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The International Consortium on Governmental Financial Management
2208 Mount Vernon Avenue
Alexandria, VA 22301-1314
Telephone: (703) 562-0035
Fax: (703) 548-9367
Email: ICGFM@yahoo.com
www.icgfm.org

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International Consortium on Governmental Financial Management

General Information

“In working globally with governments, organizations, and individuals, the International Consortium on Governmental Financial Management is dedicated to improving financial management so that governments may better serve their citizens.”

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 commitment to improving government infrastructure so that needs of the people are better met.

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, conferences, and training that bring together government financial managers from around the world to share information about and experiences in governmental financial management, and (2) promotes best practices and professional standards in governmental financial management and disseminates information about them to our members and the public.

The International Consortium on Governmental Financial Management provides three options for membership. **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 and, where applicable, discounted registration fees. (Dues: $1,000)

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Public Fund Digest - 2007
All good things must come to an end at some time and I have decided it is time for me to turn over the reins as Editor of the Public Fund Digest to another. I have been Editor since 2002 and it has been an exciting, as well as rewarding, adventure for me. But it is time for someone with new ideas to assume the Editor’s responsibilities. We are very fortunate that Andy Wynne has agreed to accept this responsibility. Andy is especially well qualified and I can only hope that you will continue to provide him with equally challenging and thought-provoking articles that you have provided to me.

The lead article in this issue by Mr. Dandago provides some great background information on financial management in an Islamic nation (Nigeria). I think that many of our readers will find this case study very informative. Following the lead article is a Case Study by Dr. Kovács on their experiences in Hungary as they moved to join the European Union. Many of us are outside of this process but appreciate the insight that he has given us in this timely article.

Following these case studies are a couple of articles by Mr. Wynne and Dr. Ouda on the pros and cons of accrual accounting. Both of these authors have written extensively on this subject previously and their articles are always very insightful. I have followed their articles with an article of my own to reflect the steps that a developing country might take as they move from a cash/modified cash/modified accrual basis of accounting to a full accrual basis using the Cash Basis IPSAS in the initial step.

This issue concludes with a collection of thoughts on auditing by Mr. Radburn. Even though audits are the final process in the area of financial management, the audits are a crucial part of the process and one needs to be constantly aware of their significance.

As always, we invite your comments on these papers and any prior publications of the Public Fund Digest as we debate the issues. Continue to contact me at jhughes@odu.edu during this period of transition to a new Editor if you would like to contribute an article or discuss a government financial management issue. Or contact us by telephone, facsimile, and on the Internet at www.icgfm.org.
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PUBLIC WEALTH AND ACCOUNTABILITY IN ISLAM: A CASE STUDY OF THE SHARI’AH ADMINISTRATION OF SHEKARAU IN KANO STATE, NIGERIA

By K. I. DANDAGO, PhD, ACA, ACTI, MNES, MNIM, MIMC
DEPARTMENT OF ACCOUNTING, BAYERO UNIVERSITY, KANO, NIGERIA kidandago@yahoo.com

ABSTRACT

This paper discusses instances of effective utilization of public wealth by the Shekarau Shari’ah administration of Kano State, Nigeria and the level of accountability being demonstrated in the process. This is done with a view to finding out whether or not the administration portrays a good example of how public wealth is to be utilized and how accountability is to be ensured, all in accordance with the teachings of Islam. Islamic religion teaches that public wealth, which technically belongs to Allah, is to be strictly used in the way of Allah, that is, to cater for the common concern of the people. Data for this paper were obtained from the Research and Documentation Directorate, at the Kano State Government House. Critical analysis was conducted with a view to identifying strengths and weaknesses. The study reveals that the administration has done fairly well in utilizing public wealth to better the lot of the masses and in accounting for it. It has been realized, however, that the level of accountability of the administration is not enough for one to conclude on its economical, efficient and effective utilization of public wealth. In the spirit of Total Quality Management (TQM), the paper recommends effective monitoring and supervision of all projects being executed; the publication of timely annual and audited financial statements of the state; the conduct of projects impact assessment and reporting thereon; the mobilization and involvement of communities in those projects that are community-based; and the development of natural resource endowments of the state for enhanced internal revenue generation.
INTRODUCTION:

Islam is not just about a set of religious rites and rituals; it is a complete and comprehensive package for fashioning human life and, at the same time, uplifting human spirit. To build a just and civilized society, human life and human spirit must be respected and protected through social justice, compassion, equity and devotion to Allah. The government that is skewed towards the teachings of Islam is in a better position to bring about that type of society than many other governments. That government is expected to effectively utilize or manage public wealth entrusted in its care for the achievement of the noble objective of sustainable socio-economic development.

In Islam, public wealth or public treasury (Bait al mal) is defined as the totality of resources in which Muslims have unqualified right and which does not belong to a particular group of Muslims or to specified people (Ali,1986). The concept of Bait al Mal is a trust and its wealth is to be treated as Allah’s wealth or Muslims’ wealth and, so, the wealth is to be utilized strictly in the way of Allah… to cater for the common concerns of the masses. Efforts must, however, be made to ensure that all the sources of public wealth accumulation are legal, that is, they are not against any of the teachings of Islam.

All aspects of the Islamic way of life should be made to contribute richly to the achievement of the major socio-economic goals of Islam. Some of these goals are: (i) Economic well-being with full employment and optimum rate of economic growth; (ii) Socio-economic justice and equitable distribution of income and wealth (Chapra 1995:p.34). The achievement of these goals would depend greatly on the human and material resources (wealth) available in the society and how the wealth is utilized and accounted for, in accordance with the teachings of Islam (shari’ah).

A shari’ah compliant state is any state out of the thirty-six (36) states of the Federal Republic of Nigeria whose people and government resolved that the Islamic legal system (shari’ah) should dictate their way of life (Dandago, 2001). The state capitalizes on some provisions of the constitution which give it the freedom to adopt a legal system that would suit the custom, tradition and other peculiarities of its people.

Ibn al-Qayyim as cited in Chapra (1995:p.33) states that “the basis of the shari’ah is the wisdom and welfare of the people in this world as well as the Hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the shari’ah”. Also al-Ghazali (ibid) states that “the very objective of the shari’ah is to promote the welfare of the people which lies in safeguarding their faith, their life, their intellect, their posterity and their property. Whatever ensures the safeguard of these five serves public interest and is desirable”.

A shari’ah compliant leadership is expected to utilize public wealth to build human intellect and to cater for the welfare needs of members of the public, with sincere demonstration of justice, fairness, mercy, well-being and wisdom. It is also expected to safeguard the faith, the lives, the intellect, the posterity and the property of the people. Effective utilization of public wealth must be supported with adequate accountability (which is simply about giving reasons or explanations as to what one does) for the public interest to be satisfactorily served.

This paper has the objective of finding out whether or not the Shari’ah administration of Shekarau in Kano State is a practical demonstration of effective and efficient public wealth utilization and accountability, in accordance with the teachings of Islam, with a view to challenging other states to work towards having in place that type of administration for bringing about sustainable human development, in particular, and sustainable economic development, in general.

The paper is divided into five sections. Section one is the introduction as above. Section two presents a conceptual framework and review of related literature. Section three states the study’s methodology. Section four discusses results obtained, while section five concludes the paper.
CONCEPTUAL FRAMEWORK AND LITERATURE REVIEW

2.1 The Concept of Accountability

Accountability is a term that enjoys a wealth of literature, especially in developing economies, where it is not practically demonstrated by those holding the responsibility of managing public wealth. In its simplest term, accountability refers to the ability to give explanations or reasons regarding what one does at any given time; it is about the ability to satisfactorily account for whatever has been entrusted in an officer’s care (Dandago, 2002).


According to Tivey (1960), accountability implies stewardship or trusteeship on the part of the managers of an undertaking, while Etzioni (1975) holds that the term accountability is used in three concrete instances:
- to refer to greater responsibility and responsiveness,
- to allude greater attention to the community (particularly the minorities);
- To show greater commitment to values (high standards of morality).

This means that to talk about accountability is to talk about responsibility, responsiveness or stewardship. This simply implies that a person or group of people to whom resources are entrusted is required to render periodic accounts on how those resources are being managed. This might have influenced Adefila (2004) to conclude that accountability means holding public officials responsible for their actions.

Mamman (2004) is of the view that accountability is a pre-requisite for any self-respecting government. It is the root of social security, equitable income distribution, employment opportunities, and efficient allocation of available resources as well as increase in national wealth and political stability. In modern governance, accountability would not be complete without audit, just as good governance would not be complete without accountability.

According to Ademolekun (1983) and Oshisami (1998), public accountability has five known patterns: political, legal, financial, ombudsman (Public Complains Commission) and public opinion. These patterns amount to assessing whether or not a public officer uses allocated resources to yield the benefits for which they are allocated. This may have very serious consequences when public officers are brought under open scrutiny.

Since public accountability is central to good governance, it has been generally taken to be the parameter for adjudging the public expectations for fairness, responsiveness and exemplary leadership (Ajittey, 1992). Maipose (2000) corroborated this view by concluding that accountability is the mechanism by which decision makers are held responsible for their performance by those affected by their decisions. Ijiri (1975), however, sees accountability as the responsibility of management to report on achievable goals for the effective and efficient utilization of an enterprise’s resources.

Ademolekun (1983) identifies three major methods that can be used to ensure public accountability in government (i) appointment of an independent official in charge of auditing government accounts, (ii) the duty of the legislature in ensuring legislative oversight over government finances, and (iii) internal checks and balances.

This position tallies with that of Johnson (1996), who sees accountability as the obligation to account for a responsibility that has been conferred, and that of Iyayi (2001) who opines that accountability is the degree to which we believe that we are responsible or answerable to our client, shareholders, employers, users of financial statements, etc, for our actions and decisions.

In Islam, the term accountability goes beyond man to man stewardship in this world; it is extended to the hereafter when everybody will appear before Allah to account fully for what he/she did in this world. Full accounting means that every one shall give detailed explanations on all his/her private and public lives to Allah, the Creator, the Seer, the Listener, the Judge.
and the Just. The noble Qur’an (Chapter 17: 71-72) says “call to mind the day when we shall summon every people with their leaders. Then who so shall be given his book in his right hand such will read his book eagerly and will not be wrong a whit. But who so is blind in this world shall be blind in the Hereafter and even more astray from the way”. The prophet (SAW) is reported to have said: “…. The record of angels leaves neither the small nor big issues unwritten. But for now you have been left temporarily till that day when you shall find yourself in the grave and account for all your deeds”.

These Islamic injunctions confirm the place of accountability in Islam; emphasizing that everyone shall appear before Almighty Allah to account for all his/her actions or inactions in this world and receive just judgment immediately. If we perfect accountability in this world, demonstrating high degree of prudence, probity, transparency, fairness, and fear of Allah in our private and public lives, there is the hope that we ‘shall receive our books in our right hands’. But if we allow ourselves to be blinded by the worldly beauties, we ‘shall be blind in the Hereafter and even more astray from the way’.

Utilization of public wealth in Islam:
In any society, the quality of wealth is given by the quality of human and material resources available. That Islam views wealth as positively good is an understatement (Haq 1996). Wealth creation is strongly dependent on the ability of the people, engaged in different occupations, to utilize the natural resources endowed onto them by Allah to produce income, capital, property and an enabling investment environment. The availability of human and natural resources is what would be used in passing judgment on the richness of a society/nation. A good leader should, therefore, consider both human and material resources as the necessary components of public wealth and, so, make all necessary efforts to develop them for proper utilization in caring for the welfare needs of the people.

In Islam, the goals of socio-economic justice and equitable distribution of wealth are unanimously considered to be part of the moral philosophy of the religion and are based on its unflinching commitment to human brotherhood. In fact, there is such a great emphasis on justice and brotherhood in the Qur’an and the Sunnah that it is inconceivable to think of an ideal Muslim society where the two have not been actualized. Both cannot be realized without equitable distribution of wealth. Hence, the two have been closely integrated into all Islamic teachings so that their realization becomes a spiritual commitment of the Muslim Society (Chapra, 1995).

Leaders in Muslim Societies or shari’ah compliant states are expected to lay strong emphasis on socio-economic justice and equitable distribution of public wealth as they play their caliphate role on earth. It is then that resources (wealth) would be seen to be effectively and efficiently utilized for the achievement of the objective of sustainable development.

Scholars of Islamic economics like Siddiqi (1981), Siddiqi (1991), chapra (1993), Abudu (1996), and Haq (1996) have all called for effective and efficient utilization of public wealth in accordance with the teachings of Islam. Public wealth could be distributed through public expenditure for the provision of social amenities and Siddiqi (1991) emphasizes that, in an Islamic state, the expenditure should be incurred with honesty and fairness.

In Islam, human welfare can be realized only through the satisfaction of both material and spiritual needs of the human personality such that neither of the two is neglected (Chapra, 1995). While Islam urges Muslims to gain mastery over nature and to utilize the resources provided by Allah for the service and betterment of mankind, it warns them against single-minded concentration on material acquisition as the highest measure of human achievement because this leads them to forget the indispensable spiritual content of the human self. In fact, there is no division between material and spiritual aspects of life in Islam. Forgetting about the spiritual content of life is the genesis of executive corruption in Nigeria, even among the Muslim leaders.

Haq (1996) postulates that without moral consciousness, as contained in Islamic doctrine, political and economic leaders would be more interested in what they will gain out of their positions than what benefits they could create to the general public, using their positions. By so doing, they would only create an unjust and exploitative environment which would tend to frustrate the aspirations of individuals to be honest and sincere. Abudu (1996) observes that an economy that is not based on Islamic teachings is bound to create too many unwarranted wants, sharpen the materialism in the people, cultivate in them greed and envy, make them too self-centered and become a major source of injustice in income and wealth distribution. An Islamic state or a shari’ah compliant society is expected to be free from all these vices and be honest and sincere in the distribution of public wealth, with high degree of prudence, probity, transparency, accountability and, above all, fear of Allah.
METHODOLOGY
This study relies on both secondary and primary data. The secondary data were searched through library materials for the purpose of literature review, as per section two of the paper. The primary data were obtained, for presentation and discussion, from the Research and Documentation Directorate in the Office of the Executive Governor of Kano State, the case study. Some remarks (made on January 13, 2004 at the opening of the 2nd National Conference on Prudence, Transparency and Accountability at Bayero University, Kano) by Governor Ibrahim Shekarau, on the utilization of public wealth and accountability by the shari’ah compliant administration he leads, are also presented and discussed. The discussions, based on the contents of the information obtained, are as critical as possible, in line with the philosophy of Total Quality Management (TQM), which is about continuous improvement in performance – that no matter how well you are already doing, you can still do better.

RESULTS AND DISCUSSION
By results, we are referring to the information obtained on various financial and non-financial activities and projects of the Kano State government, with particular emphasis on those for the year 2004. The information highlights various instances of effective, efficient and economical utilization of public wealth (funds) and the accountability that usually follows. Although Kano State does not claim to be an Islamic state, the present administration of Mallam Ibrahim Shekarau lays much emphasis on good governance in line with the teachings of Islam. This makes it to be seen as a Shari’ah compliant administration. Some of the major highlights of the administration’s effective utilization of public wealth and accountability, as extracted from our source, are as follows:

4.1 Transparency and Accountability
The state government has maintained a budgetary discipline as all activities are carried out within the confines of the Appropriation Laws passed by the state House of Assembly. The state government has published both 2004 and 2005 approved budgets for all stakeholders to go through and pass informed judgment on the activities of the government. This has not been done for more than ten years before Mallam Ibrahim Shekarau’s administration. The action was done in the spirit of transparency and accountability. Again, the Kano State Commissioner of Finance gives a monthly account of the state treasury for the members of the public to be well informed about public wealth and how it is utilized. In the year 2004, the Shari’ah compliant administration expended a total of about 30.7 billion Naira on recurrent and capital projects (R & D Directorate, Kano State).

This is a good effort at demonstrating transparency and accountability. Two issues, however, need to be raised here with a view to bringing about improvement in that effort. One, a published budget is far less important than published audited financial statements. The government has to work towards having its financial statements prepared as timely as possible, getting the statements audited in good time and then publishing the statements for stakeholders to know what has actually happened to the public wealth in each financial year. Accountability is not complete without the subjection of statements to independent audit. Two, the issue of prudence has not been emphasized in the information on transparency and accountability. To say that approximately N30.7 billion (N1=.0075 USD) has been expended on capital and recurrent projects is not enough for all the stakeholders to be satisfied. The question is ‘has the amount been expended prudently’? The government has to seriously address the issue of prudence in all its activities, with a view to making reasonable savings that could be used in executing more projects that would touch the lives of the masses.

Human Development
Mallam Ibrahim Shekarau made a solemn pledge at his inauguration on May 29, 2003 that human development shall be a cardinal programme of his Shari’ah administration. Through this programme, which is about developing the potential and strength of the people for sustainable livelihood, the administration pledged to make Kano a model state, leading other states in good governance! The strategy adopted in the pursuit of this objective involves according top priority attention to seven key areas, the first of which is the offer of leadership based on the spirit of probity, transparency and accountability. On January 13, 2004, the governor stated at Bayero University that “Prudence, Transparency and Accountability are all a government requires to honestly lead its people to good life and prosperity through programmes and policies that are primarily aimed at developing the strength and potential of the people and that are geared towards making life easier for the populace”.

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Human development is a very important policy thrust. All efforts should be put towards realizing the potential and actual capacity of the people. Quality education, health care, road network, food security and other social infrastructures must be provided before the objective of human development is achieved. The government should accept the fact that it cannot go about achieving this objective alone; it has to sensitize and mobilize members of the public for them to make their individual contributions. In fact, the objective is better achieved through communal efforts with the government serving as supervisor, technical adviser, and completer of community efforts. The government should not wholly take care of the projects (short-term or long-term) that are community based, for example charity or religious work. The amount of money being spent on those works should be better expended on providing facilities to schools or hospitals. Communities should be made to learn to contribute to their self development and the development of their future generations. That is the faster way of achieving the objective of sustainable human development.

**Education**

The first step towards skill acquisition is education. Based on this realization, the government spends more on education than on any other sector. The government committed N6.32 billion or 20.6% of the total state expenditure to education in 2004. As a labour intensive sector, the state government spent N4.13 billion on personnel cost. It should be recalled that the previous administration sacked many contract workers while the Shekarau Shari’ah administration employed additional 4,500 teachers. As a result of new recruitments and upward review of salaries, an expenditure of about N560 million was increased over what was expended on personnel cost by the previous administration. Also, over N1.03 billion was spent on overhead cost in the education sector in the year under review. There was an increase on students feeding rate by an additional N15 per student, amounting to over N370.5 million in the year 2004. In all educational institutions, overhead expenditure was raised for their efficient running. For example, Kano University of Technology (KUT) was allocated almost N5 million monthly to cover overhead cost, while Ahmadu Bello University (ABU), which is almost ten times its size, received less than N10 million for that purpose from the Federal Government.

In this sector, the following achievements were recorded in year 2004 on which N813 million was expended:
- Establishment of over 100 new secondary schools across the state
- Construction of additional 208 classrooms across the state
- Provision of seats to 33,693 secondary school students
- Repairs and renovation of 164 secondary school laboratories
- Furnishing and installation of 58 secondary school laboratories
- Repairs of 46 damaged structures across the state
- Construction of 33 blocks of five seater toilets in secondary schools across the state
- Furnishing of 26 Principals’ offices across the state.

(Source: R & D Directorate, Kano State.)

