Public Sector Accounting - An Interdisciplinary Field Involving Accounting, Economics, and Jurisprudence

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Abstract

Public sector accounting has recently been improved. Currently, there are requirements to disclose stock information in addition to the flow information presented in budget statements or accounts statements. Public sectors have prepared and disclosed their financial statements (including balance sheets and income statements) based on business accounting approaches. Moreover, as a matter of policy, the government tends to prepare and disclose cost information along with the financial statements for the individual ministries and governmental agencies.

The objectives of clarifying the fiscal conditions in a state through the preparation and disclosure of financial statements are to fulfill the state’s accountability to its citizenry and market participants and to optimize and enhance the efficiency of its fiscal activities. Most importantly, the improved information should contribute to democratic decisions on public finance.

A perspective different from the business accounting is that public sector accounting places more emphasis on inter-generational fairness. With respect to the inter-generational benefits and burdens, however, various factors must be considered, and the differences between assets and liabilities in the balance sheet may not be the indicators for that purpose.

Public sector accounting is considered to have been developed based on the business accounting approach. As such, the objective of the accounting is to retrospectively review how assets and liabilities have changed as a result of past public finance operations. Yet, in considering compelling public finance conditions, there is a need to discuss and consider expected perspectives, in order to clarify what resources will remain in the future by

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1 I am deeply indebted to Professor Katsuya Uga (Administrative Law, The University of Tokyo) and Professor Kiyoshi Yamamoto (Public Sector Accounting, The University of Tokyo) for reviewing this paper and offering advice. As the author, however, I take full responsibility for all of the opinions expressed in this paper and full blame for all of the paper’s faults.

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incorporating the aspect of future cash flows (this paper views this as a mixture of accounting thought and economic thought). It is important to recognize that both perspectives are commingled. If the forecast perspective is highlighted, the assets in the balance sheet should include taxation rights that give rise to future tax revenue. Another useful practice, from the perspective of information disclosure, is to prepare an individual balance sheet, in addition to a comprehensive financial statement, for each significant political agenda (e.g., public pension obligations).

Public sector accounting has been developed without implementing a necessary legal basis. The effects of this reform may be a matter of not much interest without infringing any democratic control of public finance under cash basis accounting. The focus for public finance, however, has certainly been transferring from flow to stock and from the aspect of political decision to the aspect of administration. The role of public sector accounting should be clarified in conjunction with the various systems.

I. Introduction

Recently in a bid to better reflect the fiscal conditions of the central government as a whole, the national accounting standards and other requirements have been improved and stock information (information on assets and liabilities) as well as cash flow information through budgets and annual accounts have now been disclosed comprehensively and systematically. In this context, the balance sheet and the statement of administrative costs have been prepared and disclosed in accordance with the approach adopted in the business accounting. We have also witnessed recent initiatives to prepare and disclose cost information for each policy implementation, in addition to the separate financial statements by ministries.

The reform of public sector accounting focused primarily on adopting business accounting models such as accrual accounting. Amidst these efforts, certified public accountants, accounting academics, and national public accountants and NPM specialists initiated the improvement of the accounting standards. In January 2003, the office of public sector accounting was then formed in the Budget Bureau of the Ministry of Finance. The Public Sector Accounting Subcommittee, Legal and Public Sector Accounting Section, and Fiscal System Committee of the Fiscal System Council mainly strove to develop the criteria for preparing financial statements. As they did, academics and practitioners in public finance, law, and public administration contributed to their efforts.

In this paper, we clarify the relationship between jurisprudence and economics by considering various issues to do with public finance. We must note in this regard, however, that public sector accounting represents a field involving accounting, economics, and jurisprudence. While accounting and economics focus on the functional aspect of the system, jurisprudence often places weight on the meaning of the system in terms of the relationships with related
various systems. (Because of this, jurisprudence is often thought to be conservatively opposed to changes in the status quo, yet it can be used constructively in conjunction with other fields, provided that it does not adhere to too closely to the history and background of the system). Public sector accounting is one of the areas where practices have advanced before the theories have deepened. I will provide insights into the roles and meanings of the public sector accounting. While doing so, I will identify the interests and purposes for which these three academic fields of accounting, economic and jurisprudence jointly collaborate. This information will provide further support for an outlook for the design of a better system, one which in fact is widely being accepted. This is the objective of my paper, one that I believe is called for in the context of the latest Financial Review.

This paper is composed of the following. First, I will give an overview of the public sector accounting system, mainly from the perspective of the separate financial statements by ministries (II). Next, I will provide functional insights in the public sector accounting and then draw on knowledge on accounting and economics to discuss the desirable types of information disclosure, assuming that the purpose of public sector accounting is to enhance information disclosure (III). Finally, I will discuss the implications of improved public sector accounting from various viewpoints of jurisprudence, and conclude this paper (IV).

Separate issues on special accounting and accounting by independent administrative institutions are topics of great interest in the context of public sector accounting, I will address these issues in another paper. Some sophisticated approaches such as full business accounting models (double entry and accrual basis) in the Tokyo Municipal Government have been observed in accounting of local governments. I will refer to them in a limited scope from time to time in this paper, as appropriate.

II. Overview of Public Sector Accounting System

II.1. History and Background

Conventionally for the balance sheet of central government as a whole, the information on cash flow has been disclosed through the budgets and annual accounts and concurrently some stock information has also been disclosed partially through various materials and data\(^1\). As noted below, however, such materials and data used to be somewhat less exhaustive and to be

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\(^1\) For the budget compilation, the government shall file with the Diet the reference documents prescribed in Article 28 of the Public Finance Law. These reference documents include a written statement of the position of the Treasury, a written statement of the status of government bonds and borrowings, a written statement of holdings of national properties, and a written statement of the assets, liabilities, profit and loss, and other results from major corporations to which the government has made equity contributions. For the annual accounts, the government shall file with the Diet with separate statements concerning the respective liabilities of the government pursuant to Article 40 of the Public Finance Law.
presented rather unsystematically.

That is, it has been difficult to piece together an accurate profile of the balance sheet of central government as a whole on an accounting basis, as previous data on assets and liabilities were separately reported in statements of general accounts and statements of individual special accounts (1). It is difficult to depict an overall picture of the national assets and liabilities, as the government discloses its fiscal disposition in separate reports such as the “General Report on Current Total Value of Government Receivables,” “Changes in National Properties and General Statement of the Current Total Value,” “Statement of the Government Liabilities,” and so on (2). As the scope of data has been separately determined according to jurisdictions and forms of administration, the data have not exhaustively identified the conditions of government assets and liabilities (3). Unlike business accounting, public sector accounting does not conventionally recognize or measure values after depreciation and amortization, nor does it provide information on provisions for retirement benefits2 (4). These issues have consistently been identified and contested.

