A proposed definition of the Modified Cash Basis

Michael Parry - March 2010

In the article in the January edition of the Public Fund Digest "The Cash Basis IPSAS: an Alternative View" Michael Parry and Andy Wynne suggested that the modified cash basis of accounting should be recognised as an intermediate basis, in addition to the simple dichotomy between the cash basis and full accrual. We also suggested that it is relatively easy to straightforward to define the cash basis. With the issue of IPSAS 28 through 30 on financial instruments, which replace the former IPSAS 15, such a definition of the modified cash basis is made more comprehensive.

In essence the modified cash basis of accounting as proposed captures all financial assets and liabilities and the flows related to such assets and liabilities. The modified cash basis excludes physical assets (current and non-current) and also excludes all intangible assets. Hence non-cash flows such as depreciation and amortisation are excluded and replaced with the actual cash flows involved in acquiring and disposing of assets.

A proposed definition of the modified cash basis is provided in the box at the end of this article. The definition draws as far as possible on existing definitions within IPSAS so as to ensure consistency with all other standards. A modified cash basis can be regarded as either (i) and intermediate stage on the way to full accrual, or (ii) a terminal stage with no intention of moving to full accrual.

The financial statements under the modified cash basis would be as defined in IPSAS 1:

(a) A Statement of Financial Position [balance sheet showing only financial assets and liabilities];

(b) A Statement of Financial Performance;

(c) A Statement of Changes in Net Assets/Equity;

(d) A Cash Flow Statement [however, a format could be devised to combine the Cash Flow Statement with the Statement of Financial Performance as there will be only limited differences];

(e) When the entity makes publicly available its approved budget, a comparison of budget and actual amounts either as a separate additional financial statement or as a budget column in the financial statements; and

(f) Notes, comprising a summary of significant accounting policies and other explanatory notes.

The modified cash basis has a number of attractions:

- It is broadly in line with the approach currently adopted by most governments which record not only cash flows, but also domestic and foreign loans (often as memoranda records rather than part of the accounting structure). But the modified cash basis extends common practice by also identifying and disclosing unpaid bills, e.g. utility bills, a problem for many countries and which are not captured under traditional government accounting. Furthermore it provides an argument for incorporating all of this information within the accounting system itself and hence improving control.
- Budgets are usually prepared using the modified cash basis (though without actually stating any basis); both cash flows and financing flows are part of the budget. Hence the reconciliation between budget and outturn as required by IPSAS 24 is straightforward.
- The modified cash basis contains important information not included in the cash basis. In particular it provides information on government borrowing and lending and also on current liabilities (e.g. unpaid bills) of the government. In fact the modified cash basis provides the key information required for fiscal management.

- A modified cash basis can be implemented under most Commercial Off the Shelf (COTS) computer packages, whereas it is very difficult to implement a pure cash basis (because such packages are designed to work through sale and purchase ledgers which have no role when the cash basis is applied).
- At the same time the modified cash basis avoids many of the technically complex issues of valuation and measuring flows associated with the full accrual (but not all; there are still some valuation issues).
- Since actual liabilities are included there is a conceptual basis for including information on contingent liabilities in the notes to the financial statements (under the cash basis there is no logic in identifying contingent liabilities when actual liabilities are not disclosed).

Hence recognition in IPSAS of the modified cash basis would provide an opportunity for governments to implement IPSAS compliant financial statements in a manner which advances their approach to financial reporting but still avoids the considerable costs and problems of moving to full accrual. Indeed for many poor countries full accrual would be an unjustified diversion of resources urgently needed to address issues of poverty and social deprivation, and anyway is probably infeasible for such environments.

There are disadvantages and limitations to the cash basis. By its nature the modified cash basis does not include physical assets and hence the benefits of control of such assets through the accounting system cannot be achieved. This also means that when comparing costs to outputs one of the objectives of the accrual basis, matching, will not be achieved.

A further issue is that almost inevitably the statement of financial position (balance sheet) will show an excess of liabilities over assets. This is because borrowings to acquire physical assets will be recorded as liabilities, but the assets will be expensed as they are acquired. This problem is inherent in the modified cash basis and the combination of the above factors may be reasons for governments moving in the longer run to a full accrual basis.

However, the contention of this article is that the modified cash basis:

- can be defined with sufficient precision.
- Provides key information for fiscal management.
- The modified cash basis a significant advance on the pure cash basis yet remains feasible for most countries to implement.
- Whilst most countries already operate a form of modified the cash basis a clear definition enables the basis to be applied consistently within and between countries – it would be even better if the modified cash basis was formally recognised under IPSAS.

© 2010 Michael Parry

Michael Parry Consulting

Web: www.michaelparry.com

E-mail: Michael.parry@michaelparry.com

Proposed definition of the Modified Cash Basis of Accounting

The Modified Cash Basis of Accounting will recognise transactions only when cash, financial assets or liabilities are paid or received. The Statement of Financial Position (Balance Sheet) will include financial assets and financial liabilities.

For the purpose of this definition:

- A financial asset is any asset that is:
  - (a) Cash
    - (i) Cash comprises cash on hand, demand deposits and cash equivalents
    - (ii) Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value
  - (b) An equity instrument of another entity;
    - (i) An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities
  - (c) A contractual right:
    - (i) To receive cash or another financial asset from another entity; or
    - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity
  - (d) A contract that will or may be settled in the entity's own equity instruments and is:
    - (i) A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
    - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16 of IPSAS 28, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18 of IPSAS 28, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.
- A financial liability is any liability that is
  - (a) a contractual obligation:
    - (i) To deliver cash or another financial asset to another entity; or
    - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity
  - (b) A contract that will or may be settled in the entity's own equity instruments and is:
    - (i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
    - (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16 of IPSAS 28, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18 of IPSAS 28, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.
- A payment occurs when there is an outflows of financial assets or an inflow of financial liabilities
- A receipt occurs when there is an inflow of financial assets or an outflow of financial liabilities.