Similarly, the state government, under the leadership of Mallam Ibrahim Shekarau, expended the sums below on projects in the various institutions and educational agencies indicated:

- Construction, renovation, repairs, provision of instructional materials in primary schools
- Scholarship allowances to over 22,000 students
- Capital projects in Tertiary institutions
- Capital projects in agencies of the Ministry of Education

The previous administration spent only N80 million in two and a half years.

The Shari’ah administration’s concern for human resource development is highly commendable. The key to sustainable human resource development is quality education and, so, the commitment of about 21% of the total estimated revenue to education is a welcome development. All the projects executed in year 2004 are laudable. It is, however, important to remind the administration of the UNESCO resolution which says that governments of developing economies should be committing at least 26% of their total revenue to education. This is just to show that the Shari’ah administration is yet to catch up with the UNESCO minimum standard for financing human resource development project, even though it is doing far better than even the Federal Government, which allocates just about 10% of its total budgeted revenue to education! Again, there is the need...
for an impact report to be prepared to show whether or not the expenditure incurred on the various projects executed have made any serious impact towards building the human intellect in the state. It would also be of interest to stakeholders to know the efforts being made by the Shari’ah administration in mobilizing the Kano community to contribute or invest money for the realization of its human resource development objective, and what efforts the community has made towards promoting and safeguarding the human intellect. How much have the communities expended on educational development in their areas? The government alone cannot achieve its noble objective of human resource development.

**Health:**
This sector has suffered neglect under the previous administrations of the state. Mallam Ibrahim Shekarau’s administration has struggled to cover the neglect of the previous administrations and this has remained a great challenge. In year 2004 alone, the administration spent N536.3 million as capital expenditure on health matters. The following were some of the capital projects undertaken by the government in 2004:

- Hospital equipments and items: Over N149 million
- Renovation and rehabilitation of hospitals: Over N97 million
- Free ante-natal and emergency care: Over N59 million
- Generating sets: Over N42 million
- Construction and upgrading of primary health care centers: Over N39 million
- Renovation of health schools and the headquarters of the ministry: Over N29 million

(Source: R & D Directorate, Kano State)

Similarly, as health is a sophisticated and labour intensive sector, the Shekarau administration employed 103 doctors, 43 pharmacists, 191 nurses and 1500 health workers. The government spent N2.286 billion on personnel cost and N154.3 million as overhead cost, bringing the total expenditure on health (including capital) to N2.772 billion, representing 9.04% of the total state expenditure. (R&D Directorate, Kano State).

Promoting the welfare of the people is of paramount importance, as the very objective of the Shari’ah lies in safeguarding their faith, their life, their intellect, their posterity and their property. Whatever ensures the safeguard of these five serves public interest and is desirable. The Shekarau Shari’ah administration’s commitment of 9.04% of its total revenue to health care delivery is commendable, as it shows government’s dedication towards safeguarding the faith and the life of the people. There is, however, the need for the government to exercise close monitoring and supervision to ensure that the expenditures are actually incurred on the specified projects; and that the money meant for some of the projects is not siphoned into private pockets. Impact assessment and reporting is very necessary in this sector for the government to be seen as thoroughly prudent, transparent and accountable.

**Agriculture**

Food security is a cardinal objective of every responsible government. This could only be achieved by making substantial investment in the agricultural sector through the provision of inputs and know how. It is with this dedication that the Kano State Government, under the leadership of Mallam Ibrahim Shekarau, committed N3.09 billion to the sector, representing over 10% of the total state expenditure in 2004. Out of this amount, over N2.4 billion was used as capital expenditure. This comes after years of neglect by the previous administrations. (R & D Directorate, Kano State).

The huge investment made to the agricultural sector of the state economy is praise worthy, especially as one compares the amount invested with the relatively meager amount spent on the sector by the immediate past administration over a period of 2 years (N957 million)! The worry here is the impact; has that investment really amounted to positive change in the ‘stomach management’ process of the people in the state? What agricultural product has been produced in excess of demand of the immediate communities for sale to other states or exportation to neighbouring countries?

**Environment**

Kano State, under the leadership of Mallam Ibrahim Shekarau, gives special attention to environmental sanitation; hence it has employed more casual sanitation workers than ever before and has purchased more refuse collection vehicles than any previous administration. This tempo of activity was intensified in 2004 when the administration committed N690.3 million,
Environmental sanitation and beautification are necessary for a number of reasons. One, a clean environment attracts visitors, who might come with capital for investment or new ideas and talents that would move the society forward. Two, environmental cleanliness is a very important preventive measure against many communicable diseases. Experts in environmental management would confirm this and count more. To, cater for the welfare of the people, therefore, a lot of attention is to be given to environmental management and, so, the huge investment made by the Shekarau administration to capital projects and programmes on environment is laudable. But, by the middle of year 2005, stakeholders should have been availed with an impact report to justify the huge expenditure. There is also the need for the government agencies in charge of environmental management of the state to come up with waste management programmes that would amount to effective revenue generation through the sale of collected refuse or through a recycling process. Those government agencies should be made to be revenue centers rather than cost centers.

Social Development

It is a well known fact that no government in recent years has strived to ensure social harmony like that of Kano State, under the leadership of Mallam Ibrahim Shekarau. Hence, it has committed billions of Naira to the welfare of the citizens, especially the senior citizens who served the state for several years and have been denied their entitlements. As at December 2004 a total of over 1.6 billion Naira was paid as pension emoluments to various beneficiaries. (R & D Directorate, Kano State).

The settlement of pensioners’ entitlements is an achievement acknowledged by even the staunch rivals of the Shekarau Shari’ah administration. It is also clear that the government has invested a lot of money on youth rehabilitation and empowerment, through some micro credit and training programmes meant for the youth to be redeemed from drug abuse and political thuggery into the economy. The A Daidaita Sahu and other societal regeneration programmes are primarily put in place to bring about the required social development and they consume a lot of money. Here again, one would be interested in the impact being made by those programmes and, if they are designed to have long gestation periods, when shall we start to reap their fruits? Some of the programmes, like A Daidaita Sahu, are not tangible and, so, if care is not taken they would just be consuming public funds without any concrete results to show. How many youths have been economically empowered (i.e. have become self-employed) through the youth rehabilitation and empowerment programmes of the Shekarau Shari’ah administration?

Islamic Education and Street Begging

Islamic Education has not received adequate attention by the previous administrations of the state; there were thousands of pupils undergoing training in various Qur’anic and Islamiyya schools across the state. The Kano State Government, under the leadership of Mallam Ibrahim Shekarau, initiated one of the most comprehensive programmes for the integration and rehabilitation of these schools aimed at eliminating begging by the pupils. In the year 2004, comprehensive data on the over 22,000 such schools were processed for the first time in the history of the state. As a result of this process, the first stage of the intervention in the schools was started and over N90 million was expended. (R & D Directorate, Kano State).

The attention Qur’anic and Islamiyya schools enjoy from the Shekarau administration is well deserved, considering the number of these schools in the state (22,000) and the numerous pupils attending them, who are also bonafide citizens of the state. Any effort aimed at a systematic withdrawal of almajirai (street beggars) from the streets of the state should be welcome by any good Muslim. The administration’s strong and practical involvement in the various programmes of integration and rehabilitation of the schools and their pupils and teachers is a clear testimony to its commitment to complete justice, fairness, mercy, well-being and wisdom in utilizing public wealth. One would be happy to hear that the pupils of Islamiyya and Qur’anic schools are put on scholarship stipends and their teachers on government payroll, just like their
counterparts in the conventional school system. The Sabo Bakin Zuwo administration was about to do this before it was overthrown through the military coup de’ tat of 31st December, 1983. All efforts should be ensured towards the success of these programmes of integration and rehabilitation of the schools. Vigilance should, however, be exercised on the possibility of incurring a flood of almajirai into the state from other states of the federation, as the Shekarau administration is trying to distinguish itself as the champion of the fight against street begging by Qur’anic schools pupils.

CONCLUSION AND RECOMMENDATIONS

In Islam, public wealth is to be utilized by the leaders in executing projects which would show respect and protection to human life and human spirit and that is to be done through strict observance of social justice, compassion, equity, well-being and fear of Allah. Whatever project executed should be accounted for as to the cost incurred and its derivable benefits to the people.

A Shari’ah compliant administration should be in the forefront of effective, efficient and economical utilization of public wealth and the rendering of accounts to show the impacts of the projects being executed towards sustainable development. The administration should also give priority to the need for it to develop and harness all the human and material resource endowments.

This paper has shown that the Shekarau administration of Kano State is doing well as a Shari’ah compliant administration that is set to achieve the major socio-economic goals of Islam. The administration has put in place laudable programmes for developing human resource (intellecutally and spiritually) through the provision of qualitative education (at all levels), effective health care delivery, food security, enabling investment environment, social security, facilities for the rehabilitation and integration of Qur’anic and Islamiyya schools, opportunities for women participation in relevant developmental projects, and so on and so forth.

There is, however, the need for the administration to seriously improve on its performance by taking care of the following: Effective monitoring and supervision of all the projects being executed (short-term or long-term) to make sure that responsibility holders are prudent in executing the projects and observe the Islamic principles of justice, fairness, mercy and compassion as they execute the projects for the benefit of the masses. Anybody found wanting in this regard should be removed from office and be ruthlessly dealt with through the Economic and Financial Crime Commission (EFCC). In Islam, public wealth is not for siphoning into private pockets!

Just as the administration is proud to publish its approved budgets, it should also make all necessary efforts to publish its audited financial statements on an annual basis. The financial statements should carry all the qualities of good information: timeliness, clarity, completeness, comparability, objectivity, etc. The publication of audited financial statements by a formal organization (public or private) is the hallmark of accountability.

Rather than reporting the amount allocated or expended on various developmental projects, the administration should put emphasis on the impact made by the projects towards developing the faith, the intellect and the posterity of the people. Impact assessment and reporting should be made first before expenditure reporting, as expenditure could be claimed to have been incurred without any impact to show for it.

The administration has too many laudable programmes for capacity building, industrialization and sustainable development. To effectively carry out those programmes, there is the need for community participation. The administration should embark on aggressive community re-orientation and involvement programmes that would make various communities be at the forefront in executing community based projects, like establishing and managing schools (primary, secondary, and tertiary), building and maintaining mosques, healthcare delivery, social security, feeder roads, etc, with the administration serving as technical adviser and supporter.

The Shekarau administration has to seriously address the agitation for resource control by a section of this country through harnessing and exploiting the numerous natural resources Allah endowed Kano State with for effective internal revenue.
generation that could amount to less reliance on federally generated revenue. A situation whereby only about 10% of the total expenditure of the state is covered by internally generated revenue does not suggest any possibility of sustaining the laudable programmes and projects of the administration, considering the success being recorded by the agitators of crude oil resource control. Ministries of Commerce, Agriculture and Finance have all the potentials to be made strong revenue centres of the state; and to be generating revenue for the financing of its capital and recurrent expenditures.

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Haq, I. V. (1996), Economic Doctrines of Islam, Virginia: International Institute of Islamic Thought (IIIT) USA.


Hungary faces historical challenges as a new member state of the European Union. As a consequence of globalization, the key criterion of the sustainable development of each country, but especially those small countries on a medium level of development with open economies which are similar to Hungary, is to stand firm in global competition. This challenge is not made easier by our membership in the EU either, since it is public knowledge that the Union itself is searching for new ways of faster development. However, our Union membership creates a historically unique opportunity to integrate, to achieve real convergence. However, our EU membership involves commitment to accession to the Eurozone and the performance of the convergence criteria, i.e. the nominal criteria required to accomplish the former.

The accession timetable, and the costs and benefits of introducing the common currency are the subject of dispute in Hungary, as well as in each new member state of the Union. The single most important strategic task of the Hungarian economic policy is to complete the process of Europeanization of the country, to establish the appropriate institutional and social capacities, as well as to harmonize real and nominal convergence according to an appropriate schedule. The public sector is the most critical area of economic policy that the government can control. Thus, what we are talking about here is not simply the fulfillment of the fiscal criteria of nominal convergence, although that in itself is a task of considerable magnitude. (Table 1)

| Table 1 - Evolution of public finance and inflation-related convergence criteria |
|-------------------------------|-------|-------|-------|-------|-------|-------|
|                               | 2004 | 2005 | 2006  | 2007  | 2008  | 2009  |
| Public finance deficit        | 6.6  | 7.5  | 10.1  | 6.8   | 4.3   | 3.2   |
| Gross public debt             | 60.2 | 62.3 | 68.5  | 71.3  | 72.3  | 70.4  |
| Consumer price index HICP     | 6.8  | 3.6  | 3.5   | 6.2   | 3.3   | 3.0   |

Source: Convergence Program, September 2006, 2004 actual, 2005 preliminary actual, 2006 preliminary performance, the others are projected figures

This is why I aim to discuss those required changes in my study which support the development of appropriate responses to these challenges from a strategic point of view. I am doing so because it is worldwide experience that the state audit offices, by relying on the experience that they have accumulated in the course of their activities, continuously review the risks of the public sector, and, by their advisory activity, they contribute to the modernization of the economic policy decisions that affect the public sector, and to that of regulation. I would like to start out by introducing a suitable theoretical framework and adapting this to the Hungarian situation. Then I am going to highlight some issues of the required modernization and reforms that I find
important. Finally, I am going to touch upon the changed and appreciating role of monitoring. However, before discussing my subject as such, I would like to give you a very brief overview of the Hungarian public sector.

**Some features of the operation of the Hungarian public finance system**

The *Hungarian system of public finances* can be divided to two levels and four sub-systems. The major player on the level of the central government is the central budget. Furthermore, the two social security funds (the Health Insurance Fund and the Pension Insurance Fund) and the separated state funds belong here as well. The second level is one of the local government sector. The current system of performing community tasks, the regulatory and state organization system that represents a democratic constitutional state, as well as the operational framework of the real economy is _politically_ based on those social compromises, which are to be reconsidered in a number of respects by now which meant the foundation of the change of political and social systems in 1989. Those values which defend the integrity of the society defined in the Hungarian Constitution, such as civil rights, the rights to enterprise, the right to health, education and civil representation (and the operation of the central and local administrative systems defined as a result) should be mentioned here, along with those which were manifested in various laws which can mostly be amended by the qualified majority of the National Assembly. The professional frameworks, requirements of the state task performance and the financial magnitude of the so-called social transfers reflected in the budget are defined by these factors.

The way of managing and accounting for public finances is regulated by the Public Finance Act and the related government and Finance Ministerial decrees introduced some fifteen years ago. However, this legislation underwent significant changes in the past few years, and in many respects it went out of date. The situation is ripe for the re-regulation of public finance management.

Central budget fulfills a critical role in the public finance system of each country. Defined in financial legal terms, this means that the role of the main budget is fulfilled by this sub-system. The income arising from state sovereignty appears on this level, and this is also the level which is entitled to relinquish some of the economic privileges arising from sovereignty in favor of the other levels of the public finance system or the players of the private sphere of the economy.

The bases of Hungary’s current taxation system were established by the tax reform introduced in 1988. 38-39% of the annual GDP is centralized by the Hungarian taxation system. The majority of revenues come from the central taxes. The weight of local taxes is around 1.5 percent of the GDP. *(Table 2)* The major problem of the Hungarian taxation system lies in that, due to the presence of the gray and black economies, the distribution of tax burdens is highly uneven, and the proportion of property-type taxes is low, plus tax administration is not efficient enough.

**Table 2 - Revenues from taxes and contributions**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<th>2009</th>
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<tr>
<td>including:</td>
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<td>Production and import taxes</td>
<td>16.2</td>
<td>15.6</td>
<td>14.6</td>
<td>14.8</td>
<td>14.7</td>
<td>14.4</td>
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<td>9.4</td>
<td>10.4</td>
<td>10.7</td>
<td>10.7</td>
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<td>Capital income tax</td>
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<td>0.1</td>
<td>0.1</td>
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<td>12.8</td>
<td>12.8</td>
<td>13.5</td>
<td>13.5</td>
<td>13.4</td>
</tr>
<tr>
<td><strong>Total revenues from taxes and contributions</strong></td>
<td>38.0</td>
<td>37.7</td>
<td>36.9</td>
<td>38.8</td>
<td>39.0</td>
<td>38.6</td>
</tr>
</tbody>
</table>

*Source: Convergence Program, September 2006, 2004 actual, 2005 preliminary actual, 2006 preliminary performance, the others are projected figures*
As regards the expense structure of the central budget, no major changes have occurred in recent years, which shows the faltering progress of real convergence. Although comparative statistical figures for the most recent period are not available in each field, it turns out from Table 3 that the extent of state involvement, and the weight of the individual functions are different in each country on a different level of development and social setup. The roles and weights of the individual functions change over time as well. The level of the redistribution of government expenses (the consolidated expenses of the public finance system as compared to GDP) as seen in the average of the old EU member states (EU-15) slightly grew from 2000 to 2003, it is currently around 48%. This growth is typical in the area of welfare functions, more precisely, in health care and social security. The redistribution level of the new members is a bit lower than that, i.e. 46.2%. The proportions of the individual areas are similar: the proportion of welfare expenses, especially the health care expenses is somewhat lower, and we spend more on economic and other functions.

Table 3. Government Expenditures in EU Member States and Hungary on a Functional Breakdown % of GDP

<table>
<thead>
<tr>
<th></th>
<th>State operation*</th>
<th>of which</th>
<th>Welfare functions</th>
<th>of which</th>
<th>Social protection (social security and</th>
<th>Economic functions**</th>
<th>Total</th>
</tr>
</thead>
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<td></td>
<td>General public</td>
<td>Law and</td>
<td>Education</td>
<td>Health care</td>
<td>Housing</td>
<td>Culture</td>
<td>(social security and welfare)</td>
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<td>operation*</td>
<td>service*</td>
<td>order,</td>
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<td></td>
<td>Defence</td>
<td>public</td>
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<td></td>
<td></td>
<td>security</td>
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<tr>
<td>EU 15 2000</td>
<td>9.9</td>
<td>6.5</td>
<td>1.8</td>
<td>1.8</td>
<td>31.4</td>
<td>5.9</td>
<td>5.9</td>
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<tr>
<td>2001</td>
<td>10.3</td>
<td>6.9</td>
<td>1.7</td>
<td>1.7</td>
<td>31.7</td>
<td>5.1</td>
<td>6.1</td>
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<tr>
<td>2002</td>
<td>10.2</td>
<td>6.8</td>
<td>1.7</td>
<td>1.7</td>
<td>32.3</td>
<td>5.3</td>
<td>6.3</td>
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<td>2003</td>
<td>10.1</td>
<td>6.7</td>
<td>1.7</td>
<td>1.7</td>
<td>33.1</td>
<td>5.4</td>
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<tr>
<td>EU 25 2003</td>
<td>10.1</td>
<td>6.7</td>
<td>1.7</td>
<td>1.7</td>
<td>32.9</td>
<td>5.4</td>
<td>6.4</td>
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<tr>
<td>Individual member states, 2004</td>
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<td>Germany</td>
<td>8.7</td>
<td>6.0</td>
<td>1.1</td>
<td>1.6</td>
<td>34.0</td>
<td>4.0</td>
<td>6.1</td>
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<td>United Kingdom</td>
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<td>4.8</td>
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<td>2.6</td>
<td>30.2</td>
<td>5.8</td>
<td>7.0</td>
</tr>
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<td>France</td>
<td>10.4</td>
<td>7.1</td>
<td>2.2</td>
<td>1.1</td>
<td>39.0</td>
<td>6.4</td>
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<td>9.5</td>
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<td>4.9</td>
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<td>1.8</td>
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<td>4.9</td>
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<td>2001</td>
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<td>2002</td>
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<td>6.1</td>
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<td>2003</td>
<td>11.4</td>
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<td>2004</td>
<td>12.7</td>
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<td>2005</td>
<td>12.4</td>
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<td>31.0</td>
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Source: Eurostat database
* The (interest) expenses of public debt management included
** Including environment protection

While the extent of redistribution in Hungary only slightly exceeds the European average, the proportion of the individual functions shows major differences. While the weight of expenses of government operation, which includes the expenses of managing public debt as well, was 14% in 2000, the same rate for EU member states was 10%. There was significant backlog in the area of welfare expenses, specifically in health care, social security, cultural and housing subsidies but, similarly to the average of the NM-10 countries, the proportion of education expenses was higher. By 2003, the expense structure approached that of the EU-members states, although the expenses of economic functions continue to be high, especially in 2002, the year of completing the construction and handing over the highways. As regards 2004 and most probably, 2005, what we can see is that the weight of health care expenses decreased again after the 2003 peak of 5.6%, and the proportion of educational expenses still exceeds the EU average, while the level of expenses used for supporting state operational functions fell, and its magnitude approaches that of the average of EU member states. The share of the costs used for supporting the economic functions is still high, which will continue to be an additional component in the structure of public expenses for quite a long time, as a result of
the justified state task of infrastructural development and the ever increasing use of EU resources for development purposes.

