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Transition towards accrual accounting and disclosure requirements: A conceptual study

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Abstract

With the importance of accrual accounting in the contribution towards accountability and performance measurement, this study therefore attempts to examine the extent of disclosure of accrual accounting information in Malaysia with a focus on the Sarawak local authorities' annual financial statement. Contrary to their counterparts in West Malaysia and Sabah, the Sarawak local authorities' financial reporting practices are very much different and majority of them are still using modified cash accounting. Drawing from the public accountability paradigm and institutional theory, three objectives of the study will be developed: (i) to determine the extent of disclosure of accrual accounting information in the annual financial statement, (ii) to identify whether certain set of variables, namely the technology infrastructure, size of local authorities, qualification of accountancy personnel, audit institution size and regulations have significant associations with the disclosure of accrual accounting information as found in (i), and (iii) to ascertain the perceptions of the Sarawak local authorities in the implementation and disclosure of accrual accounting information. Therefore, the study is expected to provide valuable inputs and frameworks for both regulators and researchers which may facilitate the Financial Management Transformation in the Sarawak local authorities by moving towards accrual accounting.

Keywords: Accrual accounting, annual financial statement, disclosure requirements, local authorities

1. INTRODUCTION

Over the years, public sector organisations in many countries have shifted away from traditional cash based accounting towards the adoption of accrual based accounting (FEE, 2008). The move towards accrual accounting principles which is in tandem with the New Public Management (NPM) reform began to take place in the late 1980s, in Australia and New Zealand and have had great influences in the public sector financial management especially in the western governments (Connolly & Hyndman, 2006). The NPM paradigm which is underpinned by the private management and market-type mechanism, has been attracted to many governments due to its emphasis on result, output and outcome as well as performance management (Hughes, 2003). Therefore, the shift from cash to accrual accounting which forms part of the public sector reform agenda is viewed to be able to enhance financial accountability and transparency (Isa, Saleh, & Hasan, 2014) and give a true and fair view of the financial position and results of operations of the organisations in accordance with the relevant financial reporting framework (FEE, 2008).

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Cash accounting, which has been predominantly used in the public sector, unable to address more meaningful information of the financial statement prepared by the government entities (Rauf et al., 2012). Critics of cash accounting dispute that the system is only concerned with disclosing cash inflows, cash outflows and changes in the cash balances held (IFAC, 2000). In addition, the system fails to provide a very long-term perspective of public finances and disclose data on public sector assets and liabilities in the financial report (PwC, 2013) as well as unable to provide information on the full cost of operations and the resources used to deliver services to the public (Hoque & Moll, 2001). In contrary, accrual accounting is argued to be able to disclose accurate reflections of government's financial position and all government assets and liabilities will be reported in the financial statement (Isa et al., 2014). Thus, the arguments to move to accrual accounting in the public sector revolve around issues such as better information for decision making, precise picture of all the costs consumed and complete record of what is owed and what is due (Connolly & Hyndman, 2006).

In this connection, there appears to be a growing public awareness regarding weaknesses in public sector financial management (Buang, 2012) and the latest developments in the Malaysian governmental accounting in bringing about public sector transformation (Rauf et al., 2012) has led to the recommendation on the implementation of accrual accounting in the Malaysian public sector to facilitate asset-liability management, and hence, comprehensive and prudent fiscal management (National Economic Advisory Council, 2010). The accrual system would help the Malaysian government to obtain quicker financial information by providing a more complete picture of government financial transactions, thus improve transparency and efficiency of the country's finances (David, 2014). Therefore, the transition to accrual basis accounting is in line with the government's aspiration to strengthen the transformation of public sector in enhancing the efficiency in financial management and accounting (National Audit Department, 2013).

In Malaysia, the implementation of accrual accounting has become one of the policy measures stipulated in the New Economic Model (NEM) unveiled by the Prime Minister Najib Razak in 2010 (National Economic Advisory Council, 2010). Due to this, a working group was set up by the Performance and Management and Delivery Unit (PEMANDU) in 2011 to develop the implementation plan (Saleh, 2013) and it is expected that all Federal Ministries will implement accrual accounting system in 2015 and state governments the following year (David, 2014). In this regard, the Sarawak Government has taken significant steps in positioning its public sector finance practice to be in line with the national policy measure. Therefore, roadmap towards accrual accounting has been focussed as one of the key strategic issues for the long term improvement initiatives from 2014 to 2020 in driving Financial Management Transformation under the Sarawak Civil Service 10-20 Action Plan although there is no specific year set for the transition towards accrual accounting for the State Ministries, Departments, Agencies and Local Authorities in Sarawak (SCS 2012).

