The International Consortium on Governmental Financial Management

Working globally with governments, organizations, and individuals, the International Consortium on Governmental Financial Management is dedicated to improving financial management by providing opportunities for professional development and information exchange.

The objectives to achieve the above mission shall include, but not be limited to, the following:

1. Providing, on an international scale, comprehensive professional development activities in the fields of accounting, auditing, budgeting, information systems, cash management, debt administration, and financial management;

2. Contributing to the advancement of government financial management principles and standards, and through educational events, promoting appropriate utilization of government financial methods and techniques to improve management control and accountability to the public;

3. Researching, disseminating, and promoting to its members and to the public throughout the world, knowledge and information concerning government financial management;

4. Promoting the observance of professional standards in the accomplishment of government financial management activities;

5. Sponsoring meetings worldwide in order to educate members and others as to the practice of government financial management as it exists throughout the world; and

6. Bringing together government financial managers from all countries to share information and experiences in government financial management and promoting professional development activities in government financial management.

The Consortium expects to limit the range of the aforementioned activities to governmental financial management disciplines. The following areas constitute the disciplines of governmental financial management: accounting, auditing, budgeting, debt administration, information technology, tax administration and treasury management. These areas provide the general frame of reference for the programs, activities and operations of the Consortium.

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The editor invites submission of articles, research papers, letters and reviews of books and documents. Please submit articles to the editorial office indicated below. Also, requests for information on the Consortium should be addressed to:

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"Working globally with governments, organizations, and individuals, the International Consortium on Governmental Financial Management is dedicated to improving financial management by providing opportunities for professional development and information exchange."

Our mission includes three key elements. First, it highlights that, within the international community, the Consortium is unique—it serves as an “umbrella” bringing together diverse governmental entities, organizations (including universities, firms, and other professional associations), and individuals. At the same time, it welcomes a broad array of financial management practitioners (accountants, auditors, comptrollers, information technology specialists, treasurers, and others) working in all levels of government (local/municipal, state/provincial, and national). Additionally the mission statement emphasizes the organization’s focus on activities to promote professional development and the exchange of information.

Our programs provide activities and products to advance governmental financial management principles and standards and promote their implementation and application. Internationally, the Consortium (1) sponsors meetings and conferences that bring together government financial managers from around the world to share information and experiences in governmental financial management in order to educate members and others about innovations, best practices, and emerging issues, and (2) fosters research concerning governmental financial management and disseminates information and results to our members and the public.

The International Consortium on Governmental Financial Management provides three options for membership.

1. **Sustaining Members:** organizations promoting professional development, training, research or technical assistance in financial management; willing to assume responsibility for and to actively participate in the affairs of the Consortium. Each Sustaining Member has a seat on the ICGFM’s Board of Directors and receives 10 copies of all ICGFM publications to be distributed within their organization. (Dues: $1,000)

2. **Organization Members:** government entities with financial management responsibilities, educational institutions, firms, regional and governmental organizations, and other professional associations. Six organization members serve on the ICGFM’s Board of Directors and organization members receive 5 copies of publications to be distributed to their members. (Dues: $250/$125*)

3. **Individual Members:** persons interested in or dedicated to activities directly related to financial management and who wish to be members in their own right. Six members of the ICGFM Board of Directors will be selected from among all individual members. Each individual member will receive a copy of all ICGFM publications. (Dues: $100/$50*)

* A special discount is offered to developing countries, countries with economies in transition and regional groups and organizations in such countries to encourage their participation. This discount is available to all countries other than Australia, Canada, China, Egypt, European countries (except transition economies) India, Iran, Israel, Japan, Kuwait, Libya, Mexico, New Zealand, Nigeria, Oman, Saudi Arabia, United Arab Emirates, USA, Russia, and Venezuela.
Foreword

It is an exciting time in governments throughout the world as they attempt to improve their financial management systems. In April, many excellent presentations were given at the 17th Annual International Conference in Miami, Florida and several are included in this issue. The lead article explains actions taken in challenging areas to quickly upgrade financial management systems through use of the FreeBalance software package. It is followed by articles on good governance efforts by donor agencies and an update on the U.S. Millennium Challenge Account.

We continue to emphasize the value in sharing your experiences with others so that they can learn from those experiences. In this issue, we include a case study on the audit challenges faced by Central and Eastern European Countries as they transition to a Supreme Audit Institution structure. We also include a case study on the municipal credit market that exists in the Ukraine and the challenges that it faces. Further, IMF has developed a Code of Good Practices on Fiscal Transparency that serves as an excellent checklist of actions needed to be considered by each country to improve their financial management.

As a member of the Consultative Group to the Public Sector Committee of the International Federation of Accountants, I attended the July 2003 meeting of the Committee in Vancouver. It was interesting to observe the due process exercised by the international public sector accounting standard setter as they deliberated each issue. The transition to accrual accounting continues to be of interest to many countries. Consequently, we have included two articles on this area so that our readership has maximum exposure to the importance of this area.

This issue concludes with an article on the use of diagnostic related groups in the medical field by OECD countries. We hope that you find the articles in this issue beneficial to you in your efforts to improve financial management. As usual, we invite your comments on these papers and any issue of the Public Fund Digest. Contact us by telephone, facsimile, or on the Internet at www.icgfm.org.

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Deploying Financial Management Systems in Developing Nations

By: Matthew Olivier, Director, Marketing Communications, FreeBalance Inc.

Developing nations are tasked with the challenge of delivering immediate and measurable results to citizens, donors, creditors, trading partners and foreign investors to promote confidence in the public sector and contribute to economic growth and prosperity. The implementation of a proven, modern, and government-focused financial management system is a key enabler in this pursuit.

Such implementations represent a significant challenge for developing nations and have recently been brought to the forefront by an international focus on good governance and fiscal responsibility.

FreeBalance has developed a new and innovative approach to building the foundation for sound financial management in some of the most challenging areas of the world, including Afghanistan, Kosovo, and East Timor. These early adopters have taken advantage of the exciting opportunity to rapidly deploy critical financial management systems and are now well positioned for future deployments that will further entrench good governance.

In Afghanistan, FreeBalance eFinancials™ was deployed to fulfill the fundamental requirement to institute a financial management system and management framework that could demonstrate accountability and transparency to donor nations, international financial institutions, foreign investors, citizens and expatriates considering returning to the country. Similar FreeBalance implementation projects in Kosovo and East Timor have resulted in democratic development and economic liberalization by providing the necessary technology to ensure sound fiscal management and good governance.

FreeBalance eFinancials™ Overview

FreeBalance eFinancials™ is a series of dynamic modules that can be assembled to form a fully integrated, GAAP-compliant financial management system. Available off-the-shelf, the eFinancials suite of modules can be rapidly installed and configured on standard hardware platforms.

At its center the eFinancials system consists of the Controls and General Ledger modules, which together offer the primary financial management functionality required in any public sector organization. Combined with the Appropriations and Expenditures modules, they form the Foundation core component of the system.

Additional modules include Purchasing, Revenues, and Assets, which can be added as required to create an interactive and scalable suite providing a complete range of corporate accounting and frontline management functionality.

Controls Module

The eFinancials Controls module manages all the business rules and parameters that are quickly configured to ensure that the entire eFinancials suite operates according to the organization’s policies and procedures. This module comes equipped with:
• A powerful, multi-dimensional, client-defined Chart of Accounts, which enables an organization to determine the level of detail at which allotments, budgets and G/L transactions are to be captured, and to define how the data is to be rolled up or rolled down for integrated reporting purposes.
• User-defined data tables which can be populated with critical business and accounting information to speed up transaction input.
• Stringent security features at the functional, data and user levels.
• Standard, GAAP-compliant periodic functions.
• Multi-tiered data audit management and reporting.
• Import links from peripheral systems, allowing for single-source entry and corporate reporting.

General Ledger Module

The eFinancials General Ledger provides the necessary financial statements required by GAAP. All transactions entered into the system are automatically posted to the G/L. This module provides an enterprise-level view of an organization’s financial information through online account inquiries, financial statements and account analysis reports. The eFinancials G/L offers:
• Multi-level consolidated financial statements at each level of the fund classification hierarchy.
• An extremely powerful chart of accounts. The coding block can have up to 10 client-defined segments, and each segment can be up to 12 characters long. Each coding block segment can invoke an unlimited number of roll-up variables. This coding structure facilitates the production of an enormous range of detailed and summary reports to support any level of analysis. Changes to the organization, program or activity structures can be implemented by simple modifications to tables.
• The ability to drill down from summary account details and journal entries to source documents for detail scrutiny.
• The ability to post journal vouchers in both interactive and batch import modes.
• Double-entry, self-balancing fund controls and accounting.
• The ability to retain data for a client-defined number of years.
• The ability to process duplicate, reverse and recurring journal vouchers.
• Automated bank reconciliation.

Appropriations Module

The eFinancials Appropriations module enables organizations to maintain allotment and budget control levels for monitoring the impact of forecasts, revenues, expenditures and commitments. These control levels can be modified to accommodate an organization’s dynamic financial needs. System parameters can be set to prevent the overspending of commitments, budgets or allotments, or to provide a warning when such situations occur. A unique feature allows spending flexibility by manager or budget, enabling senior management to apply tight constraints in certain areas while permitting more flexibility in others.

The Appropriations module includes:
• Up to three user-defined levels of budget management, providing control over appropriated funds
• Multi-fund accounting capabilities.
• Client-defined budgetary control levels for ensuring cost control at the program, project, or activity level.
• Powerful budget creation and update mechanisms that minimize manual effort.
• Drill-down capability from summary budget actuals and commitments/obligations down to source information.
• Support for multi-item and multi-year commitments/obligations.
• User-defined tolerance levels for actuals that are less than or greater than the amounts originally committed or obligated.
• User-entered monthly forecasts to support annual surplus/deficit projections.
• Multiple cash control mechanisms.

**Expenditures Module**

With the eFinancials Expenditures module, managers can track expenditures, in both domestic and foreign currency, against corresponding commitments/obligations, while maintaining a firm grip over daily payments. Complemented by a comprehensive suite of reports, managers receive an up-to-the-minute analysis of their current cash requirements. The Expenditures module offers:

• Multi-line expense vouchers.
• The ability to track expenses separately, with or without purchase orders.
• Multiple currencies to handle foreign procurement.
• Support for two levels of taxation with multiple table definitions.
• Secure procedures to ensure that expenditure transactions are properly authorized.
• Automatic liquidation of commitments/obligations upon entry of related expense(s).
• Allotment fund availability checks, ensuring that control levels are rigorously followed.
• Discount, interest charge and foreign exchange calculations.
• Release of payments on due dates, with the ability to calculate cash discounts for early payment and interest charges for late payment.
• Drill down-capability from an expense voucher to its related payment details, including the Check Register.
• The ability to print checks.
• Tight integration with the Purchasing module (e.g. creation of expense voucher from a purchase order).
• Scheduling of payments.
• Automated cost allocation routines for cost accounting purposes.

**Revenues Module**

The Revenues module provides complete billing, aging and cash collection functionality designed to streamline billing procedures, simplify accounts receivable processing and improve the effectiveness of collection activity, thus resulting in better cash management. This module offers a wide range of functionality:

• Create and maintain accurate and detailed customer invoices and reports.
• Record invoices manually or import them from other sources.
• Track cash sales, sales vouchers, debit notes, credit notes and cash receipt transactions.
• Use the Cash Reconciliation function to apply any outstanding credit notes or cash receipts against any or all outstanding transactions for a particular customer.
• Generate and print receipts and customer statements based on user-specified selection criteria.
• Generate and print bank deposit statements.
• Calculate interest on overdue customer accounts and have the charges automatically added to the outstanding balance.
• Generate and print pre-defined dunning letters (requests for payment).
• Produce customer labels for mailing or administrative purposes.

Purchasing Module
The Purchasing module is a complete, integrated procurement solution that offers streamlined order processing and solid goods receipts maintenance. It can process multi-item requisitions and purchase orders spanning multiple fiscal years, track all goods received or returned against related POs and obligations, and create up-to-date progress reports detailing the receipt or return status of particular orders.
• An intuitive ordering process in which users can create detailed requisitions which are submitted on-line to authorized buyers for approval and conversion into legally-binding purchase orders (PO).
• Requisitions and purchase orders can have multiple items, which in turn can be delivered in multiple drops over multiple years.
• POs can have a single requisition, multiple requisitions or no requisitions attached.
• Buyers can browse on-line, user-defined catalog items to facilitate procurement sourcing.
• Create requisitions and purchase orders in a foreign currency.
• Append standard or non-standard contract clauses to individual requisitions and POs.
• Set up blanket POs for selected vendors, and duplicate requisitions and POs for recurring orders.
• Commitments/obligations for related POs and requisitions are automatically created by the system.
• Print requisitions and POs on legal forms using standard forms software.
• Choose to receive ordered goods in multiple shipments by date.
• Security features prevent users from paying for goods that have yet to be received.
• Related obligations are automatically updated upon acceptance of vendor invoices.
• Reject damaged or wrong orders and track credit note status.
• The Goods Received function can automatically record the expense against the General Ledger.
• For goods returned, the system will automatically post a reversing journal entry and decrease the year-to-date actuals in the proper obligation records.

**Assets Module**

The Assets module enables an organization to monitor asset items and acquisitions, track item depreciation, and manage asset counts. This integrated module enables the recording and maintaining of the physical attributes of each asset, and accurately manages a wide range of variables including renewal-of-service contracts, insurance policies, warranty periods, services rendered on equipment and software licensing.

• Control and manage the current and historical status of assets such as office furniture, laboratory equipment and computer hardware.
• Create items using templates to increase uniformity at the item description level.
• Rapidly retrieve required items with a powerful search engine.
• Calculate depreciation by straight-line or declining-balance method.
• Divide the depreciation process into two phases: execute the depreciation calculation request, then confirm the request in order for the asset items to be updated for depreciation transactions.
• Verify asset records through the use of optical bar code readers.
• Create stock count files for downloading to another system.

**Reporting**

The eFinancials modules enable government organizations to produce a wide range of reports, including:

• Standard financial statements such as income statements, balance sheets and trial balances.
• Audit trail reports.
• On-line allotment, budget and commitment/obligation inquiries providing up-to-date information to support immediate decision-making.
• Budget reports detailing variances, surplus/deficit position, forecasts and free balance status.
• Vendor analysis reports.
• Detailed expense voucher and accounts payable reports.
• Check register reports.
• Progress reports providing the up-to-date status of each requisition and PO.
• User-defined asset item lists created by such variables as groupings, licenses, bar code numbers or modified asset items.
• Accounts Receivable reports that facilitate sales analysis and forecasts.

A report can be viewed on-line in a browser window, saved as a text file or sent directly to a printer.

**Electronic Forms**

The eFinancials Forms module enables the design of new electronic forms such as invoices, purchase orders, deposit slips, checks, and customer statements, for use with the eFinancials system, and to customize the existing forms distributed with the system to suit the specific needs of an organization.
Exports and Interfaces

The eFinancials suite is designed to work in an integrated environment, sharing information with other applications. The system includes a number of import features allowing the exchange of information in electronic form between different systems. This capability enhances both information accuracy and employee productivity by eliminating duplicate data entry.

Only authorized individuals are permitted to perform import and export functions in order to ensure data integrity, accuracy and security. Exports can be performed through most software packages that allow the appropriate relational database ODBC connection.

Integration

All of the eFinancials modules are designed to work interactively, for example:

• The Controls module manages the parameters representing the organization’s business rules and coding structures, as reflected in all the eFinancials modules.
• Spending limits set in the Appropriations module govern activity within the Expenditures module.
• Actuals and payments made in the Expenditures module automatically update related obligations, budgets and allotments in the Appropriations module.
• All transactions are automatically posted to the General Ledger for real-time reporting.
• The eFinancials application interacts with many of today’s standard desktop tools, including spreadsheet packages, forms, external report writer systems, email, graphics, fax and desktop publishing systems.
• “On-the-fly” updates to all module-specific tables are automatically reflected in the Controls module.
• Obligations are automatically created in the Appropriations module for each requisition and PO.
• Commitments/obligations are automatically updated upon receipt or return of related goods.
• Expense vouchers in the Expenditures module can be linked to procurement records in the Purchasing module for invoice referencing purposes.

FreeBalance Case Studies—Kosovo, East Timor and Afghanistan

Although FreeBalance has been serving the unique needs of governments for almost 20 years, the last three years have seen the company emerge as a preferred supplier to governments outside of North America. Based on this history, FreeBalance has been able to resolve many of the fundamental financial management problems faced by developing nations.

Recent international projects illustrate how FreeBalance was able to utilize its extensive government experience and public sector specific software to deploy mission critical systems in challenging environments and within urgent time-frames.
Kosovo

After years of conflict, Kosovo was in dire need of a financial management system that would contribute to democratic development and promote economic liberalization. The use of modern technology was critical to ensure sound fiscal management and to strengthen transparency and good governance. Kosovo also needed to protect the integrity of the revenue raising and expenditure process to ensure donor confidence.

In April 2000, FreeBalance was asked by a representative of the International Monetary Fund to enter into discussions with the European Union and the United Nations Interim Administration Mission in Kosovo (UNMIK) regarding the provision of a financial management and accounting system for the Central Fiscal Authority (CFA) of Kosovo. In May 2000, members of the FreeBalance Professional Services team traveled to Priština to perform the implementation of FreeBalance eFinancials™ for the United Nation’s interim government in Kosovo.

The CFA includes the Treasury, Tax Administration, Budgeting, Revenue, Customs, Procurement and Regulatory Office, Central Information Technology and Central Administration of the interim Government of Kosovo. The CFA is using FreeBalance eFinancials to record, manage and report on Kosovo’s budget, commitment, expenditure and treasury management functions. All government-related financial transactions that occur in Kosovo are recorded in FreeBalance eFinancials.

The entire initial FreeBalance eFinancials implementation, including installation, configuration, loading and reconciling of all year-to-date transactions, and developing Kosovo-wide financial reports for distribution to more than 100 other donor agencies, was completed in just 26 days. This is a remarkable accomplishment considering the challenges faced by the FreeBalance team, including political instability, cultural differences, travel, safety, and less than ideal technology and environmental infrastructure.

In June 2001, FreeBalance extended its presence in Kosovo through a project undertaken with the financial support of the Government of Canada, provided through the Canadian International Development Agency (CIDA). With the help of CIDA, FreeBalance was positioned to implement its financial management system across all of Kosovo, including all current ministries. Funding for additional licensing and training was also received from the Swedish International Development Agency in January 2002.

FreeBalance provided end-user training and installation support in Kosovo, and considers this local capacity building and sustainability a key priority. The FreeBalance eFinancials system has been translated into Albanian and Serbian, thereby enabling equal access to the system by public servants and employees from different ethnic backgrounds.

The implementation of the FreeBalance eFinancials system throughout Kosovo is considered a critical component of Kosovo’s democratic development and economic liberalization program. The FreeBalance system is providing Kosovo with the necessary technology to ensure sound fiscal management and to strengthen transparency and good governance.