In an international comparison, health care and social protection are underrepresented in the Hungarian budgetary expense structure, while state operation and the state’s role in supporting the economy are overrepresented, and, what is more, even the weight of educational expenses, compared to several other countries. The Social Security Funds, which play a critical role in fulfilling the health care and social protection functions are unable to finance the health services from the collected contributions, an increased reliance on the resources of the central budget will be required, and not even this is sufficient. Half of the very high public finance deficit, which is 10 % of the GDP projected for 2006, is caused by the expenses of the social security system3 (the other half is due to the increasingly difficult debt management). This draws attention to the contradictions of the social security system, which can be explained by the lack of self-sustainability, the lack of a defined content of mandatory health insurance, as well as the structural problems of the service providing system.

The second level of the Hungarian public finance system is the local governments. The system, which is highly fragmented as compared to the size of the country, - there is a total of 3,200 county, city, and community local governments, along with the relevant structure of administration and service organization – struggles with a wide range of services, even in international terms. At the same time, a so-called two-third majority of the National Assembly is required to pass each act that affects the essential setup of the system.

The public finance system as a whole is characterized by what we call the incremental planning and budgetary procedure. The operation of the sector has a few relevant budgetary rules (credit limits of municipalities, the general reserve and provisioning system of the central budget). The experience of the SAO has shown that the current practice of budgetary planning and approval is unsuitable for coercing the required structural changes, and the applied – basically cashflow-based – reporting system is inappropriate for presenting the real costs and performances, as well as the pecuniary position. Such modernization is needed which contributes to increasing competitiveness and the resulting sustainable development on well-founded strategic bases.

**Theoretical and methodological frameworks for building a public sector that supports competitiveness**

Before I start discussing the achievements and problems of the Hungarian economy’s modernization and development efforts of the fifteen years following the change in Hungary’s political and economic system, I find it worthwhile to make a few theoretical-methodological remarks.

According to the familiar and generally used definition, the major task of the state is to create conditions both in the human and the material, real infrastructure. In this sense, the state appears, in the light of the complex security interests of the functioning of the society, as a regulator of the economy, as an owner, as well as the articulator of the goals of the society, and also, as the implementer and organizer of the tasks required to be performed in order to achieve these goals. By adapting a Dutch method published in 1997, 4 we can say that the institutions “in a society are equal to the accepted rules of the game […] these are the limits set by the people, which shape the human relationships”. There are four different mechanisms in this framework.

These may become capable of coordinating the behavior of the players in a market economy. Such factors are

- **competition** among the players of the economy, the indispensable institutional aspects of which are the prices (except for rents, transportation and community services) and the liberalization of foreign trade, privatization and an efficient financial intermediary system;

- **shared values and norms**: the shared preferences of a specific group of the players of the economy, which fundamentally influence human behavior;

- **cooperative transactions** are completed as a result of the cooperation of the players of the economy, reached by bargaining. Such include, for instance, trilateral cooperation between the government, the employers and the employees, which is a
significant institutional factor, and the basis for social partnership.

- **government administration**: the ability to enforce the state’s will that influences the decisions, e.g. through government regulation, which assumes that high-level public administration complements the newly established role of the government, and legal security is guaranteed for the private sector, furthermore there is efficient management in the public sector.\(^6\)

In this article, I will only make references to the first three elements, i.e. competition, shared values and norms, as well as cooperative transactions of the method of analysis described above.\(^7\) However, I will go into more detail regarding government administration, to which I will add a few ideas regarding the main elements of change theory, which is part of the thinking of strategic management. The thing is that in the world of institutional changes, it makes sense to pay special attention to the generative role of the so-called change agents, which can also be regarded as interest groups. These change agent organizations include domestic and international entities, which gain increasing significance, and the latter also has global and European examples. If you want to build contacts with international change agents, this will mean that, in exchange for the advantages of integration, *certain government functions will rise above the level of the nation state*. This includes the process as a result of which large companies and concern-type groups of companies, then the cross-border multinational empires\(^8\) gained increased significance in providing public services in the past decade. All this has brought about a new chapter in the development of the cooperative state, unprecedented in Hungary to date.

The considerations described above are suitable tools for compiling the *reference framework* of institutional changes for the area of the evolution of economic performances, which will also include the requirements presented by globalization. The change-generating factors (global and European change agents jointly) functioning at each change agent are allocated to the relevant change agent in our table, and the required organizational characteristics are tied to the mechanisms (*Table 4*).

### Table 4  Correlations (reference framework of the changes)

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<th>Change agents</th>
<th>Competition</th>
<th>Government administration</th>
<th>Values and norms</th>
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<td>Method consciousness</td>
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It is almost a cliché-like, well-known requirement that the efficiency of the government activity in the broad sense of the word is a critical factor in the case of any state role scenario. However, opinions are already very different as to the importance of each of the elements thereof. As a comprehensive goal in the center of modernizing the mechanism of government administration, we always see the achievement of public management and public administration compliant with the changed role of the state, which is consciously directed and operated, as well as applicable for generating changes.. This key area cannot go untouched by the new forms of society. Besides the efficiency improvement measures which follow the traditional solutions (those of organizational sociology and/or public administration rationalization), let us say those of the “operational management” approach, Hungary sees an increasing emergence of philosophically new solutions, which open up public administration, which means a kind of environment-conscious approach. In the government administration of today’s Hungary— although with a high level of distrust
and inconsistency –, the major direction of change is the full-blown development of the management approach, where, however, the experts should be familiar with the activity costs day by day, as profit-oriented management cannot replace the current system in the lack of this knowledge. As the latest SAO reports suggest, there are deficiencies in this area, for the time being. We find it difficult to accept that the classic principle, according to which public administration “will stay where it is”, and this provides stability and predictability, has become relative in Hungary too. “Open system” public administration, or rather management encourages the representatives of the private sector to undertake public positions but it is a basic issue here that these players should be able to think and act in terms of the interests of the entire society.

The central government and the local governments, municipalities have to develop the content and forms of competence sharing and the potential cooperation with their new partners. This includes the development of a single rule of procedures containing norms and guiding principles, which means a guiding principle for the affected acting state and local government bodies, as well as the monitoring of financial processes relying on this system. In other words, the responses to the challenges should reflect conscious, long-term harmony in regulation, institutional system, management methodology and implementation. Multidimensional government consciousness also means that it acknowledges the following: the structure, setup, tasks, and even the personal and qualification requirements of the staff in public administration and public services are defined by the state tasks defined better or worse, i.e. the Hungarian legal system.

Starting out from the above, and on the basis of the audit office’s experience regarding the current situation, in the action plans of Hungarian change agents (connection point A12) the government administration in the broad sense of the word should ensure an internally consistent regulation compliant with the selected scenario, as well as such budgetary planning whose top priority is the sustainability of the budget, and state presence and intervention should be limited and the methods thereof should be changed. In Hungary, all this basically coincides with the accomplishment of the steps of the convergence program of accession to the eurozone.

Clear task definition, transparent planning, and a budget approved on the basis of requirements of objectives and performances renders performances more measurable, as a result of which the conditions of accountability, analysis and assessment, adjustment and – last but not least – those of monitoring will (may) improve. State operations will become more transparent for the “public” as well, a consequence of which will be a more stable government, coupled with the strengthening of political confidence. A longer-term budget thinking in terms of perspectives, as well as budgetary planning assume and require the operation of an extensively developed macroeconomic financial planning system adjusted to the nature of the current market economy.

As a result of reducing the high level of redistribution, and the accompanying high level of taxes and contributions, state presence and intervention can be limited.

- definition and narrowing of the scope of the tasks to be financed by the state;
- encouraging such changes in the proportions of financed objectives which give priority to the development, educational and environment protection requirements of international competitiveness, rather than the direct costs of production.

The limitation of state presence and intervention assumes the reconsideration of state involvement, and accordingly, the clarification of the state tasks, which require new social and political compromises – the future’s state tasks cannot be handled together with the current financing.

**Events and options in the Hungarian scenarios**

There are two dominant approaches to the content of the socio-economic changes taking place these days. It is public knowledge that one regards economic growth well definable by quantitative characteristics as the critical factor, while the other focuses on the qualitative features of sustainable development, which are more difficult to parameterize. Both growth and development involve and assume that a certain economy, country or even a social model is competitive. Whether or not this explicitly declared, competitiveness in Hungary is defined according to the latter approach, i.e. the sociological understanding today: even by sacrificing growth, we wish to achieve and maintain a dynamic balance between the production of the economy and social cohesion.
Hungarian experience has also shown that it is by far not only what we call stabilization measures in the narrow sense of the word – whether they are restrictive or permissive -, those which increase or decrease the economic burdens, economic rationalization that belong to the competiveness bases of sustainable economic development, but also the reforms, or simply the much less quantifiable preparation, decision-making, adaptation factors of adjusting to the changes, which are of critical importance in the success of integration. Thus, the process of integration and convergence – in Hungary especially – is influenced by the most diverse conditions of capacities, skills, social identification, public confidence, and all these are reflected in the evolution of competitivity. 13

There are two well-known challenges and action scenarios (which two are not juxtaposed for didactic reasons)14 that provide responses to these, for the long-term chances of domestic modernization, including development and integration:

- consolidating the bases of sustainable development by improving competitivity, and
- preserving and strengthening social cohesion.

The environment for selecting the scenario is provided by the partially already mentioned internal factors (the level of social support, traditions, political-administrative institutional system, the level of economic development, indebtedness, financial reserves, etc.) and the external conditions (EU and globalization-related commitments, NATO and other international commitments, usable EU resources, evolution of conditions of the global economy, etc.). These factors provide the action scope of the decisions. The selection of a scenario where the improvement of competitivity is placed in the center of social-economic action is aimed at reaching maximum social and financial responsibility of the individual, while at the same time minimizing or at least substantially decreasing the number of state interventions. Direct responsibility for its services, as well as the technically provided services via its own organizational system, are reduced, and the bureaucratic, administrative-type commitments are also narrowed down. The dynamics of general government expenditures are reduced, except for educational expenses, and by/in spite of decreasing the taxes imposed on entrepreneurs and consumption, more funds can be used for development and innovation subsidies. As consequence, the concentration of income may become more moderate, and the expected economic consciousness and flexibility will improve efficiency, and will become a tool in the fight against wasting funds. It is required for the long-term success of anti-inflation measures to produce as fast and significant results in increasing productivity and reducing the budgetary deficit as possible, since the achievement of growth without inflation is our objective and at the same time a requirement of competitivity.

Successful accommodation, which focuses on the strengthening of competitivity, will result in durable and accelerating economic growth, in its final effect, social modernization, development as such. However, social insecurity, tensions, the lack of equilibrium will probably grow as consequence of the changes, unequal opportunities will become stronger, the effect of which can only partially be offset by the increasing performance of the private sector. All this will act against undertaking higher economic policy risks. This means that the question is to what extent the planned action will be limited by the short-term interests of the political change economy (and the social groups that use the services), and to what extent the chances of consensus-based solutions that go beyond the election cycles will decrease. Thus, if the external support received from the boom in the world economy can be regarded as constant, then it is a fundamental criterion of implementation that faster domestic growth should be able to compensate for the unfavorable effects of public finance restrictions on the population and various institutions, on a shorter term, and no such situation may occur where the social reactions result in diverting the implementation of this scenario. This is an especially significant risk in those countries where a change of political systems took place, and which later joined the European Union. The creditability of the political institutional system, social confidence, as well as a higher level of tolerance in the hope of a future of integration are of critical importance in moderating this situation and keeping it between tolerable limits. The situation is that with regard to the chances, a favorable perspective is provided by the historical opportunity called the “integration advantage”15, as it was shown by the example of numerous successful OECD countries in the development process that followed the Second World War.

Others regard the so-called action scenario based on the strengthening of social cohesion as a suitable solution, as opposed to the idea described above. This line of thinking suggests that the relative lack of social conflicts is an economic driving force that improves competitivity, supports accommodation. This scenario builds on the operation of a social model in which, besides improving the state’s role as a service provider and service organizer and the operational efficiency of the system of service provision itself, public institutions with unchanged significance will function and provide fundamental social and innovative
services, while the private sector will gain increasing significance in the organization and the technical implementation of service provision, by receiving a service provider’s market.

Many regard this scenario as a simple “warming up” of the concept of the so-called welfare state, a kind of drifting on the waves of social needs, although it means more and something different if implemented in reality. The thing is that, if we do not only use the slogans but we in fact undertake to realize this scenario, then our goal will be to render the system of social service providers more efficient, starting out from the idea that the more efficient utilization of social and welfare expenses will bring about better social results. In order to reach this goal, it is unavoidable to modernize the service organization institutions on the regional and community levels, which involves a lot of tensions, to eliminate the old systems and to develop new ones, whose cost implications are not insignificant. In the countries acceding to the European Union this option may be preferable first of all in order to create a chance for integration, where again those states are better off where there is consensus in selecting the values, which survive the individual government terms, and/or the nation’s shared success which has a cathartic effect, such as a state’s newly received sovereignty provides social support.

It can be stated that such a scenario will almost definitely be well liked by wide strata of the society, this is why it is easier to implement. However, this is only so at the moment of announcing such a program. The situation is that a solid, secure functioning of a society involves cohesion between the active and inactive social groups, or the employers and the employees as well, along with the enforcement of the basic principle that no single generation is entitled to “live better” than their successors to the detriment of the latter, by accumulating debts. This principle is becoming more and more difficult to enforce, as the proportion of old-age population, which is especially sensitive to the issue of social and health care services, is increasing. Thus, the risks of implementation are not only related to the self-evolvement of the competitive sector of the national economy in question, the success of the entrepreneurs’ aspirations to unilaterally enforce their interests, errors in projecting the perspectives of the global economy, and perhaps to unexpected force majeure effects incurred in the material bases of the nation (such as flood or earthquake disasters) but, paradoxically, to a gap between social expectations and the ability to finance these. In the set of goals aiming at improving social cohesion, it may easily happen that the constraint of the political change economy “to maximize the number of votes”, the need to comply with the “electors’ requirements” turns the model into a drifting system, which uses disproportionately significant amounts for social expenses, even in lack of the required economic capacity. From this point, it is only possible to attempt return to the growth track of sustainable development at the cost of restrictions causing major social crises and shattering the perspectives of the society. The enforcement of the required strong financial restrictions, the introduction of an “economic policy dictatorship” will increase the chances of the appearance of a government that functions as a long-term and narrow center of power and/or an autocratic institution, as an alternative, or rather, an ultima ratio. This setup stands significant chances in post-communist countries.

As opposed to the above-described theoretical approaches, it is obvious that in reality the so-called experience scenarios that work, which often result in tangibly different development courses. The environment for choosing the scenario is provided by the above-mentioned internal characteristics and external conditions. Often there are exaggerated illusions about the size of this scope of action, just as to the power of these mutual effects, while the influence of other factors is underestimated. In Hungary, for instance, no such hope has stood the test of reality that the improvement of economic competitiveness and by this, the strengthening of growth potentials may quickly result in the solution of social problems, and as social security is in itself an important driving force – this has a favorable effect on growth already in the short run. Similarly, we have not duly considered the demographic trend, which is one of the most important components of the social-political factor mentioned among the factors affecting competitiveness and largely defining the selection of values.

Two questions arise here: Can this choice be fully objective? Furthermore, are these scenarios equivalent to each other? Both responses are clearly negative!

The selection of goals and values is not entirely objective even if scientifically and consciously well-founded, and the environmental conditions, the available tools, as well as the expected evolution of social support are precisely known. In selecting values, factors ranging from political compromises, bargaining mechanisms, social theory and ideological elements, as well as socio-psychological and human motivations also play an important role. The answer to whether the selectable scenarios are equivalent is no again. Since the goal can only be the achievement of a cohesive society and its safe operation, and the strengthening of this, it is paradox that this cannot be reached in lack of appropriate economic and financial bases, and it can only be created by
strengthening competitiveness, thus the related steps have to be taken if we want success.

The question still remains whether it is possible at all to still talk of a characteristic scenario by combining the elements related to the various value selections. My answer is yes! On the basis of a precise definition of place, an “equilibrium” action course that includes compromises which do not stretch the weight-related objectives, one which reflects a consistent selection of values, the starting point of which is that a democratic state which creates opportunities is needed, which means a coordinated economy in order to have international competitiveness, with social balancing mechanisms.

Any action scenario means a continuous selection of values, and if it is enforced in the long run, it can be interpreted in the context of development, more precisely, as part of the correlation between the political, social ideas regarding the content of development. This, at the same time, means that for a longer term, value-based choice, it is unavoidable to have a socially accepted and politically articulated vision, which can be best defined for Hungary— with major simplification – as reaching the status of the more developed countries of the European Union, becoming successful by using the advantages provided by the acquis communautaire, and at the same time preserving our identity. However, it is not sufficient to accept a model which in general reflects a more or less equivalent choice of values, in its main principles of social distribution but the adaptation of the related modernization objectives and the system of tools serving the implementation of these in specific steps is a must.

The Hungarian change of scenarios can be described by the development of a so-called “social market economy” in the early 1990’s, while the period between the spring of 1995 and the summer of 2000 saw that action was defined by a scenario focusing on the development of competitiveness. In the period between 1995 and 2000, Hungary was in such a favorable situation that increased growth and controlling the public finance deficit could go hand in hand with decreasing unemployment rates. This action scenario, which has proven to be successful, was valid in a relatively longer period. In order to create an equilibrium in the social system, in the outflow of wages, conscious - sometimes explicitly expressed, at other times concealed - restrictions were introduced in this scenario but the breakup with a social and economic policy balancing and drifting on the edge of a crisis – which developed as a result of the shocks brought about by the change of the political system - was the result of the constraint to avoid a crisis situation rather than a conscious, long-term selection of values.