Basically, the management of the Malaysian government is segregated into three tiers of government namely Federal Government, State Government and Local Government, commonly known as Local Authorities. Local authorities being the front-line agency should become the highest in terms of the people's need for services, thus there is an urgent need for transformation in their performance and accountability to better serve the needs of the people (D. Salleh & Khalid, 2011). Issues ranging from the effectiveness of financial management to the quality and reliability of the financial reports have been discussed extensively from the stakeholders whose demand for greater sound and practical financial information (Mohamed, Abdullah, Rauf, & Yatim, 2010).

For accounting and reporting purposes, the Malaysian local authorities are governed by the Local Government Act 1976 (LGA). Nevertheless, the Act does not specify the required form and content in the presentation of annual financial statement, hence a few set of accounting standards have been adopted by the Malaysian local authorities, namely: the International Financial Reporting Standard (IFRS), guidelines issued by the Ministry of Housing and Local Government, self-created accounting practices and the Federal Treasury Circulars which are more applicable for the Statutory Bodies (Coombs, Tayib, & Ameen, 1999). On the other hand, other alternative reference is the Malaysian Public Sector Accounting Standards (MPSAS) issued recently by the Accountant General's Department of Malaysia (AGD) which are based on accrual basis accounting. However, the standards are specifically outlined for all federal ministries and departments.

A study on the 42 local authorities in Malaysia by Mohamed, Atan, and Horoen (2009) reported that the disclosure of financial information was just complied with the minimum requirement of the LGA and some of the local authorities breached the standards issued by the Malaysian Accounting Standards Board (MASB). Despite the fact that the local authorities in Malaysia have been adopting an accrual accounting system in relation to the preparation of the general purpose of annual financial statements (Rauf et al., 2012; K. Salleh, Aziz, & Bakar, 2014), generally, there is no obligatory requirement for them to adopt specific financial reporting standards (Mohamed et al., 2010). For instance, Omar, Amran, and Aripin (2005) stated that although there is a positive shift towards accrual accounting by local authorities in the state of Kedah, Malaysia, somehow the adoption of accrual accounting is still not fully successful due to ambiguous reporting requirement. Therefore, in order to enhance the quality and uniformity of financial information reported, the local authorities need to have a common set of accounting standards such that the financial statements of local authorities will no more be based on a confused mixture of accounting principles (Mohamed et al., 2009).

This paper only focuses on a conceptual model which will lead to the upcoming study in exploring the disclosure requirements for the transition to the accrual basis of accounting in Malaysia with a focus on the Sarawak local authorities (SLA). Therefore, there are three objectives designed for the study, namely: (i) to obtain an insight on the extent of disclosure of accrual accounting information in the annual financial statement, (ii) to examine the determinants associated with the transition towards accrual accounting, and (iii) to ascertain the perceptions of the SLA in the implementation and disclosure of accrual accounting information. This paper is organised as follows: Section 2 discusses accounting practices in the SLA. Section 3 highlights the theoretical perspectives deployed in the study. Section 4 presents the proposed hypotheses and conceptual schema. Section 5 covers the research method that going to be conducted. The last section provides a brief conclusion.

2. ACCOUNTING PRACTICES IN THE SARAWAK LOCAL AUTHORITIES

As the lowest rank in the Sarawak State Government structure, local authorities serve direct to the constituents within their area of jurisdiction under the power conferred by the Local Authorities Ordinance 1996 (LAO). The power and duties of the SLA are to develop the constituency and provide basic amenities. While, the fund used for the maintenance and development of these amenities are generated through their own revenues such as licences, permits and assessment rates or from the operating grant received from the Sarawak Government. There are also numerous types of funding received from the Federal Government such as Development Grant and Malaysian Road Record Information System (MARRIS) allocation for the maintenance of roads in the local authorities' jurisdiction.