Efforts to improve the public sector accounting started with two guidelines: first, the “Basic View on the Preparation of the Balance Sheet of Central Government” which was developed by specialists and academics in the private sector, in October 2000; second, the “Balance Sheet of Central Government (draft)” developed and issued based on such guidelines (the statement has been prepared and issued from fiscal year 1998).

Next, the Fiscal System Council developed guidelines for the preparation of, and accounting standards for, the financial statements of special corporations or independent administrative institutions, and special accounts3. The Council issued its “Basic View on Public Sector Accounting” in June 2003, followed by the “Guidelines for the Preparation of Separate Financial Statements by Ministries, in June 2004. The first separate financial statements for fiscal 2002 by the ministries (general accounts and special accounts) were issued in October 2004. For the accounts for fiscal 2003 and thereafter, the government has issued “Separate

2 “Basic View on the Preparation of the Balance Sheet” (October 2000).
3 For special corporations, Guidelines for the Preparation of the Statement of Administrative Costs were adopted in June 2001. For independent administrative institutions, Guidelines for Accounting for Independent Administrative Institutions were decided in February 2002 and revised in March 2003 and in June 2005. Individual ministries have issued these statements in the years since. For special accounts, the “New Guidelines for the Criteria for the Preparation of Financial Statement of Special Account” was issued in June 2003 (the criteria were incorporated into the criteria for the preparation of separate financial documents by ministries in June 2004). In addition, the Law Concerning the Promotion of Administrative Reform for the Realization of Small and Efficient Government (Act No. 47 of 2006) and the Law Concerning Special Accounts (Act No.23 of 2007) were enacted in June 2006 and March 2007, respectively, to form a common legal basis for accounting for special corporations and independent administrative institutions. After the enactment, it became mandatory to prepare financial statements in a manner consistent with the accounting practice of business enterprises (Article 19 of the Law Concerning on Special Accounts).
Financial Statements by Ministries” (including consolidated financial statements incorporating independent administrative institutions and special corporations) annually, along with the “Financial Statements of Central Government” (aggregating the “Separate Financial Statements by Ministries and Government Agencies”).

The “Separate Financial Statements by Ministries” and the “Financial Statements of Central Government” issued in February and June 2010, respectively, were the sixth round of the issuance.

During this period, the Ministry of Public Management, Home Affairs, Posts and Telecommunications (former Ministry of Home Affairs) issued a “Survey Report on Comprehensive Financial Analysis at Local Governments” (MPHP model) in March 2000 and in March 2001. The preparation and disclosure of the balance sheets or the administrative statements of administrative costs have been encouraged and promoted. Some local public organizations prepared their balance sheets according to their own approach. Other organizations including the Tokyo Metropolitan Government have fully adopted accrual basis accounting, as well as the double entry model (effective from fiscal 2006).

In the sections below, I spotlight the Separate Financial Statements by Ministries and Government Agencies, and provide a general overview, as well.

**II.2. Overview of the Separate Financial Statements by Ministries and Government Agencies**

The government is obliged to monitor whether the accountability requirements of each ministry and government agency are fulfilled. For this purpose, each ministry and agency prepares its own financial documents.

The financial statements by ministries consist of (1) “separate financial documents by ministries” aggregating general accounts and special accounts, (2) financial statements for general accounts by ministries, and (3) financial statements for special accounts. The government also prepares financial documents consolidating independent administrative institutions into general accounts and special accounts.

The separate financial statements by ministries are first prepared based on the accounts of revenues and expenditures developed on a cash and single entry basis and the values in the government property register after the end of the previous year. Then, necessary adjustments for reconciliation to an accrual basis will be made. It is therefore currently difficult to prepare and

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4 According to the Financial Statement of the Central Government for fiscal 2008, a document issued in June 2010, the balance sheet of the central government showed total assets of ¥664.8 trillion and total liabilities of 982.2 trillion, which translated into net liabilities of ¥317.4 trillion. If this had been a balance sheet of the private sector, the statement would have represented liabilities vastly in excess of net assets.

5 This approach is identical to that in the UK.
disclose the financial documents concurrently with the annual accounts of revenues and expenditures. This gives rise to a problem with the availability of information disclosed on a timely basis. That is, unlike the case in business accounting, timely disclosure is hardly attained in the public sector accounting. The early preparation and disclosure of financial statements cannot be achieved without overcoming the significant challenges such as routine bookkeeping and the implementation of double entry from the first stage of recording.

The financial statements of central government as a whole are prepared on the basis of the values included in the separate financial statements by ministries by eliminating any intra ministerial receivables and payables. There are three types of financial documents of central government: the “financial statements of central government (general accounts and special accounts),” the “financial documents for general accounts,” and the “consolidated financial documents” consolidating data from independent administrative institutions, etc.

The separate financial statements by ministries are composed of the following: (1) balance sheet, (2) statement of administrative costs, (3) statement of change in net assets, (4) cash flow statement, and (5) schedules. The values included in each statement are mutually correlated with values in other statements. From herein, I will comprehensively describe the nature of each statement.

(1) Balance sheet

The balance sheet clearly presents the financial position of assets and liabilities attributed to each ministry at the end of fiscal year. The financial position is classified into assets, liabilities, and net assets (differences between assets and liabilities).

i) Assets

Assets represent resources attributable to each ministry as a result of past transactions or events, including cash and deposits, securities, inventories, loans, property, plant and equipment, and equity contributions. The ministry or agency can expect these assets to improve its future

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6 Double-entry bookkeeping and accrual basis accounting have been adopted in the routine bookkeeping of independent administrative institutions and incorporated national universities from the beginning of the fiscal year (paragraphs 2 and 33 of the Accounting Standards for Independent Administrative Institutions, and paragraphs 2 and 37 of the Accounting Standards for Incorporated National Universities). To learn more about the current status of the development of the system for the early publication of financial statements, please see the Report on the Development of the System for Preparing Financial Statements submitted by the Public Sector Accounting Working Group of the Fiscal System Council on June 24, 2010.