The selected economic policy scenario gradually changed from 2000 onwards, as the results were overvalued but it seemed to be the case even in 2002 that after the adjustments, we can realistically count on a high rate of economic development even into the future, since the interest system of competitiveness will be returned to the center of action. This did not happen. Instead, an experiment was undertaken to execute both scenarios at the same time. The action program that at last wished to enjoy the fruits of the changed political system, which has promised a “change of social systems” and has set to improve competitiveness and reach “European integration" at the same time, has proven to be unfeasible. The fiasco is due not only to the fundamental lack of financial resources but to the value choices excluding each other and the inconsistency of the timing and setup of the measures already taken. Insecure leadership and the raising of welfare hopes that exceeded the realistic opportunities caused a situation where simultaneous efforts were taken to reduce the employer’s taxes and contributions (with a view to increasing the employment rate and the activity rate) on the one hand, and to increase the old-age and pension-type benefits on the other hand. In the available structure of the social systems of service provision, the growing number of old-age people and the health state of the population required increasing expenses even with a decreasing standard of these services. Those questions, partly related to public confidence, remained unanswered or were given highly biased answers such as who in fact will reap the benefits of economic growth, via what kind of transfers and by what time these result will reach the entire society, whether they may reach that level at all. This is partly the reason for why the matter of executable action scenarios came to be the subject of the daily political conflicts. The salary measures that were taken in 2002 and 2003 as a result of giving in to social pressure had rather modest effect on increasing the level of social satisfaction. This can partly be put down to the wrong time schedule and disregarding the performance requirement, and partly to the unrealistic expectations. As a result, the steps taken without any increase in efficiency and productivity turned out to be detrimental for the economy, and they brought about a serious and enduring loss of the equilibrium of public funding.

We were wrong to think that state involvement can be defined by the consecutive zigzags of the specific measures that affect the choice of the values “competitiveness” versus “enhancement of social cohesion”. The starting point was also erroneous: we thought that the funding of the modernization needs of the state organization may be provided by financing technical modernization and the campaign-like streamlining of the institutional system rather than a task-adjusted planning of resources. The so-called
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Yo-yo effect was a natural consequence: after the “slimming diet” the undisciplined “patient” – the Hungarian system of public finances – was continuously burdened even more, rapidly growing “kilograms” of the countless promises disregarding the real positions of public funding during the election campaign of 2006, which was made even worse by postponing the required measures until after the elections. These processes and the consequences which are traceable in deteriorating chances of integration are well-known in Europe and the OECD countries. We should consider the backlisting in the competitiveness, investor, and credit ratings natural, and not the least, the rejection in late 2005 of the convergence program of our euro accession which was submitted to the EU earlier.

In order to avoid falling behind, currently there is agreement in that the stabilization of the public finance system that took place in the summer of 2006, further steps need to be taken besides the immediate restrictive measures that aim to improve the equilibrium of the public finance system – starting out from a position worse than the one two to three years before. This should be done on the basis of a scenario which places the improvement of competitiveness into the center, undertakes the fast transformation of the social service provider systems, and at the same time, does not jeopardize the equilibrium of the public finance system either. This process is illustrated by the government’s new euro accession convergence program approved by the government in late August.

No target dates for Hungary’s euro accession are defined in the document. However, the realization of such growth- and development-oriented economic policy is envisioned in it which is based on an enduring balance of the public funding system and leads to the introduction of the single European currency in Hungary in the foreseeable future. According to the idea of the program, the public finance equilibrium will only be achieved if reforms affecting the functioning of the state are introduced, besides the adjustment measures with a merely short-term effect (such as the increasing of taxes and contributions, higher burdens on the population and entrepreneurs, as well as the decreasing of general government expenditures. The intention is that the program will systematically prevent government overspending, and will avoid that the process of integration is hindered by the regular breakdown of the equilibrium of the system of public finances, as well as that of the balance of payments. Accordingly, the latest mid-term economic policy – action scenario - of the Hungarian Government can be divided into two well-definable phases:

• 2006-2009: creation of a durable equilibrium with the lowest possible sacrifice in growth. In order to accomplish this goal, the intention is to highly reduce the public finance deficit by relying on adjustment measures and the introduction of reforms; to halt and then reduce the growth of public debt. It is taken into account by the program that in 2007 – 2008, the economic growth rate, which transitionally fell to 2 – 3%, will return to the earlier rate of 4%. The real income of the population will decrease in 2007, it will remain on the same level in 2008, while it will finally increase in 2009;

• 2009 – 2011: the process of durable increase in living conditions will start on the basis of the established equilibrium. As the reforms unfold, the consolidation of the equilibrium, further moderation of the public finance deficit and the public debt; enforcement of the increasingly stronger effect of growing development funds on the economic vigor; return to the fast and sustainable growth course; tangible upturn in employment rates and income

Besides the National Bank of Hungary and the economic experts involved (the ad-hoc “convergence board”), the program was also commented by the State Audit Office. The expert opinions were rather similar to one another. According to these, the starting points of the program— as opposed to the previously submitted ideas – reflect the realities of the economy and public funding: the starting parameters, effects and forecasts assumed for the macro-economic correlations of the adjustment course are realistic, according to the information available to the commentators; and the program contains endeavors to clarify the borderlines between the government sector and the players of the economy.

The intention of the Government to execute comprehensive reforms in order to ensure the sustainability of the budget cannot be disputed either, neither is it questionable that they regard a genuine, internal long-term change in the community service provider systems as necessary. However, several doubts have surfaced as to the feasibility of these programs and the planned practical steps. The Government’s answer contains that the missing links – i.e. the steps related to the specific modernization ideas which contribute to longer-term sustainability of the program, which are to be taken after 2008-2009 - will be developed by the end of the year. I think that SAO’s comment was justified even in this context as well. According to this comment, in drafting the alternative courses of action, security and a guarantee of keeping on track would have been provided if the document had
contained what should be done if the external (boom-related) and internal (aspects of social support and the ability to introduce reforms) conditions taken into account in the development of the balance course evolved less favorably than expected.

I regard the internal risks as more significant from the aspect of the implementation of the program. It is very hard to make progress against the daily interests of a divided Hungarian society, one which has lost its confidence as a result of welfare promises which are impossible to fulfill, and one with very limited openness to anything new. In this situation it is only natural that the backlash of the years started without the appropriate financial resources, carrying endeavors that mutually exclude each other, providing benefits which are not tied to performance, those which did nothing but promised to transform the obsolete systems of service provision appears in the very first, most sensitive phase of switching onto a new course of action. They simultaneously strengthen all those tensions, many times manifested in the loss of public confidence, which otherwise would belong to one or the other dominant value.

**Further issues relating to the reform of Hungarian public funding and financial audits**

With the implementation of the convergence program, the chances of staying on the track of necessary modernization raise the question that for a change in course it is not enough to raise taxes, cut costs and to implement changes solely within the scope of the economy. A break from this forced course also requires change in correlated social expenditures (social transfers), which cannot be resolved without rethinking constitutional rights (primary and secondary education, health care, old-age and disabled care etc.), reformulating social-political compromises (regional administration, the system of municipalities, reformulating the role of the state and rebuilding of the state) and without reforms based on these new fundamentals.

The first question to be clarified is: what do we mean by reforms or changes of reform value? There is no consensus in this regard in Hungarian professional public opinion. We share the opinion that this would require a changed method of operation of the system and a change in the behavior of the actors of the system. The substance of the changes within the public sector is the improvement of the performance of the system. The absorption of EU-funds, a public funding system promoting improvement of competitiveness and the institutional conditions of budget sustainability have to be established simultaneously.

The rethinking of the content of state duties and a more precise definition of their scope is a fundamental question of competitiveness and modernisation in Hungary today. A clear definition of tasks, authorities and responsibilities would assume a clarification of the borders between the governmental sector and other actors of the economy, the operation of “understandable” mechanisms serving the management and coordination of activities of the government, a clear, expedient allocation of responsibilities within the government and, last but not least, within the legislative, executive and jurisdiction branches of power. On the basis of these foundations, the method of financing of tasks can be defined; then, adjusting to and reflecting and implementing these methods a way opens for the separation of the government’s tasks and powers and for the clarification of the system of forums and the content of reporting.

The content objective of financial control is to serve and strengthen the security of public financing. Control gives assurance of security and induces intervention if security is missing or is at risk. The extension and appreciation of the content of the role of control by audit institutions is a global phenomenon of our time. Today, globalisation-driven convergence can be observed in the operation of public funding systems. This also affects financial audit activities. The internal control system of the public sector and within this, the operation of independent internal audits is regulated by international standards.

An important value of the main state audit institutions is independence. This also means that their tasks do not include the qualification of the economic and fiscal policy of the governments in power. However, independence does not mean indifference. In its own was, SAO is responsible for the budget sustainability and the effective, correct and efficient spending of public funds. It is the responsibility of the main financial audit institution to express, on the basis of but also beyond the scope of direct audit experience, its conclusions, the risks it identifies and the corrections it considers necessary thereby advising and suggesting means for situation analysis and for decisions relating to the change in course. Though, the audit office’s observations always reflect on the past and present, they are about the future and for the future.

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Hungarian Center for Democracy Studies, Budapest

2 Updated Convergence Program of the Government of the Republic of Hungary, September 1, 2006

3 The system of Hungarian social security funding was established in the context of the public finance reforms that followed after 1990. From the early 1990’s, these two systems operated as funds independent from the central budget. The revenues of the funds come from the contributions paid by the employees and the employers. The contributions are collected by the central tax authority. In the case of the Pension Insurance Fund, the surplus expenditure is fundamentally related to the increased pensions and the political promises (such as the 13. month pension), where the amount of the expenses can be exceeded without an obligation to modify the appropriations, according to the relevant law. In the case of the Health Insurance Fund, the appropriated expenses are regularly exceeded by the spending on medicine.

4 Springer-Verlag, Challenging Neighbors: Rethinking German and Dutch economic institutions (Central Planning Bureau, 1997)

5 By supporting the self-sustaining process of the rules, these play an important role in making the economic transactions easier. The self-sustaining process based on mutual understanding and good will is a very important qualitative factor, which is often manifested in lower costs as well. Confidence in the third partner, i.e. civil society through the state is further strengthened by the shared values and norms, and the members of this society try to find answers to problems that can be resolved by a community decision, through cooperation;

6 Public sector (financial) audits play an important role in its implementation, especially in Central and Eastern Europe, where it is rather difficult to enforce the existing laws. This is why it is justified that this function should not only be seen within the context of government administration but also as an independent mechanism, which works side by side with the government and is closely related to it.

7 A major research project was launched by ÁSZ (SAO) FEMI and the Competitiveness Research Center of the Budapest Corvinus University on the subject of the correlations between competitiveness and the public sector—by taking into consideration the government-level OECD recommendations meant to encourage corporate competitiveness (OECD 2005, Micro-policies for growth and productivity: final report), the findings of which will be published in the first half of 2007.

8 Although rather high hopes were invested into the economic force of the small and mid-size enterprises for a long time, the opening up of the so-called dual structure of the Hungarian economy continued in the past three years, i.e. the larger companies gained strength, while the market weight of the small and mid-size enterprises decreased. See: Péter Ákos Bod: Ha az állam költekezik (When the state spends too much) (Bank & Tőzsde, 2005, issues 3-4, appendix)

9 The impact and cost analyses of the individual measures regularly failed to be prepared, decisions on headcount reductions were made earlier than the definition of the tasks of the affected organizations, etc. See: SAO report on the 2005 final accounts, as well as the reports on the Ministry of the Environment and the Prime Minister’s Office. www.asz.hu). In 2007, the efficiency of the transformation of the central public administration will be reviewed by SAO, with the professional participation of the UK National Audit Office, based on the partnership between the two organizations. Until this review takes place, in the context of the methodological solution described in this article, the experience of this review and the related proposals, in a breakdown by various topics, will be made available to the government commissioner in charge of the implementation of the program.

10 No strict dividing line can be drawn in the government areas, or in the municipalities representing local politics between who is a manager living off his salary as a public administration (senior) official in today’s Hungary, and who undertakes public functions as a businessman. The idea is that governance functions better and more efficiently if management is done by self-made men rather than by intermediaries, career bureaucrats or those politicians whose only source of livelihood is their political activity.

11 Financial audits are not only the “built-in stabilizers” of the functioning of the system of budgetary institutions but more recently, they have also become the guarantees for ensuring the compliant and efficient cooperation of the public sector and the private enterprises affected (also) by the business relationships generated by the public sector. It is not a one-sided or exaggerated statement that if these institutions function appropriately, they can be regarded as the special, guarantee and security elements of the state organization.

12 The concept of the competitiveness of the national economy was introduced into economics in the United States as a result of the challenges of the world economy in the 1980’s. The content of this concept has been the subject of lively debate ever since, Competitiveness can be characterized both from the approach of supply and also, from that of demand. Various, many times complex, synthetic indicators exist, and sometimes even areas covered by the descriptions and explanations related to these indicators are also used in this quality. Examples for such indicators include natural-environmental, geopolitical resources, the level of qualifications, technical and information technological standards, the performance of the economy and the “competition” sector and the innovative capacity thereof, the power of the banking system, the standard of the infrastructure, as
well as the development level of the community service provision systems, etc.

13 Such include historical and tradition-related features, and the strength of social cohesion, which is determined by the former factors as well, the general openness of society to the new as such, “tolerance”, accommodation to new situations and the sensitivity to the preservation of values, political-cultural and leadership efficiency/cooperation (the professional conditions of public administration and government with regard to the institutional system), as well as the global competition, the world economy, the operation of international organizations, the effect of integration.

14 Value selection can be regarded as one dimension of economic policy decisions, where the choice is not made on the basis of optimization, or ranking by efficiency, as opposed to the definitions of the scope of action for economic policy (resource allocation, macro-level demand, legislation). See: László Antal: A 90-es évek gazdaságpolitikája (The Economic Policy of the 1990’s), in: Fejezetek a gazdaságpolitikából (Chapters fro Economic Policy), edited by József Veress (Aula Kiadó, Budapest, 2004), p. 183, and p. 185


16 For example Hungarian economist László Szamuely: The “Dying” Welfare State in the 1990’s (Közgazdasági Szemle, 2004, year 51, issue 10) p. 948, and pp. 967-969

17 Such solutions may become necessary especially because of the social groups that need to be supported due to the structural changes (for instance in the area of agriculture). Innovation services, such as R&D support, helping small- and mid-size enterprises to the market, etc., contribute to the strengthening of competitiveness, as well as standing firm in the global market, and in the single internal EU market.

18 In the countries affected by the fall of the Berlin Wall, the erosion of the social security arising from the benefits provided by the paternalistic state caused an especially painful social disillusionment because not one of the countries in our region had high-standard welfare services in the modern sense of the word (so nothing could be reduced from this, and nothing can, as such has practically been non-existent), on the contrary, society has hoped the development of a social market economy to be brought about by the very transformation of the economic system. G. Báger –Á. Kovács: Privatization in Hungary (SAO FEMI, 2004)

19 The unfavorable evolution of the age composition of the population is not a Hungary-specific problem but it causes serious and increasing trouble to nearly each EU member state, as well as a number of developed OECD countries. The real problem lies not only in the decreasing population but the aging of the inhabitants. The consequences are manifested not only in the chances for innovation, problems in the labor market, the proportion of active and inactive groups and other similar effects but also in the political decision-making mechanism. It is not only the social-political division of the population that deteriorates the chances of rethinking the state tasks on the basis of consensus but the increasingly unfavorable demographic situation also means a forced course. The short-term system of interests related to the social services to be provided to the aging population creates rather harsh constraints. We should even face that the worsening proportion of active and inactive population in Hungary does not only slow down further economic development but– since an increasingly higher proportion of the national income has to be used for supporting the old-age population, which is becoming inactive – it may even become an obstacle to it.

20 The salaries of public employees and civil servants grew by 30-50%.

21 The public finance deficit grew to 9.1% of the GDP in 2002 and it remained high, i.e. 7.3% in 2003 as well.

22 In spite of several warnings by the EU Financial Commissioner, a law in which tax reductions were planned was pushed through by the Government, while the opposition campaigned by promising even more significant reductions of tax and contribution amounts than those defined in this act.


24 Hungary is not the only country where the tasks of the state are not defined in detail either in laws or in other legal documents regulating the operation of the public finances. What are the limits to governmental tasks, why does public financing extend to specific tasks and services and why to that specific extent? There are a number of states (the United Kingdom, Israel) operating excellently without detailed rules of operation of the state organization. For us, such a change would mark a new era also in the sense that it would eliminate the forced plan-approach under which the decision is enough: the decision “makes” money: i.e. the tasks of the state are determined by a 50%-+1 vote of the Parliament!
IS THE MOVE TO ACCRUAL BASED ACCOUNTING A REAL PRIORITY FOR PUBLIC SECTOR ACCOUNTING?

Andy Wynne, Head of Public Sector Technical Issues, ACCA
Andy.wynne@accaglobal.com

Introduction

Over the last 20 years, there have been sustained calls for governments to move towards accrual based accounting and to adopt private-sector-style financial statements. Indeed, this move has become some what of a trend or fashion and accrual accounting was described recently as the hero of the day at an academic conference on public sector financial reporting.

However, 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. Accrual accounting is not an end in itself, but rather, a means of shifting the emphasis of the budgetary process away from cash inputs, towards outputs and outcomes, in the hope that this will result in greater management efficiencies, and hence, better outcomes for governments and the communities they serve. The move to accrual accounting is primarily aimed at facilitating contestability or competition in the provision of public sector services. Thus it aims to allow comparisons of the current cost of providing the service with potential alternative providers of these services from either the public, not-for-profit or private sectors.

IFAC’s International Public Sector Accounting Standards Board has set itself the task of developing a full set of accruals-based international public sector accounting standards and ensuring that these are adopted as widely as possible. IFAC International Public Sector Accounting Standards Board argues strongly that all governments should adopt the accrual basis. Even in the introduction to its cash basis accounting standard (IFAC, 2003) it states that the Board “encourages governments to progress to the accrual basis of accounting”. In many of its other publications it puts the case for transferring from the cash to the accrual basis.

In addition, several multi-lateral aid agencies have been recommending the move to accrual accounting, from the World Bank recommendation to Nepal, in 1981, to SIGMA, the advisory body for new and candidate countries of the European Union, making the same proposals for Cyprus earlier this year.

These, and other agencies, claim a wide range of benefits arising from this fundamental change to public sector financial accounting. These include improved accountability, better management of capital assets and increased general efficiency. However, the advantages have yet to be clearly demonstrated in practice as, so far few rigorous objective studies have been undertaken.

Perhaps as a result, only 10 governments have actually adopted the accrual basis for their central government accounts. The central governments of Italy and Germany have no plans to adopt the accrual basis for their accounts; China, Japan, Malaysia and Mauritius have all considered the costs and benefits and are not convinced that reform would be advantageous.

Unless the issues involved in moving to accrual accounting are carefully considered and all the associated risks are adequately managed it is possible that the past mistakes of some countries adopting, for example, zero-based budgeting may be repeated. In this case, a radically new approach was adopted by some countries before it was adequately assessed anywhere. The approach was subsequently dropped almost everywhere and retained on only a very limited scale after being significant refined.
Any move to the introduction of private style financial statements and changing the basis of public sector accounts to the accrual basis should only be introduced as part of an overall reform strategy for public sector financial management. In many cases such changes, even if considered necessary will not have a particularly high priority.

This paper provides an overview of the benefits, risks and costs of governments moving to an accrual basis for their financial statements. It accepts that whilst there may be some advantages, there are considerable risks, costs and disadvantages which should not be overlooked.

**The move to accrual accounting**

Government financial accounting has traditionally consisted of providing an out-turn report comparing the actual payments and receipts with those which were authorised by parliament in the annual budget. This approach still forms the basis of accountability for almost all governments across the world. It is a simple and robust approach which provides assurance, through the audit of such accounts, that government spending has been in line with the agreed budget and that fraud and other irregularities have been minimised.