In maintaining the proper books and accounts of the SLA, every local authority shall prepare and present for auditing the annual statement of the preceding financial year within four months following the close of the financial year. In this regard, the annual financial statements are subject to the inspection, examination and certification by the Auditor General or external auditor appointed by the local authorities based on the recommendation made by the Auditor General in order to ensure the financial regulations or any other written government circulars are being complied with. This compliance includes presenting a true and fair view of the financial position of the local authority and all the requirements set by the appointed auditor. In addition, the local authorities are subject to various management audits such as Accountability Index star-rating system conducted by National Audit Department of Malaysia (NAD).

Apart from the LAO, the Local Authorities Financial Regulations 1997 (LAFR) is the other source of references which govern the financial management practices of the SLA. There are various regulations stated in the LAFR 1997 discussing on the accounting principles and procedures that shall be implemented by the SLA. For instance, Regulation 19 LAFR requires the local authority to follow the generally accepted accounting principles and practices in maintaining proper books and accounts. The regulation also states if there is a conflict between legal provisions and generally accepted accounting principles and practices, the legal provisions shall take precedence. In another context, Regulation 16(1) LAFR states that expenditures which are incurred in the prior financial year are allowed to be paid within the month of the succeeding financial year and are reported as expenses for the prior financial year. This accounting treatment is therefore, consistent with the practices adopted by the Federal and State Governments in Malaysia which used modified cash basis of accounting (K. Salleh et al., 2014). Drawing from these two regulations, all material aspects of bases and policies pertaining to the accrual accounting framework are not clearly defined for the preparation of annual financial statement. As such, the use of accrual accounting system is only guided either by a review of best practices or recommendations made by the Auditor General.

Currently, the disclosure of annual financial statement and accounting practices vary between local authorities. Out of the twenty-six SLA, only Kuching North City Hall (DBKU) practices accrual accounting and the presentation of annual financial statement is based on the Malaysian Private Entities Reporting Standard (MPERS) and also the mandatory requirements of the LAFR. On the other hand, Bintulu Development Authority (BDA) adopts modified accrual accounting which is based on the Statutory Body Ordinance (Financial and Accounting Procedure) 1995. While the other twenty-four local authorities apply modified cash accounting and the disclosure of their annual financial statements is solely based on the LAFR. As a result of the different sets of accounting standard and unavailability of best accounting practices, the local authorities have been given discretion to adopt any accounting standards. This has led to inconsistency in the presentation of annual financial statements, which are difficult to compare within the same entities.

Further, a study on the financial position of the SLA revealed that most local authorities lack the management reporting system to assist in managing the cost of providing the services and the inability to provide accurate reporting of revenue and expenditure. Therefore, Ernst & Young (2009) highly recommended the local authorities' annual financial statement to consider adopting an accrual system of accounting that would ensure the recognition of all cost and revenue incurred in the production of council services. Additionally, in the 2013 Auditor General's Report, the Chief Minister's Department and the Ministry of Local Government and Community Development (LGCD) Sarawak advocated to take the initiative to migrate to an accrual based accounting by giving priority to city and municipal councils in order to strengthen the transformation of public sector and further enhance the efficiency in financial management. Following that, the State Government has to consolidate the local authorities' financial management, particularly in the management of assets and inventory as a prelude towards the new accounting basis (National Audit Department, 2014).

On a study of the investigation into the implementation of accrual accounting for the local authorities in Sarawak, Junaidi (2013) pointed out that majority of the SLA prefer to adopt accrual-based system in the preparation of annual financial statement although modified cash accounting is still prevalently practiced throughout the state. The study also highlighted that the success on the implementation of accrual accounting system in the SLA, *inter alia,* lies on the readiness of IT infrastructure, knowledge and skill capacity and revision to the current financial regulations. In addition, the study suggested that the implementation of accrual accounting should be done in stages. The changing process, therefore, should take into account on the standardisation of chart of accounts, enhancement to the computerised accounting system and adoption of an incremental approach in relation to the disclosure requirements in the annual financial statement.