7 The following descriptions mainly draw on the Preparation of Financial Statements by Ministries issued by the Fiscal System Council on June 17, 2004 (revised on November 19, 2007).
capability to provide services or to provide future economic benefits.

With respect to the evaluation of property, plant, and equipment, the values recognized for national properties are based on the values in the national property register. In the case of public utility properties, the values recognized for the evaluation are based on the estimated costs derived by accumulating the historical costs for the lands and project costs over the useful life of facilities.

ii) Liabilities

Liabilities represent the present obligations of each ministry and agency arising from past transactions or events. They include payables, government short-term securities, borrowings, public bonds, and provisions for retirement benefits. The fulfillment of these obligations reduces the future capacity to provide services and reduces economic benefits.

The accounting for deposit money for public pension plans (employees’ pension and national pension schemes) is especially an issue with regard to liabilities. The recognition approach differs according to the funding approach or unfunded pension plan adopted. Under the current approach (adopted 2007), the following is accounted for as deposit money for public pension funds in liabilities: the amount derived by deducting the payables from the totals of employees’ pension accounts in pension special accounts and cash and deposits and money deposited for management (accumulated funds) in the national pension accounts and other assets held for the appropriation to the financial resources for future pension benefits. Other information is included in the notes to such documents.

iii) Statement of change in net assets

Unlike the case with business accounting, the differences between assets and liabilities in the public sector accounting are presented under single heading, “net assets.”

According to the “Basic View on the Preparation of the Balance Sheet of the Government” (developed in October 2000) and the “Preparation of Separate Financial Statements by Ministries” (developed in June 2004 and revised in November 2007), the public sector has not given any significant meaning to the net assets because the public sector has no transactions in relation to the paid-in capital which are recognized under the business accounting and the meaning of the income statement is less significant. The net assets are not disaggregated unlike the case with business accounting.

(2) Statement of administrative costs

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8 The treatment of public pension liabilities is also a major problem in other countries. The System of National Accounts (SNA) does not account for public pension obligations as liabilities.
The statement of administrative costs clarifies the costs incurred at individual ministries and agencies in providing services. Though the income statement under the business accounting is prepared by corresponding revenues to expenses (correspondence basis of expense and revenue), the public sector accounting does not adopt the concept of the incurrence of expenses to generate revenues. Hence, the statement of administrative costs only presents expenses (the “total performance expenses for the current year” tied to the total performance expenses for the current year” described at the last of the statement of change in net assets).

The statement of administrative costs is prepared by extracting the values to be included in assets from such annual accounts of revenues and expenditures. Then the statement is adjusted for any non-financial transactions such as any deferred and accrued accounts, depreciation costs, and provisions, which can be identified on an accrual basis\(^9\).

(3) **Statement of change in net assets**

The statement of change in net assets discloses any changes in the net assets in the balance sheet at the end of previous year and those at the end of current year by factor. The statement of administrative costs does not exhaustively present all the changes in the net assets in the balance sheet. Hence, any changes not included in the statement of administrative costs (e.g., financial resources, valuation differences on assets) are recognized in the statement of net assets.

(4) **Cash flow statement by sector**

The cash flow statement by sector is prepared with a view to clarifying the flow of fiscal funds by sector at each ministry and agency. The statement is prepared by dividing the administrative cash flows and financial cash flows based on the values presented in the annual accounts of revenues and expenditures. This statement enables the understanding of cash flows on a cash basis while other statements are prepared on an accrual basis.

The “outstanding balances of cash at hand and deposits for the current fiscal year” in the cash flow statement by sector correspond to the values in “cash and deposits” in the balance sheet by adding the carry-forward provided for the next year revenue, the translation differences of cash flows and funds off the revenues and expenditures, and the outstanding balances of deposit

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\(^9\) They also include finance costs for operating expenses of each ministry and labor costs and expenses for government buildings in the category of the special account disbursed from the general account. The information about these costs is presented only for reference. The financing costs for public debt incurred by ministries are described in the notes as public-debt-related information pertaining to the outstanding balance of public debts.
money and contractual guarantee money to the “cash flows for the current fiscal year” aggregating the administrative cash flows and financial cash flows.

II.3. Preparation and disclosure of cost information by policy

Financial information provided by the “Separate Financial Statements by Ministries” is disclosed at the level of individual ministries and agencies, and general accounts and special accounts, respectively. The statement of administrative costs included in the respective financial documents provides information on costs (administrative costs) incurred by individual ministries and agencies in performing their services. It is prepared at the ministerial and agency level.

However, the disclosure of financial information at this level faces certain limitation in terms of the usage for the enhanced efficiency and fairness of fiscal activities\(^\text{10}\). Hence, the government is considering initiatives to measure and disclose costs at the level of each policy, separately from the disclosure of cost information by ministries and agencies in their financial statements (budgets and annual accounts were reviewed in 2008 and certain measures to reconcile the budget items and account items with the policy assessment items were partially implemented in 2008 for some ministries and agencies\(^\text{11}\)). The clarification of cost by policy on an accrual basis is useful, in that it enables comparisons with costs in the private sector entities engaged in similar activities\(^\text{12}\).

The preparation of cost information by policy faces the following challenges: the unit at which cost information by policy is prepared, the accounting for common expenses (such as personnel expenses), the accounting for assets (whether to account for the amount required for the acquisition of an asset as cost (settled amounts) or to account for the amount equivalent to the depreciation cost as cost from the accrual viewpoint).

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\(^{10}\) “Further development of the basis for public sector accounting: interim report”; Fiscal System Council (June 14, 2006).

\(^{11}\) “Disclosure of cost information for enhanced use” (June 26, 2007) and “Identification and disclosure of costs by policies (July 20, 2010); Fiscal System Council.

\(^{12}\) If, however, a public sector is already providing a service, the capital charge (asset holding costs) should have been added based on the replacement cost of the facilities owned. Yet the public sector would not need to acquire facilities anew. So the private sector may win the competitive bid at a relatively higher cost. This issue remains unsolved.
III. Functional Insight into Public Sector Accounting - Drawing on Knowledge on Accounting and Economics

III.1. A sharp distinction between the information disclosure function and decision-making

The reform of public sector accounting was advocated with a view to adopting the accrual basis at the settlement of accounts. As identified, there are certain significant differences between business accounting and public sector accounting in conjunction with the differences between private sector activities and public sector activities (including government activities)\(^{13}\).