East Timor

East Timor has endured decades of violence and civil unrest due to the nation’s struggle for independence. In October of 1999, the United Nations Transitional Administration in East Timor (UNTAET) was established to administer the territory. A key component and area of responsibility for the
transitional administration was to establish modern comptrollership practices, systems, policies and procedures for transference to the new government in East Timor. A sound, modern, flexible, and proven government financial management system was identified as a key requirement in this process.

In July 2000, FreeBalance was asked by a representative of an international donor agency to enter into discussions regarding the provision of a financial management and accounting system for the Central Fiscal Authority (CFA) of East Timor. By August 2000, FreeBalance had completed the initial implementation of FreeBalance eFinancials for the CFA in East Timor. The CFA includes the Treasury, Tax Administration, Budgeting, Revenue, Customs, Procurement and Regulatory Office, Central Information Technology and Central Administration of UNTAET. The initial FreeBalance eFinancials system, including the Foundation and the Assets modules, was on-line in 60 days.

The CFA is using FreeBalance eFinancials to manage World Bank trust funds, Asian Development Bank trust funds, United Nations trust funds, funds from the International Monetary Fund and donor nations, and the Consolidated Revenue Fund of East Timor. The FreeBalance system is used by the CFA to record, manage and report on East Timor’s budget, commitment, expenditure and treasury management functions. All government-related financial transactions that occur in East Timor are recorded in FreeBalance eFinancials.


Afghanistan


Afghanistan and its people have endured years of civil unrest that has hindered economic development and the operation of State Institutions. Following the removal of the Taliban administration, and its replacement with the Afghan Interim Administration, the country faces the incredibly daunting task of re-establishing basic administrative services and a functioning bureaucracy. Included in this process is the fundamental requirement to institute a financial management system and framework that can be accountable to the people and is transparent in its operation.

FreeBalance was brought in to assist in the rebuilding of three areas of the financial management framework in Afghanistan—strengthening the procurement processes, supporting the Ministry of Finance in its core function of expenditure management, and operating and supporting the development of a sound audit capacity within the Ministry of Finance.

FreeBalance eFinancials was selected as the solution of choice for an urgently required “off-the-shelf” government expenditure management and accounting system, which met the requirements for disbursement control in a central government budgeting and accounting environment. This includes an allotment process, commitment accounting, basic cash management and payment control capabilities. FreeBalance is ideally suited to handle this challenging project and was able to deploy the system rapidly due to the public sector-specific design and architecture of the system and the experience and dedication of the FreeBalance International Professional Services team.
The Afghanistan project recorded its first milestone event on November 23rd, when the Treasury Department successfully completed its first month of computerized operation, producing some 4,700 checks through the FreeBalance eFinancials system. The first-ever electronic check was presented to Dr. Ashraf Ghani, Minister of Finance, during a ceremony in Kabul.

The initial phase of the Ministry of Finance project in Afghanistan was scheduled to last six months with its first system implementation accomplished in Kabul within 60 days of project initiation.

Lessons Learned

Based on the successful delivery of financial management systems in some of the most challenging environments in the world, FreeBalance has developed a unique expertise and draws upon its many lessons learned to constantly improve project delivery and system implementation and acceptance.

The deployment of software built exclusively for government means that implementations are rapid and can scale up or scale down based on any number of unique organizational requirements. The ability to scale up is rarely a problem for financial systems, but the distinguishing factor for FreeBalance is the ability to scale down and deliver immediate results when faced with limited infrastructure and other environmental challenges. If a widely-used, mission critical system in a developing nation is overly complex, requires sophisticated maintenance, cannot operate in an austere technology environment, or incurs significant ongoing costs of ownership, the project will fail. The ideal system will be flexible enough to satisfy immediate and urgent needs and able to scale to provide growth opportunities for the future.

Given the window of opportunity that exists for developing nations to gain credibility in the eyes of its citizens, donors, creditors, trading partners and foreign investors, initial deployments of financial management systems must be in production quickly (30-90 days). The system must visibly solve significant problems to gain acceptance from local users, must illustrate progress to donors so they continue to provide funding, and must demonstrate measurable results to the citizens so that the government can gain the credibility necessary to deliver on its mandates. Substantial functionality and visible results were achieved in less than 60 days in Kosovo, East Timor, and Afghanistan.

Software built exclusively for government not only reduces implementation time, it also provides parameter-driven functionality that can effortlessly reflect unique public sector operating mandates with no further coding. This approach avoids additional costs, reduces overhead, and creates long term sustainability. Overall system acceptance is substantially more effective through parameterization, as end-users are not intimidated with complex systems and challenging coding projects.

Parameterization also leads to increased system acceptance, which is a primary consideration for any vendor providing technology solutions in a developing nation. The success of a software deployment often hinges on the vendor’s ability to transfer ownership of the system to local representatives in a timely fashion. In North America, a timely fashion might be three to four years. In a post conflict country, a timely fashion is closer to three to four months. Additionally, the vendor must ensure that the local representatives have the necessary capacity to use, control and maintain the system with minimal intervention from the international community. The system must be a long-term
solution and the vendor must commit to providing adequate training and capacity building.

It is also important to take into consideration the initial costs as well as the cost of ownership over time. Typically, software designed specifically for government provides the most affordable scenario, since configuration takes place within the system and not through customization and coding.

**Conclusion**

The international community is committed to ensuring that developing nations have the financial management tools required to deliver immediate and measurable results to citizens, donors, and other stakeholders. The international community demonstrates its commitment by funding the purchase and implementation of a financial management system, and providing additional funds, trade relations and other enticements to persuade recipient nations to adopt transparent public sector financial management practices. The implementation of an appropriate, proven, modern, and government-focused financial management system is a critical step in this process.

In an environment driven by ever increasing control, audit and reporting requirements, the need for purpose-built software designed exclusively for government and a vendor with a legacy of public sector success on an international level. International projects present unique challenges to vendors, including the complexity and modernity of available systems, localization, capacity building, and long term sustainability.

Highly complex systems simply cannot be deployed in a timely fashion. As such, the identification and procurement of a solution that can be rapidly deployed with immediate measurable results is a key priority. If a financial management system implementation is scheduled to take several years, there is little hope that government credibility can be achieved in the near term.

Developing nations looking to build a solid foundation for good governance must consider the complexity of the solution and select the most appropriate vendor. This means seeking out those vendors that offer government-specific functionality and that do not burden clients with unnecessary and overly complex functionality. Recent implementations of larger systems that have been built for the private sector have run into major cost overruns and serious delays. This has prompted many countries to re-evaluate the “fit” that exists between software built for private sector versus software built for public sector.

All government financial management solutions should be based on proven, first-world software applications that have the potential for growth and are dynamic enough to evolve as government requirements and mandates change. The system must operate on-line in real time, and be affordable, sustainable and upgradeable. The system must also take into consideration the infrastructure, or lack thereof, in developing nations and have the ability to scale up and scale down effortlessly. Developing nations must be able to adapt modern financial management principles into on-line, electronic business rules that will reduce corruption and enhance accountability.

System deployments in developing nations must also be delivered and localized rapidly if widespread system acceptance is to be achieved. To do so, the system must produce measurable results in financial accountability in an understandable and user-friendly environment. Systems designed exclusively for government will enjoy greater success, since milestones can be measured quickly and users are able to gain advanced knowledge of the system in less time.
FreeBalance has been called upon to deliver advanced financial systems in demanding international environments and each time has responded positively to such challenges as short implementation cycles, political instability, lack of infrastructure, travel concerns, and cultural differences. This would not be possible without the expertise in government financial management, delivery and support capabilities that FreeBalance has developed over the course of 20 years.

For more information on FreeBalance and FreeBalance eFinancials™, please visit www.FreeBalance.com or contact Grice Mulligan, Director of Global Solutions, at gmulligan@FreeBalance.com.
Good Governance Efforts by Donor Agencies

The 17th International Consortium of Government Financial Managers
Miami, Florida, April 2, 2003
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Good Morning Ladies and Gentlemen. Let me begin by thanking the organizers of the ICGFM for the invitation to participate in this event. I’m particularly pleased to be able to talk about a topic which we at USAID feel is of fundamental importance to our work, and to development in general. And that topic is, of course, Governance.

USAID’s Office of Democracy and Governance was established in 1994 in response to growing awareness of the need for specialized expertise in this complex area. The DG Office helps USAID field missions, design and implement democracy strategies, provides technical and intellectual leadership in the field of democracy development, and manages some USAID programs directly.

As the office has grown and matured, so has our understanding of both democracy and governance. Not only have we learned something about what works and what doesn’t (sometimes we’ve learned these lessons the hard way!), but more importantly we have learned some important lessons about the links between these two often difficult-to-define concepts.

Disclaimers

Before I begin, I’d like to note that my comments this morning are focused on the ways in which USAID promotes good governance and democracy in the field through our programs in the countries we work in. There is another equally important component of governance that is of concern to donors, and that is the ways in which we as an organization ensure the good governance of our internal operations, at home and abroad, and the governance aspects of the projects we fund. Governance in that context is obviously important to ensure that our efforts are not diminished, or derailed, by corrosive effects of corruption.

Although this area is of critical importance, I will not address it here, as I’m sure the topic of internal controls and oversight has been addressed thoroughly in other sessions. Rather, I will talk about how the agency works with host countries to institute good governance at the national and local levels through our programmatic activity.

I’d also like to make one disclaimer: The title of this session is Governance Efforts by Donor Agencies. My comments refer to the work and thinking of USAID. I would not presume to speak for any other donor, and certainly not for “all donors” in any general sense. Thus, my comments only apply to USAID, our views on governance and our efforts to promote governance in our work.
Agenda

I’d like to share with you some thoughts about governance and its relationship to development, as well as the relationship between governance and democracy. That will set the stage to look at the growing importance that governance is assuming in development and foreign policy circles, and I’ll finish by telling you a bit about USAID’s work in this arena.

I have drawn much of the thinking on this subject from the publication Foreign Aid in the National Interest recently released by USAID, particularly the chapter entitled “Promoting Democracy and Governance,” by Larry Diamond of Stanford University. This thoughtful piece lays out the scope and nature of the development challenges that the donor community will face in the next 10 to 20 years and includes recommendations on how foreign assistance can adapt to meet future challenges more effectively. If anyone is interested in this document, you can find a link to the complete text on the USAID website. (www.usaid.gov)

Governance defined

Before we launch into a discussion of governance, I thought that I would offer you at least a working definition of the concept. For the sake of this discussion, governance is the way in which power is exercised in the management of a country’s economic and social resources for the public good. Democratic governance is characterized by institutions which are accountable, transparent and responsive to the people they serve.

You can’t talk about governance without also looking briefly at its antithesis, corruption. The lack of good governance allows corruption to flourish, and corruption undermines good governance at every turn. This is somewhat a “chicken and egg” question. Does corruption engender poor governance, or does poor governance engender corruption? Obviously, both are true.

Link between Governance and Development

So let’s look for a moment at the link between Governance and Development.

In the more than a half century since USAID was established, much has been learned about development. And some of the basic assumptions we have held have recently come into question as we have learned more about the role of governance.

One such tenet of conventional wisdom about development was that poor countries were poor because they lacked the kinds and quantities of resources necessary to ensure their growth. If we could only transfer enough resources to them, the thinking went, they would develop. However, this has not proven to be the case. Despite sometimes massive infusions of resources many countries have not developed.

Russia has for more than 10 years been a major recipient of US foreign assistance, yet in development terms Russia’s rating on the UN’s Human Development Index has actually decreased by 4 percentage points (from 0.824 to 0.781) over that 10-year period. Likewise, Kenya and Ethiopia have been important targets of US funds. But Ethiopia, almost at the bottom of the Human Development Index, demonstrated scant progress towards development and Kenya also showed a retreat on that same index over the last five years. So large donor investments do not necessarily translate to development.
And according to the logic that resources are the prerequisite for development, the existence of abundant natural resources should also be positively correlated with development. But many of the countries richest in natural resources have stagnated. You only have to look at countries like Angola for example, and some of the oil-rich countries of Central Asia to realize that such plentiful natural riches definitely do not guarantee development. In fact, such endowments are perhaps more likely to engender corruption on an equally plentiful scale.

Recent reports by the international NGO Global Witness have claimed that more than $140B of oil revenues and concession fees have gone missing from the national treasury of Angola.

Many development professionals have argued that economic growth is the prime engine of development. But, again, despite enormous investments in economic growth programs in some Eastern European and Former Soviet Union countries in the last decade, many of these countries have not experienced the economic growth the programs were designed to achieve, nor have they improved in other key development indicators. Economic growth, while important, is insufficient by itself to ensure development.

Others have proposed that health or education is the necessary precursor to development. However investments in health and education, alone, have not been shown to improve the success of development, and often, these investments have been, themselves, compromised by poor governance in the form of corruption.

In fact, in environments plagued by endemic corruption, investing in Economic Growth, Health, Education or any other worthy development goal, may not only fail to achieve the development goals we expect, it can actually put off needed reforms and contribute to the entrenchment of vested interests.

More and more, people who had looked to technical solutions and resource flows to achieve development have now identified issues of governance as the major constraints to progress. It is predatory, corrupt, wasteful, abusive, tyrannical or incompetent governance that is seen as the primary stumbling block to development.

In cases of bad governance, neither public resources nor donor funds are used for the public good. Rather, they are expropriated for the personal enrichment of corrupt officials.

I do not want to suggest that all poor governance is corruption. That would be an oversimplification of an extremely complex problem. Poor governance includes things like a lack of political competition, a lack of the checks and balances among the branches of government, institutional weaknesses, and even simple ineptitude. However, it must be stated, that all of these conditions of poor governance give rise to and enable corruption. And of course, corruption reinforces these underlying conditions that allow it to flourish.

Until countries can improve their governance and reduce corruption, they will not develop effectively. And good governance is the necessary pre-condition that enables investments in health, education and economic growth to yield the development dividends they promise.

Studies by the World Bank Institute corroborate this relationship. These studies evaluate countries on a series of governance indices, such as rule of law, government effectiveness, regulatory burden, graft, voice and accountability, etc. Countries which score better on these governance indicators also tend to have lower infant mortality and higher literacy rates, as well as higher per capita
incomes. In fact, the World Bank has identified corruption as “the single greatest obstacle to economic and social development.” We at USAID also believe it is a key obstacle to political development as well.

I think it is clear from this discussion that governance issues stand at the heart of the development challenge. That is easy to say, of course, but much harder to do anything about. How, indeed, does a country go about improving its governance?

**Link between Governance and Democracy**

This question brings us to the critical link between good governance and democracy.

Not all democracies are the same. And not all of them contribute with equal effectiveness to the goal of good governance.

The century just ended has been called the century of Democratization. And indeed, we have seen tremendous growth in the prevalence of democracy as a form of government. Since 1974, the number of democracies in the world has roughly tripled to the current 120 or so.

Unfortunately many of these newer democracies exhibit growing problems of governance that are eroding their legitimacy in the eyes of their citizens and endangering their stability. In fact, while these democracies may hold regular elections, they fall short of real democracy in many important ways. Democratic governance should be characterized by

- holding regular, free and fair elections,
- encouraging citizen participation and oversight at all levels of government,
- being both transparent and accountable to the citizens which elect it to power,
- protecting the civil and human rights of its diverse citizens, and
- guaranteeing their citizens fair access and equal treatment under law.

Democracies that exhibit all of these characteristics are considered to be what we call “liberal” democracies.

Where democracies are less liberal, such as in some of the countries I referred to a moment ago, the quality of governance has been shown to be more corrupt, wasteful, incompetent and unresponsive. More worrisome still, this situation contributes to the entrenchment of poverty, obstructs economic development, and paves the way for recurrent crises. And this is a recipe for state failure.

Liberal democracy, on the other hand, is the fundamental building block of good governance, which, in turn, fosters and sustains broad-based development.

Interestingly enough, Democracy, itself, is not a guarantee of good governance. Nor is it, strictly speaking, a pre-requisite for good governance. There are lots of examples of democratic or at least quasi-democratic states that do not demonstrate good governance. For example, countries like Russia, Indonesia, Nigeria and Kenya, until recently, demonstrate some elements of democracy; however, these countries are textbook cases of poor governance and have extremely high levels of corruption.

On the other hand there are a few examples of non-democratic states, that nonetheless appear to be well-governed. Singapore is the first to come to mind—Singapore has a Freedom House rating of 5.5 which qualifies it as Partly Free, but on the border of Not Free. This is a country where freedom of speech and
freedom of association are quite tightly limited by the state. But Singapore is admirable in some respects. For example, it ranks at the very top of Transparency International Corruption Perceptions Index with a score of 9.3, indicating extremely low levels of corruption. It is an economic powerhouse in the region, provides economic stability and good public services and affords an excellent quality of life for its multi-ethnic citizens.

However, there is little evidence that such a regime is either replicable in other countries or, in fact, desirable.

So, while democracy doesn’t guarantee us good governance, and good governance can perhaps exist in less than democratic environments, USAID believes that democracy offers countries the best way to move towards good governance.

Democracy creates the political space within which to fight for good governance. It is the indispensable instrument for securing accountable government and for ensuring that public resources are used for the public good. It builds trust and confidence in institutions and gives citizens voice.

USAID’s Office of Democracy and Governance strongly believes that democracy is an admirable goal in its own right. We believe that all people deserve the kind of self-determination and human dignity afforded by democracy, and that government must be subject to the will of its citizens. So we see democracy as an end in itself.

But this is not the only reason for supporting democracy. Democracy is a means and an end. Good governance is key to development, and democracy is the best incubator we know of for good governance. So it is clear that we must support countries in their efforts to strengthen and consolidate their democracies in order to improve their governance, and thus their opportunities for development.

**Growing international consensus**

The view that poor governance and corruption are the key impediment to development has been steadily gaining adherents in the development and foreign policy fields for some time now.

The Monterrey Consensus, released by world leaders at the International Conference on Financing for Development in March of last year was one of the clearest examples of this agreement. The Consensus document itself says: “Fighting corruption at all levels is a priority. Corruption is a serious barrier to effective resource mobilization and allocation, and diverts resources away from activities that are vital for poverty eradication and economic and sustainable development.”

**MCA**

Another example of how good governance is thought to be central to development can be seen in this administration’s planned Millennium Challenge Account. Last year, the president pledged that the US would increase its core development assistance by 50% over the next three years, resulting in an annual increase of $5B by FY06.

Because good governance policies are seen as an essential condition of development the MCA will be devoted to projects in nations that do three things:
• invest in their people, and
• encourage economic freedom, and
• govern justly.

Investing in people is seen as providing better health care, broader immunizations and better schools with wider access to education.

Economic freedom is seen in terms of issues like having more open markets, sustainable budget policies and the ability to start and operate a small business without obstacles of stifling bureaucracies and the need for bribery.

And by governing justly, the administration means countries that respect human rights, adhere to the rule of law and make real and sustained efforts to root out corruption.

If you look at these three criteria, they all speak to matters of good governance, defined broadly.

But of all these criteria, one has been singled out as a first “hard hurdle” that must be cleared in order to be eligible for MCA funding. And that criterion is “control of corruption.” Failure to demonstrate control of corruption will disqualify a country from inclusion in the MCA. The message here is that this Administration will work with countries that are making a serious and sustained effort to address corruption.