In contrast, the move to accrual based accounting is generally part of a reform movement which has come to be known as New Public Management. This includes:

- privatisation and outsourcing of public services
- deregulation
- commodification and charging for public services
- creation of purchaser/provider splits and agencies to deliver specific services.

Accrual accounting can play a key role in New Public Management developments as the means by which measurements are made, achievements are documented and negotiations take place. Some countries have seen an increasing role for the private sector in providing public sector services and the adoption of private sector style management practices. This has also led to the adoption of private-sector-style financial statements including the equivalent of a profit and loss account, a balance sheet and a cash flow statement. In the process, all major capital assets may be valued and the costs of these assets are charged to the government services over their useful lives through the application of some form of depreciation.

The use of accrual accounting by public sector entities is still unusual. Very few governments have actually adopted this approach, certainly at the national level. Spain was possibly the first in 1989 followed by the celebrated case of New Zealand by 1993 and Australia in 1994. A few other countries followed over the next decade or so, but the total is still around 10 of the nearly 200 countries in the world. Even fewer have adopted the accrual basis for their central government budgeting system.

<table>
<thead>
<tr>
<th>Country</th>
<th>Adopted by central government</th>
<th>Accrual budgeting used</th>
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</thead>
<tbody>
<tr>
<td>Spain</td>
<td>1989</td>
<td>No</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1993</td>
<td>Yes</td>
</tr>
<tr>
<td>Sweden</td>
<td>1993</td>
<td>Yes</td>
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<tr>
<td>Australia</td>
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<td>UK</td>
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<td>Canada</td>
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<td>Finland</td>
<td>2005</td>
<td>No</td>
</tr>
<tr>
<td>France</td>
<td>2006</td>
<td>No</td>
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</tbody>
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Several of the governments of the largest economies in the world have yet to introduce such changes, for example, Germany, Italy, Japan and Russia. Almost no middle income countries are adopting this approach and several, for example Malaysia, Mauritius and Namibia have decided against the introduction of this type of reform.

**The introduction of accrual accounting in the UK public sector**

The use of accrual accounting in the public sector is not a new idea in the UK and the arguments for and against its use have been around for at least 150 years. It was being used by some public sector organisations as soon as it was developed in its current form in the private sector. Thus accrual based accounting was introduced for UK local authority accounts from the mid-nineteenth century. Birmingham City Council (the sixth largest economic entity in the UK at the time), for example, adopted accrual based accounting from 1850.

Accrual accounting was not generally accepted in the public sector, however, and the cash basis of reporting was established by the Treasury (UK equivalent of the ministry of finance) as part of the major reforms introduced in 1866. Thus it was the cash basis which was introduced in the then British colonies over the next 100 years or so.

By the end of the nineteenth century it had been adopted by most of the larger, local councils, although in the early years of the 20th century there was a vigorous debate on its suitability. Eventually all but the smallest local councils were required to adopt the accrual basis of accounting after the re-organisation of local government in 1974. However, local councils used debt costs rather than depreciation to spread costs of capital expenditure across the years in which the assets were used.

With the major reforms of the UK National Health Service in the early 1990s the internal market was adopted and hospitals were established as quasi-independent businesses accounting on the accrual basis. At about the same time the move from the cash to the accruals basis was agreed for central government. This was implemented with effect from the annual accounts for 2001/02.

**Few cost benefit studies on the move to accrual based accounting**

Almost no full cost benefit studies have been undertaken on the actual move to accrual accounting in the few countries which have adopted this approach. Most of the papers and publications on this subject have been produce by authors or organisations which initiated the reforms or who are openly arguing for their adoption by other countries.

Andrew Likierman, who led the UK move to accrual accounting in central government, said (2000, p253) that a “full analysis will only be possible once the new systems have been working for a number of years”.

An IFAC International Public Sector Accounting Standards Board report on the proposed reforms in France (2003) concluded that the

**transition to accrual accounting is a long-term project. National and international experience indicate that a time period of about 8 to 10 years is needed to change the accounting system and fully implement the necessary reforms.**

The UK experience suggests that realisation of the benefits may take even longer. In a report, published in December 2003, the UK National Audit Office concluded on the move to accrual accounting (first announced in 1993):

**In most cases it is too soon to identify any discernible benefits from better resource management in terms of contributing to improved public services from for example, enhanced efficiency (Page 31).**

ACCA funded some academic research on this issue in one region of the UK (Northern Ireland). The conclusions of this study are that although the costs of the reforms were perceived as being substantial, significant benefits have yet to be realised and there is little evidence that the additional information is, at present at least, being extensively used in decision making, perhaps because it is rarely understood. Further details of the results of this research are provided later in this paper.

The costs of implementing a move to accrual accounting are difficult to estimate as it is difficult to identify the costs of a particular reform. As a result few organisations developed a specific budget for this type of reform. The United Nations agreed...
in July 2006 that the accounts of all its member organisations would move to the accrual basis by 2010. A budget of US$23 million was agreed for this reform or around 1.8% of the UN Organisation’s annual budget. In 2002 Hong Kong agreed a one-off budget equivalent to US$6.3 million (only 0.02% of annual expenditure) with an estimated re-current cost of US$1.2 million. The Hong Kong reforms are cheaper because they are not adopting the full requirements of the accrual based IPSAS, for example, infrastructure assets are not usually valued and valuation of capital assets was estimated to be 90% of the cost of the Hong Kong reforms.

In the case of New Zealand, often held up as a model of this type of reform, two academics recently concluded that “whilst not denying the need for reform in the 1980s, nor that accrual accounting has had some positive impacts on decision making, asset management, and the range of information available formal accountability purposes” they concluded that “various financial mechanisms built on the accrual accounting base have, over the long term, had a detrimental effect on departmental capability in a manner that has escaped parliamentary understanding and control” (page 8). They also argued that this reform “promised significantly more in terms of efficiency, better service, and increased public choice than it delivered in practice” (page 7). Powerfully, they point out that much of the literature evaluating New Zealand’s financial management reforms has been written by the key reformers themselves and appears more promotional than objective.

The message from Australia is similar. The same book notes that “observations of actual outcomes of the NPFM change processes [including accrual accounting] have been limited to those made by the initiators themselves, while formal independent studies of public sector change impact have been rare” (page 4). Another leading Australian academic has claimed that the “present mode of presentation of the accrual budgets and financial statements of Australian Government departments has become a controversial matter. It has led to widespread dissatisfaction in Parliament and parts of the Public Service” (Barton 2004).

**Arguments Advanced in Support of Accrual Accounting**

The International Public Sector Accounting Standards Board summarises the advantages of reporting on an accrual basis in the public sector as follows:

- it shows how a government has financed its activities and met its cash requirements
- it allows users to evaluate a government’s ongoing ability to finance its activities and to meet its liabilities and commitments
- it shows the financial position of a government and changes in its financial position
- it provides a government with the opportunity to demonstrate successful management of its resources and
- it is useful in evaluating a government’s performance in terms of its service costs, efficiency and accomplishments.

In 2002, the UK Government summarised the benefits of accrual accounting as follows:

**For Parliament**
- Better information on how resources are used to meet objectives and whether taxpayers are receiving value for money.
- More and better focused information resulting in better scrutiny of public spending and enhanced accountability to Parliament.

**For central government**
- More sophisticated and strategic approach to public expenditure planning and better data to inform decisions on how to allocate resources.
- Enhances the current fiscal framework by distinguishing more clearly between consumption and investment.
- Contributes to the Modernising Government agenda.

**For Departments**
- Better information on costs, assets and liabilities to assist resource management.
- Resource allocation and capital spending linked to the delivery of services.
- Full costs of activities measured (whether or not there is a cash cost) and costs recorded when they are incurred rather than when they are paid.
- Assets apportioned over the years in which they are consumed in the provision of services.
- Incentives to improve management of debtors, creditors and stock (working capital) and fixed assets.
The disadvantages of accrual based accounting

The major disadvantages of the move to accrual based accounting are the costs involved and the increased complexity of the financial statements. IFAC’s International Public Sector Accounting Standards Board has summarised the costs of introducing accrual based accounting in to the following categories:

- identifying and valuing existing assets
- developing accounting policies
- establishing accounting systems, including the purchase of computer systems and pilot testing these systems
- developing the necessary skills and providing training for both the preparers and users of financial information.

Many of these costs will be ongoing rather than being ‘one off’. This will include the increased costs of employing significantly more professionally qualified accountants. Governments have traditionally had few qualified accountants in their civil service because of the simplicity of their cash accounting systems; for example, in 2002 Norway had only one professionally qualified accountant on the staff of its Ministry of Finance.

The number of professionally qualified accountants working across the UK central government increased nearly fourfold from almost 600 in 1989 to 2200 in 2003 (the period over which accrual based accounting was introduced – personal communication). In addition, for example, the auditors fees for the UK National Audit Office increased by 67% with the introduction of accrual accounting in 2001/02.

The approach to accrual accounting which is generally being adopted requires regularly revaluations of all capital assets. When Tanzania undertook such an exercise in 2005 the cost was comparable to the annual salary of all accountants employed within its central government ministries.

Other disadvantages of introducing accrual based accounting in the public sector include:

- It designed to measure profit, a concept which is largely meaningless in the public sector, where surpluses can arise from the failure to provide agreed services.
- Maintenance of public assets is more important than providing information on their value; for instance, the backlog of maintenance in the UK health service was nearly 10% of its budget in 2000, but this had not been clearly identified in its accrual based accounts.
- It takes budgetary control away from finance staff, as they decide when cash is paid, but non-financial managers and suppliers decide when invoices are issued.
- It does not appear to have ensured adequate costing systems in the UK health service as, 10 years after the introduction of accrual based accounting, the Department of Health admitted that, “there remains an unexplainable variation in the reported costs for many clinical procedures. Costing and activity recording must be improved”.
- It is not a tried and tested approach for central government accounting – it has not been widely used and has only been introduced in a handful of countries over the last 15 years.
- Cash-based accounting is comparatively simple and objective.
- The complexity of accrual accounting may mean that there is less surveillance by Parliament and so the government is less accountable.
• It requires greater professional judgement by both the preparers and the auditors of government accounts.

• It may lead to loss of control; in the UK, for example, the number of financial accounts for central government ministries which were qualified by the auditor or submitted after the due date rose to nearly 60% and then fell again to 10–15% over the period when accrual based accounting was introduced.

The approach to accrual accounting which is generally being adopted in the public sector is based on the conceptual framework being developed by the International Accounting Standards Board and the US Financial Accounting Standards Board. They see the objective of financial reporting as to provide useful information for individuals when they make investment, credit or similar decisions. Citizens and their representatives in parliament have different needs. They cannot easily exist from their government and its institutions. Thus they require financial information that fulfils their stewardship function rather than helping them to appraise investment opportunities.

An American academic made the point that the “burning issue for the British Government now that it has adopted private sector accounting practices is, what will it do to prevent Enron-style corruption from occurring within its jurisdiction?” (D’Souza J, 2004). At a time when, with Enron, World Com, Parmalat etc private sector accounting is being heavily criticised, its adoption by the public sector appears strange. In the UK we now (September 2006) have our own little Enron with the company iSoft which is responsible for developing software for reforms in the health service. The company has lost 90 per cent of its share value this year as it was recognising income too early.

**The impact of accrual accounting in the UK public sector**

In 2005, ACCA published research on the costs of benefits of adopting accrual accounting in Northern Ireland, a region of the UK. This was undertaken by Ciaran Connolly and Noel Hyndman two academics based in the region.

Their report provides background on the government in Northern Ireland and an explanation of the key features and case for the introduction of accrual accounting. They found little evidence that accrual accounting information was extensively used in decision making within the public sector. Many interviewees identified the problems of unnecessary complexity and incomprehensibility of the information as undermining its potential use. A number of stakeholders suggested that, as problems relating to resources and levels of understanding are addressed, more substantial benefits may be realised in the long term.

Claims that the implementation of accrual accounting would have limited cost impact (claims made by both UK Treasury and the local department of finance) were acknowledged, but dismissed out of hand, by stakeholders. In addition, the interviews revealed that while no department had prepared a budget for the introduction of accrual accounting, or kept records of actual costs, the costs were perceived as being substantial (in particular, those relating to payroll). Some stakeholders argued that the production of accurate cost information, either in advance or as part of an ex-post evaluation, was unlikely to be welcomed by those promoting accrual accounting.

**National Audit Office (NAO) review of the implementation of accrual accounting in the UK**

As mentioned above, in December 2003 the UK National Audit Office published its report *Managing resources to deliver better public services*. Over all this report concludes as follows:

• Since 1995 a number of important changes, led by the Treasury, have been introduced to improve how departments manage resources… This report assesses the progress which departments have made in improving their resource management.

• Public Service Agreements are ensuring that resources are better allocated to key priorities and aligned to targets to improve public services. Just over a quarter of departments and agencies we examined have made good progress in implementing accruals-based accounting… The complexity of the changes particularly the introduction of accruals accounting means that the full benefits of the new approaches… will take some time to be realised.

Thus, at least by implication, nearly three-quarters of the departments and agencies were not using accrual based accounting
information within their organisations to improve resource management. In only two departments and agencies (4%) is information on their activity “reliable, regularly produced and underpins decision making and future investment strategy”.

Despite the fact that the move to accrual-based accounting was first announced more than 10 years earlier the NAO found that:

• In most cases it is too soon to identify any discernible benefits from better resource management in terms of contributing to improved public services from for example, enhanced efficiency. (Page 31)

In addition, the NAO found that:

• Around half of the departments and agencies examined consider that for smaller organisations the arrangements under resource accounting and budgeting for requesting resources has created a level of administrative effort disproportionate to their size and the focus of their work (page 6).

• Around 16 departments and agencies (35 per cent) still rely mainly on cash based management information and the preparation of accruals financial statements was a separate one-off exercise at the year end to meet external reporting requirements (page 6).

• Progress in improving resource management is constrained in some departments by insufficient IT system capability and not enough financial expertise (page 12)

• Greater use should be made of resource based information to improve efficiency to release resources for front line service delivery. Accruals based information in providing more comprehensive and complete cost and performance information is a powerful tool to identify scope to improve efficiency and make better use of resources. As yet it is not widely used in this way by departments (page 13).

• Accruals accounting is, however, complex and requires more resources both financial and people to operate and many of the necessary skills are still being developed in departments (page 28).

• At a general level accruals accounting is methodologically more complicated than cash accounting and some departments have encountered difficulties through their failure to implement full accruals accounting (page 29).

Departments identified a number of barriers which they considered explained why progress has not been more uniform of achieved more quickly. These were:

• Insufficient financial expertise. Some 63 per cent (29 departments) considered that this was a barrier though many are making good progress in addressing this.

• Understanding and awareness. Some 39 per cent (18 departments) consider that the main barrier to changing the focus of control from cash to accruals was raising awareness and understanding among operational managers who often lacked the necessary financial expertise.

• IT systems’ capability. Some 11 per cent (5 departments) consider that their existing IT systems were not capable or not sophisticated enough to produce integrated financial and output performance information (page 29).

The Highways Agency’s existing financial systems for example, were not designed for the production of resource accounts. Its first set of resource accounts in 1990 [sic] - 2000, were produced by consultants and temporary staff. This was an expensive process, costing more than £2.5 million or around three per cent of its total administrative budget (page 30).
The risks of moving to accrual based accounting

Internationally, the limited experience of governments moving to the accrual basis of accounting means that there are still a significant number of risks involved in adopting this approach. These may include:

- loss of financial control with the introduction of a more complex system
- reduction in budgetary control – in the UK, expenditure in excess of budget occurred in nearly one in five ministries, and Parliament has retained cash reporting in addition to accrual information to monitor governmental expenditure
- diversion of resources from more productive reforms
- the possibility of government accounting being brought into disrepute if accrual accounting fails
- the possibility that international accounting standards could be applied with no real understanding of the issues involved, especially as they are principles-based standards
- the ‘gaps’ in the standards not being properly addressed
- the standards not being continually made up to date and relevant
- decisions on accounting treatment being made on political grounds
- the external auditor being unable to prevent politically-based amendments to the accounts
- an adequate timescale and budget not being allowed for the change
- the IT systems not being adequate
- the process of financial management and expenditure control being made more difficult for members of Parliament and members of Parliament, the government, staff of the ministry of finance and other ministries and the external auditors not being given enough training.

Accounting issues to be agreed before accrual accounting can be introduced

One of the major problems is that there is no agreed comprehensive suite of accounting standards for the introduction of accrual-based financial accounting in the public sector. A principles-based set of such international standards is being developed by IFAC’s, but this has yet to cover such vital issues as the accounting for taxation or social policy obligations such as education, health and state pensions. The standards are also not generally accepted, as although several international organisations have agreed to adopt them, for example OECD and UN, not a single country has implemented them as their accounting standards.

As a result, a series of accounting issues need to be agreed before accrual based accounting can be introduced. These have been identified by, for example, the European Federation of Accountants. The most important of these may be considered to be the following:

- Taxation revenue
  - when should tax revenues be recognised?
  - when the profits are made?
  - when the profits are reported?
  - when the tax assessment has been made?
  - when the tax is paid?
• **Depreciation** - how should decisions be made about asset lives?
  - should these be a matter for the asset user or for the ministry of finance?
  - should adjustments be made to depreciation that is caused by lack of maintenance or investment to prolong the asset life?

• **Approaches to the recognition and measurement of property, plant and equipment** - there can be disagreement about:
  - which assets to value
  - the valuation methodology
  - current, historic or replacement cost and
  - how often to revalue.

• **Military assets** - should military assets be
  - capitalised and depreciated (what life?) or
  - treated as revenue?

• **Infrastructure assets** - should infrastructure assets be capitalised and if so how should they be valued?
  - should land and the structures on it be treated differently?
  - how should they be valued and re-valued?

• **Natural resources such as mineral reserves and forests** - are these to be included in the accounts and if so on what basis are they to be valued?

In addition, the role of the public sector external auditor changes fundamentally with the introduction of accrual based accounts. The nature of the external auditor’s opinion changes from a judgement on budgetary and legal compliance to one on whether the accounts show a true and fair view of the financial position of the organisation. This is a move from an objective view on whether the budget has been complied with to a subjective professional opinion on the validity of the accounts.

**The essential pre-conditions for the introduction of accrual based accounting by government**

The European Federation of Accountants has identified what it calls “the essential conditions for success in the introduction of accrual accounting” as follows:

1. **Consultation and acceptance**
   To be successful, the organisation needs to be prepared culturally for its introduction and be willing to recognise and accept the benefits that the changes will bring about and the costs of implementation in their widest sense. The pre-consultation exercise within government departments and the public consultation exercise are important preconditions for success. Another prerequisite is a willingness by the civil service to accept that the reforms would change the role of those responsible for financial management in government, significantly changing their influence and responsibilities.

2. **Participation of the accountancy and other professions**
   The accountancy profession must be prepared to be interested in and involved with the public sector because not only is the accountancy profession the expert in accounting standards but, traditionally, it has also trained financial managers for the private sector. To be successfully implemented and operated, the reform requires not only an increase in the number of financial managers (who may or may not be qualified members of a professional body) employed by government but also an acceptance of their contribution to the efficient and effective management of the public services. There also needs to be a willingness to meet the financial management education and training requirements of the public sector either directly by the accountancy profession or through other institutions. In addition, as the application of accounting standards may require the use of valuation and actuarial skills, those professions also need to be involved in the process.