The primary difference between the activities of the private sector and the activities of the government is that the private sector activities seek to maximize the differences between revenue and costs (revenue earning), while government activities are required to maximize administrative performance under the constraints on the “resources invested.” The performance of the government cannot always be measured on a monetary basis, and the measurement of performances by non-financial information will be material (in this respect, the enhancement of the approach for the assessment of policy would presumably be about as important as that of the public sector accounting system).

I can also point out here that the activities of government have external effects not seen in exchange transactions on markets, and thus have fundraising advantages. The same cannot be said for the activities of the private sector.

The activities of government significantly differ from the activities of the private sector in many respects. Yet, various principles of business accounting, including the principle of correspondence between revenue and cost, are now applied to public sector accounting, with some retrofitting through relevant amendments.

Incidentally, business accounting primarily focuses on the discharge of stewardship accountability in line with the assets trusted to management through the appropriate understanding and reporting of financial conditions\(^{14}\). We thus see that it is one thing to clarify the financial conditions, and apparently another to make decisions based on the clarification.

Yet, one of the purposes of public sector accounting embraces the enhanced efficiency and fairness of fiscal activities in the processes leading to decision-making\(^{15}\). We need to provoke thoughts on the interactions of business accounting and public sector accounting, i.e., why the efficiency and fairness of the fiscal activities will be enhanced by providing clear stock

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\(^{14}\) For details on the concepts of accounting responsibility and stewardship, see Hiroshi Yoshida “Theory of Public Sector Accounting – Public Sector Accounting to Control Taxes,” Toyokeizai 2003, p15 onwards.

\(^{15}\) See the “Basic View on Public Sector Accounting” Fiscal System Council, June 2003.
information on assets and liabilities under the business accounting model, and what path must we take to achieve such enhanced efficiency and fairness\(^{16}\).

The areas where information obtained through improved public sector accounting can be used to effectively include the fiscal discipline of the entire country, fiscal targets of individual ministries and agencies, and targets for each project\(^{17}\).

We can use information obtained under public sector accounting as guidance in setting the rules for fiscal discipline, in order to achieve sound fiscal discipline for the entire country\(^{18}\). In practice, the fiscal restraint to maintain the net assets in the balance sheet at a certain level is identified as a goal of fiscal affairs to ensure that the golden rule has been satisfied. When the net assets are maintained at the same level, no profit and loss is generated in administrative cash flows. Some countries have identified this maintenance of the net assets as a fiscal objective\(^{19}\). Naturally, towards this end, the government needs to express its political commitment to the adherence to rules.

To contribute to the enhanced efficiency and fairness of fiscal activities, the government must organically correlate the information available from its financial statements with the compilation and allocation of its budgets. Yet, there are two restraints on efforts to do this.

The first restraint is to align the account items in the financial documents with the corresponding items in the budgets and annual accounts. It is very difficult, in practice, to tie them very closely. The government should thus take steps to enhance the efficiency and fairness of individual projects by clarifying cost information by policy and project, rather than clarifying financial information by ministry, agency, and organization.

The second restraint is to achieve the correspondence of cut off timing of annual account items and budget items. Any financial information for the current term obtained from the annual accounts may only be reflected in the budgets in the fiscal year following the next, at earliest. The primary objective of the settlement of accounts is to confirm the disbursement as scheduled by administering the budgeted amounts. To address this issue, the administrative entities

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\(^{16}\) Sachio Konishi, “Relationship between Disclosure of Fiscal Information and Budget Control – Application of Balance Sheet Analysis to Fiscal Operations”; No. 28 of Kaikei-Kensa Kenkyu (2003), p55: This paper also distinguishes between the information-disclosure function in the disclosure of fiscal information and budget-control function.

\(^{17}\) For details on the future use of financial statements by ministries, see Nobuo Azuma, “Challenges and Prospects for Financial Statements by Ministries” No. 33 of Kaikei-Kensa Kenkyu, p292 onwards.

\(^{18}\) For details on the use of financial information to arrest soft budget constraints between different accounts, see Takero Doi, “Public Sector Accounting, Financial Analysis of the Public Sector and its Application,” ; Toshihiro Ihori, “Performance Evaluation of the Public Sector – Roles of the Public and Private Sector,” University of Tokyo Press, 2005, p39 onwards.

preparing financial documents should refer closely to the budgets disbursed for the current fiscal year and assume that the annual accounts should correspond with the budgetary items (this does not mean that the annual accounts are taken lightly). This approach cannot preclude the preparation of financial statements on an accrual basis, in addition to conventional budget documents at the stage of budget compilation (the possibility of co-existence of cash basis budgets and accrual basis budgets).

Any financial information becomes meaningful when fiscal policymakers use the information or when the information interacts with rules to discipline the decision-making of fiscal policymakers. The current efforts to improve public sector accounting spotlight the enhanced reporting of accounts or ensured accuracy or transparency of fiscal information. Thus, it will be inevitably necessary to consider what comprises useful information for democratic decision-making on fiscal affairs. In the next section and thereafter, I will discuss these issues.

III.2. Inter-generation fairness and inter-time fairness

One issue less weighted by business accounting but more heavily and deliberately weighted by public sector accounting is the consideration to potential bearers of burdens in the future. (Business accounting emphasizes accountability for existing and potential shareholders and creditors, but these entities may take exit strategies at their discretion. In this respect, accountability under public sector accounting is very different from that in the private sector, in nature.)

We have no need to reiterate that fiscal democracy (Article 83 and subsequent articles of the Constitution) may prefer decision-making of the current working generation from the perspective of common pool issue and may neglect to consider benefits for the future generation.

Against this backdrop, a push to review and confirm the sustainability of fiscal affairs and the fairness of inter-generational bearing of burdens has emerged.

In this regard, it may be difficult, in an environment where the net assets in the balance sheet

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20 In the context of information disclosure, there should be precise separation between the discussions in relation to the national people and the discussions in relation to parliament and the administration. Yet, this paper discusses the disclosure by embracing both. Business accounting also distinguishes between the reporting function to discharge accountability for investors out of economic entities and the management function to support the judgment and decision-making of relevant persons in economic entities.

21 The aforementioned Basic View on Public Sector Accounting may embrace future generations of the national people, in addition to the current people and market participants, depending on the information disclosed.