The President has just recently sent his proposal for the MCA to Congress for approval. If anyone would like more information on the MCA, you might visit the White House website at www.whitehouse.gov.

So clearly, governance matters. More and more international voices are expressing this viewpoint. And USAID has long been at the forefront of these voices.

USAID strategy

Indeed, the issue of good governance is taking on growing importance within USAID. Increasingly it is being seen not only as an issue for Democracy and Governance programs, but one which cuts across all the activities of USAID, all regional and functional bureaus, and of course, all Missions.

And the Agency’s concern with fighting corruption is one of these cross-cutting themes. In fact, several months ago, Andrew Natsios (the agency Administrator) asked the Democracy and Governance office to take the lead in developing an agency-wide anti-corruption strategy. The purpose of this effort is to assist the agency and our Missions better understand the complexities of fighting corruption, and to be better able to design and implement programs to fight it across all strategic objective areas we are working in. This includes health, education, tax and customs, energy, agriculture, rule of law, elections and others.

Types of programs

I’d like to conclude by telling you a bit about the kinds of programs USAID currently supports in an effort to assist host countries achieve important improvements in governance.

Much of the emphasis of USAID programming is on preventative measures. Our comparative advantage is in the areas of addressing the underlying conditions that give rise to corruption. Other US Government agencies, such as the Departments of State, Justice and Treasury have complementary programs that
aim more specifically at assisting countries on the enforcement aspects of good governance.

These agencies focus on critical problems like money laundering, asset recovery, diplomacy, implementation of international conventions such as the OECD convention and the Inter-American Convention Against Corruption. They provide assistance directly to local law enforcement agencies and encourage international cooperation in law enforcement.

But, of course, enforcement is not sufficient by itself. Building sustainable systems to prevent corruption, as this audience knows well, is essential to having any lasting impact on corruption. Where high-level political will exists, our programs will work with both government and non-governmental partners in civil society and the private sector. But where credible political leadership is lacking, USAID will work almost exclusively with civil society to build constituencies for reform and to generate political will. Our work with civil society has long been seen as one of our greatest strengths.

USAID has worked with civil society in a variety of ways.

**We help communities to increase citizen participation**

- In Colombia, we have supported efforts to train and empower Veedurias Ciudadanas, or citizen oversight committees to act as watchdogs over critical government activities.

**We support many different types of programs in numerous local NGO’s. In many countries, we support the national chapters of Transparency International (as well as TI’s international secretariat),**

**We provide training and technical assistance to the media**

- In Paraguay, in addition to training print and broadcast journalists in investigative reporting techniques, the Mission supports three community radio station networks to broadcast investigations on corruption, and a 30-minute television program on corruption and transparency is in development.

**We support public awareness and civic education campaigns**

- A program in Mexico produced a short film shown in movie houses and on long-distance buses throughout the country to promote awareness of the cost of corruption and a similar program in Honduras used traditional media approaches, as well as bumper stickers, t-shirts and billboards to get its anti-corruption message across.

These are only a few of the strategies we have employed in support of local civil society. Our work with host county governments is equally diverse:

**USAID has worked with government counterparts to reform their judiciaries, increase access to justice, and improve the efficiency of judicial systems and procedures.**

- Justice reform projects Bolivia, Guatemala and Colombia have helped those countries move from written to oral procedures. In Colombia we have helped establish Casas de Justicia, neighborhood judicial centers where citizens can access a range of justice and social services in one location.

**We have supported national legislatures as well as local councils to improve their transparency, participation and accountability, and to increase their overall effectiveness and responsiveness as elected representatives.**

- In Mexico, we have helped the legislature create effective audit oversight of the government; and we have worked in El Salvador to promote citizen efforts to increase participation in and citizen oversight of the legislature.
We have helped governments to design and implement decentralization strategies and provided assistance to local governments to ensure that they have the capacity to execute their newly devolved responsibilities.

- In Peru, we assisted the national government to decentralize its procurement activities, and provided training and technical advice to hundreds of local governments in procurement and other basic management skills.

In Latin America, as many of you may know, we have aided governments to improve their capacity in budget and financial management as well as internal controls and audit, and in critical functions like procurement.

- The AAA project is very well known to many of you. Suffice it to say that this project has been the backbone of USAID efforts to improve financial management skills and systems in countries the length and breadth of the region.

And of course, we have worked explicitly in the area of anti-corruption efforts, helping governments establish anticorruption commissions,

- We have provided technical assistance to the Honduran Independent Anticorruption Authority on the development of its national anticorruption strategy and in Ecuador we provided expertise on improving the investigative capacity of the Civic Anti-corruption Commission.

We have encouraged government to enact Freedom of Information Laws, in Paraguay, Mexico, Nigeria and Bosnia.

We have helped governments establish ethics regimes.

- In El Salvador we supported the development of a code of conduct for public servants and the establishment of an Office of Government Ethics, and in Ghana we are assisting government Ministers to design and adopt a code of conduct with a system to monitor compliance with it.

And we have aided governments to establish an Ombudsman’s Office in countries as diverse as Peru, Malawi and Namibia.

New frontiers for USAID include efforts to address corruption in the delivery of basic services such as health and education. Another new area of interest is transparency in political financing. Though money is required to finance democracy, undisclosed and unregulated campaign funds have the potential to warp political contests and the resulting governing processes. USAID will soon be publishing a new handbook entitled *Money & Politics Handbook: A guide to Increasing Transparency in Emerging Democracies*, by Dr. Gene Ward. Copies of the Executive Summary are available on the back table in both Spanish and English.

**Conclusion**

I hope that I have made a convincing case for the primacy of governance as a development issue. Without good governance, all of our development investments will yield diminished results, if they yield results at all.

This brings me to the critical role of government financial management. What function could be more sensitive to the need for good governance than managing the financial resources of a nation?

You, as the authorities responsible for this vital function are a very visible symbol of good governance to the citizens of your countries. And effective management and accounting for the resources designated to accomplish the political aims of your leaders surely legitimizes the authority of your governments.
The integrity, transparency and professionalism that you bring to your offices are an important prerequisite for engendering the respect and confidence of citizens, of investors, and of the international community. USAID is honored to have had the opportunity of working with many of you and your offices. And we look forward to continued collaboration with you in our mutual efforts to achieve the highest possible standards of governance for the benefit of the world’s citizens.

Finally I would like to recognize the ICGFM for its tireless efforts over 17 years in bringing together government financial managers such as yourselves from around the world, to share your experiences and best practices, and to learn from each other. And I would like to end by acknowledging each of you for being leaders of good governance in your countries, and indeed, for being role models of good governance for the entire world.
Corruption is a major impediment to development. It inhibits investment and job creation. Corruption erodes trust and confidence in the political system. The poorest nations are disproportionately affected by corruption because they do not have the systems in place to control it. For political systems to function effectively there must be the political will to fight corruption. This in turn gives credibility and legitimacy to government.

The United States Agency for International Development (USAID) is a US Government Agency established to implement assistance to developing countries. Transparency and Anti-Corruption is a USAID priority. It is fundamental to development efforts and poverty alleviation. USAID promotes proper financial management and civil society oversight of the use of public funds.

USAID’s experience with Transparency and Anti-Corruption programming began in the late 1960s. These efforts were organized with host country governments to introduce improved methods of financial management, to establish and strengthen audit and control entities and to improve the administration of justice.

The Agency’s first program designed to fight corruption was the Regional Financial Management Improvement Project launched in 1989. This project later became what is now the Americas’ Accountability and Anti-Corruption Project or AAA. The AAA Project has a two-fold purpose, to foster Transparency and Accountability in the administration of public resources and to increase public awareness of corruption in Latin America and the Caribbean.

In 1994 Anti-Corruption became a specific Agency objective in the area of governance. Anti-Corruption measures were integrated into many existing Agency activities. The number of development programs targeted specifically to reducing corruption has risen. USAID has worked hard to develop the expertise required to support civil society groups. USAID has also increased efforts to coordinate with other international donors to promote Transparency and Anti-Corruption initiatives.

Since 1995, USAID has also provided grant assistance to Transparency International, an organization specifically established to foment a global Anti-Corruption movement. In recent years, USAID has expended considerable resources in a worldwide effort to mitigate corruption. USAID has on-going programs related to Transparency and Anti-Corruption efforts in some 60 countries.

USAID’s Transparency and Anti-Corruption programs include working with the private sector to raise awareness about corruption’s effects, promote monitoring of government activities and advocating for changes in attitudes and practices.
USAID has an Office of the Inspector General that is responsible for audits and investigations of USAID’s programs and internal controls to enhance effectiveness and efficiency. They also address fraud, waste and abuse in the implementation of USAID programs. The Office of the Inspector General has worked to enhance the capacity of Supreme Audit Institutions to provide improved oversight of their own country’s resources. A collateral benefit is to have these Supreme Audit Institutions conduct audits of USAID assistance as in the case of Honduras where the Supreme Audit Institution has been approved by the Regional Office of the Inspector General to conduct and/or supervise audits of USAID funded programs.

USAID’s Administrator, Andrew Natsios, requested the development of an Agency-wide Anti-Corruption and Good Governance Strategy. This strategy underscores the Agency’s high-level commitment to working creatively to fight corruption and promote good governance.

Administrator Natsios has also put forth four essential elements for successful development, better known as the “4 P’s for Development.” First, successful development requires POLITICAL leadership. Countries must show political will. Second, successful development requires POLICY reform. Third, successful development requires an investment in PEOPLE. Finally, successful development requires PARTNERSHIPS. Only working in tandem with the global community, both public and private sectors, and in coordination with all donors, can development work.

USAID’s Transparency and Anti-Corruption Efforts include:

- Support to Public Awareness Campaigns that inform and educate.
- Providing technical assistance and training to auditors, accountants, and government officials.
- Promoting the enactment of needed legislative reforms.
- Supporting empowerment and formation of civil society organizations and the establishment of public and private partnerships.
- Promoting cooperation and coordination of efforts with other international donors. International financial institutions and donors including USAID are now addressing corruption through conditionalities. They are giving special attention to Anti-Corruption and Good Governance in making decisions on assistance and lending. Examples include the World Bank and International Monetary Fund sponsored Poverty Reduction Strategy as well as the process for Highly Indebted Poor Countries (HIPC) initiative. These integrate considerations of quality of governance and emphasize the importance of adequate systems for tracking public expenditures related to poverty reduction.

The U.S. government has recently announced a major new commitment to increase development assistance for low income countries by $5 billion a year over the next three years. This new model for increased aid is called the Millenium Challenge Account that is to begin in Fiscal Year 2004. The goal is to provide developing nations with the necessary tools to seize opportunities in the global economy. Access to the Millennium Challenge Account will be provided to those countries that are judged to have relatively “effective” policies and institutions that root out corruption, respect human rights, adhere to the rule of law, invest in their people, and establish economic freedom.

In Central America in January of this year, negotiations were held for the U.S.-Central America Free Trade Agreement or CAFTA. The trade agreement will seek to eliminate tariffs and other barriers to trade in goods, services,
agriculture, and facilitate investment between Central America and the United States.

This agreement commits the countries involved to greater openness and transparency, which will help to deepen the roots of democracy, civil society and the rule of law. In other words, given that foreign investment flows into areas that provide an enabling environment of security, transparency, and justice, the signing of the CAFTA by the end of this year and its proper implementation have the potential to start the countries of Central America on the path to higher growth and prosperity in the future.

It is clear that corruption is a major impediment to development. This concept is now an accepted fact throughout the donor community creating a worldwide awareness of this important issue.

Before I close, I would like to thank the AAA Program and Casals & Associates for the support and assistance they have provided to our Transparency and Anti-Corruption program in Honduras, which will be discussed by other panelists.
AAA Project Context

The AAA Project is the result of growing concern and commitment at the Country level in Latin America about the need to strengthen democracy and good governance, increase transparency and reduce corruption at all levels. It is also an integral part of USAID strategies in this area, as a means to alleviate poverty and improve the quality of life among the poorest segments of society in developing nations. USAID, as most of the donor community, is convinced that corruption is the single most important factor that undermines the ability of countries to meet the social and economic development needs of their people.

As such, the fight against corruption is critical because it is pervasive and affects a wide range of sectors and areas in the development of any given society:

- It curtails the ability of central and local governments to finance and provide social services—education, health, water, sanitation, etc.
- It reduces trade and investments.
- It erodes the effectiveness and reliability of the rule of law and the judicial system.
- It undermines democratic institutions.
- It prevents the participation of civil society in the oversight of how public resources are utilized.

Casals & Associates has undertaken the AAA Project with the conviction that corruption and lack of transparency are structural problems in our societies. Accordingly, the fight against corruption cannot be viewed as an event but rather as a long term and complex process. It requires the unwavering commitment, determination, perseverance and a permanent partisan with an active attitude and behavior on the part of many actors. First and foremost, this would include civil society in general, central and local governments, the legislature, the media, the legal systems, educational institutions, the international bilateral and multilateral donor community, and others if it is to succeed over time.

Under the AAA Project, as designed by USAID, Casals has undertaken a series of activities designed to improve transparency, principally at the local level, through the active participation of civil society groups and individuals in the oversight of planning and implementation of projects at the Municipal level. However, it will also maintain project interventions at the central level, particularly in the area of integrated financial management systems to improve the accountability of Governments in the use of public resources.
A. AAA PROJECT PURPOSE

To improve public sector accountability and transparency in Latin America and the Caribbean.

B. EXPECTED PROJECT OUTCOMES

• Governments able to make operative the principles of transparency and accountability by undertaking specific institutional strengthening efforts; and
• Civil society empowered to play a greater role in reducing corruption through citizen oversight activities and advocacy for reform.

C. AAA PROJECT COMPONENTS

1. Improve Government Policies and Practices to Reduce Corruption

This component is carried out through the assessment and dissemination of successful policies and practices with demonstrable impacts on corruption, in the form of Technical Assistance Modules (TAMs). This information will be shared with a multiplicity of stakeholders, including USAID Missions, throughout the Latin America Region. Examples of TAMs presently being developed by Casals & Associates include:
• Latin American Framework for Internal Control.
• Monitoring Government’s Compliance with the Inter-American Convention Against Corruption (IACC).
• Best Practice Case Studies (Bolivia and Chile)/World Bank Financial Management Modernization.
• El Salvador Control Self Assessment.
• Social Auditing and Citizens’ Participation at the Local Level in Honduras and Latin America.
• Strategic Planning and Citizens’ Participation at the Local Level in the Dominican Republic and Colombia.
• Assessment of integrated financial management systems (IFMS) at the municipal level in Central America.

2. Enhanced Support for USAID Missions’ Anti-Corruption Strategies and Activities

Through this component, the AAA Project works with USAID Missions throughout the Latin America Country (LAC) Region in developing and/or improving their information base in order to better design anti-corruption strategies and project level activities. Examples of this type of assistance to Missions include work completed in Ecuador in December, 2002 and ongoing dialogue with the USAID Mission in Guatemala.

3. Facilitate Donor Coordination

The Donor Consultative Group (DCG) was created in Phase I of the Project (1989). It meets regularly every three months to discuss topics related with corruption issues and promising anti-corruption practices in the LAC Region. Casals & Associates, through the AAA Project, holds the Secretariat for the DCG. The objective of this component is to make the DCG more actively engaged in coordinating anti-corruption strategies as well as planning and implementing anti-corruption/accountability activities in the Region. As the
focus on corruption issues continues to grow in the Region, the DCG will become even more vital to the sector.

4. ResponDanet Website and Electronic Newsletters

This component of the Project provides a way to link individuals, organizations and government officials involved in the fight against corruption. It is aimed at maintaining reform momentum in the Hemisphere and worldwide, by information sharing, distance learning courses, and networking with groups advocating anti-corruption/accountability measures in specific countries.

It is highly encouraging that regional and world wide interest on financial management and corruption issues is increasing almost on a daily basis. AAA Project statistical information, for example, shows that the amount of hits that the RespondaNet website receives is growing significantly every year: in 2000 the website received 919,447 hits; in 2001 the number of hits went over 2 million (2,243,601); and in 2002 the hits were 3,735,292.

As the AAA Project will terminate at the end of calendar year 2004, Casals & Associates has agreed with USAID to develop a plan for the sustainability of the RespondaNet website into the future. For this purpose, we are actively pursuing the possibility of a partnership(s) with interested and qualified institutions aimed at establishing a framework for maintaining the RespondaNet website and the services that it provides well beyond the termination of the USAID funded activity.
The Tasks of the Supreme Audit Institutions in the Service of the Central and Eastern European Countries

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1. General requirements and challenges

Along with other transitional challenges the Central and Eastern European Countries (CEECs) had to re-establish their supreme audit functions. The former supreme audit institutions (SAIs) were replaced or, re-constituted on the major turn of the socio-economic changes beginning with the year of 1989. These changes were based on new laws, largely benefited from the audit experience gained in the Western democracies, in most countries.

From the very beginning of the transition process, the new SAIs intended to serve jointly both the political transition and the profound economic changes with a view of building a new role for the state and establishing democracy. Consequently, two “transitional” features represented the bulk of the major tasks of the SAIs:

1. to respond to the challenges of a transitional society (e.g. increased demand for regularity audits because of the numerous irregularities due to such phenomena as privatisation, the re-establishment of the partnership between the state and the rapidly growing private sector, the likelihood of corruption, etc.);

2. to help build new relations between the Parliaments and SAIs in the new constitutional as well as socio-economic systems of the countries concerned.

In general, the SAIs fulfilled these “transitional” tasks in the CEEC region. Their service was valuable in the field of privatisation where the objectives and high expectations were not always met, and its process were often followed by considerable criticism and controversy.

As regards the new relationship between the SAIs and the Parliaments, the change has been remarkable too. The SAIs became indispensable elements of the complex system of accountability by their audits. Their independence from the governments appeared to be a common feature in line with the Lima Declaration and the INTOSAI Auditing Standards. Despite the progress made in the relations between the Parliaments and the SAIs, there were many perceived shortcomings in SAIs’ relations with the legislative bodies. One of them was the fact that the Parliaments were interested in regularity audits only owing to the responding needs to the actual political issues as well as to the conformity to those laws they had been previously voted for.

From the mid-1990s, two new challenges started to orient the activities of the SAIs increasingly in the CEES region. These were as follows:
1. Needs due to the demands of better responding to the use of budget resources through not just financial but performance audits and quality assurance in the flow of auditing work. The CEECs have long recognised the importance of government reforms and accountability. In the course of the different reform efforts, the SAIs have been asked by their governments and legislative bodies to assess the results achieved, as well as to examine and to help improve the financial and economic control systems (including the internal control systems). The results achieved have been many times the economy, efficiency and effectiveness of their programmes and projects.

2. It is important to note that the development impact of the demand derive also from the “candidate country” status to the European Union. In this context, it is of great importance that beyond the incorporation of the acquis communautaire, there is also need to “develop the public services required to implement the Community rules with the same guarantee of effectiveness as in the Member States.” In order to form close links among these systems there was a need for close co-operation between the European Court of Auditors and the SAIs of the Central and Eastern European Countries, Cyprus, Malta, and Turkey. This co-operation started on the initiative of the European Court of Auditors in the year 1996.