3. **Joint development of accounting standards**
   The accountancy profession must co-operate in the development of accounting standards for the public sector and become
involved in the application of those standards and the monitoring of their implementation. Without that independent involvement the government could be seen as setting its own accounting standards and applying them in a manner that suited the political circumstances of the moment. That would damage not only the credibility of the process but in the end would also mean that the disciplines that accrual based accounting and budgeting are meant to achieve could not be established. Independence of the standards adopted, together with a critical appraisal process, although potentially uncomfortable for government, are essential. This also means that the accountancy profession must have a capacity both to understand the nature of the public sector and to recognise that circumstances are different from those of the private sector, so that any comments have to be made, and made clearly, from a politically disinterested perspective.

Successful implementation of accrual accounting depends heavily upon the understanding of, and willingness to support, the system by the government external auditor. As accrual based accounting requires not only more complex systems but also a range of new judgements (e.g. about asset values and lives, matching issues, prudence, materiality and going concern), the responsibilities and expectations of the auditor will increase and change considerably. Therefore, the external auditor should be involved in the process from the outset. This may require that the organisation, career structure and training of auditing staff should be significantly enhanced. Auditors will need a thorough understanding of accounting principles and how those principles can be maintained under the pressure of day-to-day administrative decisions. This may require the appointment of qualified accountants (ideally members of a professional body) to the staff of the government auditor, rather than relying upon the more traditional internal training of auditors.

5. Comprehensive management training.
There is the need for comprehensive training of departmental managers in the information available from an accrual based accounting system as there are considerable differences from a cash accounting system. Such a training programme should cover the following points.

(a) An appreciation of the basic financial concepts underlying accrual based accounting: managers will need to understand how and why an accrual based accounting system is different from a cash accounting system. They will therefore need to know about the basic financial concepts that underlie accrual based accounting.

(b) How accrual based accounting allows for the introduction of improved (i.e. accrual based) budgeting and financial control systems: managers will need also to appreciate how control will change from a control of budgetary inputs. With an accrual based system managers will need to focus on resources used and the price paid for those resources. The management emphasis should therefore shift to efficiency and effectiveness and line managers will need training not only to appreciate this, but also to understand how they can make full use of the accrual based information which becomes available.

(c) An understanding of the accounting information systems that are needed including the general ledger system. Other systems needed are a purchase order system, an accounts payable system, and an asset register.

6. An appropriate cultural approach.
A public sector cultural ethic is required which has internalised the requirements for a neutral (i.e. non-political) civil service with a strong, well regarded central agency (the Ministry of Finance), responsible for the management of the government finances. There must be well understood and accepted systems of control over departments.

7. A robust audit process.
A comprehensive annual independent audit of the accounts of each department must be made at the end of each financial year, with reports to Parliament and detailed scrutiny where appropriate.

8. No corruption.
There must be no systemic corruption and certainly no problem at all with corruption of whatever sort. Therefore, no informal parallel processes will have evolved or be allowed to complement the formal processes and, consequently, rules specified about the introduction of accrual based accounting and budgeting will be obeyed.

9. A recognition of the elapsed time needed.
From the outset there must be a willingness to recognise that the introduction of accrual based accounting and budgeting will take time, usually stretching beyond the lifetime of one Parliament and possibly, therefore, stretching beyond the period of
control by one political party. The reform therefore needs widespread support across the political spectrum.

10. An IT capacity.
IT capacity must be able to respond to the new and additional requirements that the introduction of accrual based accounting, budgeting and performance measurement will introduce. The process of transition from a cash-based system to an accrual-based system can impose significant additional resource costs not only in terms of money but also in terms of demand for specialist IT skills. The scale of the change could raise questions about the overall capacity of suppliers, as well as government experts, to be able to manage the change process.

11. A willingness to use incentives and penalties.
Financial incentives and penalties must be developed and applied to encourage a practical day-to-day management approach that looks for more efficient ways of using resources and delivering services. An example of this is a charge for the use of capital resources.

12. That the accrual based approach is part of a process of reform.
Another essential ingredient is that the introduction of accrual based accounting and budgeting is seen as part of a process of reform and it has not been ‘parachuted’ into a stable, unchanging management process.

The continued validity of cash accounting

Cash-based accounting has the virtues of simplicity and objectivity. SIGMA has argued that, “a cash-based financial reporting system has the advantage of being simple and comparable to monetary data” (p. 291). These virtues should not be underestimated, particularly where, as in many government organisations, there are few, if any, skilled accountants employed and where financial management is seen as of lesser importance than legal compliance.

The cash basis of accounting has served almost all countries well for over two hundred years. The 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. These approaches have been developed and refined by professional accountants and their use was almost universally accepted until relatively recently. So, for example, Andrew Likierman (the person who was later responsible for the transition to accrual based 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.” (page 23)

Perrin observed the UK situation in the 1970s and explained the view then held by HM Treasury on 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.*

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, page 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.

IFAC’s International Public Sector Accounting Standards Board issued its International Public Sector Accounting Standard on the cash basis of accounting early in 2003. Thus the benefits of clear international credibility and standardisation can now be added to the advantages of the cash basis of accounting. This standard, and the cash basis of accounting it supports, should be accorded its appropriate status as a valid, modern approach to public sector financial accounting.

Conclusions

Noel Hepworth, until recently Chair of the Federation of European Accountants’ Public Sector Committee, concluded recently from his experience of the introduction of accrual based accounting in Eastern Europe that:

To introduce accrual accounting is costly, time consuming and requires a diversion of resources from other activities. It requires a great deal of co-operation from key actors and will need significant changes of substance to the organisation, procedures and responsibilities of managers. As Parliament is also affected because of the changes that will be needed to the cash allocation and budgetary control processes it too will need to be consulted. What is more, accrual accounting provides wide scope for the exercise of judgement and this requires technical knowledge, a disciplined approach and an audit system capable of monitoring how judgement is exercised… For these reasons the introduction of accrual accounting also carries considerable risk. A premature decision to migrate from cash to accrual accounting also risks increasing the timescale for its eventual adoption and could bring the process into disrepute.

An IMF working paper stated that often “emerging economies have too eagerly accepted this reorientation [to accrual based accounting], and have overlooked a number of important issues” (page 3) and that “while agreeing that accrual accounting systems are more comprehensive and provide a wealth of financial information, it is important at the same time not to overstate the case” (page 3). Thus “for a large number of developing and less developed transitional countries, the move to accrual accounting is of dubious relevance” and “even more advanced middle-income countries may also find the costs and challenges of introducing accrual accounting too great”(page 14).

The cash basis of accounting is a simple, robust and well-tried and tested approach to accounting for public sector organisations. In contrast, the accrual basis fails, even in its own terms, to account adequately for government debt, and many other unique aspects of public sector accounting have yet to be adequately resolved. For many countries, the adoption of the accrual 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 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 based accounting may facilitate New Public Management reforms but it is not an end in itself.

The transition to the accrual basis of accounting may bring certain advantages in the appropriate context. However, it is a costly and complex reform and the benefits take many years to arise. It certainly produces more information, but much of this may not be used. As the IMF working paper referred to above recognises “it is important to recognise that there may be intermediate solutions or alternative ways of gaining some of the benefits accorded by accrual accounting” (page 27). Rather than just adopting accrual accounting because it provides more information, it may be far more efficient to consider the cheapest way of providing the specific financial information which is actually needed.
The cash basis of accounting has served almost all governments well over at least the last two hundred years. As a result, many countries are now joining the Malaysia, Mauritius, the Netherlands, Namibia and others in deciding that despite the potential benefits of accrual accounting, its significant costs mean that it is not a priority reform.


And


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ACCRUAL ACCOUNTING PRINCIPLES AND POSTULATIONS IN THE PUBLIC SECTOR: RHETORIC OR REALITY (1)

Dr. Hassan A. G. Ouda
EurNet Consultancy - The Netherlands
ouda@eurnet.nl

1. Introduction

Even though the transition to accrual accounting has been the most notable reform of government accounting in the last two decades for many countries, there remains considerable room (and indeed there is a need) for further debate and research. While IFAC has issued the IPSASs (International Public Sector Accounting Standards) in order to be applied to the public sector entities, there is a lack of conceptual framework which is really required for transferring accrual accounting concepts into public sector. For instance, accrual accounting is based on some principles and postulations (e.g. matching principle and going concern postulate) that have been used for decades as an obstacle in the way of its adoption in the public sector. These principles and postulations need a further clarification and making clear how they can be applied to the public sector. While ASB-UK (2005) has attempted to develop a conceptual framework for the public sector entities in its Statement of Principles for Financial Reporting –Proposed Interpretation for Public Benefit Entities, the clarification of accrual accounting principles and postulations and making clear how they can be applied to the public sector have not clearly been considered. Consequently, there is a need for further research to develop a conceptual framework that can take into consideration such clarification. This paper is a small step in this direction. Therefore, this paper aims at clarifying some of the accrual accounting principles and postulations that their application can create confusion within the public sector and making clear how such principles and postulations can be applied to the public sector in order to facilitate the adoption of accrual accounting. Accrual accounting is based on the following generally accepted principles and postulations:

a- Generally accepted principles:
   Matching principle;
   Recognition/ realization principle;
   Conservatism principle;
   Consistency principle;
   Full-disclosure principle;
   Objectivity principle; and
   Materiality principle.

b- Generally accepted postulations:
   Going concern postulation;
   Stable unit of measure postulation (monetary measurement unit); and
   Accounting entity postulation.

Herein, the focus will only be on the principles and postulations that their application can create confusion within the public sector, in particular matching, conservatism, consistency, full-disclosure and recognition/realization principles, this is in addition
to the going concern postulate. The rest of the principles and postulations are excluded either because they can similarly be applied to both public and private sector or their application problems seem to be quite close to those of the private sector.

2. Accrual accounting principles

2.1 Matching principle

The matching principle requires that revenues and expenses be matched. Matching of costs and revenues refers to the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events (Ingram et al 1991). Therefore, an objective of measuring net income requires a process (1) to identify revenue and (2) to identify assets which expired in the production of that revenue. This process of identifying revenue and related expired assets (expenses) utilized to produce it, is called matching. Then, the matching principle is the process of reporting the expenses on the basis of a cause-and effect relationship with reported revenues. Therefore, 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 direct and traceable linkage between expenditures and revenues has made some of the opponents of the transition to accrual accounting in the public sector to conclude that accrual accounting with its matching principle cannot generally be properly applied to governmental organizations (Monsen and Nasi 1997, p.13). 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, there is no need to apply the matching principle to government accounting. Consequently, in the absence of 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. However, unlike the private sector, public sector 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, 1991, p.16). In this context, the application of matching principles can be addressed in two approaches as follows:

- Conceptual approach:

In an earlier study (Ouda, 2003), it is assumed that the matching principle can be used in the public sector 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. Where the use of the matching principle by this way in the governmental entities will show to what extent the governmental entities have used the resources, which are entrusted to them, efficiently. 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. We might call this conclusion Conceptual Approach.

However, the operationalization of the conceptual approach through the financial statements has revealed that it is not possible to gauge efficiency from the financial statements, since one has to determine whether the outcomes (the policy objectives, for example) have been delivered. If they have been delivered, then one can ask whether they could have been delivered as effectively for a lower cost – which is the efficiency point. So it has been found that it is so difficult and even it is impossible to prove the conceptual approach by the financial statements, as they do not indicate the level or the quality of the good and services which have been provided. Accordingly, we think that the conceptual approach is only right to the extent that the accruals accounts show the resources consumed in providing services. That is, the inputs are matched against the outputs in financial reporting terms but the inputs and outputs are not matched against the outcomes. In fact, this conclusion makes us to agree with Guthrie (1998) about his comment on the National Commission of Audit NCA 1996, Australia: “it has been argued that the changes from the use of cash based statements to accrual based statements reflect a focus on an efficient and effective output and outcome (National Commission of Audit NCA 1996, Australia). This fails to recognize the reality that accounting statements are themselves focussed on inputs. Outcomes are no more easily measured via the use of accrual financial reporting than cash based reporting and are usually determined on the basis of separate surveys, for example of customer satisfaction or the state of health or
- Practical approach:

Due to difficulties inherent in the operationalization of the conceptual approach, there is a need to address the application of matching principle to the public sector in a practical way that can justify the adoption of accrual accounting with its matching principle. In fact, the use of accrual accounting in the public sector will allow for the measurement of the total cost of providing services on an aggregated basis and also allow for more accurate cost measurement of specific programs and activities. The total costs include not only the cost of goods and services produced or purchased and paid during the accounting period but also the cost of using long-lived assets (e.g. depreciation and cost of capital) and other non-cash costs. Accrual accounting with its matching principle means that the actual cost will be recognized in the year in which it occurs. It is stated in the Consolidated Financial Statements of the NSW Public Sector 1996-97 that “expenses are recognized when incurred and are reported in the financial year to which they relate”. In addition, Sacco (1997) argued that in government, matching would be central to calculating intergenerational equity, that is, there are sufficient revenues collected this period to cover all costs, whether actual outlays or promised outlays.

Consequently, the matching principle can be used to allow for the total costs of one period to be charged to the operating statement in the period in which they are incurred and matched with the total revenues (whether levied through the sovereign power or earned through the operations) related to the same period.

In fact, taking into consideration the specific nature and characteristics of the public sector in comparison with the private sector, the matching of revenues with expenses of a certain fiscal year should be based on a timing relationship instead of an exchange relationship. GASB (1987) argued that “governments generally use resources from a variety of sources to pay for a variety of services. The “matching” relationship that normally exists between resources provided and services received is a timing relationship (that is, both occur during the fiscal year) rather than an exchange relationship”. So in the context of lacking the direct link between the revenues and expenses, the matching principle can be used in the public sector to show the surplus (or deficit) of revenues 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. Thus, comparing revenues with total expenses helps in assessing the inter-period net assets/equity (i.e. whether current revenues are sufficient to cover the costs of programs and services provided in the current period).

In addition, the use of matching principle in the public sector entities will assist in fulfilling the intergenerational fairness by charging the costs incurred in production of 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”. 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 the generation who has ever consumed some services (usefulness) should pay for their costs, and this in turn will fulfil the intergenerational fairness.

The matching principle means that 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. This assists in ensuring an equitable distribution of expenses between generations and that the long-term position of the government remains sound (Bartos, 2000). In addition, it is argued in Financial Information Strategy Accounting Manual of Canada (2001) that in the case of tangible capital assets, a systematic and rational allocation policy is used to approximate the matching principle. This type of expenses recognition involves making assumptions about the benefits that are being received as well as the cost associated with those benefits. The cost of long-lived asset is allocated over the accounting periods during which the asset is used because it is assumed that the asset contributes to the generation of the benefits throughout its useful life. So in order to operationalize the practical approach, the financial statements of New Zealand government can show how accrual
accounting with its matching principle is applied to the public sector. These are: Statement of financial performance (operating statement), Statement of movements in equity and Statement of financial position: for six months ended 31 December 2004 and published on 18 February 2005 (see the next page). Generally, the expenses can be provided in the statement of financial performance in one of two ways (IPSAS 1): **the first** is referred to as the nature of expense method. Expenses are aggregated in the statement of financial performance according to their nature (for example depreciation, purchases of materials, transport costs, wages, salaries), and are not reallocated amongst various functions within the entity. **The second** is referred to as the functional method of expense classification, classifies expenses according the programs or purpose for which they were made (for example Health expenses, education expenses, defence expenses, etc.). This presentation often provides more relevant information to the users than the classification of expenses by nature. The following statement of financial performance of the New Zealand government uses the functional method: (see the next page).

The statement of financial performance of the New Zealand government can show to what extent the New Zealand government has managed to meet current expenses from current revenues and whether the government actions have added to the net worth of the state, and whether the current generation has increased or decreased the worth of what is leaving for the next generation. It is evident from the statement of financial performance of the New Zealand government that the current expenses have been covered by the current revenues and the government has achieved a surplus (positive operating balance) of $4.526 which in turn means that the government actions have improved the net worth of the state and intergenerational equity. Thus, identifying a surplus or deficit each year would over time enable a conclusion to be reached about whether a government is eroding, enhancing or maintaining the net worth.

**Statement of Financial Performance (Operating Statement): For six months ended 31 December 2004**

<table>
<thead>
<tr>
<th><strong>Revenue Levied through the Crown’s Sovereign power</strong></th>
<th>$. Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxation revenue</td>
<td>22.877</td>
</tr>
<tr>
<td>Levies, fees, fines and penalties</td>
<td>1.547</td>
</tr>
<tr>
<td><strong>Total revenue levied through the Crown’s Sovereign power</strong></td>
<td>24.424</td>
</tr>
</tbody>
</table>

**Earned through the Crown’s operations**

Sales of goods and services  5.371
Investment income         1.926
Other revenue             1.003

**Total revenues earned through the Crown’s operations**  8.300

**Total Crown Revenue**  32.724

**Expenses**

**By function classification**

Social security and welfare  8.535
GSF pension expenses       .966
Health                     4.083
Education                  4.185
Core government services   .897
Law and order              1.050
Defence                    .600
Transport and communication 2.707
Economic and industrial services  2.140
Primary services           .560
Heritage, culture and recreation  .833
Housing and community development  .336  
Other  .014  
Financial costs  1.356  
Net foreign-exchange loss/(gains)  .005  

**Total expenses**  28.267  

**Revenue less expenses**  4.457  
Net surplus/deficit attributable to  
State-Owned Enterprises and Crown entities  .069  

**OPERATING BALANCE**  4.526  

Statement of Movements in Equity: For the six months ended 31 December 2004  

<table>
<thead>
<tr>
<th></th>
<th>$.Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Crown Balance</td>
<td>35.463</td>
</tr>
<tr>
<td>Operating balance for the period</td>
<td>4.526</td>
</tr>
<tr>
<td>Net revaluations</td>
<td>.002</td>
</tr>
<tr>
<td>Total Recognized Revenues and Expenses</td>
<td>4.528</td>
</tr>
<tr>
<td>Closing Crown Balance</td>
<td>39.991</td>
</tr>
</tbody>
</table>

Statement of Financial Position: As at 31 December 2004  

<table>
<thead>
<tr>
<th></th>
<th>$.Million</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
</tr>
<tr>
<td>Cash and bank balances</td>
<td>3.202</td>
</tr>
<tr>
<td>Marketable securities, deposits &amp; equity investments</td>
<td>29.442</td>
</tr>
<tr>
<td>Advances</td>
<td>7.941</td>
</tr>
<tr>
<td>Receivables</td>
<td>12.783</td>
</tr>
<tr>
<td>Inventories</td>
<td>.903</td>
</tr>
<tr>
<td>Other investments</td>
<td>.211</td>
</tr>
<tr>
<td>Property, plant &amp; equipment</td>
<td>58.553</td>
</tr>
<tr>
<td>Commercial forests</td>
<td>.251</td>
</tr>
<tr>
<td>Investment in TELs</td>
<td>4.449</td>
</tr>
<tr>
<td>Intangible</td>
<td>.777</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>118.512</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>LIABILITIES</strong></td>
<td></td>
</tr>
<tr>
<td>Payables and provisions</td>
<td>13.259</td>
</tr>
<tr>
<td>Currency issued</td>
<td>3.667</td>
</tr>
<tr>
<td>Borrowings- sovereign guaranteed</td>
<td>30.317</td>
</tr>
<tr>
<td>Borrowings-non-sovereign guaranteed</td>
<td>7.504</td>
</tr>
<tr>
<td>Gover. supperannuation fund pension liabilities</td>
<td>13.976</td>
</tr>
<tr>
<td>ACC liabilities</td>
<td>9.798</td>
</tr>
</tbody>
</table>
Total Liabilities 78.521
Total Assets less Total Liabilities 39.991
Crown Balance
Taxpayer funds 20.030
Revaluation reserve 19.822
 Minority interest .139
Crown Balance 39.991

2.2 Recognition/realization principle

A considerable numbers of writers have used the recognition principle as synonymous for the realization principle (see for example, Larson and Pyle, 1987, p.21 and Hendriksen, 1982, p.178). On the other hand, many writers and professional bodies are making differences between recognition principle and realization principle (see for example, FASB –SFAC 5- paragraph 83). According to FASB –SFAC 5- paragraph 83, revenue should be recognized in the financial statements when:

- it is earned; and
- it is realized or realizable.