22 Many studies have assessed the fairness of inter-generational benefits and burdens through the analysis of balance sheets. The following paper identifies net assets (differences between the assets and liabilities) as benchmarks to assess the inter-generational fairness: Marc Robinson, *Public Sector Net Worth: Is it Worth Measuring?*, Department of the Parliamentary Library, Research Paper, No. 36 (1995-96), p13.
of central government as a whole are largely negative, to find any meaning in the values in a
given year. Yet, if we look at year-on-year changes, we may find certain meaning. Assets
generate benefits for future generations and liabilities constrain available funds as they are
redeemed in the future. If differences between assets and liabilities decrease in a given year
against the previous year, some argue that a burden equivalent to the decrease is passed to
future generations as a consequence of the fiscal operation in the year.

Yet, if we are to set the maintenance of the differences at a constant level as an objective,
assuming that increases, decreases, and changes in the differences between assets and liabilities
represent the relationship between the inter-generational benefits and burdens, a careful
consideration and discussion will be required to work out the best approach to do so.

Financial documents published annually are always appended with a note informing readers
that the net assets do not always represent the amounts of burden to future generations. And by
way of explanation, they state the following: i) assets used for calculating the differences
between assets and liabilities largely include assets that are held for providing administrative
services (including public utility properties like roads and rivers) and are not expected to be
liquidated into cash by sales; ii) though local governments and agencies hold large outstanding
balances of municipal bonds issued, the outstanding balances of the net assets are positive due
to the asset formation backed by subsidies and the like of the central government. In light of the
foregoing, the financial documents state that the outstanding balances of ordinary government
bonds (or the differences between financial assets and liabilities) which will be redeemed by
taxes paid by future generations can be an indicator of the liabilities to be incurred by future
generations.

The measurement of individual items in assets and liabilities may have shortcomings such as
poor accuracy or exhaustiveness (e.g., measurement of special fixed assets). And even if we
were to neglect these issues, the net assets may be inappropriate as a benchmark to assess
inter-generational burdens.

If we discuss the fairness of inter-generational burdens, we may have to compare the
amounts received with the amounts paid during the whole life of each generation, as is done in
the case of inter-generational accounting (inter-generational accounting, however, will continue
to encounter the issue that the benefits are not always attributed to individual persons)\(^{23}\). Yet, the
comparison of the inter-generational burdens must rely on various forecast factors and the
results may vary dependent on such factors.

In addition, when the number of retirees or persons entitled to receive pension benefits is
expected to increase as society ages, the government has to attain the inter-generational fairness

\(^{23}\) For details on generational accounting, see the well-known work by Kotlikoff, Laurence J.,
“Generational Accounting: knowing who pays and when, for what we spend” (translated by Yutaka
Kousai); Nihon Keizai Shimbun Sha 1993; Also see “Generational Accounting,” a feature article of the
of burdens by increasing the assets required to address rapidly growing fiscal demands. This will always be necessary, unless the population distribution remains constant.

Hence, the changes in the net assets could only be perceived to be a benchmark to assess the fairness of burdens at given times (from the perspective of the government) separately from inter-generations (from the perspective of each generation), in that the changes match the differences between cash inflows and outflows. Yet, as changes in cash inflow and outflow differences will not completely match the changes in the net assets when any valuation gains or losses arising from the price fluctuations of assets or gains or losses on the sales of assets arising from any privatization take place, the changes in the net assets may be of limited use as a benchmark to assess fairness at the given times.

III.3. Historical and prospective perspectives

I have reaffirmed that public sector accounting provides a meaningful information-disclosure function, not a decision-making function, per se. With respect to the meaning of the net assets which has given rise to some controversy, it would thus appropriate to utilize the differences between assets and liabilities as a benchmark to assess the fairness among given times, instead of inter-generational fairness.

What information should be provided in the financial documents as an objective of financial reporting?

The numerical values of an entity mainly provide meaning for the first time when they are comparable to those of other entities under identical standards, as is done in business accounting. There are no comparisons currently assumed among ministries and agencies, entities with different purposes. Only the consideration of values of the central government as a whole would be less meaningful. In this context, the values presented in the financial documents would have meaning on a time series basis. If the financial documents on general accounts, on special accounts, and on general accounts and special accounts combined were prepared and stock information aggregating independent administrative institutions were annually clarified and accumulated, it would be possible to verify and trace any changes that take place at individual ministries and agencies based on their historical financial operations.

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24 See Kiyoshi Yamamoto, “Reform of Government Accounting – Future of Central Government, Local Governments and Independent Administrative Institutions,” Chuokeizai-Sha 2001, p28. In the interest of the long-term financial stability of fiscal affairs, this paper notes that current generation should not defer burdens that do not correspond to the benefits of future generations. The author also contends that the current generation should take on the obligation of protecting future generations from unexpected burdens arising from events such as force majeure.

25 In local public accounting, however, information could be made comparable between sectors by introducing a single convered model. It would also be made comparable between countries if many countries were to adopt and develop International Public Sector Accounting Standards (IPSAS).
from monetary viewpoints.

When considering the functions of public sector accounting from these perspectives, the disclosure of financial information must achieve two way objectives. One is to improve information disclosure to enable retrospective assessment of the results of historical fiscal operations. The other is to improve future prospective information in order to clarify the degree of resources available in the future.

Most of the current financial information disclosures highlight information to verify the historical fiscal operations retrospectively. Balance sheets under business accounting primarily present assets in which funds are invested on the debit side on the left and liabilities arising from fundraising on the credit side on the right, based on the historical balances of cash inflows and outflows. If we are to weight these perspectives heavily, any subjective information assessment accompanying forecasts may be beyond the scope of accountability required under the accounting standards. Speaking on extreme terms, it may come to be, as a natural consequence, that the public pension obligations necessary for determining the burden of the national people in the future should not be recognized in the liabilities of the balance sheet.

On the other hand, information on the degree of resources available for future use is certain to be a great concern amidst the harshly tightening fiscal conditions. In fact, the current financial documents have adopted the accounting treatment where the provisions for retirement benefits and deposit money for the public pension scheme are recognized to the maximum extent in order to enhance the quality of such information. For the deposit money for the public pension schemes specifically, the notes to financial documents describe the present value of future benefits corresponding to the historical period with the expected amounts of fiscal resources26.

Up-to-date accounting academics and economists have undertaken initiatives for the enhanced public sector accounting, and this trend is unlikely to change going forward. One can plausibly argue that business accounting focuses on retrospective perspectives from the historically oriented viewpoints, while economics (including public finance) places importance on forward looking perspectives27.