2. The Warsaw Protocol

To answer the question of how the CEECs have been given a proper response to these challenges, we needed a “scale of measurement” to give a conceptual comparative basis. First of all, the so-called Warsaw Protocol offers itself for such a purpose. The Presidents of CEEC’s SAIs, and the European Court of Auditors (based on the Lima Declaration of Guidelines on Auditing Precepts, the INTOSAI Auditing Standards, and the European Implementing Guidelines for the INTOSAI Auditing Standards) adopted the creation of a Working Group with the objective to “define main convergence criteria required for integration of the CEECs within the European environment” in Warsaw in March 1998.

As a result, the Working Group proposed a set of 11 recommendations needed to be fulfilled for an effective SAI. management (internal) controls. These recommendations were adopted by the Presidents in Prague on 25-26 October 1999, and are as follows:

**Recommendation 1:** SAIs should have a solid, stable and applicable legal base that is laid down in the Constitution and the law, and is complemented by regulations, rules and procedures.

**Recommendation 2:** SAIs should have the functional, organisational, operational and financial independence required to fulfill their tasks objectively and effectively.

**Recommendation 3:** SAIs should have powers and means that are clearly stated in the Constitution and the law to audit all public funds, resources and operations (including EU funds and resources), regardless whether they are reflected in the national budget, and regardless of who receives or manages these public funds, resources and operations.

**Recommendation 4:** SAIs should undertake the full range of public sector external auditing, covering both regularity and performance audits.

**Recommendation 5:** SAIs must be able to report freely and without restriction on the results of their work. Reports may be submitted to Parliament and should be made public.
Recommendation 6: SAIs should formally adopt, promulgate and disseminate auditing policies and standards, compliant with INTOSAI Auditing Standards, European Implementing Guidelines for INTOSAI Auditing Standards and any relevant public sector auditing standards issued by IFAC and accepted for application in the EU. Auditing standards should be applied on a consistent and reliable basis to an SAI's work to ensure that audit work is of an acceptable quality and competence. The SAIs should therefore develop auditing manuals and detailed technical guides to help promote the practical use and achievement of the standards.

Recommendation 7: SAIs should ensure that their human and financial resources are used in the most efficient way to secure the effective exercise of their mandate. To this end, SAI management will need to develop and institute appropriate policies and measures to help guarantee that the SAI is competently organised to deliver high-quality and effective audit work and reports.

Recommendation 8: SAIs should develop their internal organisation as a supportive structure for the proper conduct of work related to the requirements of the pre-accession period.

Recommendation 9: SAIs should ensure that their staff are competent, capable and committed to help guarantee that effective audit work is produced in conformity with international standards and good European practices.

Recommendation 10: SAIs should develop the technical and professional proficiency of their staff through education and training.

Recommendation 11: SAIs should focus on the development of high-quality, effective internal (management) control systems in audited entities.

3. Current state of affairs

With this point the question arises: how do the SAIs meet the requirements of the Warsaw Protocol through developing action plans? The answer should benefit from the results of a self-assessment based on a questionnaire and SIGMA2 checklist, and carried out by an appointed working group in 2000 (TEST 1).

It seems also useful to benefit from the analysis and opinion of the European Union as they are summarised in the Regular Reports in its Chapter 28: Financial Control in particular for the year 2002 (TEST 2).

Independence (Recommendation 2)

Although this pivotal requirement for the SAI and its auditors is guaranteed by the Constitutions, in some countries there has been a need for draft bills to be drawn up to achieve a clearer legal basis and greater consistency in the last years. According to TEST 1, another task in the area of the strengthening of independence is that of financial independence. From among the 14 candidate country SAIs, seven are financially independent with the right to submit budgets to their Parliaments. Many times, politicians do not understand that the SAI must work in compliance with the accepted guidelines, rules, etc. The remaining seven SAIs have to submit their budget proposals to the ministers of finance as being constitutionally responsible for the budget preparation. The weight of the problem is illustrated by the fact that six from those seven SAIs intend to modify the currently existing legislation.

The European Union (TEST 2) takes with satisfaction that the operational and functional independence of the SAIs, and their audit scope respectively are broadly satisfactory in almost all countries.
Clear authority for the SAI (Recommendation 3)

In line with the Lima Declaration, the auditing responsibility of the SAIs extends over the entire financial management of the State. This idea appears to be particularly important in the context of EU enlargement due to the need of auditing all EU revenues (own resources) and expenditure. According to the finding of TEST 1, eight out of the fourteen SAIs have clear authority to audit all public funds and resources, bodies and entities. Since the competency to audit EU funds is of outstanding importance, it is promising that all of the fourteen SAIs can audit EU funds and resources. Notwithstanding, all of the SAIs has decided to exercise this right.

TEST 2 attaches special attention to the control of the structural action expenditure and the related institution-building. In the light of its results, only three countries (Cyprus, Estonia, and Malta) should be identified where both the legislation and the necessary administrative structures are generally in place.

The range of audits (Recommendation 4)

Following the INTOSAI Auditing Standards, the SAI is required to carry out regularity and performance audits. As suggested by TEST 1, almost all SAIs carry out both types of audits. Their proportions, however, are very different.

As regards the development of audit methodologies, the TEST 1 informs us about the trend in distinguishing methods, approaches and procedures for both types of audits. The TEST 1 also puts a stress on the importance of performing pilot audits in order to acquire new experience. They proved to be very useful for creating the audit manuals.

In order to assist the SAIs in this region, the Audit Activities Working Group in the auspices of the Co-operation of the Presidents of the Supreme Audit Institutions of the Central and Eastern European Countries, Cyprus, Malta, Turkey, and the European Court of Auditors achieved a remarkable development in terms of pilot audits. This Working Group was established in 2000 with the purpose to provide opportunities for the SAIs from the candidate countries to work on specific audits with the benefit of inputs and advice from a SAI from the European Union. The Working Group has been acting as a generating and advisory group for partnership between the SAIs.

We have achieved the first results; there were more striking examples of audit co-operation. These results mean that beyond the increasing number of twinning co-operations the so called audit activities have contributed significantly to the adaptation of those skills we call best practice within the European Union in cases of a good number of supreme audit institutions.

The new Task Force on Audit Activities (replacing the former working group) has a special task to elaborate; a Good Practice Guide in order to sum up experiences gained during pilot audits. The importance of learning from experiences was also emphasised.

Free reporting; relations with Parliament (Recommendation 5)

It is well-known that the right of the SAIs to report freely and without restriction is an indispensable pre-condition for performing quality audits. As it could be seen from TEST 1, all SAIs communicate with the Parliaments freely and (with one exception) with the public. The parliaments and the concerned parliamentary committees focus on the review of the annual audit programs and activities mainly as well as the follow-up of the audit findings and recommendations in these stronger and stronger relations.
The SAIs co-operate mostly with the following parliamentary committees:

- those charged with the various branches of administration and the economy;
- those responsible for inquiring into all matters related to the public accounts (Cyprus, Malta);
- those supervising the operations of the SAIs (Hungary, Poland, the Czech Republic);
- those specifically responsible mainly for the SAIs’ budget-related matters: the approval of the SAI’s budget, etc. (Malta, Romania).

Despite the stronger relations between the SAIs and Parliaments several shortcomings and missing links should be identified. On the basis of the weaknesses, several threats should also be identified that are contemplated in view of weaknesses in existing system of relations. However, one requirement (the regular, formalised relationship) appears to have benefits for all SAIs. This is why the EU pays special attention to it.

**Audit Manuals (Recommendation 6)**

According to the recommendation, the adoption and dissemination of audit manuals are one of the most important tasks of SAIs. In general, there has been a lack of strategy in most SAIs. The development is rapid in this field. Let me mention only one example. In order to promote the preparation and efficient use of audit manuals, a working group was established in the framework of the once quoted co-operation of the presidents.

There is need for effective quality control measures in the auditing process as well. Most SAIs carry out some form of quality control to ensure that audit standards are adhered to. Quality management, in any type of work carried out, is today considered essential in order to ensure good products or services. There is also an initiative and a good work aiming at elaborating a guide for quality assurance in the audit work from the planning to the follow-up of the recommendations under the auspices of the co-operation of the presidents.

**Internal organisation and training (Recommendations 7, 8, 9 and 10.)**

The first subject matter of concern here is the adoption of internal regulations. According to the results of TEST 1, the regulation covered the following areas in 2000: audit procedures (in six SAIs), structure of SAI (in two SAIs), management rights and obligations (in one SAI), administration and financial management (in one SAI), code of ethics (in one SAI), organisational and administrative activities (in one SAI), supervision and control over internal regulations (in one SAI), adoption of IFAC and INTOSAI auditing standards (in two SAIs). Taken into account the developments in the last two years, the internal regulations are satisfactory.

Another remarkable domain of concern is the reorganisation of the SAIs aimed at meeting the requirements of monitoring the application of *acquis communautaire*, and considering the audit of the use of EU funds. Following the Opinion (TEST 2) with regard to the control of structural action expenditure, substantial efforts need to be made in order to enhance the administrative capacities in nine candidate countries.

As regards the recruitment of personnel and training, it is a new additional task to train the staff on EU matters and requirements relating to the audits of pre-accession and structural funds. In this connection, the results of TEST 1 showed that training on 15 EU Guidelines was received by six SAIs. Five SAIs have elaborated training strategy by the end of 2000; however, two others reported theirs under preparation. Five SAIs had no training strategy but one
SAI has anticipated working out a strategy of this sort while two other SAIs had annual training plans or programmes. Half of the SAIs concerned had a designated training unit while six SAIs reported no answers.

4. Conclusion

The SAIs of the CEECs, including here Cyprus and Malta, have achieved remarkable progress on the development of their external audit function. They have benefited considerably from their independent status; they are building up modern, well-functioning audit institutions. The co-operation with the European Court of Auditors (and again through this channel, with many of the SAIs of the EU Member States and SIGMA) contributed to their progress. The traditional bilateral relations between SAIs were well topped by the twinning instrument, introduced by the European Commission through the Phare Programme in 1998. We cannot leave undisputed that some other SAIs outside the EU offered tremendous assistance to this region, e.g. the U.S. General Accounting Office whose International Auditor Fellowship Program have made it possible for many auditors to become better trained.

I am convinced that this historical undertaking, the rapid development of most of the SAIs in the region is unprecedented in the sense that the individual SAIs could multiply their efforts with the strong co-operation of their traditional and new partners, and moreover, by the common efforts offered by the unified basic goals. These SAIs are on the way to become advanced. The present situation shows a constantly improving situation in the scope of audits, the report writing procedures and many more. These SAIs still have a good deal of priorities. I want to give only a bunch of them without the aim at completeness: pre-accession EU fund auditing, anti-fraud arrangements, procurement audits, broadening the range of audit types, quality assurance in the audit process, better adherence to the internationally accepted auditing standards, etc. all need to be further strengthened. Naturally the stresses and the needs are put not equivocally on the same place since there are no uniform requirements.

The majority of the CEECs, Cyprus, and Malta are on the eve of the accession to the European Union. Therefore, it is suitable and righteous that we would mention some words about the European Court of Auditors. It is not directly involved in the negotiation process, notwithstanding that it has offered tremendous assistance through its networking activities with EU national SAIs. The earlier mentioned 11 recommendations adopted by the Presidents were quite obvious for the European Commission to apply them as benchmarks for the quality of external control pursued in the applicant countries. This circumstance shows us in a pragmatic way how the desires, goals, recommendations, and accomplishments made up a complex building in the process of the preparation to the EU membership. It is an imperishable merit we owe to the European Court of Auditors that we could set the goals through its help, and we could attain our ones.

These SAIs have very different backgrounds; however, we can easily understand each other. I regard the past twelve years as also a process of the mutual understanding as well as a co-operation which will serve well within the European Union. These SAIs can co-operate with each other on good terms as many examples show. For those who know profoundly the history of the Central and Eastern European region, the whole complexity in this branch of activities is almost a wonder.
End Notes

1. Under this notion, in the sense of the co-operating supreme audit institutions, the Central and Eastern European Countries (and as this group was gradually widened) included so-called candidate and applicant countries to the European Union. These countries were Albania, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia in 2002.

2. SIGMA (Support for Improvement in Governance and Management in Central and Eastern European Countries) is a joint initiative of OECD and the European Union, principally financed by the EU’s Phare Programme. SIGMA was established in 1992 with the aims to assist beneficiary countries in their search for good governance, to help build up indigenous capacities at the central governmental level and, to support initiatives of the European Union and other donors to assist beneficiary countries in public administration reform. This latter aim includes also the field of financial control/audit.
Further Development of the Municipal Credit Market in Ukraine

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Ukrainian municipal borrowing is very limited nowadays. Since Odesa’s default in 1998, there were almost no municipal bond issues due to the restrictive policy of the Ukrainian government and other reasons. In this article, the author outlines the Ukrainian experience with municipal borrowing and discusses prospects for its further development.

It is very important for Ukraine to move the development of its municipal credit market forward. First of all, Ukrainian cities have old infrastructures that need to be renewed. Many Ukrainian cities are only supporting their old, inefficient infrastructures, keeping them from being completely destroyed. The problem is that the older they become—the more money is needed from cities’ budgets to maintain them.

The more strategic point of view though is the following: Ukrainian cities depend upon money transfers from higher levels of government. Consequently, the unpredictability of authorizations limits the cities’ decision-making ability that, in turn, constrains the process of decentralization and establishment of democracy in Ukraine. On the other hand, the ability to borrow might dramatically reinforce these processes.

The first issue of municipal bonds in Ukraine was made by the city of Cherkasy in 1995. Since that time at least twenty-five Ukrainian cities have tried to borrow money for their needs. Actual borrowing happened in less than half of those cases. In fact, only six issues were fully sold to investors while another five were partly sold (sales ranged from 25% to 75% of the planned amounts).1

The main purpose for issuing bonds was to finance projects in the areas of housing, transportation, and other municipal services. However, some of the cities borrowed money for arbitrage purposes; that is, they put the funds into a bank account and thus made some profit.

In 1997, the city of Odesa issued bonds in the amount of UH 61 million at very high interest rates. The total debt that Odesa had to repay in 1998 was UH 91 million—60% of the city’s budget. Consequently, the city defaulted. Due to the participation of foreign investors, the default spoiled the reputation of Ukrainian cities as borrowers. From that time till today, there has been only a tiny amount of municipal borrowing by Ukrainian cities. Recently, the city of Lviv received a credit from the World Bank to reconstruct its water system.

There are four key elements necessary for the appearance of a municipal credit market:

• Institutionally and financially healthy cities
• Legislation allowing cities to borrow
• Mechanisms for repaying money in case of default
• A willing investor community
Ukrainian cities have problems with their creditworthiness, despite the new budget code with formula-based intergovernmental transfers that provides some sort of predictability. The ability to do long-term planning is limited because the cities’ own revenues are usually less than 20%. Transfers of funds from the national government to the cities are usually aimed at the cities’ survival and maintenance rather than at their development and growth. In addition, the transparency level of municipal operations is usually not at a satisfactory level. The old way of thinking and management, used decades ago, still permeates all levels of government.

An example of one Ukrainian city’s situation is the city of Kyiv, which recently received a B/Negative credit rating from Standard and Poor’s. This example, though, is not typical—the city of Kyiv is Ukraine’s capital and is in a much better position than many other Ukrainian cities. As is stated in Standard and Poor’s research regarding Kyiv’s ratings in January 2003, the ratings were constrained by:

- Low revenue predictability and flexibility, owing to central government controls, the evolving inter-budgetary system, and changing tax rates, types and shares;
- An extensive infrastructure that is in need of upgrading and will require significant financing;
- Restricted expenditure flexibility owing to budgetary pressures and existing local and national regulations. Kyiv’s administration is unable to move funds between expenditure items without the approval of the city council;
- Low liquidity with small cash balances and dependence on short-term borrowing; and
- The need to improve transparency of operations and financial and debt management.

The ratings were supported by:

- The strategic position of Kyiv as the country’s financial, commercial, and cultural center, which gives impetus to the city’s above-average economic development and finances;
- Income levels above the national average and unemployment below the national average;
- Low debt by international standards, at 3% of operating revenues in 2002, and the expectation that it will remain below 30% in the medium term;
- Sound financial performance, with average operating balances of 23% for the past four years and small surpluses after capital expenditure, supported by growing revenues.

Ukrainian legislation, allowing cities to borrow including all procedures and constrains, is concentrated mostly in two documents: the decree by the Securities and Stock Market Commission (October 13, 1997), and in the Budget Code (June 21, 2001).

Mechanisms for repaying money in case of default are very important for investors, both domestic and foreign. The ability of local government bondholders to create and enforce security interests in assets pledged as collateral in Ukraine needs to be improved. While the legal provisions are mostly in place to allow local governments to pledge cash flows, securities, and physical assets such as land, buildings and equipment, there is little history of judicial enforcement.
The high risk associated with long-term investments in Ukraine overall has resulted in high interest rates (22% - 28%). It is difficult for municipalities to borrow money and pay such high interest. Although foreign capital presents a currency risk due to fluctuating exchange rates resulting from inflation, it is much cheaper and is considered to be an attractive alternative to domestic borrowing. However, there is a limitation in the budget code: only cities with populations greater than 800,000 are allowed to avail themselves of external borrowing. This rule limits the number of the Ukrainian cities that can borrow from foreign lenders to approximately half a dozen cities. Saying that, it should be stressed again that development of a domestic municipal market is of great importance.

There are several reasons why the Ukrainian government is not encouraging cities to borrow. First, the tradition towards centralized governance is still very strong in Ukraine. Thus there is no political will from the government to allow municipal borrowing. Fear of defaults is a second reason. A third reason is a desire to avoid competition between municipal and national bonds by the government in the financial market.

In order to ease the development of the municipal credit system in Ukraine, it has been recommended that the sharing of the best practices be supported among Ukrainian cities in all areas of city management, especially in the spheres of budgeting, accounting, long-term financial planning and debt management. In addition, the state has been encouraged to enforce the four above-mentioned key elements for evolving a municipal credit market. The government could create an agency or municipal bank to provide loans to municipalities. However, the efficiency of such a scheme might not be as high as supposed – the experience of many countries that have tried to control municipal borrowing in this way has shown its inefficiency over the long-term. This is due to the tendency to create risky credit portfolios and politicize the decision-making process. Finally, the cities themselves have been encouraged to focus primarily on borrowing money to finance projects that generate sufficient revenue streams or otherwise save money. These might be projects in the recreational and tourism area, as well as more efficient water, sewer, electricity equipment, or transportation systems. It is hoped that the experience gained in the Ukraine will be of benefit to other countries as they develop their municipal credit markets.

End Notes

Code of Good Practices on Fiscal Transparency

IMF is an ICGFM Member Organization

Countries are encouraged by the International Monetary Fund (IMF) to implement the following Code of Good Practices on Fiscal Transparency. The Code is based around the following key objectives: roles and responsibilities in government should be clear; information on government activities should be provided to the public; budget preparation, execution, and reporting should be undertaken in an open manner; and fiscal information should attain widely accepted standards of data quality and be subject to independent assurances of integrity.

The Code sets out what governments should do to meet these objectives in terms of principles and practices. These principles and practices are distilled from the IMF’s knowledge of fiscal management practices in member countries. The Code will facilitate surveillance of economic policies by country authorities, financial markets, and international institutions. Guidelines to the implementation of the Code are provided in a supporting manual, which has been revised in line with the changes in the Code, and updated in a number of areas.