3. THEORETICAL PERSPECTIVES

In this study, two theoretical perspectives will be used interchangeably namely, (i) the public accountability paradigm, and (ii) the institutional theory. In principle, the public accountability paradigm is useful to develop the disclosure index which will be deployed to measure the extent of accrual accounting disclosure in the annual financial statement (Objective i). While, the institutional theory is needed to contribute to the understanding of how various factors combine for external financial reporting within the domain of public sector accounting. In short, the institutional theory is useful for providing a strong basis for the hypothesis development (Objective ii) as well as for interpreting and explaining the findings relating to the perceptions of the SLA in the implementation and disclosure of accrual accounting information (Objective iii).

3.1 Public Accountability Paradigm

Public accountability paradigm acts as a useful framework for public sector annual reporting disclosure (Ryan, Stanley, & Nelson, 2002; Tooley & Guthrie, 2007) and would include important features of a stewardship perspective, as well as accommodating the decision usefulness perspective (Coy, Fischer, & Gordon, 2001). Looking at the perspectives of the Malaysian Government, public accountability concept has been discussed in details with regard to the financial provisions of the Federal Constitution 1957 and the Financial Procedure Act 1957 (K. Salleh et al., 2014). Besides, public accountability requires government personnel to report their actions to the publics and comply with all laws, rules and regulations in executing their obligations (Rauf et al., 2012). This is consistent with Section 4 of the Financial Procedure Act 1957, which provide for the control and management of the public finances of Malaysia as well as for financial and accounting procedure. Due to the importance of financial reporting in providing a response to the stakeholders for the purpose of discharging accountability as well as "one of the key ways in which disclosure and transparency are achieved" (Palmer, 2013, p. 236), this study therefore adopts public accountability paradigm as it recognises the entitlement of stakeholders to comprehensive information disclosure from the annual financial statement produced by the SLA.

3.2 Institutional Theory

Institutional has been widely applied in accounting research by a number of respectable authors in the public sector (e.g. Carpenter & Feroz, 2001; Falkman & Tagesson, 2008). By definition, institutional theory is "a way of thinking about formal organisation structures and the nature of the historically grounded social processes through which these structures develop" (Dillard, Rigsby, & Goodman, 2004). The theory assumes that organisations can influence and be influenced by the society in which they operate (DiMaggio & Powell, 1991). They respond to pressure from their institutional context and adopt structure and practices that are socially accepted as the appropriate organisational choice and considered legitimate by other organisations in their field (Carpenter & Feroz, 2001; DiMaggio & Powell, 1983). In this respect, one of the key tenets of the institutional theory is legitimacy, which DiMaggio and Powell (1983) pointed out that legitimated structures and practices can be defused to organisations through three different mechanisms (isomorphism) namely: (i) coercive, (ii) mimetic, and (iii) normative. In essence, isomorphism refers to the process through which one organisation tends to resemble others in the same sector (DiMaggio & Powell, 1991). Due to this pressure, organisations will become increasingly homogeneous within given domains and conform to expectations of the wider institutional environment thus influence their structure and practices (Carpenter & Feroz, 2001).

According to DiMaggio and Powell (1983), coercive isomorphism occurs due to regulative and political influences which stem from pressures exerted on organisations by other organisations upon which they are dependent for resources or support, and also by cultural expectations of society where they operate. In relation to this study, an example of coercive pressures is the implementation of accrual accounting for Federal Government in 2015. While, mimetic isomorphism occurs when organisations seek to imitate the practices of other similar organisations in their field which have been perceived to be more legitimate, so that legitimacy can be maintained, or uncertainty be reduced at less cost (DiMaggio & Powell, 1983). For instance, the adoption of computerised accounting system with accrual accounting elements by the local authorities is perhaps, to protect their legitimacy by not standing out as being different, which is consistent with the concept of mimetic isomorphism. Lastly, the normative isomorphism which stems mainly from formal education and the growth and elaboration of cross-organisational professional associations or networks (DiMaggio & Powell, 1983).

4. HYPOTHESES DEVELOPMENT AND CONCEPTUAL SCHEMA

There will be five hypotheses developed in this study. On the other hand, the dependent variable for this study is the extent of the disclosure of accrual accounting information which is quantified in the SLA annual financial statement. The control variable in the study is the type of local authorities.