26 In the “Balance Sheet of the Central Government (draft)” up to 2001, public pension liabilities were presented based on three approaches in accordance with the recognition principles of public pension liabilities described in the “Basic View on the Preparation of the Balance Sheets of the Central Government.” Two of these three approaches accounted for the public pension liabilities by assessing the benefits corresponding to a historical period at the discounted present value.

27 Economics are better at identifying future uncertainties mathematically along the lines of physics (economics played a important role in the analysis of policy costs under the fiscal investment and loan programs and cost-benefit analysis). For reference, see the following: the sections after p44 in the abovementioned paper by Doi; Yoichi Takahashi, “Future Cash Flow Analysis of Fiscal Issues – From the Perspective of the Burden Incurred by Future Generations”; Masahiko Aoki/Kotaro Tsuru, “Fiscal Reform in Japan - How to Improve,” Toyokeizai, p157 onwards. Accounting is a practical discipline: it tends to identify things that are objectively certain because it emphasizes the importance of utility for
That is, business accounting requires that the income statements prepared and reported present the causes and circumstances leading up to the occurrence of profit and loss on an accrual basis, a basis suitable for calculating profit and loss in a given period, and requires that the balance sheet prepared and reported present the sources of management resources and their appropriation as of the end of the period. Recently, however, business accounting has spotlighted a prospective perspective in the asset and liability management approach. Notwithstanding this, the measurement of assets and liabilities based on future cash flows has hardly been emphasized.

On the other hand, economics highlighted the potential for economic rewards without adhering to the concept of assets and liabilities in the context of accounting. This is clearly evidenced by the argument that the assets in the balance sheet should include the power to tax. Some argued that the recognition of any asset not expected to be sold gives rise to the recognition of any assets with future cash inflows, and that the assets representing future tax revenues (their present value) generating future cash inflows should be recognized instead. The argument has also required the recognition of all the social security and other benefit liabilities incurring future cash outflows. Yet, the balance sheet prepared through such steps may not be qualified for being called “accounting”, and in effect lacks in the correlation between budgets and annual accounts.

While acknowledging that public sector accounting mixes retrospective perspectives and prospective perspectives, a more important thing is to enhance the quality of the fiscal information. The presentation of items assessed by different approaches line-by-line on the debit side and credit side of the balance sheet only represents the general inventory showing assets and liabilities. Or, it might be perceived to be structured to obscure some of the vast liabilities in the central government’s balance sheet by assets.

The treatment of the public pension liabilities is especially hard. Even in foreign countries, some have argued that unless public pension benefit liabilities are recognized, the balance sheet will not be legitimately complete or integrated. Others, meanwhile, have noted that the recognition of such vast liabilities could impair usefulness of the balance sheet. This has been decision-making. Yet this is only the view of the author, a person specialized in another academic area. In this context, the differences between economics and accounting have become relative. I certainly welcome criticism on my view in this regard.

28 With regard to the recent discussions about changes of the business accounting system, see the articles published in “Achievements and Challenges of Accounting System,” Kinyu Kenkyu, August 2008 Issue.
29 A recent argument proffered mainly by economists contends that the complete financial statements of the government should include the power to tax in the assets. For these points, I referred to Gian Maria Milesi-Ferretti, Kenji Moriyama, “Fiscal adjustment in EU countries: A balance sheet approach,” Journal of Banking & Finance 30 (2006), p3282; the aforementioned book by Yamamoto, p88, and the references therein. The following clearly describes the reasons for advocating the framework of forward-looking balance sheets: Takashi Sasaki, “Study on Audit and Accounting Structure – Time Series Audit,” p271, Moriyama Shoten, 2002.
an intensive controversy. When the public pension liabilities have a strong aspect of future forecast and they are themselves policy challenges, it would be useful to prepare a separate balance sheet only in terms of the liabilities, in addition to the “present values of employees’ pension benefits and financial resource architecture” described in the notes to the balance sheet\(^{30}\). The preparation of a comprehensive balance sheet would be an important tool for gaining the comprehensive and integrated understanding of financial information. But such preparation alone would give rise to cases where the issues of public debt and public pension liabilities are likely to be bundled and may distort the perception of individual issues by making them seem less serious.

IV. What Does System Reform Mean? - From the perspective of jurisprudence

IV.1. Legal positioning of public sector accounting

At this stage, ministries and agencies are required to prepare and disclose financial documents in practice, but not within a legally binding framework. (On the contrary, independent administrative institutions and special accounts are legally required to adopt business accounting principles and to prepare and disclose financial documents subject to business accounting principles. We can confirm the legal basis in Articles 37 and 38 of Procedural Law Concerning Independent Administrative Institutions, and Articles 19 and 20 of the Law Concerning Special Accounts). Though not mandatory by law, the preparation and disclosure of financial information through a business accounting approach (e.g., accrual basis accounting) have widely been accepted in practice. In this section, I will discuss what preparation and disclosure actually mean in this context.

Public sector accounting is primarily applied based on a cash basis and attempts to discipline the fiscal activities of the government from a financial viewpoint. That is, (1) national fiscal activities never purport to generate profit from subsidies granted to local governments; (2) fiscal expenditures for investments in education and research and development activities must yield external economic effects or rewards; and (3) revenues are difficult to quantify on a monetary basis. It has therefore been argued that public sector accounting will not comfortably accommodate the cost and revenue concept from business accounting\(^{31}\).

\(^{30}\) Noriyuki Takayama/Takayuki Shiohama advocate this approach in “Pension Reform – Balance Sheet Approach,” No.1, Volume 55, Keizai Kenkyu, 2004. The paper observes that the balance sheet of employees’ pension schemes should be divided into a portion that corresponds to past contributions and a portion that corresponds to future contributions. While the liabilities for the past contributions are far in excess of the net assets, the excess for the portion corresponding to future contributions is quite small. This provides a policy implication: it would be inappropriate to hike the pension premium to reduce the obligations of past contributions; rather, intensive compensation by public funds would be desirable.

The objective of national fiscal activities is to procure necessary goods and funds and allocate them to the national people in a democratic manner. In this context, the cash basis has been adopted. To ensure the fair disbursement of budgets, the government has to assess the existence or non-existence of revenues or expenditures based solely on the receipt and disbursement of cash (see Article 2 of the Public Finance Law). Judging from the aforesaid, cash basis accounting is meaningful from certain aspects.