The Code acknowledges diversity across countries in fiscal management systems and in cultural, constitutional, and legal environments, as well as differences across countries in the technical and administrative capacity to improve transparency. Most countries have scope for improvement in some aspects of fiscal transparency covered in the Code. Diversity and differences across countries, however, inevitably imply that many countries may not be able to move quickly to implement the Code. Moreover, it is recognized that there may be a need for technical assistance if existing fiscal management practices are to be changed. The IMF, together with other international organizations, will give some priority to providing technical assistance to those countries that need help and are strongly committed to improving fiscal transparency.

Revised Code of Good Practices on Fiscal Transparency

I. Clarity of Roles and Responsibilities

1.1 The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.

1.1.1 The structure and functions of government should be clearly specified.

1.1.2 The responsibilities of different levels of government, and of the executive branch, the legislative branch, and the judiciary, should be well defined.

1.1.3 Clear mechanisms for the coordination and management of budgetary and extrabudgetary activities should be established.

1.1.4 Relations between the government and nongovernment public sector agencies (i.e., the central bank, public financial institutions, and nonfinancial public enterprises) should be based on clear arrangements.
1.1.5 Government involvement in the private sector (e.g., through regulation and equity ownership) should be conducted in an open and public manner, and on the basis of clear rules and procedures that are applied in a nondiscriminatory way.

1.2 There should be a clear legal and administrative framework for fiscal management.

1.2.1 Any commitment or expenditure of public funds should be governed by comprehensive budget laws and openly available administrative rules.

1.2.2 Taxes, duties, fees, and charges should have an explicit legal basis. Tax laws and regulations should be easily accessible and understandable, and clear criteria should guide any administrative discretion in their application.

1.2.3 Ethical standards of behavior for public servants should be clear and well publicized.

II. Public Availability of Information

2.1 The public should be provided with full information on the past, current, and projected fiscal activity of government.

2.1.1 The budget documentation, final accounts, and other fiscal reports for the public should cover all budgetary and extrabudgetary activities of the central government, and the consolidated fiscal position of the central government should be published.

2.1.2 Information comparable to that in the annual budget should be provided for the outturns of the two preceding fiscal years, together with forecasts of the main budget aggregates for two years following the budget.

2.1.3 Statements describing the nature and fiscal significance of central government contingent liabilities and tax expenditures, and of quasi-fiscal activities, should be part of the budget documentation.

2.1.4 The central government should publish full information on the level and composition of its debt and financial assets.

2.1.5 Where subnational levels of government are significant, their combined fiscal position and the consolidated fiscal position of the general government should be published.

2.2 A commitment should be made to the timely publication of fiscal information.

2.2.1 The publication of fiscal information should be a legal obligation of government.

2.2.2 Advance release date calendars for fiscal information should be announced.

III. Open Budget Preparation, Execution, and Reporting

3.1 The budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks.

3.1.1 A statement of fiscal policy objectives and an assessment of fiscal sustainability should provide the framework for the annual budget.

3.1.2 Any fiscal rules that have been adopted (e.g., a balanced budget requirement or borrowing limits for subnational levels of government) should be clearly specified.
3.1.3 The annual budget should be prepared and presented within a comprehensive and consistent quantitative macroeconomic framework, and the main assumptions underlying the budget should be provided.

3.1.4 New policies being introduced in the annual budget should be clearly described.

3.1.5 Major fiscal risks should be identified and quantified where possible, including variations in economic assumptions and the uncertain costs of specific expenditure commitments (e.g., financial restructuring).

3.2 Budget information should be presented in a way that facilitates policy analysis and promotes accountability.

3.2.1 Budget data should be reported on a gross basis, distinguishing revenue, expenditure, and financing, with expenditure classified by economic, functional, and administrative category. Data on extrabudgetary activities should be reported on the same basis.

3.2.2 A statement of objectives to be achieved by major budget programs (e.g., improvement in relevant social indicators) should be provided.

3.2.3 The overall balance of the general government should be a standard summary indicator of the government’s fiscal position. It should be supplemented where appropriate by other fiscal indicators for the general government (e.g., the operational balance, the structural balance, or the primary balance).

3.2.4 The public sector balance should be reported when nongovernment public sector agencies undertake significant quasi-fiscal activities.

3.3 Procedures for the execution and monitoring of approved expenditure and for collecting revenue should be clearly specified.

3.3.1 There should be a comprehensive, integrated accounting system which provides a reliable basis for assessing payment arrears.

3.3.2 Procurement and employment regulations should be standardized and accessible to all interested parties.

3.3.3 Budget execution should be internally audited, and audit procedures should be open to review.

3.3.4 The national tax administration should be legally protected from political direction and should report regularly to the public on its activities.

3.4 There should be regular fiscal reporting to the legislature and the public.

3.4.1 A mid-year report on budget developments should be presented to the legislature. More frequent (at least quarterly) reports should also be published.

3.4.2 Final accounts should be presented to the legislature within a year of the end of the fiscal year.

3.4.3 Results achieved relative to the objectives of major budget programs should be presented to the legislature annually.

IV. Assurances of Integrity

4.1 Fiscal data should meet accepted data quality standards.

4.1.1 Budget data should reflect recent revenue and expenditure trends, underlying macroeconomic developments, and well-defined policy commitments.

4.1.2 The annual budget and final accounts should indicate the accounting basis (e.g., cash or accrual) and standards used in the compilation and presentation of budget data.

4.1.3 Specific assurances should be provided as to the quality of fiscal data. In
particular, it should be indicated whether data in fiscal reports are internally consistent and have been reconciled with relevant data from other sources.

4.2 Fiscal information should be subjected to independent scrutiny.

4.2.1 A national audit body or equivalent organization, which is independent of the executive, should provide timely reports for the legislature and public on the financial integrity of government accounts.

4.2.2 Independent experts should be invited to assess fiscal forecasts, the macroeconomic forecasts on which they are based, and all underlying assumptions.

4.2.3 A national statistics agency should be provided with the institutional independence to verify the quality of fiscal data.

End Note

Accrual Accounting in the Government Sector

Background, Concepts, Benefits and Costs

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Abstract

The last two decades have witnessed a metamorphosis change in the public sector of some countries such as: New Zealand, UK and Australia. In addition, the Asia-Pacific region (especially the countries which are called Asian Tigers such as: Malaysia, Singapore, Thailand, and Philippines) has also witnessed remarkable public sector reform initiatives in terms of changing the role of state and its impact on public sector management; state/private sector relationship; resource use and efficiency; and decentralized planning. However, public sector reform is complex; cross-sectoral and multi-disciplinary. This paper will be restricted to research the governmental accounting reform. In short, it will only deal with a small part of this subject, which is the background, concepts, benefits and costs of the application of accrual accounting in the governmental sector. In fact, governmental accounting reform means the shift from cash accounting to accrual accounting. In other words, the shift from a less informative accounting system to one that is more informative.

From our point of view, government accounting reform is a shift from a cash flow and cash balances concept to a total-economic resources concept. Namely, it is an extension of measurement focus to encompass the total economic resources of governmental entities instead of only concentrating on the cash resources. Accrual accounting provides more comprehensive information (assets, liabilities, revenues, expenses, net assets and changes therein) about governmental entities and whether these entities are operating economically and efficiently.

Background, Concepts, Benefits and Costs

The adoption of accrual accounting and budgeting techniques has not been an end itself, but rather, a means to the enactment of significant changes in the scope, scale and style of the public sector administration and activity.
—James Guthrie, Macquarie University, Australia

Accrual accounting can really work in the governmental sector only if parallel management reforms are made, too. Should this not take place, the adoption of accrual accounting will not have major effects on the performance of the governmental sector.
—Hassan Ouda, Tilburg University, Holland
1- Introduction

The last two decades have witnessed a metamorphosis change in the public sector of some countries such as: New Zealand, UK and Australia (see, for example, Ball et. al. 2000; Ball and Pallot). In addition, the Asia-Pacific region (especially the countries which are called Asian Tigers such as: Malaysia, Singapore, Thailand, and Philippines) has also witnessed remarkable public sector reform initiatives in terms of changing the role of state and its impact on public sector management; state/private sector relationship; resource use and efficiency; and decentralized planning.

In reality, public sector reform is a dynamic and fast-moving process. It is likely that processes for public sector reform will continue well into the future for most countries in the world. In fact, in the years to come, globalization and national factors alike may take reform initiatives into directions that cannot be foreseen today. And to transform public management into forms that will be radically different from those now in existence. As a result, one can conclude that the public sector reform, including management and accounting reforms, is a must. It will take place whether the countries want it or not. It is a matter of time where some countries have the ability to quickly respond to the external and internal events and other countries take some time to respond, but in the end they will follow. Therefore, scrutinizing where we have been certainly helps us to better know where we are headed. This is why it is essential to better understand the many types of public sector reform initiatives, how they are inter-related and the impacts they generate.

However, public sector reform is complex; cross-sectoral and multi-disciplinary. The context for reform ranges across such aspects as:

• Civil reform;
• Fiscal management and budgeting;
• Executive decision making and cabinet systems;
• Performance management;
• Alternative services delivery;
• Change in the role of government and state;
• Privatization of state-owned enterprises;
• Legislative and regulatory reform;
• Management reform;
• Accounting reform, and so on.

These initiatives in the framework of the New Public Management (NPM) are encouraging the implementation of the private sector management techniques in the public sector, as well as the development of performance audits in order to monitor the degree of efficiency and effectiveness with which the public sector services are delivered and to evaluate the financial consequences of management decisions. Moreover, these initiatives have had a substantial impact on public sector accounting, where accounting as an information system plays an essential role in whatever reform process any governmental entity would want to undertake. In addition, these initiatives, especially NPM, resulted in changing the accountability concept. From accountability in terms of procedural compliance to accountability in terms of efficiency and results (effectiveness and cost effectiveness). Accountability for results depends on clear objectives stated in measurable terms and on budgets showing the minimum results to be achieved. This must also be based on expenditure limits and on accounting and auditing...
systems that measure and report on actual results. Of course, this raises the desirability of accrual-based accounting since the traditional cash-based accounting is of little relevance where a high portion of the expenditures for a government service occurs either before the period under review, or later.

This paper will not present all the above-mentioned content of the public sector reform, but it is restricted to research the accounting reform (accrual accounting). More determined, it only deals with a small part of this subject, which is the background, concepts, benefits and costs of the application of accrual accounting in the governmental sector. In fact, public sector accounting (government accounting) reform means the shift from cash accounting to accrual accounting. In other words, the shift from a less informative accounting system to a more informative accounting system. According to Luder 1992, a more informative accounting system performs two functions: it supplies comprehensive and reliable information on public finance, and provides a basis for improved financial control of government activities.

Another writer called public sector accounting reform a modernization of governmental accounting that aims to disclose financial information useful to evaluate the financial position of the entity and the effort and the accomplishment performance, as a way to improve their usefulness for decision-making purposes, and the accountability of the public entities. This means an evolution of public sector accounting towards the utility paradigm.

In addition, we see that government accounting reform is a shift from a cash flow and cash balances concept to a total-economic resources concept. Namely, it is an extension of measurement focus to encompass the total economic resources of governmental entities instead of only concentrating on the cash resources. Accrual accounting provides more comprehensive information (assets, liabilities, revenues, expenses, net assets and changes therein) about governmental entities and whether these entities are operating economically and efficiently.

The paper is structured as follows: the following section will focus on the main considerations for the adoption of accrual accounting in the governmental sector from an international perspective, followed by a discussion of the nature, concepts and principles of accrual accounting in the governmental sector (section 3). In addition, section 4 deals with the benefits of accrual accounting in the governmental sector. Finally, costs of the application of accrual accounting in the governmental sector are tackled in section 5.

2- Main considerations for the adoption of accrual accounting in the governmental sector: An international perspective

Until the end of the 1980s, governmental accounting had not received the study and reforms it warranted. In the late 1980s and early 1990s, some countries made an attempt to improve their governmental accounting systems and to make them efficient, such as New Zealand, UK and Australia. These countries have reformed their accounting systems by shifting from cash-based accounting system to accrual-based accounting system and moving from the separate accounting reporting to consolidated financial statements. This section outlines the background (main considerations) to the adoption of accrual accounting across the New Zealand, UK and Australia public sector. In other words, it explores what were the main reasons for the adoption of accrual accounting in the public sector of these countries.
2.1 The New Zealand Experience

New Zealand government, like other countries over the past two decades, has been concerned with the growth of public expenditure and the necessity to search for ways to increase the effectiveness of the use of resources that are available for the governmental entities. Prior to 1984, the New Zealand government had made various attempts to improve public sector operations. Following the election in mid-1984, the incoming government faced an economy with an extended history of slow growth; very high deficits; high debt including substantial liabilities resulting from various guarantees given by previous governments; and a highly sheltered private sector (Ball & McCulloch 1992).

In addition, Richardson (IFAC 1997) stated that the imperative for change in New Zealand was three fold:

- Sick economy—one of the worst performance in the Organization for Economic Co-operation and Development (OECD),
- Sick public institutions—lack of efficiency and effectiveness in government agencies,
- Sick social policy—neither fair nor affordable.

Richardson has also added that New Zealand suffered from two deficits:

- Financial deficit—in continuous deficit for two decades (70s and 80s) pushing net public levels up from 5% of Gross Domestic Product (GDP) to over 50% of GDP,
- Performance deficit—while public expenditure levels climbed from 30% of GDP to over 42% of GDP over those two decades, the standard and quality of performance in our public institutions and agencies dropped (IFAC 1997).

It is clear from the aforementioned that New Zealand was suffering from an economic crisis. This in turn induced the government to undertake a program of economic reforms—one element of which was public sector reform. The public sector reform has taken place by introducing three major changes:

1. Separating commercial operations from other government production,
2. Strengthening lines of ministerial and executive accountability,
3. Designing budget and financial management systems to improve measurement of the public sector performance.

The last reform includes:

a. shifting from an input to an output based system,

b. changing from cash to accrual accounting,

c. and creating different forms of appropriations for different types of government activities. (Goldman & Brashares 1991).

We do not intend to discuss the above stated reforms. The aim here is to discuss the main reasons for the adoption of accrual accounting in the New Zealand public sector.

Before the public sector reform took place, particularly in the early 1980s, the New Zealand government’s management system was based on program budgeting, but was in fact dominated by centralized input controls, such as the requirements for government departments to use centralized monopoly suppliers for accommodation, vehicles, computers and office services. All public money was required to be paid into a consolidated bank account. In accordance with treasury instructions, departments submitted vouchers for payment to
treasury offices that organized payment, and reported on the transactions in the “Public Accounts.” (IFAC 1996). Budgeting was formalized in a set of appropriations for cash payments for loosely designed purposes (programs). The appropriations could be expressed in terms of the recipient, the government activity, or the type of payment (e.g., a grant or a capital payment) (Ball & Bradbury 1998).

Furthermore, in this environment, accountability was seen mainly in terms of compliance with written rules aimed at limiting discretion, the absence of corruption, and the avoidance of mistakes or political embarrassment. In this environment, the New Zealand government accounting and financial system was suffering from a number of deficiencies that have led to accounting changes. In other words these deficiencies were the main reasons for the adoption of accrual accounting in the New Zealand public sector. These deficiencies are:

- Accountability is unclear.
- Assets levels are poorly maintained, and changes in value or depreciation are not required to be recorded.
- Goals and performance requirements of government departments are poorly specified.
- Losses, long-term liabilities, and future revenues are obscured by modified cash-based accounting system.
- Incentives often encourage dysfunctional behaviour (for example, year-end spending).
- Responsiveness to changing circumstances is slow.
- Global competitive forces that demand efficiency for survival are often ignored in designing governmental financial systems. (Ball et. al 2000).

In addition to these deficiencies, there are other reasons that made the New Zealand government to shift to accrual accounting:


Cash accounting provides information, which satisfies the annual compliance interest of legislators, but unfortunately has a number of serious limitations and drawbacks. In short, a cash-based accounting system is not intended to provide information on cost of services, earned revenues, accounts receivable, accounts payable, long-life assets, long-term liabilities, accrued interest on external debt, cost effectiveness, and property inventories. In addition, cash-based information alone does not provide an indication of long-term fiscal strength and the relationship between revenues, expenses and changes in net worth, and the trade off between the burdens of current and future taxpayers (IFAC 1997). So cash-based accounting failed to provide complete and effective financial information, which is essential for the decision-making process and discharge accountability. These drawbacks and limitations were the main reasons behind the application of accrual accounting in the New Zealand public sector.

b. Owner—Purchaser Distinction

The public sector reform has caused New Zealand ministers to have two relationships with their departments: 1) as their “owner,” and 2) as the “purchaser” of the goods and services they produce. The different interests of the government in departments (as owner and purchaser) imply different approaches to performance measurement. The ownership interest is concerned with how effectively resources are being maintained and used. This requires the same types of financial reporting, as are generally accepted practices in the private sector. This
includes distinguishing of capital and current expenditure, notion of capital maintenance, and hence, the use of accrual accounting. Without accrual accounting there is no reliable basis for measurement.

As "purchaser" of services from the departments, the government is looking for quality of goods and services at the best competitive price. Herein, the purchaser wants to know the full cost of services that are delivered by the departments, and this inevitably requires the adoption of accrual accounting. On the other hand, cash accounting is inadequate for satisfying this purpose because some cost elements are not fully allocated to outputs. Once again in order to meet the information that would satisfy both the owner’s and purchaser’s interests, the use of accrual accounting in the New Zealand public sector was an imperative.

c. World-wide Market Competition

As it has been seen in the last two decades the forces of internal and international competition have increased, because of unsustainable fiscal commitments of the governments. Consequently, many countries have attempted to reform and reinvent government activities in an effort to reduce government size and improve efficiency. New Zealand was subjected to these pressures earlier than many other governments, and answered in part with accounting reform (Ball et al. 2000). Moreover, some writers expect that it is likely the same global market forces will make the adoption of accrual accounting by other governments inevitable in the next two decades.

d. Intergenerational Equity

Intergenerational fairness is important in fiscal policy. Cash accounting allows the government to hide both their liabilities and the real state of their finances. Accordingly, traditional government accounting enables the governments to pass off the present costs to future generations. On the other hand, accrual accounting recognizes the short and long-term liabilities and provides a longer-term perspective for judging the impact of policies. For example, without the use of accrual accounting, decisions on pensions that create pension liabilities may not fully consider the impact of the liabilities on future budgets.

e. Public-Private Competition and the Costing of Outputs

As it was previously noted, cash accounting does not provide information on the total cost of goods and services delivered by the governmental entities. Hidden costs make the prices of public goods and services artificially lower than the same goods and services provided by the private sector. In other words, cash accounting makes government appear to deliver services more cheaply than the private sector, which is forced to include non-cash expenses as depreciation in its account. This is not true because the taxpayer subsidizes the difference. In order for governmental entities to be able to provide competitive goods and services, all costs must be allocated to these goods and services. Accrual accounting lets all costs be allocated to an output. This was also another reason for adoption of accrual accounting in the New Zealand public sector. In addition, the New Zealand financial reforms have resulted in the following:

- Budgeting, accounting and appropriations are now all done on an accrual basis;
- There is a charge for the use of capital;
- All budgeting and management is done according to outputs not inputs;
- Accountability is now clear;
- Managerial discretion is significantly greater than in other nations.
Bear in mind that these financial reforms did not occur in isolation. They were part of a movement to make the New Zealand economy more competitive as well as to make the government more competitive and accountable. In other words, the New Zealand approach with respect to public sector reform is a consistent and comprehensive framework, which comprises all the mechanisms of accounting, reporting, budgeting, parliamentary appropriations, performance specifications and monitoring, rather than dealing with accrual accounting as a separate issue. (Ball & Bradbury 1998).

