'management and maintenance' and obligations-cash for 'construction' and 'replacement and renovation'. Adopting an accrual system would put an end to this bilingualism. Keeping two systems at the same time is confusing, complicating and, moreover, inefficient.

¹¹ https://www.epsas.eu/en/documents/1_EN_ACT_part1_v5.pdf

The introduction of an accrual accounting system is also an opportunity to reconsider and improve information that currently has to be provided separately – such as memorandum accounts, information on assets and liabilities for Statistics Netherlands – and to sort out the budget reserves, budget funds, end of year margins, cash transfers, off-budget funds and various other stopgaps currently used to transfer funds from one financial year to another. An accrual accounting system provides a transparent means to transfer provisions and reserves from one year to the next.

Accrual system contributes to the success of Operation Insight into Quality and Digital Budgeting

The government announced in the coalition agreement that Operation Insight into Quality and Digital Budgeting would strengthen the systematic insight into and control over the efficiency and effectiveness of government policy. An accrual system places the total cost of policy at the centre of the budget and accounts and is therefore essential for insight into efficiency, an important aspect of quality. It helps parliament perform its duty of scrutiny by answering the key questions, 'How much will it cost/has it cost?' and 'How efficient is/was it?'.¹² The government has introduced the *To a Digital Budget* programme to realise a fully automated financial accounting system that generates reliable information quickly. Its technical backbone, built on Standard Business Reporting/XBRL, assumes there is far-reaching standardisation and uniformity in the financial data. An accrual system offers the most appropriate starting point for such information. It is the automatic starting point in all professional education courses that are relevant for the future recruitment and retention of sufficiently qualified personnel in the financial function. The Advisory Committee's indicative estimate of the investment in an accrual system will therefore also be of benefit to both of these reforms.

Recommendation

In the light of the above arguments, we recommend that parliament initiate a debate with the government on the desirability of a government-wide accrual system, the concrete steps necessary to introduce it and a definite date of introduction.

We would be pleased to provide further information regarding this letter.

¹² House of Representatives, Manual on Budget and Account Control (15 May 2014), p. 6.

We shall also send this letter to the President of the Senate and copies to the King, **8/8**
the Minister of General Affairs, the Minister of the Interior and Kingdom Relations
and the Minister of Finance.

The Netherlands Court of Audit

A.P. (Arno) Visser,
president

C. (Cornelis) van der Werf,
secretary