On the other hand, the accrual basis accounting embraces, recognizes, and measures all other economic resources in addition to income and expenditure on a cash basis. Unlike public sector accounting, it has the merits of being both exhaustive and comprehensive. Accrual basis accounting also overcomes a common problem with public sector accounting, namely, the demerits arising from the arbitration or manipulation of accounting. This is true, for example, of cases where a fixed rate provision for the Special Account for the Government Debt Consolidation Fund is discontinued or when expenditures for the renewal or repair of necessary facilities are deferred to the next fiscal year or later. In the case of a discontinuation of this type, accrual basis accounting recognizes the reduction in cash expenditures concurrently with the corresponding liabilities, and, for deferred expenditures, the liabilities for expenses for a deferred renewal or repair are recognized in a manner that induces an entity to carry out renewal or repair according to the schedule originally planned. On the other hand, accrual basis accounting also has demerits. There is a risk, for example, that the assessment of assets and liabilities will be arbitrarily determined, and in some cases there are rules requiring a determination to draw on certain assumptions. And besides these factors, one may also wonder, with regard to business accounting, whether the national people will readily understand the concept of accrual basis accounting, the concept represented by the depreciation and amortization approach, in conjunction with the accountability for the national people.

Business accounting incorporates the statement of cash flows in the required financial statements, and the result of cash flows is very important in the case of both business accounting and public sector accounting. Though the cost revenue concept embodied in business accounting may not fit comfortably with public sector accounting, there is no chance that all the disbursements will be expended and completed in a given fiscal year, as government

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32 Two issues can be identified as issues specific to the financial statements of the public sector: first, the information available from the balance sheet gives no insight into external benefits; second, one must choose the right approach for measuring the values of fixed assets (measurement based on salable price or measurement based on the regulated rate income). In conjunction with this issue, many have questioned whether the former Japan Highway Public Corp. was in excess of the net assets or liabilities.

33 The issuance and redemption of public debts clearly represent the difference between income and expenditures under the Public Finance Act and the revenue and expense in terms of accounting. Under the Public Finance Act, public debt is accounted for as income and redemptions are accounted for as expenditures.
fiscal activities are operated consecutively over a number of fiscal years. Thus, some “remainder of cash (assets and liabilities)” is certain to exist. As long as government fiscal activities are operated consecutively over a number of fiscal years, public sector accounting will also have to adopt a accounting treatment similar to business accounting which recognizes assets and liabilities and carries forward profit and loss in the balance sheet.

Public sector accounting now adopts a budget system and annual account system to ensure the democratic control of fiscal affairs on the one hand, while also adopting a business accounting approach for the preparation of financial documents. Since the budget system and annual account system have not been largely revised, the financial documents prepared through the business accounting approach are unlikely to pose problems insofar as they are prepared and disclosed along with the current budget and annual account documents. It would be fair to say that the democratic control function of fiscal affairs by the Diet is compatible with the business accounting model.

Conventionally, the government has only provided information on cash flows based on the budgets and annual accounts for national fiscal conditions. The financial documents now in use give the national people ready access to an exhaustive and systematic flow and stock information, and one should not overlook the significance of this. Moreover, the preparation and disclosure of these documents can also contribute to the ongoing control and monitoring functions by providing information on fiscal operations (a resolution on the budget is opposed to this, as it represents a one-time control)\(^{35}\).

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\(^{34}\) Under the “Basic View on Public Sector Accounting,” entities prepare budgets and annual accounts in order “to ensure democratic control by the Diet.” On the other hand, financial statements for the purpose of financial reporting are said to perform the functions of “enhancing information disclosure and fulfilling accountability,” as well as the function of “achieving the enhanced efficiency and fairness of fiscal activities.” The functions of the budgets and annual accounts have been separated from the function of the financial statements prepared under the business accounting model. According to Takumaro Kimura ("Modern Change of Fiscal Control" – Preliminary View with an Emphasis on the Diet and Auditing Board of Japan,” Jichi Kenkyu, Dai-Ichi Hoki, No. 3, Volume 79, 2003, p46), the Constitution of Japan requires not only that accounts be prepared on a cash basis, but also that financial statements be prepared on an accrual basis. Yet in taking this approach, one wonders when the financial statements prepared on the accrual basis supersede the existing accounts and budget documents (i.e., full adoption of accrual basis accounting). In order to achieve this, there are some obstacles to be overcome (including the revised Public Finance Law) (depending on the interpretation, a constitutional revisions may be required). For details on the utility and challenges of accrual basis budgets, see Hiroyuki Kohyama, “Response to Fiscal Deficit – Fiscal Disciplines and Time Framework” Jurist, 1397 (2010), p16 onwards.

\(^{35}\) See the following for details on the distinction between the “decision/control model” (a model friendly with budgets and annual accounts on a cash basis) and the “consistent on-going control” model as a continuous monitoring function for fiscal operations: Takumaro Kimura, “Memorandum on Basic Theories of Public Finance Law, including the Relationship between Taxpayer Suits and the Resolution of Waivering Rights,” Jichi Kenkyu, Dai-Ichi Hoki, No. 5, Volume 86, 2010, p57 onwards.
IV.2. From “flow” to “stock,” from “political decision” to “administration”

As noted above, the system reform has been evolving routinely. Yet, as it does, an approach for democratically controlling fiscal affairs by cash basis accounting has existed in tandem with the business accounting model on an accrual basis (problematically, however, some differences have arisen between outstanding balances in cash flows on a cash basis and an accrual basis). In spite of such problems, there will be both practical and theoretical implications if business accounting concepts and models are applied more thoroughly than ever before within public sector accounting. I will discuss these issues below.

We may identify the following as the first implication. When any document similar to a balance sheet under a business accounting approach is prepared, we acknowledge that the fiscal affairs of the central government may give rise to the outstanding balances (assets and liabilities). With respect to assets, a modern nation (eliminating the concept of patrimonialism where all assets and properties are deemed to belong to a lord or monarch) is certain to depend on tax revenues for their activities. (In this sense, it is appropriate to assume that the liabilities in the statement of financial position are discharged not by the assets held by the government, but by the government’s power to collect taxes.) For liabilities, the issuance of construction bonds or special rule government bonds is approved by permanent or annual prescriptive legislations (separate from the fact that vast public debts are issued each year). This has obscured the relationship between liabilities and cash flow. It is hard to perceive that the expenditures for the national fiscal activities are entirely financed by the revenues generated for that year. If an economy based on consumption for national fiscal affairs is not attained, the basis for the control of fiscal activities solely on a cash basis will certainly be lost.