After having discussed the main considerations for the adoption of accrual accounting in the New Zealand public sector, we would like to discuss an issue, which is often raised by some opponents. This issue is that the New Zealand has successfully reformed their public sector, namely the implementation of accrual accounting in the public sector, because:

- It is a small country; and
- It was suffering from an economic crisis.

This has led to the following questions:

- Can an economic crisis and the size of the country be considered as the only main reasons for making public sector reforms?
- Do England and Australia (in making their public sector reform) have the same economic crisis as that of the New Zealand?
- Are England and Australia small countries like the New Zealand?

Answering these questions will bring us to the UK and Australian cases.

2.2 The England experience

In November 1993, the Chancellor of the Exchequer announced the proposed introduction of Resource Accounting (RA) (1) to UK central government departments. This was followed by a consultation paper (Green Paper) in July 1994, which specified that resource accounting would be implemented in the majority of government departments by 1 April 1997 and in all departments by 1 April 1998. Subsequently, White Paper was published in July 1995, which described the progress that had been made in developing resource accounting and the Government’s proposals to introduce Resource Budgeting (RB) (2), moreover, it stated that the first published accounts would be in respect of 1999-2000 (HMSO 1995).

These proposals can be seen as a further step in a process of government financial management reform that laid down in 1982 in the Financial Management Initiative (FMI), focusing on value for money and improved accountability. Also the introduction of accrual-based resource accounting underpin other initiatives taken since 1982, including Next Steps. As part of the Next Steps initiatives, accrual accounting has already been adopted for executive agencies within central government; building on well established principles from commercial accounting procedures. These proposals aimed at applying the resource accounting coherently to the whole of central government, and not just its executive agencies.

1. Resource Accounting: resource accounting comprises a set of accrual techniques for reporting on the expenditure of central government and a framework for analysing expenditure by departmental aims and objectives, relating these to outputs where possible.
2. Resource Budgeting: resource budgeting covers planning and controlling public expenditure on a resource accounting basis.

   The adoption of resource accounting in the UK central government implies:
   • identifying outputs and the processes by which produced;
   • charging for all resources consumed including the use of capital assets, central services and non-cash items;
   • classifying and valuing all assets;
   • compiling and publishing a balance sheet showing assets, depreciation, stocks, debtors and creditors;
   • reconciling resource flows and cash funding.

   From the above-mentioned, the key feature of resource accounting can be summarized as follows: using of accrual accounting techniques to provide a more accurate measurement of resource consumed; accounting for the use of capital and current resources consistently, in terms of resource consumed; a financial reporting structure to match resources used to departmental objectives, and linking these objectives to quantified measures of output and performance; provision of essential cash accounting information; and a coherent accounting framework to fulfil a range of requirements from low level management information to high level financial reports (Green Paper 1994).

   In addition, resource budgeting comprises two elements: managing the Public Expenditure Survey (PES) on a resource accounting basis; and presenting Supply Estimates to Parliament on a resource accounting basis.

   As previously noted, UK has proposed two papers (Green Paper 1994 and White Paper 1995) with respect to introduction of resource accounting and budgeting (RAB). The main reason for introducing resource accounting and budgeting was the improving of the efficiency and effectiveness of the public sector. Moreover, resource accounting and budgeting was envisaged in the White Paper as a milestone in modernizing the state by:
   • focusing more on resources consumed and not just on cash spent;
   • treating capital and current expenditure in a way which better reflects their economic significance;
   • encouraging the discipline of a greater emphasis on outputs and the achievement of aims and objectives.

   In addition to improving the efficiency and effectiveness of public sector, there were a number of reasons that have entailed the adoption of RAB in UK central government:
   • There was in UK government dissatisfaction with the use of cash accounting (especially in decisions about capital);
   • There was an increasing focus on the objectives and outputs delivered, performance measurement and value for money (rather than cash inputs). This was a natural consequence of the Financial Management Initiative (FMI) that was designed to encourage departments to produce better information on objectives, output and performance.
   • The UK government wanted to make the changes that would provide information for better management decisions so that government departments can improve the use of resources to fulfil their objectives;
   • Fiscal control: Control of public sector finance has also contributed to the development of public sector accrual accounting in the UK. From its
inception, it was envisaged that the change to an accrual accounting basis in central government would have impact on the presentation of public sector plans (HM Government, 1994). However, the new budgeting framework could only be introduced once the new accounting systems were in place (Ellwood 1999).

- The continuing interest in reducing avoidable difference between public expenditure survey and the parliamentary processes; (Likierman 1998)
- The departmental ability to exercise financial control, and to plan and to structure their resources will be enhanced by implementing the resource accounting and budgeting;
- The UK government believes that resource accounting will help promote better management by government departments of the resources and assets made available to them by parliament;
- But the most significant reason is the increasing use of accrual-based accounting in the other parts of the UK public sector (such as, the NHS, Local authorities and executive agencies within central government departments) and in other countries such as, New Zealand which has moved furthest in introducing accruals accounting and budgeting, linked closely to financial management reforms including output-based performance contracts. In addition, other countries (for example Australia, Iceland, Canada, USA and Sweden) are moving in a similar direction;
- In addition, the UK government believes that the accounting and budgeting changes will provide benefits not only for individual departments, but for the public sector as a whole and for the economy more generally as follows:

For the Department: there is the provision of improved management information, especially on costs and assets. This will open up the opportunity for the making of better-informed decisions on the allocation of the resources, especially on capital and on comparison between internal and external providers. And will assist managers in planning and controlling the use of resources within departments.

For the public sector as a whole: the accounting changes provide also for the public sector as a whole a number of benefits:
- improvements in the way in which government conducts its public expenditure planning and control procedures at all levels;
- facilitating the development of cash control at a higher level than hitherto, whilst keeping tight control of public spending as a whole ; and
- in line with other initiatives, contributing to the further development of a strategic approach to managing the Civil services, in line with the principles of the Financial Management Initiative. (Green Paper 1994)

For the economy as a whole: there will be better information for formulating economy policy and preparing National Accounts on the value and use of fixed assets and capital consumption in the public sector; and the possibility of a reduction in the public sector’s call on funds by promoting better use of resources. (Green paper 1994).

2.3 The Australian experience

As in other countries, the poor economic performance of the 1970s led to a reassessment of the role of the Australian public sector and its management. The Australian public sector was suffering from the lack of a system of performance measurement, the absence of incentives to encourage greater
efficiency and the lack of competition as a pressure for improved performance (Mascarenhas 1990). This led to generating pressure for reform, focusing on improving efficiency, effectiveness, responsiveness and accountability. The Financial Management Improvement Program (FMIP), which launched in 1984, was an umbrella under which other administrative reforms were undertaken (e.g. running cost, devolution responsibility, program management and budgeting, user charging, contracting out, corporate planning, and commercialization) (Guthrie 1998). FMIP was concerned as much with effectiveness as with efficiency. In fact, the major concern was to improve the links between programs outcomes and the resources required for achieving them. Hence, the key feature of the FMIP were:

- the development of budgetary and regulatory processes which encourage efficient and effective management practices in departments;
- identifying and promoting techniques and systems that help departmental and agency managers focus on results; and
- changing administrative procedures and practices to give managers more incentive to manage and greater awareness of resource costs (Department of Finance 1988, 5)

Although FMIP focused on the budget—dependent sector, FMIP principles have been a driving force for commercialization of the common services of government and for reform of government enterprises (Keating and Holmes 1990).

This general shift towards a more commercial ethos has highlighted the need for a more commercial style of accounting, involving a move from cash accounting to a full accrual basis of accounting. Consequently, the administrative reforms in the name of improved efficiency, effectiveness, responsiveness and accountability were one of the most important reasons for the adoption of accrual accounting in the Australian public sector. The National Commission of Audit (NCOA) in March 1996 said that a full accrual accounting framework was an essential complement to the structural and cultural change the Government was seeking by way of a more competitive, efficient and effective public sector. So it can be inferred that the adoption of accrual accounting in the Australian public sector was a response to management reforms.

In addition, the need for a more transparent and accurate picture of government spending and the use of resources was recognized as far back as the 1970s and early 1980s. Since then other significant pressures have been developed that require governments to have a clear understanding of their use of resources, their whole-of-government financial position and, basically, how to get the best value out of every tax dollar (www.dofa.gov.au/budgetgroup/pressroom/speeches/cpaspeech.asp). This recognition has also required the adoption of the accrual accounting in order to achieve these objectives.

Moreover, there were other factors which created a climate for an explosion of discussion about the application of accrual accounting to the public sector, such as: various state governments were hit by the emergence of serious fiscal problems, as well as the failure of two major state banks (Guthrie 1998). Furthermore, the lack of cash accounting to provide the new required information, by managers as a result of management reforms, has also generated pressure for shifting to accrual accounting. Guthrie said that as commercialization and contracting out reforms started to impact government agencies, new information sets were required to help managers engage with these reforms; these included pricing of goods and services for cost recovery; cost control; liability containment; asset management; evaluating contracting out and leasing options;
and workplace bargaining. As in other countries such as New Zealand and UK, the drawbacks of cash accounting was one of the main considerations for the adoption of accrual accounting in the Australian public sector.

Based on the aforementioned, we can answer the previously posed questions under the New Zealand experience. Frankly speaking, the UK and Australia experience has revealed that the two countries have reformed their public sector without having the same economic crisis like New Zealand. However, the reform of the public sector (including the accounting reform) in the name of improved efficiency, effectiveness, responsiveness and accountability does not require per se an economic crisis to be started and achieved. In fact, there are other reasons or considerations, which create a pressure for reforming the public sector as it has been seen from the UK and Australian and also from the New Zealand experience. On the other hand, the size of the country can make the reform process easier especially for the small countries in comparison with the big countries, but it is not a condition for starting a public sector reform. As it is known the size of the UK and Australia is bigger than that of the New Zealand. Yet, the two countries have successfully revamped their public sector. Therefore, it can be concluded that the economic crisis and the size of the country are one of many considerations but they are not the only main considerations for starting and achieving the public sector reform.

In addition, the ideas underlying the New Zealand, UK and Australia reforms apply to any government, including developed and developing countries. They represent good management practices—what one would expect to see in any well-managed organization, public or private. The experience of New Zealand, UK and Australia shows the extent to which accounting, budgeting and financial-management reforms can be successfully applied in the public sector, provided that they are part of a well-designed system. Ball said: if a government can be run in this fashion, why would we continue with outmoded conventional practices?

In conclusion, the main considerations/reasons for the adoption of accrual accounting in the public sector whether for developed and developing countries can be summarised as follows:

• Management reforms: it is evident from the experience of New Zealand, UK and Australia that the adoption of accrual accounting in their public sector was a response to managerial reforms. The movement to expand the focus beyond inputs towards a “performance-based” or “output-based” management, to improve the efficiency, effectiveness and accountability of the public sector, and to increase the managerial discretion which gives managers incentive to manage and greater awareness of resource costs, has led to major changes in the public sector accounting system. In other words, these management reforms entailed the adoption of accrual accounting in the public sector of New Zealand, UK and Australia. Moreover, they will make the adoption of accrual accounting inevitable by other governments, which confirmed their intention to make such managerial reforms in the next decades.

• Problems, shortcomings and drawbacks of cash accounting: as earlier noted there was in UK and New Zealand (also in other countries) dissatisfaction with the use of cash accounting. This is because cash-based government accounting does not provide the users with complete and comprehensive financial information that they need for decision-making purposes and does not assist to a great extent in discharging the accountability. On the other hand, accrual accounting seems to provide this information and it can to a great extent overcome the shortcomings and drawbacks of cash accounting.

• Serious fiscal and economic problems: the New Zealand experience has revealed that New Zealand was suffering from an economic crisis. This crisis induced
the government to undertake a program of economic reforms, one element of which was public sector reform (including accounting changes). Moreover, the Contingency Model (Luder 1992) has specified the serious financial problems as driving forces for the accounting changes.

- **Harmonizing the governmental accounting system:** by inducing the practice, we found out that many countries such as France, the Netherlands, Spain and Sweden are using the accrual accounting in the local government. In addition, some parts of the central government such as agencies have also used the accrual accounting system. Then, the use of accrual accounting will bring the accounts of the central government into line with the other parts of the governmental sector, where the accrual accounting is in place.

- **World-wide market competition:** as previously pointed out, the global market forces have led to the adoption of accrual accounting in the public sector in the last two decades and it will make the adoption of accrual accounting by other governments inevitable in the next two decades.

- **Intergenerational Equity and Net Worth:** intergenerational fairness and net worth became important measures for fiscal policy. Intergenerational equity reflects the degree to which the government today is paying the costs of services today, as opposed to shifting costs to other periods. Net worth represents the net assets after subtracting the liabilities. Changes in net worth would give an indication of whether the government follows a deliberate fiscal policy or not. Only the accrual accounting provides the financial information required for measuring and judging the impact of fiscal policies.

- **Increasing the international interest in, and experience of, accrual accounting and budgeting in government:** in addition to the New Zealand, UK and Australia experience, accrual accounting has also been introduced in a number of other countries such as Sweden, Finland and the USA (Hansen et al, 1998). In Sweden, government agencies moved to accrual accounting approach between 1991 and 1994, as a development from the new management system of comparing outputs with resources consumed in the public sector. In Finland as part of the new public management reforms, accrual accounting was adopted in local government in 1997 and in central government in 1998. In the USA, the federal government made a commitment to full accrual accounting following statements on federal accounting issued by the Federal Accounting Standard Advisory Board, but accrual accounting was only introduced in 1998 and the approach adopted does not capitalize military and heritage assets (Ellwood 1999). Also the Netherlands adopted accrual accounting in local government (municipalities and Provinces) in 1985 and in central government agencies in 1994.

- **Its benefits in comparison with its costs:** discussion about whether to apply accrual accounting in the public sector should be approached in terms of costs and benefits of such application. As we shall see in sections 4&5, if the benefits of applying accrual accounting in the public sector are weighed against the costs of such application, the cost/benefits analysis has no doubt a positive balance.

- **Fighting of corruption and fraud:** The corruption and fraud phenomena are common for both developed and developing countries. Generally, without exception, all developing countries are suffering from the corruption and fraud, since there are serious weaknesses in the internal operations of the governmental sector in the fiscal field. These weaknesses penetrate into the heart of every governmental transaction. The governmental accounting system is outmoded and cumbersome. It does not indicate what was accom-
lished with the money spent in the year past. The budget system does not indicate accurately what the costs of each activity will be over the coming year. Therefore, the weaknesses of the budgeting, accounting and internal control systems within the governmental sector have resulted in increasing the corruption and fraud. Consequently, improving the accounting and budgeting systems, by the adoption of accrual accounting and performance budget, will aid to some extent in reducing the corruption and fraud phenomena.


Under the accrual basis of accounting, the financial effects of transactions and events are recognized in the periods in which they occur, regardless whether or not cash has been received or paid (IFAC 91). This means that the revenues are recognized in the period earned, in other words, revenues are recorded when the right to collect them is generated and the expenditures are recorded at the time goods and services are received, irrespective of when cash payments are made or when invoices are rendered.Unlike cash basis, accrual-based accounting reports on the total assets (financial and physical), total liabilities (short and long-term liabilities), net assets/equity/net worth, expenses, and revenues. Although the focus of accrual accounting is on all assets, not just cash, accrual accounting records contain complete information on cash flows, and a statement of cash flows is an integral part of accrual financial statements. Accrual financial statements usually comprise:

- **Statement of Financial Position (Balance Sheet)**, this includes details of all recognized assets and liabilities. The balance of assets less liabilities is referred to, in the public sector, by a variety of terms including net assets, public equity, net financial position or net worth.

- **Statement of Financial Performance (statement of revenues and expenses or an income statement)**, this comprises details of all recognized revenues and expenses. It shows the surplus (or deficit) of revenue over expenses. This is a useful measure of whether a government has managed to meet current expenses from current revenues, and whether its net resource position has increased or decreased. This measure is consistent with one element of golden rules, which states that the government should finance current expenditures from current revenues.

- **Statement of Cash Flows**, this encompasses a summary of cash receipts and cash payments during the year, classified under various sub-headings (operating, investing and financing) and reconciles opening and closing cash balances (IFAC 2000).

Moreover, accrual basis of accounting makes difference between the expenditures and the disbursements, makes distinction between current and capital expenditures, requires the capitalization of expenditures on the acquisition of all capital assets and recognizes the depreciation of these assets (IFAC 93). In addition, it recognizes the short and long-term liabilities and this assists in making the long-term consequences of these liabilities visible. So the information which is generated by using accrual accounting reflects more accurately and comprehensively the sequence and variation in assets and liabilities as a result of financial transactions. The main difference between cash accounting and accrual accounting is the timing of the recording the transactions. The timing of recording these transactions is vital for management decision making and accountability (Guthrie 1998). Hence, the information which is provided by accrual accounting is significant and useful for the decision making process in
government in comparison with the information provided by cash-based accounting system.

In addition, accrual accounting is based on the following principles:

• **Matching principle:** The main focus here will be on whether the matching principle can be applied in the public sector or not. However, one of the cornerstones of the accrual accounting system is the matching principle. This principle means that the revenues, which were earned during the accounting period, should be matched with the associated expenses. The matching principle is used by the business enterprises to measure the net income. Thus, the process of identifying the revenues and assets, which expired in production of those revenues, are fundamental for the matching principle. Accordingly, the direct link between revenues and expenses is a prerequisite in order to apply the matching principle. On the other hand, in the governmental entities the direct link between services and revenues is mostly missing and so is the link between expenses and monetary value of the output. The lack of the direct and traceable linkage between expenditures and revenues has made some of the opponents of the application of accrual accounting in the public sector to conclude that the accrual accounting with its matching principle cannot generally be properly applied in governmental organizations (Monsen 1997, p.13). Furthermore, Monsen stated that it is true that it can be applied for certain activities where the linkage between expenses sacrificed and revenues earned is direct or close enough, but in general this is not the situation in government accounting (Monsen 1997).

So according to Monsen, the general lack of a coupling between expenditures and revenues in governments indicates that the matching concept cannot be applied similarly in government accounting as it is applied in business accrual accounting.

Generally, the opinion of the opponents is based on the fact that since the measurement of the net income, which is so central to business organization accounting, is not a goal of the governmental entities, no need exists to apply the matching principle in governmental accounting. Consequently, in the absence of the direct link and hence the measurement of the net income, the application of accrual accounting with its matching principle will create a great confusion and distortion for the governmental entities.