Basically, revenue is earned when the earnings process is completed or virtually completed. It is realized when cash is received and it is realizable when claims to cash are received and can be converted into a known amount of cash. Then, a distinction can be made between the recognition and realization as follows:

- Recognition is the process of recording an item in the financial statements.
- Realization is the process of converting non-cash resources into cash.

Herein, we agree with the second point of view, which does not use the recognition principle as synonymous for the realization principle.

Under the traditional government accounting (cash-based system), the revenues are recognized and realized when cash is received. In addition, receipts and revenues are identical since no difference is made between the time when they are recognized and when they are collected. Generally, under this system the cash inflows are recognized as receipts regardless of source or type. For instance, borrowings and custodial receipts are included as revenues although they may be identified separately from other sources of revenues. So the problem of recognition and realization does not exist under the traditional government accounting system. On the other hand, the transition to accrual accounting in the public sector entails making a distinction between the point at which the revenues are considered to be recognized and the point at which they are considered to be collected. The revenues are usually recognized at the time of the exchange transaction when goods are sold or services rendered. For instance, revenue is recognized at the time of invoicing. It is at the point in time that the amount of the accrued revenue can reliably be measured, for example, the amount of the debtor invoice for accrued income. On the other hand, because an accrual basis attempts to recognize events in the period in which they occur, it is possible that unrealized gains (e.g., increase in the value of assets, increases caused by growth of livestock or forests) are included among revenues. This will depend on whether or not, in a particular jurisdiction, realization is considered to be a criterion for the recognition of revenues (IFAC, 1996). Furthermore, in other jurisdictions such as the UK, the realization principle states that assets value increases should not normally be accounted for and reported on until such time as they have been realized in terms of either cash or near-cash resources. Conversely, asset value decreases should be recognized and accounted for as soon as they arise, irrespective of when realization of the asset concerned will take place (United Nations, 1984). Consequently, because earned income is not reported until realized and assets values are understated, the financial statements of the entity are misleading. For instance, when the current valuations of assets...
do not fall below their original costs, the balance sheet will value unrealized assets at their original cost minus any depreciation allocations in the case of fixed assets and not at their current valuation. Thus, the balance sheet does not reflect the entity current value but rather its original transaction value (United Nations, 1984). Unlike the private sector, governments own different sources of physical assets such as infrastructure assets, heritages assets, defense assets, community assets, natural resources, etc. These assets are, to a great extent, difficult to measure reliably; and the realization of the value increases of these assets will also be difficult. Then, the problems that are associated with the recognition and realization principles will create a great confusion within the governmental entities that are not accustomed to having those problems.

In addition, the government obtains its inflows from different sources, and this in turn makes the recognition and realization problems in case of the adoption of accrual accounting more difficult since diversity of sources will require different recognition points. The main categories of inflows to government are (IFAC, 1996):

(i) Revenues derived from exchanges in a manner similar to the private sector. These include revenues from sales of goods or services, dividends, interest and gains arising from the sale of assets;

(ii) Revenues derived from the use of sovereign powers; these include a variety of direct and indirect taxes, duties, fees and fines. These revenues are called non-exchange revenues. These are:
   - Income tax;
   - Fringe benefits tax;
   - Sales tax;
   - Value-added tax;
   - Payroll tax;
   - Property tax;
   - Capital gains tax;
   - Stamp, cheque and credit duties;
   - Death/estate duties;
   - License tax;
   - Road-user charges and motor vehicle fees;
   - Lives; and
   - Fines.

(iii) Other non-exchange transfers such as grants or donations from other governments, from supranational authorities or from the private sector;

(iv) Financing inflows, notably borrowings; and

(v) Custodial receipts. These include taxes collected as agent for another government, contributions towards pension and welfare funds, and other receipts collected as agent for another entity.

As aforementioned, governments raise revenues from both exchange transactions and non-exchange transactions. For the majority of the exchange transactions which are comparable to those of the private sector and where similar circumstances are to be found, the IASB standards and IPSAS 9 can be applied (IFAC, 2000 and 2004). On the other hand, the main problem here is concerned with the non-exchange transactions (including taxes and transfers), where the probability and measurability criteria can hardly be applied. For example, when are the tax revenues considered to be recognized and measured? The answer to this question under traditional government accounting is easy, as the tax revenues are considered to be recognized and measured when cash is received. Thus, there is one point at which the tax revenue can be recognized and measured. However, under accrual accounting, whilst it may be probable that a government is entitled to revenue at the time a taxpayer earns income subject to taxation, it may not be possible to measure the amount of the tax revenue until some later point – for example, at the end of the income year, when tax returns are filed or when tax is assessed (IFAC, 1996). Furthermore, there may be a considerable time lag between the point at which the transaction which gives rise to the revenue takes place and the point at which the amount can reliably be estimated. For example, there may be a lag between the time sales tax is collected by vendor and the time it is accounted for by the government. However, the recognition problem can fairly be overcome by using the experience of the
earlier adopted accrual accounting countries such as New Zealand and Australia. For instance, the New Zealand Government has mentioned (in the Financial Statements for the year ended 30 June 1999, Statement of Accounting Policies, Page 58) the recognition points of non-reciprocal revenues levied through the Crown’s sovereign power (IFAC, 2000). Also see the Crown Accounting Policies for the External Financial Reporting – Treasury- section 3 (http://www.treasury.govt.nz.instructions/3.asp):

Where possible, revenue is to be recognized at the time the debt to the Crown arises. So, the recognition points of major non-reciprocal revenues are summarized below (in Table 1):

### Table 1: Tax Revenue

<table>
<thead>
<tr>
<th>Revenue Type</th>
<th>Revenue Recognition Point</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source deductions (PAYE)</td>
<td>When an individual earns income that is subject to PAYE</td>
</tr>
<tr>
<td>Residents withholding tax</td>
<td>When an individual is paid interest or dividends subject to deduction at source</td>
</tr>
<tr>
<td>Fringe benefits tax (FBT)</td>
<td>When benefits are provided that give rise to FBT</td>
</tr>
<tr>
<td>Provisional tax</td>
<td>Payment due date</td>
</tr>
<tr>
<td>Terminal tax</td>
<td>Assessment filed date</td>
</tr>
<tr>
<td>Goods and services tax</td>
<td>When the liability to the Crown is incurred</td>
</tr>
<tr>
<td>Excise duty</td>
<td>When goods are subject to duty</td>
</tr>
<tr>
<td>Road user charges and motor vehicle fees</td>
<td>When payment for the fee or charge is made</td>
</tr>
<tr>
<td>Stamp, cheque and credit card duties</td>
<td>When the liability to the Crown is incurred</td>
</tr>
<tr>
<td>Other indirect tax</td>
<td>When the debt to the Crown arises</td>
</tr>
</tbody>
</table>

Furthermore, the Commonwealth Government of Australia has also given (in Financial Statements for the year ended 30 June 1997- Notes to and forming part of the Financial Statements, Pages 38 and 39) some bases of non-reciproal revenues recognition (IFAC, 2000).

Taxation Revenue: Revenues are recognized when the Government gains control of the future economic benefits that flow from taxes and when those future economic benefits can be measured reliably. The bases of recognition for major types of taxation revenue are summarized as follows (in Table 2):

### Table 2: Tax Revenue

<table>
<thead>
<tr>
<th>Major type of taxation revenue</th>
<th>Basis of revenue recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax from individual (PAYE, PPS, Provisional Tax)</td>
<td>recognized on earnings of taxpayers during the reporting period where such amounts can be reliably measured and are expected to be collected</td>
</tr>
<tr>
<td>Company Tax &amp; Superannuation Fund Tax</td>
<td>recognized on company income for the reporting period</td>
</tr>
<tr>
<td>Sales Tax &amp; Withholding Tax</td>
<td>recognized on defined sales and other relevant activities occurring during the reporting period</td>
</tr>
<tr>
<td>Fringe Benefits Tax</td>
<td>recognized on fringe benefits provided to employees</td>
</tr>
<tr>
<td>Excise Duty</td>
<td>recognized when goods are distributed for home consumption</td>
</tr>
<tr>
<td>Customs Duty</td>
<td>recognized when imported goods are distributed for home consumption</td>
</tr>
</tbody>
</table>

In addition, the promulgation of IPSASs in the near future may tackle the recognition problems of non-exchange transactions. In January 2006, IFAC has issued an Exposure Draft (ED–29) with respect to revenue from Non-Exchange transactions (including taxes and transfers). ED-29 proposes requirements for the recognition, measurement and disclosure of revenue from non-exchange transactions. It develops an “assets and liabilities approach” that requires entities to recognize revenue when an inflow of resources is recognized as an asset, to the extent that liability or contribution from owners is not also recognized and stated in...
paragraphs 54, 55 and 58 the following recognition and measurement criteria of revenue from non-exchange transactions:

- An inflow of resources from a non-exchange transaction recognized as an asset shall be recognized as revenue, except to the extent that a liability is also recognized in respect of the same inflow.

- As an entity satisfies a present obligation recognized as a liability in respect of an inflow of resources from a non-exchange transaction recognized as an asset, it shall reduce the carrying amount of the liability recognized and recognize an amount of revenue equal to that reduction.

- And if an inflow of resources satisfies the definition of the contributions from owners, it is not recognized as a liability or revenue.

- Revenue from non-exchange transactions shall be measured at the amount of the increase in net assets recognized by the entity as at the date of initial recognition of assets arising from the non-exchange transaction.

Consequently, the issuance of an ultimate IPSAS in respect of the recognition of revenue from non-exchange transactions can assist in better understanding of how the recognition/realization principle can be applied to the public sector.

In fact, assets, liabilities, revenues and expenses arising from transactions and events must be recognized in the financial statements when they have an economic impact on the government, regardless of when the associated cash flows occur.

Basically, the governments have to record tax revenues as having accrued once an economic transaction that gives rise to a tax liability occurs. But as earlier pointed out, there are many types of tax. Accordingly, it is very difficult to know when all these types of tax take place. Therefore, tax revenues can be recognized as a tax liability when this tax liability has been booked against a taxpayer by the taxation office. This can only take place once a taxpayer makes a self-assessment to the taxation office or when the taxation office issues an assessment to a taxpayer.

In connection with the above stated, the Australian Department of Finance and Administration (2001) has mentioned that there are usually two changes required to align cash estimates with accrual estimates. These are adjustments for (1) receivables, and (2) bad and doubtful debts:

the adjustment for receivables recognizes revenue for which an assessment has been issued but which has not yet been received in cash. (This adjustment is reduced by any cash received in payment of receivables booked in prior periods).

The adjustment for bad and doubtful debts allows for the expectation that some of receivables are never paid by debtors and are thus written off. At the end of each financial year, provision is made for receivables that are, in future, likely to become uncollectable. This provision is expensed in that year ensuring a better matching of financial flows (i.e. aligning the expense with the accrual revenue booked). In this way expenses are matched to the period in which they were incurred.

### 2.3 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 fact, the 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 procedures 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. In addition, it is difficult for the user to separate the fluctuations caused by internal and external economic factors.

While the use of the consistency principle in the business enterprise is necessary, its use in the public sector is an imperative. For instance, it has been stated under matching principle that the matching principle can be used in the public sector to show the
surplus (or deficit) of revenues over expenses. As long as the rules of recognizing expenses and revenues have been established and are applied in accordance with the principle of consistency, the variations in the surplus or deficit over years can provide important information about the impact of fiscal policies. In addition, the use of the consistency principle in the public sector can provide the user with reliable measure of the net worth, period after period. The user can measure and judge the impact of government actions on the net worth, whether those actions have deteriorated or improved the net worth. Without the use of persistent accounting policies or procedures, the government can easily affect the net worth, for example, by valuing its assets at historical cost at some periods and at replacement cost in other periods. Consequently, it will make the comparison of net worth from period to period meaningless. Similarly, the use of consistency principle will provide a reliable measure for the intergenerational equity, period after period. Also without the use of consistency principle the true and fair view about the financial position of the government can be distorted.

Furthermore, the adoption of accrual accounting by the public sector entities will require preparing consolidated accrual statements for the whole government. One significant issue that arises from the use of accrual accounting for the consolidated statements of the government as a whole is the meaning of any reported deficit. A deficit would reflect the fact that the government had not used its compulsory revenue-raising powers sufficiently to cover all costs, e.g. it would indicate the extent to which emerging liabilities are not being funded (Shand, 1989). On the contrary, the deficit under cash accounting indicates the net borrowing requirement to fund current cash outlays. However, the main problem emerges when separate legislative powers exist within the government and especially when the existence of these powers has resulted in not producing uniform accounting policies for like transactions and other events in similar circumstances. If the public sector entities use accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, the deficit included in the consolidated accrual statements would not indicate the right meaning of the government deficit. For instance, under accrual accounting the public sector entities should disclose the amount of the unfunded liability for superannuation commitments. While some of the public sector entities can treat it as a liability on their balance sheet, other entities can only show the amount of liability as a parenthetical note. Then the varying treatment for the accumulated liability will affect the reported deficit or surplus. Therefore, the adoption of accrual accounting for such consolidated statements would need to be accompanied by careful explanations and appropriate modifications to the way financial information might otherwise be displayed (Shand, 1989). In addition, if governmental entities use accounting policies other than those used in the consolidated financial statements for like transactions and events in similar circumstances, appropriate adjustments should be made to their financial statements when they are used in preparing the consolidated accrual statements. In general, in order to avoid the ambiguity about the meaning of the reported deficit, there should be uniform accounting policies for the government as a whole and it should be used in preparing the consolidated accrual statements. If there is a deviation from the use of the uniform accounting policies in preparing the consolidated accrual statements, this should be disclosed in the notes that accompanied the consolidated accrual statements. What makes this disclosure important is that there are inevitably problems attached to the interpretation of government financial statements, whether consolidated or not. As above stated, the liabilities (e.g. unfunded pensions) are much more under the discretionary control of government than would ever be the case for private sector decision-makers (Heald and Georgiou, 2000). Furthermore, future tax revenues, which will be the means for meeting these liabilities as they mature, are not capitalized, thereby increasing the difficulty of interpreting the meaning of the government deficit.

Thus, the development of uniform accounting policies and using them on a consistent base (consistency principle) for the government as a whole is an essential step towards the indication of right meaning of the government deficit. So in order to avoid the misinterpretation of reported deficit, the governmental entities financial statements and the consolidated financial statements for the government as a whole should be prepared and presented on unified and consistent accounting policies. In other words, the use of unified accounting policies and procedures and application of the consistency principle in the public sector is necessary for better interpretation of reported deficit, for analyzing and evaluating the impact of fiscal policies, for comparing years, for measuring trends and discerning the effects on the governmental entity caused either by external or internal factors.

2.4 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). So: recognize no gains until they happen but record all possible losses even before they take place. Unlike the private sector, the government obtains its revenues (inflows) from different sources, and this in turn makes the recognition and realization of these revenues in case of the adoption of accrual accounting more difficult since diversity of sources will require different recognition points. The main categories of revenues to government are: revenues derived from exchanges in a manner similar to the private sector, these include revenues from sales of goods or services, dividends, interest and gains arising from the sale of assets; revenues derived from the use of sovereign powers: these include a variety of direct and indirect taxes, duties, fees and fines; and other non-reciprocal transfers such as grants or donations from other governments, from supranational authorities or from the private sector. The conservatism principle holds that some degree of risk is involved in the collection of these revenues. Hence it may be unwise to treat these revenues in the financial statements as fully collectable. The historical data may support the fact that, over the past several years, government had only been successful in collecting 90% of these revenues. An application of conservatism principle in this case would be to state the probable collection of revenues based on this objective information. In general, government accountants should also avoid the use of subjective judgement in making estimates for financial statements. In this instance, there is some support both for the use of historical trends and taking a more conservative view. Furthermore, unlike the private sector, governments own different sources of physical assets such as infrastructure assets, heritage assets, etc. These assets are, to a great extent, difficult to measure reliably; and the realization of the value increases in these assets will also be difficult. Then, overstating of the value of assets can result in overstating the probable asset base of the governmental entity. Similarly, recording the value of these assets should be based on the historical data and conservative view. Consequently, it may be concluded that the conservative principle is more required and applicable to public sector accounting in comparison with the private sector accounting. This means that proper allowance should be made for all known and foreseeable losses and liabilities; income should only be included where there is a reasonable certainty of it arising (Green Paper, 1994). Thus, pessimism is assumed to be better than optimism in budgeting and financial reporting of the governmental entities.

2.5 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 company for which they were prepared (Larson and Pyle, 1987). This principle is one of the most important accounting principles that is missing in governmental accounting. The lack of this principle has led to the governmental activities being 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 which are clearly of capital nature- for example the sale of government assets. Hence, the lack of this information has resulted in confused and distorted information used during the decision-making process in the public sector, and accountability is not effectively discharged. For instance, when there is no information available about the assets, the focus of the decision will be on whether or not to spend on new assets; when this information is available, then the focus will be extended to whether to retain or upgrade the existing assets. In addition, full disclosure can promote the accountability through greater financial transparency. Generally speaking, transparency and accountability are interrelated concepts and mutually reinforcing. Without transparency there could not be any accountability. Unless there is accountability, transparency would be of no value. In fact, transparency is built on a free flow of information and it requires that the governments should be explicit about their fiscal objectives and should report on a wide range of economic and fiscal information. On the other hand, transparency is a key element of bureaucratic accountability that entails making available for public scrutiny all public accounts and audit reports. Therefore, the governments are requested to overcome the lack of financial transparency and the poor quality of financial information by reporting information about their assets, liabilities, revenues and expenses as well as information about their exposure to losses and potential obligations related to contingencies and commitments (IFAC, 1998). Thus, the adoption of accrual accounting in the public sector will improve the quality of governmental financial information.

3. Accrual accounting postulations:

Herein, the focus will only be on the postulations that their application can create confusion within the public sector. Therefore, the going concern is one of the accrual accounting postulations that give rise for a heavy debate about how it can be applied to the public sector.
3.1 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). In practice, most governments are using cash accounting. One of the fundamental flaws in argument for cash accounting is that assumes that government is not a going concern (Hardman, 1982). Certainly, the apparent ownership of government operations may change periodically with the election of a 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 independent of the successive governments. Frankly speaking, 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 to the public sector due to the very long life of many physical assets and long-term liabilities in comparison with the business enterprises. The governmental entities are also expected to continue providing services in the future as a consequence of the yearly allocation of appropriations (political decision). The UK Financial Reporting Manual stated that for non-trading entities in the public sector, the anticipated continuation of the provision of a service in the future, as evidenced by inclusion of financial provision for that service in published documents, is normally sufficient evidence of going concern. This also means that the continuation of the governmental entities is not only based on an economic decision but also on a political decision. Unlike the private sector, governmental entity has a certain power or agreement that makes it more going concern. IPSAS 1 argued that there may be circumstances where the usual going concern tests of liquidity and solvency appear unfavorable, but other factors suggest that the entity is nonetheless a going concern. For example:

- In assessing whether a government is a going concern, the power to levy rates or taxes may enable some entities to be considered as a going concern even though they may operate for extended periods with negative net assets/equity; and
- For an individual entity, an assessment for its statement of financial position at the reporting date may suggest that the going concern assumption is not appropriate. However, there may be multi-year funding agreement, or other arrangements, in place that will ensure the continued operation of the entity.