4.1 Hypothesis One: Technology Infrastructure

Quite a number of previous studies on public sector reform have examined the relationship between technology infrastructure and its key success factor for accrual accounting implementation (e.g. Cameron, 2011; Cohen, Kaimenaki, & Zorgios, 2007). Technology infrastructure not only presented challenges but also facilitated the implementation of accrual accounting system through its technical features (Seguin, 2008). Therefore, the reform process in the modern era should involve an increasing use of computerized information systems as a key component of financial management (Ouda, 2003). Therefore, it would be inadvisable for a public sector to attempt to implement full accrual accounting without the aid of a integrated financial management information system (Seguin, 2008) with proven functionality in areas such as general ledger, accounts payable, assets management, etc. (Khan & Mayes, 2007). Thus, the following hypothesis is proposed:

> *H_1: There is a positive association between the technology infrastructure and the extent of disclosure of accrual accounting information in the annual financial statement of SLA*

4.2 Hypothesis Two: Size of Local Authorities

Size of government organisations have been examined previously in public sector accounting research as one of the determinants for choice of accounting standard (Falkman & Tagesson, 2008) and have been found to be positively associated to various disclosure practices including financial disclosure (Gordon & Fischer, 2008). Although there are many ways to measure an organisation's size, local authorities' revenue in terms of assessment rates is used due to its direct relationship with the number of assessed properties and the amount of resources required in governing the local authorities, thus produce better reporting disclosure. In this study, size is appropriately measured by income from assessment rates. Therefore, the following hypothesis is developed:

> *H_2: There is a positive association between the size of local authorities and the extent of disclosure of accrual accounting information in the annual financial statement of SLA*

4.3 Hypothesis Three: Qualification of Accountancy Personnel

As reported by Cohen et al. (2007), insufficient knowledge of accounting and unavailability of any professional accounting qualifications have resulted the accountancy personnel to encounter difficulty in assessing the quality of accounting information in terms of functionality, accuracy and usefulness. Therefore, high-quality training or qualifications as accountancy personnel, which cover knowledge and experience of private-sector accounting, resulting in a more positive basic attitude to the introduction of a more informative system (Luder, 1992). With regard to the institutional theory, innovation linked to cultural authority is more likely to have influence and easier implementation of accounting reform especially when the cultural innovation is supported by national or worldwide professional associations (Meyer & Scott 1982 and Meyer & Rowan 1977, quoted in Carpenter & Feroz, 2001, p. 570). The hypothesis design to test this statement is formally stated as follows:

H_3: There is a positive association between the qualification of accountancy personnel and the extent of disclosure of accrual accounting information in the annual financial statement of SLA

4.4 Hypothesis Four: Audit Institution Size

The existence of audit institution is perceived to give influence of the private sector accounting profession on government accounting (Saleh, 2007). In addition, the auditing and consulting institutions have been claimed in public sector to be an important factors in the process of institutionalising accounting standards and compliance reporting (Falkman & Tagesson, 2008). Similarly, the presence of audit institution [in the form of established and renowned audit firms] has a positive relation to the disclosure level for the local authorities' financial statements (Copley, 1991). It is expected that audit institution size will have a positive correlation with the extent of the disclosure of accrual accounting information. Hence, the hypothesis is stated as:

H_4: There is a positive association between the existence of audit institution size and the extent of disclosure of accrual accounting information in the annual financial statement of SLA

4.5 Hypothesis Five: Regulations

Institutional theory suggests that regulations are a relevant organisational factor for the reform implementation in government organisations (Brignall & Modell, 2000). In New Zealand, the public sector experienced a major reform in the late 1980s and early 1990s (IFAC, 1994). Due to this, the New Zealand government has enacted the Public Finance Act 1989 which mandates the financial reporting by the government entities to be in accordance with GAAP. Consequently, this regulation factor has triggered fully accrual accounting adoption by all government departments by 1991 (Simpkins, 1998). Similarly, the requirements set out in the CIPFA Code of Practice on Local Authority for Great Britain (1993), for instance, has influenced the UK local authorities to adopt proper accounting practice and disclosure (Coombs et al., 1999). Therefore, the hypothesis is stated as:

H_5: There is a positive association between the existence of regulations and the extent of disclosure of accrual accounting information in the annual financial statement of SLA.