In reality, for the application of the matching principle in the governmental entities, we can say that it is not necessarily the matching principle as a cornerstone of the accrual accounting to perform exactly the same function as it did in business firms, and that simply, because the nature and objectives of the business firms and governmental entities are largely different. The objective of the business firms is the profit motive, therefore, the function of the matching principle here is the measurement of the net income by matching the revenues with the associated expenses.

So: Revenues – matched with -- associated expenses = the measurement of the net income

Hence, the matching principle performs here the function that is consistent with the objective of the business firms. On the contrary, the governmental entities do not aim at making profit but at serving the public interest by providing the services and goods required. Hence, the matching principle can perform other function, which should be consistent with the objective of the governmental entities. Basically, for the governmental entities the net annual measure is of
the net resources consumed to provide services during the year and net accumulated figure is a measure of unconsumed economic resources (IFAC 91, p.16)

Therefore, the matching principle can be used here to match resources consumed during the accounting period with services and goods provided (and usefulness accomplished) during the same accounting period, or to match outputs with the associated costs. Whereas the use of the matching principle by this way in the governmental entities will show to what extend the governmental entities have used the resources, which are entrusted to them, efficiently. For instance, the efficiency of an organization can be measured by the ratio:

\[
\frac{\text{Output}}{\text{Input}}
\]

The greater the ratio, the more output for input, the more efficient the organization. Similarly, if we considered the resources consumed as input and the services and goods provided (and usefulness accomplished) as output, then the efficiency of the governmental entities of using the public resources could be measured by the following ratio:

\[
\frac{\text{Services and goods provided}}{\text{Resources consumed}} = \text{Efficiency of using the available resources}
\]

So: Services and goods provided -- matched with -- Resources consumed = the measurement of the efficiency of using the available resources

Thus the matching principle can be used in the public sector not to measure the net income, but to measure the efficiency of the government in using the available resources and hence serving the public interest. Moreover, we see that, as it is the case in the business firms, the accounting system is used to fulfill the objective of these firms. Similarly, the accounting system that should be used in the governmental entities has to be able to achieve the objective of these entities. Accordingly, the traditional governmental accounting system is not in position to assist in measuring of the government’s efficiency in using the available resources. On the contrary, accrual accounting with its matching principle can efficiently fulfil this task.

However, the New Zealand experience regarding the public sector reform has demonstrated that the accrual accounting with its matching concept is an essential element in order to achieve the desired performance and to discharge the accountability in the government. As a consequence of enactment of State Sector Act 1988, the management system in New Zealand is changed from an input focused system to an output focused system. Accordingly, the chief executives have been given extensive authority in the use of resources, such as staffing, purchasing, travel, office accommodation, information technology, etc. As part of this change, the chief executives have annual performance agreements, which are linked to departmental purchase agreements. These purchase agreements specify in detail the outputs or services to be provided by departments during the forthcoming financial year. In other words, the chief executives are clearly accountable for the delivery of agreed services, and are accountable for all the resources that they consume in the production of those services.
Consequently, the application of the accrual accounting with its matching principle has assisted the chief executives (agent) in discharging their accountability, at least, towards the ministers (principal) who have specified in the beginning the performance that is required of the chief executives. In other words, its application was inevitable in order to measure the performance and efficiency of the chief executives in the use of the resources to provide the agreed services. Hence, the adoption of accrual accounting in the public sector became a reality and it has performed another function than only measuring of the net income. Therefore, we can say to the opponents of the application of the accrual accounting in the public sector that the matching principle is not confined to the measurement of the net income but it can be extended to include the measurement of the performance and efficiency of the government.

In addition, the use of the matching principle in the public sector entities will assist in fulfilling the intergenerational fairness by charging the costs incurred in production the usefulness to the period in which this usefulness will be consumed. Bac 2000, stated that good allocation and sound intergenerationally neutral government financing demands that the cost of government activities will be so divided over time that cost will be attributed to the period in which the usefulness of such activities and the referred assets will be consumed (Bac 2000).

This means that:

Costs incurred should be -- attributed to -- the period of consumption of the usefulness

From the sound intergenerationally neutral government financing point of view we agree with Bac that who ever has consumed some services (usefulness) should pay for their costs, and this in turn will fulfil the intergenerational fairness. Whereas the matching principle means that both revenues and the costs incurred in earning such revenues are to be recognized in the same reporting period. Similarly, both usefulness and the costs incurred in providing this usefulness have to be recognized in the same reporting period in order to prevent the current generations from benefiting on the account of the future generations or vice versa. In other words, the use of accrual accounting with its matching principle enables intergenerational issues to be identified, such as accrued debt and maintenance of assets. This assists in ensuring an equitable distribution of expenses between generations and that the long-term position of the government remains sound.

Consequently, our conclusion is thus that the matching principle can generally be applied in the governmental entities in order to perform other functions (such as assisting in measuring the efficiency of governmental entities of using the available resources and fulfilling the intergenerational fairness) than those it performed in the business firms.

• **Consistency principle:** the consistency principle refers to the use of the accounting procedures by a single firm or accounting entity from period to period and the use of similar measurement concepts and procedures for related items within the statements of a firm for a single period (Hendriksen 1982). In other words, consistency principle requires a persistent application by a company of any selected accounting method or procedures, period after period. As a result, a user of company financial statements may assume that in keeping its records and in preparing its statements the company used the same procedures used in previous years (Larson and Pyle 1987). The use of consistency principle is important because if different measurement proce-
dure are used, it will be difficult for the user to discern the effects on the company, from period to period, caused by external factors such as changes in economic conditions.

Moreover, it is difficult for the user to separate the fluctuations caused by internal and external economic factors. While the use of consistency principle in the business enterprise is necessary, its use in the public sector is imperative. However, the use of consistency principle in the public sector can provide the user with reliable measure of net worth, period after period. The user can measure and judge the impact of the actions of the government on the net worth, whether these actions have deteriorated or improved the net worth. Without the use of a persistent accounting method or procedures, the government can easily affect the net worth, for example, by evaluating its assets at historical cost at some periods and at replacement cost in others. Yet, it will make a comparison of net worth from period to period meaningless. Similarly, the use of consistency principle will provide a reliable measure for the intergenerational equity. Also without the use of consistency principle the true and fair view about the financial position of the government can be distorted.

- **Conservatism principle:** this principle is sometimes expressed simplistically as “recognize all losses but anticipate no profits” (Larson and Pyle 1987). The conservatism principle is generally used to mean that accountants should report the lowest of several possible values for assets and revenues and the highest of several possible values for liabilities and expenses. It also implies that expenses should be recognized sooner rather than later and that revenues should be recognized later than sooner (Hendriksen 1982). This principle can also be used in the public sector accounting. This means that all expenditures and commitments should be charged to the budget sections as soon as they are recognized and the revenues should only be recognized when it becomes clear that they are realized. Thus, pessimism is assumed to be better than optimism in budgeting and financial reporting of governmental entities.

- **Full-disclosure principle:** this principle implies that financial statements and their accompanying notes should disclose all information of material nature relating to the financial position and operating results of the accompany for which they were prepared (Larson and Pyle 1987). This principle is one of the most important accounting principles that is missed by governmental accounting. The missing of this principle has led to governmental activities managed with poor quality financial information. The accounts of governments usually do not fully report the liabilities or assets of the government, and frequently take items into revenue that are clearly of capital nature— for example the sale of government assets. Hence, the missing of this information resulted in decision-making process in the public sector that has been confused and distorted, and the accountability is not effectively discharged. Therefore, the governments are requested to overcome the poor quality financial information by reporting information about their assets, liabilities, revenues and expenses as well as information about their exposure to loses and potential obligations related to contingencies and commitments (IFAC 1998). Thus, the application of accrual accounting in the public sector will improve the quality of governmental financial information.

In addition to the aforementioned principles, there is one postulate, which is worth to be discussed here; this is the **going concern.** The going concern postulate assumes that the accounting entity will continue in operation long enough
to carry out its existing commitments. In other words, the accounting entity will exist for a time period sufficient to justify the deferral process inherent in business organization accrual accounting (Ingram et al 1991). As earlier noted most of the governments are using cash accounting. One of the fundamental flaws in argument for cash accounting is that assumes that governments are not a going concern. Certainly, the apparent ownership of government operations may change periodically with the election of new government, however, the business, management, assets and clientele of government continue more or less unchanged through successive governments.

This also means that the existence of the public sector entities is loose of the successive governments. In other words, the governing and legislative bodies can be changed but the governmental entities themselves will remain in operation. Moreover, the going concern postulate means that it is expected that the business will remain in operation at least as long as the longest useful life of any of its resources or obligations. Simply, this assumption is more applicable in the public sector due to the very long life of many physical assets and long-term liabilities in comparison with business enterprises. On the other hand, Hendriksen 1982, stated “that going concern postulate should be accepted on the basis of their ability to permit predictions. Information regarding a specific firm should be presented in such a way that users of financial reports could make their own assessments regarding the future of enterprise. However, it is relevant postulate, leading to the presentation of information regarding resources and commitments and operational activity on the ground that such information may aid in the prediction of future operational activity.” Similarly, users of governmental financial reporting require information that assists them in making the prediction regarding the ability of the government in meeting its future obligations and the continuity of providing the services in the future. So it can be inferred that the public sector and the private sector are not sufficiently different to reject the notion of accrual accounting.

4. Benefits of the application of accrual accounting in the governmental sector

Before starting the discussion of the benefits of accrual accounting in the public sector, it should be clear from the outset that the accrual accounting should not be seen as a magic solution for all the government problems. But it is an important element in order to achieve the desired performance and to discharge the accountability in the government. Guthrie (1998) stated that the adoption of accrual accounting and budgeting techniques has not been an end itself, but rather, a means to the enactment of significant changes in the scope, scale and style of the public sector administration and activity. In addition, the adoption of accrual-based system is an essential tool in moving to a more strategic, result-focused, and business like public sector that is able to compete both domestically and globally for the provision of the public goods and services. However, the shifting from cash based-accounting to accrual based-accounting in the public sector offers important benefits as follows:

- **Improving the financial reporting by the government**
- **Presentation of a full picture of the financial position of the government**
- **Providing information on the total costs of the government’s programs and activities**
- **Better assets and liabilities management by the government**
- **Extending and improving the performance measurements by the government**
• Providing reliable measures for the fiscal policy
• Improving the financial transparency by the government
• Creating an opportunity to use and build cost accounting systems in the government
• Assisting in developing the budget system by the government
• Supporting the management changes by the government

In addition to the aforementioned benefits, the following survey presents practical evidence on the signification of the adoption of accrual accounting in the governmental sector. At present, government using accrual accounting include (IFAC 2000):

• Australia (state, federal and local government);
• Canada (target date for reporting on a full accrual basis at whole of government level is fiscal year 2001-2002);
• Finland (government agencies and whole of government);
• France (local government);
• Germany (some government organizations);
• Iceland (agencies and whole of government);
• Ireland (pilot project for selected government departments);
• Italy (local government);
• Malaysia (local government);
• The Netherlands (agencies and local government);
• New Zealand (national and local government);
• Sweden (central government agencies and local government);
• Switzerland (local government);
• Tanzania (local government);
• United States (federal government)

It is worthwhile to mention that all the above-mentioned countries have only shifted to accrual accounting in the last two decades, as a response to the winds of change that have blown in order to encounter the challenges arising from globalization, and economic and fiscal problems.

5. Costs of the application of accrual accounting in the governmental sector

The implementation of accrual accounting in the public sector requires some changes which, in turn, entail additional processing costs. These costs can be presented as follows:

• System Changes

As a result of changing the accounting system, the old system needs to be developed, modified or to be changed in order to be valid for the new changes. There is a need to develop the hardware and the software, and to make new improvements to internal control procedures. Moreover, the adoption of a new accounting system requires the use and development of series of new accounts and supplementary accounts or records to serve specific purposes. The setting up of new systems will entail to a set-up cost. From New Zealand experience it is noticed that the set up cost of the new accounting system was not so big. I. Ball (Arthur Andersen 1994) has mentioned that the Auditor-General estimated...
that over a 6-year period the set-up costs were between NZ $ 160 million and NZ $ 180 million. However, this amount is not big in comparison with the benefits that are obtained from the new system. Bear in mind that this amount was estimated over a 6 year period (the set up cost per year was between NZ $ 26 and 30 million). By comparing the set up cost per year with the total expenses of year 1993, which were NZ $ 31.468.00 million (see the financial statements of the government of New Zealand 1993 - operating statement for the year ended 30 June 1993 - Arthur Andersen 1994 p.28). We found out that the set up cost per year was between 0.08% and 0.09% of the total expenses.

• **Staff Training and developing accounting policies**

  It has been noticed from the experience of different countries that the personnel with advanced knowledge in government accounting are scarce. This will entail investment in building up expertise in government accounting entities at all levels, both in technical aspects of accrual accounting and more generally to meet the wider changes in management culture (Clarke 1996). There should be training programs for the old staff and these programs should be carefully planned and designed. New staff with finance and accounting skills can be recruited. In addition, the accounting policies should also be developed in order to be consistent with the nature and requirements of the new accounting system.

• **Campaign costs**

  A campaign for the dissemination of information is essential in order to inform the politicians and all the members who will participate in the changing process (especially that most of them have no knowledge about accrual accounting) about the advantages of the new system and its benefits in comparison with the old system. Booklets, accounting instruction manuals, and case studies etc. should be issued to illustrate the different aspects of the new system. Such campaign has taken place in New Zealand, whereas they produced a booklet called “Putting Simply,” which is a plain guide to the changes. So the campaign costs can be justified as a result of its important role in convincing all the members and the public for what can be obtained from the new system and to what extent the new system can overcome the drawbacks of the old system. Thus, it assists in reducing the resistance to change, which is considered one of the most common problems that usually arise during the process of implementation of the accrual accounting in the public sector. Usually, the resistance to change arises always from the lazy people who like holding on to the old habits and do not like carrying out new procedures that involve additional work, and from the people whose position will be negatively affected as a result of those changes.

• **Management involvement**

  The introduction of accrual accounting in the public sector will require a significant commitment of the management time from the most senior levels downwards (Clarke 1996). Also some pressure can occur between different levels of the management, especially in determining the specification of the output of every department. Furthermore, it requires a cultural change by managers within governmental entities through an understanding and acceptance of how to use the additional information and of the potential benefits, which it produces, and commitment to change.

• **Identifying and valuing assets costs**

  One of the consequences of the use of cash-based accounting system by the governments is that both national assets and departmental assets are not accu-
rately identified and valued. This is because, under cash-based accounting, the assets whether current or physical are deemed to be fully depreciated in the period in which they are paid in cash. Accordingly, there were no incentives to identify and value the assets owned by the governmental entities. On the other hand, the application of accrual accounting would require the capitalization of the physical assets in order to spread their costs over their expected useful life. Of course, this inevitably entails that national and departmental assets should be identified and evaluated. This process will give rise to a new cost element as a consequence of creating assets registers.

**Conclusion**

As a consequence of discussion of the accrual accounting principles and the going concern assumption, it could be inferred that the public sector and the private sector are not sufficiently different to the extent that the notion of accrual accounting can be rejected. Also increasing the international experience of accrual accounting and budgeting in government (see New Zealand, UK and Australia experience) has revealed that difficulties in getting accrual accounting adopted universally in government are implementation problems, not matters of principle. In addition, the ideas underlying the New Zealand, UK and Australia reforms apply to any government. The experience of these countries has shown the extent to which accounting, budgeting and financial-management reforms can be successfully applied in the public sector, provided that they are part of a well-designed system.

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The Transition to Accrual Accounting in Context

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The paper identifies accrual accounting as part of one approach to the management of public services that may be considered to have value within certain circumstances and on certain preconditions. There is a danger in accepting per se the universal validity of the transition to accrual accounting. We argue that this transition should not be a high priority for all countries and that other public sector financial reforms may well take precedence. This will be particularly true in underdeveloped and transitional countries. Within this context an International Public Sector Accounting Standard (IPSAS) on cash accounting is seen as imperative and furthermore the IPSAS should give the cash basis of accounting appropriate status as a valid modern approach to public sector financial accounting.

Introduction

This paper situates the transition to accrual accounting in the context of the introduction of New Public Management in many countries over the last two decades. As such, accrual accounting is identified as part of one approach to the management of public services that may be considered to have value within certain circumstances and on certain preconditions. However, the value of accrual accounting must be assessed in context; it may not be appropriate for all countries.

Emphasis on advantages of accrual accounting by IFAC Public Sector Committee

IFAC Public Sector Committee (PSC) has made considerable progress over the last few years in developing a comprehensive set of IPSASs on financial reporting under the accrual basis of accounting for the public sector. In addition, the PSC has developed an IPSAS for financial reporting under the cash basis of accounting. However, the emphasis of the PSC has been on encouraging all governments and other public sector entities to make the transition to the accrual basis of accounting for their general purpose financial statements. The PSC has commented extensively on the benefits of accrual accounting for governments and individual public sector entities in its studies (Studies 5, 6, 8, 9, 10, 11 and 14) and occasional papers (Papers 1 and 3). Less effort has been expended on considering whether the transition to the accrual basis of accounting is universally applicable and, if so, describing the particular preconditions for its success.
New public management

Accrual accounting should not be considered in isolation, but as part of a package of reforms which have come to be known as New Public Management (NPM). NPM emphasises the introduction of private sector management techniques and the application or simulation of competitive market behaviour. Typical reforms include features such as:

- clearly defined outputs and goals
- resource allocation linked to performance measurement
- yardstick competition and benchmarking
- greater flexibility in hiring and compensation
- cost-cutting and labour discipline and
- breaking up monolithic ministries into decentralised units or agencies centred on well-defined products or tasks.

More generally NPM includes the following characteristics:

- increased orientation on the private sector to provide public services and as a model for managing these services
- devolution of responsibilities, an increased emphasis on managerialism and giving managers the power and right to take an increasing range of decisions and
- a move from the state being a provider of services to purchasing these services from the private or voluntary sectors through out-sourcing, contracting or public private partnerships.

NPM can be said to have started with, or have a background in, the reforms that were carried out in Britain during the Thatcher era. At that time such reforms were seen as highly political and ideological. Over the years, the ideological element of the reforms has been de-emphasised and they are instead described and argued for in terms of technical expertise. NPM has become a trend, its ideas have come to be regarded as universal and as being applicable everywhere, regardless of the special circumstances of different countries or regions of the world.

The techniques associated with NPM, including accrual accounting, have become generalised in the sense that they are now often claimed to be how public sector entities in general should be managed, controlled and structured. They have become apolitical and are now promulgated and defended on the basis of expertise rather than their ideological considerations.

Nevertheless, there has in recent years been concern expressed in developed countries as to whether the practical achievements stand up to scrutiny (Guthrie 1998; Stanton and Stanton 1998; Froud, Haslam, Sukhdev, Ahaol & Williams, 1998).

Preconditions for introduction of accrual accounting

Developing and transitional countries have an understandable desire to accelerate public sector reform by adopting the most advanced innovations devised by industrialised countries. Just as they have been keen to adopt the most advanced technological solutions to their more general problems. Thus there has been significant concern over the recent purchase by the Tanzanian government of an air-traffic control system from the UK. We must ensure that
the planned introduction of accrual accounting in Tanzania and other countries is immune from such criticism.