Next, the adoption of business accounting models might heighten the importance of the management by the governing administration in the course of fiscal affairs, relative to resolutions by the Diet. The old accounting law (Notice No. 33 of 1881) adopted in the Meiji era was significantly affected by the then French accounting system and was alleged to apply the double entry system (Article 21 of the same law). Later, however, when the Meiji accounting law was adopted in line with the enactment of the Meiji Constitution, the related rules and regulations adopted a single entry, cash basis accounting approach. This was considered to be an integral phase of the development of Japan’s modern parliamentary system. Prior to the development of parliamentary system, a classical method for managing assets and

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36 See Takeshi Fujitani, “Memorandum on Identification of Fiscal Activities from a Substantive Law Perspective,” Kokka Gakkai Zasshi, No. 3-4, Volume 119, p53, p65; Note 136. The author highlights the differences in the timing for incurring expenses and benefits arising from the holding of assets (liabilities) by a public organization (and the discretion of policymakers in this regard). However, he observes that the essence of this issue, that is, the limitation of cash basis accounting and the adoption of accrual basis accounting in the course of public sector accounting reform, can be characterized by a tension between the holding of assets by public organizations and public finance as a conduit (in the classical sense).
properties was emphasized. Later, once the parliamentary system was developed, the emphasis shifted to “political decision” of resource allocation through the budget compilation.\(^{37}\) Conversely, we may detect a trend where the governing administration is granted more discretion as a management entity as public sector accounting evolves and improves.

We cannot claim, however, that the reform of public sector accounting will incentivize individual administrative institutions to use the assets more effectively.

First, there are also important accounting issues to consider. The implementation of accrual basis accounting is generally believed to enable the identification of the costs of the central government activities, as long-term fixed assets are to be depreciated and induce the government to use assets more efficiently from the perspective of lifecycle cost (if an asset is difficult to maintain and must be renewed for a shorter period than the original useful life, there may be a shortfall of financial resources). In addition, invisible costs (including capital charges\(^{38}\), etc.) need to be clearly measured. If necessary amounts are budgeted to cover invisible costs, the initiative may induce the efficient use of assets. An entity must also contend with an important though somewhat exogenous issue, namely, its competitiveness with other entities on the market. In this case, cost information or stock information in accrual basis accounting may be more useful.

Second, we may spotlight the restraints under the legal framework. Speaking of administrative properties and general properties in the financial documents by ministries, there are restraints on the lending or transfer of administrative properties strictly subject to the distinction between administrative properties and general properties\(^{39}\). Furthermore, the Ministry of Finance has provided a framework for centrally managing general properties (Article 6 of the National Property Law). Individual ministries and agencies are not entitled to

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\(^{37}\) We are not able to fully understand every aspect of the environment in which the bookkeeping method evolved so significantly within such a short time. See Takafumi Kamei, “Public Sector Accounting in Meiji” Hakuto Shobo, 2006, p110. See also Fumiki Sakurai, “Public Sector Accounting – Decision Making of the Central Government and Governance,” NTT Publishing, 2004, p34. Observing that double-entry bookkeeping had been adopted for a short time until the enactment of Meiji Constitution, he argues that when the Constitutional parliamentary system was adopted, decision-making on the management of properties at the management level changed into decision-making at the governance level with enforceable legal binding power (budgets subject to legal restraints), and that this change promoted the accounting on a single entry and cash basis (cameral bookkeeping in Germany).

\(^{38}\) The financing costs for taxes and borrowings used for the acquisition of assets are not measured in the accounting at each ministry. Therefore, capital charges are introduced to ensure that the costs of assets held by managing ministries are recognized and that the effective use of assets and disposal of excess assets are enhanced. See Kiyoshi Yamamoto, “Public Sector Accounting – Movements in Foreign Countries and Implications on Japan,” IMES Discussion Paper (Institute for Monetary and Economic Studies, Bank of Japan) No.99-J-23 (1999), p16 onwards.

manage or dispose of any national properties at their own discretion. These regulations are partly based on technical aspects, and they may be reasonable per se. Some still argue, however, that there are challenges to be addressed in conjunction with the relationship between the efficient and flexible management of properties by administrative institutions and the existing legal framework.

Having said so, the incorporation of any business accounting approach into public sector accounting may place the public sector in a competitive environment on a more or less equal footing with the private sector and integrate the economic activities of the central government as a single entity that exercises property rights in its economic activities in the market. This is one possible consequence of the business accounting models.

Yet as prescribed in the Constitution, the fundamental structure of central government, where the Diet controls the administration of fiscal activities, is very unlikely to change. Thus, a swing back to property management in the classical context is hardly expected. We continue to closely watch what consequences the development of the public sector accounting would have, amidst these constraints, in conjunction with the implications brought about by the business management approach in the broader context of administrative organizations.

In the conviction that it is desirable to provide abundant information to the national people, public sector accounting in Japan (except any requirements under development) has been reformed with an emphasis on improved accountability through enhanced information disclosure. These efforts have never infringed any part of the existing legal framework.

This paper demonstrates that the objective of public sector accounting is to improve the quality of information to a level at which it will reliably contribute to democratic decision-making. Most of discussion herein has focused on the categories of financial information to be provided. If any other roles are added to public sector accounting, such as performance control by the administration or target setting for fiscal discipline, organic inter-relations and interactions with the various other related frameworks will be inevitable and the clear positioning of public sector accounting in the legal framework will have to be defined.

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40 See Minoru Nakazato, “Interpretation of Statute Laws and Discovery of Common Laws,” Jurist No. 1368 (2008), p140 onwards. The publication gives an overview of the meaning of the Diet’s resolutions on budgets (control of administrative power through budgetary process) from a historical perspective, including the relationship with the control of administrative power by legislation.

41 For example, this positioning may require entities to present the diet with accrual basis financial statements for free perusal by the national people, or it may determine the timing for filing. In France, la loi organique relative aux lois de finances en 2001 (LOLF) provides that the budget deliberation should not be commenced unless the annual accounts of the previous year (including accrual basis financial statements) are filed with the French parliament (Articles 30, 41, and 54 of the same law).