4.6 Control Variable: Type of Local Authorities

To test the main hypotheses, the type of local authorities is included as a control variable in the model. Organisational type is a variable that has frequently been used in both private sector as well as public sector for explaining financial disclosure practices. For example, various studies have examined the relationship between the disclosure practices and the choice of accounting standards with the forms of organisation based on the categories of municipal-district versus regional-city councils or different type of government organisations (e.g. Ingram & DeJong, 1987; Laswad, Fisher, & Oyelere, 2005).

4.7 Conceptual Schema

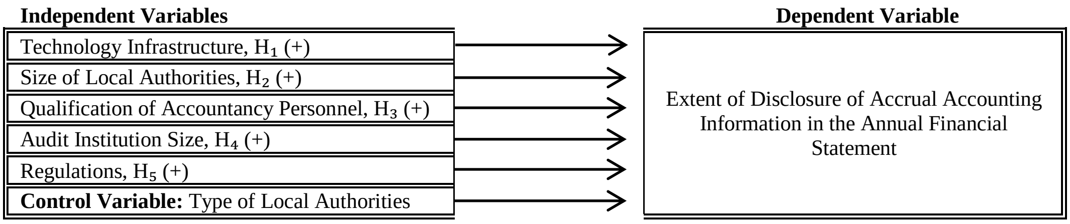

Figure 1. A conceptual schema underlying the testable hypothesis

5. RESEARCH METHOD

Both quantitative and qualitative methods will be deployed in the study. The quantitative method will be used to answer the first two objectives of the study while the qualitative method (semi-structured interviews) will be adopted to answer the third objective of the study.

5.1 Measurement of Dependent Variable: Disclosure Index

The focus of this study is the extent of accrual accounting information disclosed in the SLA annual financial statement. Basically, various approaches have been used by public sector disclosure studies in developing their disclosure index which include the disclosure requirements as specified by various guidelines provided by professional, authoritative and regulatory bodies (e.g. Gore, 2004; Pérez & López-Hernández, 2009). In short, this study focuses on the extent of accrual accounting information disclosed in the annual financial statement of SLA and this will be measured using a disclosure index. The extent of disclosure of accrual accounting information (Objective i) is determined by analysing the content of the entire annual financial statements collected from the LGCD by using a disclosure index approach.

An index which is based on public accountability paradigm (Hooks, Tooley, & Basnan, 2012; Stanley, Jennings, & Mack, 2008) will be created to analyse the accrual accounting items disclosed in the annual financial statement. This index relates the minimum requisites for the information to be provided in the annual financial statement, as recommended by the AGD, the NAD, the MPSAS, the MASB and the LAFR with the actual information disclosed in the SLA annual financial statement. In addition, the IPSAS requirement will also become the cross-reference in identifying the potential financial items to be disclosed. The index will be further segregated into mandatory and voluntary disclosures.

5.2 Sample Selection

The sample selection for this study will be based on the 182 audited annual financial statements (2008-2014). The sample represents the entire population of SLA (3 city councils, 4 municipal councils and 19 district councils). On the other hand, a pilot test will be carried out on 5 local authorities' annual financial statements.

5.3 Independent and Control Variables

Internal documents and annual financial statements will be used as a measurement and obtained from the LGCD and the SLA. A number of statistical techniques will be employed to analyse data and to test the hypotheses based on the annual financial statement disclosure index analysis.

5.4 Qualitative Phase: Interviews

Semi-structured interviews will be conducted with Head of Finance Department of the ten local authorities and senior accountant from the LGCD. The chosen sampling will represent most of the city, municipal and district councils. The LGCD is included in the interviews due to its important role in managing the SLA.

6. CONCLUSION

This conceptual paper is expected to contribute towards the accrual accounting knowledge theoretically and practically by providing further insight on the public sector accounting disclosure especially in developing countries. In addition, the study findings are expected to make significant contributions to improve transparency and accountability by producing an acceptable reporting mechanism as well as providing useful information towards accrual accounting implementation, particularly for the SLA. It is hoped that the objectives of the study will be achieved as the implementation of accrual accounting is in line with the aspiration of the Malaysian Government in moving towards accrual accounting practices.

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