As Allen Schick of the World Bank stated:

“I believe that there are important preconditions for successfully implementing the new public management approach and that these should not be ignored by countries striving to correct decades of mismanagement. In contrast to those who take the position that managerial deficiencies should be the driving factor in determining the suitability of these types of reforms, I argue that they should be deterring factors. The greater the shortcomings in a country’s established management practices, the less suitable the reforms.” (Schick 1998)

Noel Hepworth, in his paper developed for the Norwegian government (Changes to accrual accounting in Central Government, IPF/FEE April 2002, unpublished), outlined what he considered to be the essential conditions for a successful transition to accrual accounting. These are as follows:

- consultation with and acceptance by civil servants and the public
- of the accountancy profession
- joint development of independent public sector accounting standards
- support and involvement of the government external auditor
- comprehensive management training
- an appropriate cultural approach
- a robust public audit process
- low levels of public sector financial corruption
- an adequate IT capacity
- a willingness to use incentives and penalties and
- recognition of the accruals approach as part of a comprehensive process of reform.

Hepworth then went on to argue that:

“The significance of these preconditions will vary from country to country. Developing countries are in a wholly different position from, for example, the countries of Western Europe. Issues that will need to be considered include the strength and interests of the national accountancy profession, the state of progress on other public sector reforms, whether resources exist to implement accrual accounting reform and the degree of political consensus about the need for reform.”

**Priorities in public sector financial management reform**

Effective public sector financial management reform is a long and incremental process. Before embarking on the more sophisticated reforms, such as a move to accrual accounting, governments need to ensure that they have some of the more fundamental technical and governance elements in place and working effectively.

Allen Schick (1999) has described this as “Getting the Basics Right.” In elaborating his argument, he states that governments should:

- foster an environment that supports and demands performance before introducing performance or outcome budgeting
- control inputs before seeking to control outputs
• adequately account for cash before accounting for accruals
• establish external controls before introducing internal control
• establish internal control before introducing managerial accountability
• operate a reliable accounting system before installing an integrated financial management system
• budget for work to be done (outputs) before budgeting for results to be achieved (outcomes)
• enforce formal contracts in the market sector before introducing performance contracts in the public sector
• have effective financial auditing before moving to performance auditing
• adopt and implement predictable budgets before insisting that managers efficiently use the resources entrusted to them.

(Schick 1999, emphasis added)

If governments are to invest additional funding to upgrade their accounting function, they need to consider carefully whether a move to accruals accounting is near the top of their priorities. Some other aspects of financial management may well be considered more important, for example:
• reducing waste and extravagance and ensuring value for money is achieved
• ensuring that accurate accounting records are maintained
• reducing fraud and corruption
• ensuring that up to date and efficient accounting systems are utilised with appropriate use of IT and banking services and
• ensuring that audit queries are responded to promptly and audit recommendations agreed and implemented in good time.

None of these objectives are predicated on a transition to the accrual basis of accounting.

**Questioning of the universal relevance of NPM and accruals accounting**

A number of agencies who accept the validity, in industrialised countries, of the introduction of NPM style reforms, including the transition to accrual accounting, have argued that these reforms may not necessarily be suitable for less developed countries. So, for example, SIGMA (an organisation established to assist Central and Eastern European countries preparing for entry into the European Union) has noted that, “both the effectiveness of the [NPM] reforms in countries where they have been implemented and their suitability for transition countries remain subject to debate among academics as well as practitioners” (SIGMA Papers: No. 32, September 2001).

In addition the UK Department for International Development has argued that, “moving to the use of accrual accounting is … not a priority for developing countries struggling to keep their cash under control.” (Department for International Development 2000)

**The continued validity of cash accounting**

In addition, it should be recognised that the cash basis of accounting has served many countries well over at least the last two hundred years. The stan-
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Standards for accounting on the cash basis may not have been independently and formally agreed, but they do provide a number of well-tried and tested approaches to public sector financial accounting. In many cases these approaches have been developed and refined by professional accountants and their use until relatively recently was almost universally accepted. So, for example, Sir Andrew Likierman (the person who was later responsible for the transition to accrual accounting in UK central government) was able to say, in a book published as late as 1992 that:

“Those who believe that private sector accounts are superior need to bear two factors in mind. First, that there are no immutable accounting or other financial reporting rules which apply irrespective of the nature and purposes of the organisation whose activities and results are being displayed or the objectives of presentation. Second, that cash accounts, despite their crudeness, have a degree of transparency that accrual accounts cannot give and that many private sector financial reports do not seek to offer” (Likierman 1992: 23).

Perrin observed the situation in the 1970s and explained the view held by the UK Treasury of accounting for central government departments:

The Treasury view was that accruals accounting involving allocating costs between years on the basis of resource use rather than cash funding was incompatible with Parliamentary sovereignty and therefore unacceptable. Parliament voted cash funding year-on-year, so therefore the main control accounts, reports and accountability must be on an annual cash basis (Perrin, 1998, p. 8).

Cash accounting is simple, relatively cheap to operate and objective. It also has close links to fiscal control and the monitoring of public finance. Cash accounting, as Guthrie (1998: 5) explains, “reflects the fundamental principle that no public monies should be spent in ways and in amounts not specified in annual parliamentary appropriations. Cash accounting records the cash receipts, payments and balances at the time cash is exchanged, hence cash accounting financial statements have traditionally shown sources of cash receipts, the allocation of cash expenditure and provided a comparison of actual against budgeted expenditures.”

Another publication from SIGMA (see above) has argued recently that, “a cash-based financial reporting system has the advantage of being simple and comparable to monetary data” (OECD/SIGMA 2001).

Conclusions

The cash basis of accounting is a simple, robust and well-tried and tested approach to the accounting for public sector organisations. For many transitional and underdeveloped countries the adoption of the accruals basis of accounting for their public sector organisations may not be appropriate and certainly should not be considered to be a high priority.

Reform of public sector financial accounting can bring many benefits in terms of the quantity and the quality of services that are provided to the citizens of many countries across the world. However, these reforms should be considered carefully. Aspects, such as the basis of accounting that are to be adopted, should be decided in the context of the overall priorities of the reform process and not just of the basis of the perceived superiority of one basis of accounting over another. Accrual accounting may facilitate NPM reforms but it is not an end in itself.

The transition to the accrual basis of accounting may well bring many advantages in the appropriate context. In contrast, the cash basis of accounting has
served almost all governments well for more than a hundred years. The issue by IFAC PSC of its IPSAS on the cash basis of accounting should emphasise this and add the benefits of clear international credibility and standardisation to the advantages of the cash basis of accounting.

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Introduction

Over the last forty years, much of the discussion surrounding healthcare has centered on the word “crisis.” Many experts agree that numerous healthcare systems across the world are in crisis and, if some actions are not taken, this crisis could reach pandemic levels. Many countries, including the United States, have introduced different forms of payment systems to address these cost containment and related concerns. Many agree that these systems have been less effective than desired.

In this paper, we present a historical background of the crisis in the United States and illustrate how other countries are experiencing similar problems with their healthcare systems. We also provide some preliminary analysis of the predictable effects of different payment systems on the costs and quality of healthcare services.

Many countries are experiencing virtually unlimited demand in the face of limited resources causing costs to skyrocket. One of the most difficult issues that policy makers face is how to contain and control healthcare costs. The historical background of healthcare systems and the preliminary analysis of the effects of different payment systems addressed in this paper should assist health planning...
boards, policy makers, consumer advocacy groups, the voting public, and other interested parties in their efforts to address the current crisis in healthcare. To better understand where we are, we must understand where we have been.

**Historical Background of the Healthcare Crisis in the United States**

In terms of the history of the United States, the issue of skyrocketing healthcare costs is a relatively recent problem. Prior to 1946, federal expenditures on health and human services were extremely low. Hospitals and clinics were combined, technology was low cost, and low break-even levels were achieved with little or no government involvement. In 1946, the Hill-Burton Act introduced federal grants for hospital construction, in exchange for charity care. In 1965, the Johnson administration introduced the “Great Society” philosophy of government. Since then, the United States has experienced an exponential explosion of expenditures on social services.

Exhibit 1 presents the federal health and human services expenditures from 1960 to 1995. Since 1965, the federal health and human services expenditures have skyrocketed from below $50 billion in 1965 to over $800 billion in 1995. This Exhibit includes federal expenditures on social security, income security, Medicare, Medicaid, and education. Medicare is a government healthcare program for the elderly and Medicaid is a joint federal and state government program for the indigent. Income security includes unemployment benefits and social security for retirement.
While Exhibit 1 illustrates the exponential increase in expenditures on social services from 1960 to 1995, Exhibit 2 illustrates the corresponding exponential increase in the US national debt from 1905 to 1995. The increase in the national debt follows almost the identical pattern to the increases in social service expenditures. As with expenditures on social services, there was very little national debt before 1965. Except for the increase in the national debt from World War II, the national debt did not increase significantly from 1945 to 1965. However, since 1965, the national debt has skyrocketed from below $500 billion in 1976 to over $4.5 trillion in 1995. We have paid for the expanded social services by borrowing money and leaving the repayments to our children and grandchildren. This is called inter-generational inequity.

Before September 11, 2001, there was much discussion about how the United States was in a surplus condition and how the US was reducing its public debt. However, if you combine the reduced public debt (amounts owed to private investors) with the increase in government debt (amounts owed to other governmental agencies), the total debt of the United States is still increasing and the surplus was not even an on-budget surplus. (US OMB 1999). In fact, the surplus condition was primarily from the collection of excess social security taxes during the boom period of the US securities markets.

In an attempt to meet the healthcare needs of our society, and then control skyrocketing healthcare costs, the United States has experimented with three basic forms of healthcare payment systems over the last thirty-seven years. These payment systems are (a) cost reimbursement, (b) prospective payment, and (c) capitation.
In 1965, the United States developed the Medicare program under the principle of cost reimbursement. Today, this is one of the most common approaches used around the world. The focus of the cost reimbursement approach is on meeting the previously unmet healthcare needs of society, rather than controlling costs. Under this system, healthcare providers are financially rewarded for expansion of capacity, increases in healthcare research and development, escalation of costs and over-treatment of patients. In fact, the higher a healthcare provider’s costs are, the more revenue the provider will receive.

From 1965 to 1983, the United States operated under the cost reimbursement approach. By the early 1980’s, the healthcare system in the United States reached crisis levels. The federal health and human expenditures increased from below $50 billion in 1965 to nearly $300 billion in 1983 (see Exhibit 1).

By 1983, the United States implemented the first significant price controls on healthcare. This approach is called the prospective payment system. Under this system, unit prices for healthcare services are set before the fact, rather than reimbursing costs after the fact.

In developing this system, 20 million patient records were reviewed by Medicare to determine the average patient length of stay (LOS) and cost of treatment, by groups of diagnoses. These groups of diagnoses are known as diagnosis related groups (DRGs). In 1983 there were 467 original DRGs; today there are 523. When a patient is discharged from a hospital, they are classified according to one of these DRGs and the hospital is paid a fixed price per day for a fixed number of days for treating the patient. If a hospital treats the patient at a lower cost, the hospital makes money. If the hospital treats a patient at a higher cost, it loses money.

Although DRGs provide an incentive to hospitals to reduce costs, the approach provides no control over patient volume. As long as the DRG based payment rate is slightly above cost, and hospitals can shift costs to the private sector, hospitals will continue to increase patient volume, because an increase in volume will increase profits. Thus, from 1983 to 1995, the United States continued to experience an explosion of healthcare costs. Federal health and human services expenditures increased from a little above $400 billion in 1985 to over $800 billion in 1995 (see Exhibit 1).

With the failure of the Clinton healthcare initiative in 1994, the healthcare markets began to drive expansion of the use of capitation. Capitation is the first real introduction of patient volume controls. Under capitation, a healthcare provider is allowed a fixed payment per patient per month, regardless of how much or how little service that patient requires. This approach was called “managed care.” The theory behind this program is that it would be in the best interest of the healthcare provider or health plan to invest in preventive medicine to keep the patient healthier across their entire lifetime, and thus reduce costs of care. Since a healthcare provider is allowed a fixed price per patient per month, a healthier patient would be a more profitable patient over the long-term.

The incentive to keep the patient healthier across their lifetime has not worked well in the US, largely because of the mobility of the American people. If a provider invests in preventive healthcare and incurs the upfront costs, there is a high probability that the provider will not benefit from the healthier patient because the patient will probably move to another location, or their employer may change to some other health plan. However, if a provider defers treatment, postpones care, or under-treats the patient, the provider will achieve an initial cost savings, and when the patient is sicker later in life, the patient will have already moved on to some other plan and will become someone else’s problem.
Under capitation, healthcare providers make more short-term profit by under-treatment or deferral of treatment. In many cases, patients have complained about long wait times and lack of adequate referrals to specialists under managed care (capitated) plans.

While the United States was introducing capitation, numerous other countries around the world have adopted our type of prospective payment system based on DRGs. Some of these countries have adopted essentially the same DRG categories as the US version, but most countries have modified the groups to suit their own national healthcare systems.

**Preliminary Analysis of the Predictable Effects of Different Payment Systems**

The Organization for Economic Cooperation and Development (OECD) is an organization of countries that provides a forum for exchange of economic and social policy. To become a member of the OECD, a country must have a market economy and a pluralistic democracy. There are currently 30 member countries in the OECD (see Exhibit 3 for a list of these countries). The combined OECD countries produce approximately two-thirds of the world’s goods and services. Of the 30 countries included in the OECD, approximately 10 countries have adopted prospective payment systems similar to the United States.

**EXHIBIT 3**

**OECD MEMBER COUNTRIES**

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<thead>
<tr>
<th>1. Australia</th>
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<tr>
<td>2. Austria</td>
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<td>3. Belgium</td>
<td>18. Mexico</td>
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<td>4. Canada</td>
<td>19. The Netherlands</td>
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<td>5. Czech Republic</td>
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<td>14. Italy</td>
<td>29. United Kingdom</td>
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<tr>
<td>15. Japan</td>
<td>30. United States</td>
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</table>

To better understand the impact of different payment systems on the cost and quality of healthcare services, we analyzed the impact of prospective payment systems on hospital inpatient cost per case, average hospital LOS, and case mix index (CMI) for members of the OECD. Our sample included all countries with at least two-thirds data coverage for mean patient LOS and patient discharges by diagnostic category from 1990 to 1997. We used this time period because the data for LOS and discharge rates had the greatest availability compared to years earlier than 1990 or later than 1997.
Based on these criteria, 10 of the 30 OECD countries had sufficient data to be included in our analysis. These countries included (1) Austria, (2) Canada, (3) Finland, (4) Mexico, (5) The Netherlands, (6) Norway, (7) Spain, (8) Sweden, (9) Turkey, and (10) United States. As of our sample time frame, four of the 10 countries (Norway, Spain, Sweden, and United States) had adopted some form of prospective payment system as a part of their healthcare payment systems. The remaining six countries (Austria, Canada, Finland, Mexico, The Netherlands, and Turkey) had not adopted a prospective payment system as part of their healthcare payment system.

It is difficult to correlate exactly when countries began implementing prospective payment systems because the approach of adoption varied considerably across countries. The system was usually phased-in over several years, and at different levels of budgetary aggregation. However, by 1993, Norway, Spain, Sweden, and United States had phased a substantial portion of prospective payments into their systems, and we analyzed their aggregate inpatient hospital costs. Hospital costs were not available by individual diagnosis category. We also did not examine outpatient costs and other medical expenditures such as prescription drugs. Even with aggregate data, we are able to observe notable effects in our predicted directions, although the magnitude of the effects is somewhat muted.

**EXHIBIT 4**

**AVERAGE HOSPITAL INPATIENT COST PER CASE**

Exhibit 4 presents the average hospital inpatient cost per case, both in tabular and graphical format, for adopters and nonadopters. This graph shows a fairly sharp drop in inpatient cost per case after the implementation of prospective payment systems around 1993. However, this reduction in cost per case was short lived. Providers evidently learned how to attract and categorize patients in diagnostic related groups that provided higher fees, and the cost per case began to increase once again. Exhibit 4 shows a large absolute difference.
between cost per case for adopters and nonadopters. The inpatient cost per case for countries that adopted a prospective payment system is $4,000 higher, on average, than countries that did not adopt this type of price control.

Exhibit 5 presents the average patient LOS, both in tabular and graphical format, for the adopters and nonadopters. As expected, countries that adopted a prospective payment system experienced a larger decline in average LOS compared to countries that did not adopt a prospective payment system. In 1990, both adopters and nonadopters had an average length of stay of about 11 days. In 1997, the average length of stay for adopters dropped to about 7 days while the average length of stay for nonadopters was above 8 days. Adopters had an incentive to move patients out of the hospital faster because a prospective payment system pays the same amount per diagnosis regardless of how long the patient stays in the hospital.

EXHIBIT 5
AVERAGE HOSPITAL LENGTH OF STAY

![Graph showing average hospital length of stay for adopters and nonadopters from 1990 to 1997.]

The CMI is a measure of the complexity of patient cases being treated in a hospital. Our CMI is a cost-weighted index, and used patient LOS as the proxy for resource consumption, as was originally done by Medicare (Forgione & Vermeer 2002). Our mean international case mix index is equal to one. Thus, if a country has a CMI greater than one, its patients, on average, consume more resources than the average of all the countries included in our sample. If a country has a CMI less than one, its patients, on average, consume fewer resources than the average of all the countries included in our sample.

Exhibit 6 presents our international CMIs, both in tabular and graphical format, for adopters and nonadopters. The CMI for adopters and nonadopters is basically stable. In general, hospitals may have very little control over their CMI because it may be driven by the country’s national health demographics and legislative mandates to treat all presenting patients. However, the CMI for the adopters is substantially higher than for the nonadopters. Since our index is a
cost-weighted index, the difference is primarily caused by adopters having significantly higher costs per case.

Summary

Many experts agree that numerous healthcare systems across the world are in crisis and, if some actions are not taken, this crisis could reach catastrophic levels. In this paper, we present a historical background of the crisis in the United States and other countries and present some preliminary analysis of the predictable effects of different payment systems on the cost and quality of healthcare services.

The United States and other countries have been largely unsuccessful in attempts to control healthcare costs. Under the cost reimbursement approach, healthcare providers are rewarded for expansion of costs and over-treatment of patients. Under the prospective payment system, hospitals continue to increase their volume because, as long as the DRG based payment is slightly above cost, an increase in volume increases profits. Under capitation, healthcare providers make more short-term profits by under-treating patients. If a capitated provider defers treatment, postpones care, and undertreats the patient, the provider will benefit from initial costs savings and, when the patient is consequently sicker later in life, the patient will have already moved to some other plan and location, and become someone else’s problem.

The information presented in this paper will hopefully assist health planning boards, policy makers and other interested parties in their efforts to address the crisis in healthcare. If a government is interested in containing the explosion of healthcare costs, capitation may be an effective system, if it can be determined how to eliminate the financial incentives for under-treatment. Capitation would
be successful if it is modified to reward appropriate care—which is the best quality of care for the patient, within the limited resources available to the nation.

References


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