Consequently, one can conclude that the major difference between the private and public sector is that in the private sector the going concern is an economic decision that may be based on the financial statements. In the public sector it is a political decision and the financial statements may or may not assist with this decision. A state enterprise, which is considered politically essential, may be retained despite making huge losses.

Yet, the 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 (Hendriksen, 1982). Similarly, many users (i.e. investors, creditors, the public, lenders, service customers, etc.) of governmental financial reporting require information that can assist them in making prediction regarding the ability of the government in meeting its future obligations and the continuity of providing the services in the future. Therefore, the assumption that government is not a going concern can not be justified, due to the fact that the going concern assumption is based on different criteria in the public sector i.e. political rather than financial factors.

4. Conclusion

As a consequence of the 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. In reality, this makes us agree with Macmillan (1982) that difficulties in getting accrual accounting adopted universally in government are implementation problems, not matters of principle. In fact, accrual basis of accounting recognizes transactions
and events when the transactions or events occur rather than when cash is paid or received and its financial statements disclose the total assets (include current and physical assets), total liabilities (include short and long-term liabilities), net worth, revenues and expenses. Accordingly, the measurement focus under full accrual accounting is on the total economic resources. Effectively, assets, liabilities, revenues and expenses arising from transactions and events must be recognized in the financial statements when they have an economic impact on the government, regardless of when the associated cash flows occur. Furthermore, it has been revealed that the accrual accounting postulation, which has been considered for decades as an obstacle for its adoption in the public sector, such as the going concern, is more applicable to the public sector than the private sector as this is not based only on economic factors but also on political factors.

END NOTE
(1) This article is a revised version of a paper prepared for the Scientific Conference: Accounting and Performance Management Perspectives in Business and Public sector Organizations, Tartu University, Estonia 29-30 September, 2005.

REFERENCES
Introduction.

Much time and effort is being spent by governments in many countries to transition to the full accrual basis of accounting prescribed by the International Public Sector Accounting Standards (IPSAS) Board of the International Federation of Accountants. The IPSAS Board has published Study 14 (December 2003) titled “Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities” which provides detailed procedures to consider during the transition phase. This paper discusses a stepwise approach that can be used by developing countries to assist in this endeavor. It suggests implementing the Cash Basis IPSAS as a starting point since the information for this IPSAS is generally readily available in most countries. In addition, compliance with the Cash Basis IPSAS is an internationally approved accounting standard that the Supreme Audit Office can use to express an audit opinion on the fair presentation of the Statement of Cash Receipts and Payments required by the IPSAS.

Step 1-Reporting Entities

One of the most difficult tasks in transitioning to the accrual basis of accounting is to identify the types of reporting entities within government. Yet this step is critical since the type determines how the accounting will be done for the entity. IPSAS 6 (Consolidated Financial Statements and Accounting for Controlling Entities) provides guidance on determining whether control exists for financial reporting purposes and should be referred to in determining whether to include them in the government financial statements. The types of government entities are as follows:

1. Government Business Enterprises (GBEs) include both trading enterprises (such as utilities) and financial enterprises (such as financial institutions). GBEs (IPSAS 1) are no different from entities conducting their activities in the private sector and, as such, prepare their financial statements in accordance with the International Accounting Standards/International Financial Reporting Standards. A GBE has all of the following characteristics:
   a. Is an entity with the power to contract in its own name;
   b. Has been assigned the financial and operational authority to carry on a business;
   c. Sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery;
   d. Is not reliant on continuing government funding, to be a going concern (other than purchases of outputs at arm’s length); and
   e. Is controlled by a public sector entity.
2. Associates (IPSAS 7) are entities in which the investors have significant influence and which is neither a controlled entity nor a joint venture of the investor. Generally, the government is considered to have significant influence if it holds 20% or more of the voting power of the investee. If less than 20%, it is accounted for as an investment at market value. If over 20%, it is accounted for as an investment under the cost or equity method of accounting.

3. Joint Ventures (IPSAS 8) are binding arrangements whereby two or more parties are committed to undertake an activity which is subject to joint control of operations (such as a manufacturing entity), assets (such as a toll road), or the entity (such as a jointly owned corporation). A proportionate share of the assets and liabilities of these entities are accounted for on the consolidated statements of the controlling entity.

4. Inclusion of all other governmental entities is determining by applying the benefit and power criteria defined in IPSAS 6. If the government entity benefits from the activities of the other entity, has the power to govern the financial and operating policies of the other entity, and the power to govern the financial and operating policies are presently exercisable, the government entity controls the other entity. Thus, the other entity would be included in the financial statements of the controlling entity. Each government entity would need to be evaluated against these criteria.

Decision flowcharts are provided in Appendices 1 and 2 to assist in this evaluation. Priority attention on the accounting procedures to follow should be given to identifying those that belong to the “all other” entities in Category 4 above. To determine the approximate number of entities and the accounting basis presently being used in each category, complete the following table:

<table>
<thead>
<tr>
<th>Reporting Entities</th>
<th>Number of Reporting Entities</th>
<th>Cash Basis (Y/N)</th>
<th>Accrual Basis (Y/N)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. GBEs (IPSAS 1)</td>
<td></td>
<td></td>
<td>Partial (Y/N)</td>
</tr>
<tr>
<td>2. Associates (IPSAS 7)</td>
<td></td>
<td></td>
<td>Full (Y/N)</td>
</tr>
<tr>
<td>3. Joint Ventures (IPSAS 8)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. All Others (IPSAS 6):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State Budgets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NCEs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Step 2. Accounting for Cash**

Most countries have procedures in place to properly account for cash and they only need to review their procedures to assure that they are in compliance with the Cash Basis IPSAS. Cash is defined as cash on hand, demand deposits, and cash equivalents. Cash equivalents are defined as short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. In your review of current procedures to account for cash, the following should be considered:

1. For all controlled entities (other than GBEs), determine the amount of cash, demand deposits and cash equivalents on hand at the beginning and end of the fiscal year. Identify the source of all cash received by each controlled entity, as well as the economic classification of all cash payments during the year. The beginning balance plus all cash receipts less all cash payments should equal the balance at the end of the fiscal period.
2. Complete the following table:

<table>
<thead>
<tr>
<th>Name of Entity</th>
<th>Beginning Cash Balance</th>
<th>Cash Receipts</th>
<th>Cash Payments</th>
<th>Ending Cash Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(continue to end)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Combined Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3. Determine if there were any cash transfers between entities during the fiscal period. If so, eliminate the offsetting cash receipts and cash payments in order to prevent any double-counting. The total of the eliminations column should always equal zero. After the cash transfers have been eliminated, the first column of the consolidated Statement of Cash Receipts and Payments can be prepared. This elimination process is illustrated in the following table where entity 2 transfers 1,000 in cash to entity 1:

<table>
<thead>
<tr>
<th>Illustration of Transfer Eliminations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Combined Total</td>
</tr>
<tr>
<td>Entity 1 Receipts</td>
</tr>
<tr>
<td>Entity 2 Payments</td>
</tr>
<tr>
<td>Net Change</td>
</tr>
</tbody>
</table>

4. For all controlled entities (other than GBEs), identify any payments by third parties on behalf of the entity. If this information is not collected by the entity, a request should be sent to the donor making the payment on behalf of the entity requesting the amount of the cash payment. This information is needed to assist in determining the cash needed to sustain the same level of service. Now the second column of the consolidated Statement of Cash Receipts and Payments can be prepared.

5. Accounting policies and explanatory notes should be disclosed with the Statement of Cash Receipts and Payments. The explanatory notes should include information about the entity, as well as any restrictions on cash balances and access to borrowings. This completes compliance with Part 1 of the Cash Basis IPSAS for all controlled entities (other than GBEs).

6. In the migration to the accrual basis of accounting, an entity is encouraged to present a Statement of Cash Receipts and Payments in the same format as that required by IPSAS 2 on Cash Flow Statements. This format requires a breakout of cash flows by Operations, Investing and Financing.

**Step 3. Optional Disclosures Under Part 2 of the Cash Basis IPSAS**

Many countries have some procedures in place to compile asset and liability information. However, these procedures generally do not fully comply with the requirements of the accrual IPSASs. As a transition to the accrual basis of accounting, Part 2 of the Cash Basis IPSAS encourages countries to disclose their asset and liability values (as well as other select information) as part of the Statement of Cash Receipts and Payments. To eventually be in compliance with the accrual IPSASs, asset and liability information for controlled entities such as State Budget Institutions (GBEs, Associates, and Joint Ventures will be considered at a later date) should be compiled as follows:
1. Liabilities are formally defined as “present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential”. On a full accrual basis, these liabilities would be included in the Statement of Financial Position.

   a. Current liabilities (liabilities to be paid within the next year) are to be recognized at the time that goods or services are received and not at the time that cash is paid. For example, paid vacation or sick leave would be accrued at the time that it is earned by the employee rather than at the time vacation or sick leave is taken. In addition, the liability for goods received would be recognized at the time title passes (generally at time of receipt) to the government rather than when an invoice is paid. A Schedule of Current Liabilities should be included in the Explanatory Notes to the Statement of Cash Receipts and Cash Payments.

   b. As prescribed by IPSAS 15, financial instruments (such as notes, bonds, etc.) should be recognized when the liability is incurred and a Schedule of Long Term Debt should be included in the Explanatory Notes to the Statement of Cash Receipts and Payments. As prescribed by IPSAS 5, borrowing costs (effective interest and other expenses incurred by an entity in connection with the borrowing of funds) should be recognized as an expense in the period in which they are incurred not in the period in which they are paid.

   c. As prescribed by IPSAS 13, leases should be classified as finance or operating leases. A finance lease is defined as “a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred”. For finance leases, assets acquired and associated lease obligations should be recognized at amounts equal at the inception of the lease to the fair value of the leased property. An operating lease is a lease other than a finance lease and the cost of the lease is charged to the period incurred on a straight line basis over the lease term. As part of the Explanatory Notes to the Statement of Cash Receipts and Payments, specific information on the finance and operating leases should be disclosed as prescribed by IPSAS 13.

   d. As prescribed by IPSAS 19, a provision (liability of uncertain timing or amount such as a lawsuit) should be recognized when an outflow of resources will be required and a reliable estimate of the obligation can be made. A contingent liability (liability where an outflow of resources will probably not occur or the amount of the obligation can not be reliably estimated) should not be recognized. A Schedule of Provisions should be included in the Explanatory Notes to the Statement of Cash Receipts and Payments.

2. Assets are formally defined as “resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity”.

   a. Current assets other than cash are assets expected to be converted to cash within the next year. These assets are to be recognized when ownership passes to the entity. Some examples are as follows:

      i. Accounts receivable should be recognized when the government is entitled to collect funds owed not when cash is received. For example, accounts receivable are established when some countries privatize previously owned GBEs and sell shares to employees with repayment over the next five years. A Schedule of Accounts Receivable (by type) should be included in the Explanatory Notes to the Statement of Cash Receipts and Payments.

      ii. As prescribed in IPSAS 12, inventories (i.e., ammunition, consumable stores, spare parts, stocks of unissued currency, etc.) should be recognized on a first-in, first-out (FIFO) or a weighted average basis. A Schedule of Inventories (by type) should be included in the Explanatory Notes to the Statement of Cash Receipts and Payments. The inventories would be expensed when sold, exchanged or distributed.

      iii. As prescribed in IPSAS 16, investment property (property held to earn rentals or for capital appreciation or both) will be recognized at cost when initially acquired. Generally, the investment will be subsequently recognized at fair value with a holding gain or loss as appropriate. A Schedule of Investments (by type) should be included in the Explanatory Notes to the Statement of Cash Receipts and Payments.
b. Property, plant and equipment (PP&E) are tangible assets that are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used during more than one reporting period. As prescribed in IPSAS 17, PP&E would include land, infrastructure assets (i.e., roads, bridges, curbs and gutters, etc.), buildings, specialist military equipment, and general use equipment. These assets would generally be recorded in an Asset Register and initially recognized at cost. A Schedule of Property, Plant and Equipment (by class) should be included in the Explanatory Notes to the Statement of Cash Receipts and Payments. On a full accrual basis, these assets would be depreciated over their useful life and included in the Statement of Financial Position.

**Step 4. Miscellaneous Optional Disclosures Under Part 2 of the Cash Basis IPSAS**

As a transition to the accrual basis of accounting, Part 2 of the Cash Basis IPSAS encourages countries to disclose other select information as part of the Statement of Cash Receipts and Payments. To eventually be in compliance with the accrual IPSASs, this select information for controlled entities such as State Budget Institutions (GBEs, Associates, and Joint Ventures will be considered at a later date) should be compiled as follows:

An entity is encouraged to disclose in the notes to the financial statements, the amount and nature of cash flows and cash balances resulting from transactions administered by the entity as an agent on behalf of others where those amounts are outside the control of the entity. These administered transactions generally occur when the entity collects taxes for subsequent transfer to another entity.

An entity is encouraged to disclose in the notes to the financial statements information required by IPSAS 20 relating to Related Parties. This accrual IPSAS defines related parties and other relevant terms, requires the disclosure of related party relationships where control exists and requires the disclosure of certain information about related party transactions, including information about aggregate remuneration of key management personnel.

An entity is encouraged to disclose in the notes to the financial statements a comparison of actual revenue and expenditures with the budgeted revenue and expenditures on a comparable basis. An IPSAS Exposure Draft (No. 27 with comments due by 10 February 2006) of a proposed IPSAS has been issued and is being deliberated at the present time. It is expected that an IPSAS on Budget Reporting will be issued by December 2006.

An entity is encouraged to disclose in the notes to the financial statements the proportion of ownership interest in controlled entities and, where that interest is in the form of shares, the proportion of voting power held. Where applicable, the name of any controlled entity in which the controlling entity holds an ownership interest and/or voting rights of 50% or less, together with an explanation of how control exists, should be disclosed. Further, the name of any entity in which an ownership interest of more than 50% is held but which is not a controlled entity, together with an explanation of why control does not exist, should be disclosed. The method used to account for controlled entities should also be described.

An entity is encouraged to make disclosures about joint ventures which are necessary for a fair presentation of the cash receipts and payments of the entity during the period and the balances of cash as at reporting date. Disclosures about joint ventures may include a listing and description of interests in significant joint ventures as prescribed in IPSAS 8.

**Conclusion**

When all preceding actions have been materially implemented, full accrual accounting will have been established and all IPSASs in effect will have been adopted. A Consolidated Financial Statement for the State Budget Institutions can then be prepared. As GBEs, Associates, and Joint Ventures are addressed, financial statements for the Whole of Government as prescribed in IPSAS 6 can then be prepared.

The International Monetary Fund (IMF) published a Government Finance Statistics Manual (GFSM) in 2001 to collect information needed for a statistical reporting system. The GFSM also expects the governmental entities to implement an accrual accounting
The GFSM should be taken into consideration during implementation of any accounting system since it identifies the asset, liabilities, revenue, and expenditures desired by the IMF. Thus, the information desired can be easily extracted from the accounting system.

Each developing country is at different stages in the transition to the accrual basis of accounting. An implementation plan is suggested in Appendix 3 to assist in establishing target dates and offices responsible for achieving the prescribed actions.

Appendix 1. Identifying Level of Control of Another Entity for Financial Reporting Purposes

- Does the entity benefit from the activities of the other entity?
  - No
  - Yes
    - Does the entity have the power to govern the financial and operating policies of the other entity?
      - No
      - Yes
        - Is the power to govern the financial and operating policies presently exercisable?
          - No
          - Yes
            - Entity controls other entity and should be included in Consolidated Statement as prescribed in IPSAS 6.
            - Control does not appear to exist and should be excluded from Consolidated Statement.
Appendix 1. Identifying Level of Control of Another Entity for Financial Reporting Purposes

1. Does the entity meet all the criteria as a Government Business Enterprise?
   - Yes → Entity should comply with the IFRS/IASs.
   - No

2. Does the entity meet the definition of an Associate?
   - Yes → Entity should comply with IPSAS 7.
   - No

3. Does the entity meet the definition of a Joint Venture?
   - Yes → Entity should comply with IPSAS 8.
   - No

4. Does the entity plan to implement accrual accounting?
   - Yes → Entity should comply with Parts 1 and 2 of the Cash Basis IPSAS during transition period.
   - No → The entity should comply with Part 1 of the Cash Basis IPSAS.

   - No → Entity should comply with all the accrual IPSASs when accrual accounting has been fully implemented.
### Appendix 3. Phased Implementation Plan For Cash Basis IPSAS and Transition to Accrual IPSASs

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>DESCRIPTION</td>
<td>Target Completion Dates</td>
<td>Primary Project Support*</td>
<td>Comments</td>
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<tr>
<td>2</td>
<td>I.</td>
<td>Appoint Steering Committee to approve policies relating to the implementation of the Budget Classification and Accounting System</td>
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<td>3</td>
<td>II.</td>
<td>Appoint Working Group to establish procedures, subject to the approval of the Steering Committee, relating to the implementation of the new system</td>
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<td>4</td>
<td>III.</td>
<td>Provide Training on International Public Sector Accounting Standards (IPSAS) and GFS Manual (GFSM) to Steering Committee and Working Group Members</td>
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<td>5</td>
<td>IV.</td>
<td>Assign a Working Group Member responsibility for identifying information requirements and overseeing the preparation of each separate step in paragraphs IX-XVI. Perform the following actions by dates specified for the respective Statements:</td>
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<td>6</td>
<td></td>
<td>A.</td>
<td>Identify information necessary to prepare Statement</td>
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<td>7</td>
<td></td>
<td>B.</td>
<td>Collect information available and prepare Statement on available information</td>
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<tr>
<td>8</td>
<td></td>
<td>C.</td>
<td>Identify information not available and develop procedures to collect information not available</td>
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<td>9</td>
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<td>D.</td>
<td>Prepare Statement to include both available and previously unavailable information</td>
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<td>10</td>
<td></td>
<td>E.</td>
<td>Prepare prescribed Statement per IPSAS when all information available</td>
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<td>11</td>
<td></td>
<td>F.</td>
<td>Extract data from system to prepare prescribed GFSM reports</td>
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<tr>
<td>12</td>
<td>V.</td>
<td>Establish Coding Structure for new system to comply with the IPSASs and GFSM</td>
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<tr>
<td>13</td>
<td>VI.</td>
<td>Identify Number of Entities by Category for Each Level of Government</td>
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<td></td>
<td>Need to identify the number of entities involved in the preparation of the financial statements</td>
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<td>14</td>
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<td>A.</td>
<td>Controlled Entities (IPSAS 6)</td>
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<td>15</td>
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<td>1.</td>
<td>Government Activities</td>
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<td>2.</td>
<td>Government Business Enterprises (GBEs)</td>
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<td>Associates (IPSAS 7)</td>
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<td>C.</td>
<td>Joint Ventures (IPSAS 8)</td>
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<tr>
<td>19</td>
<td>VII.</td>
<td>Provide Training on new coding structure to those entities to be involved in the pilot tests</td>
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<tr>
<td>20</td>
<td>VIII.</td>
<td>Prepare initial draft of a Policies and Procedures Manual</td>
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<tr>
<td>21</td>
<td>IX.</td>
<td>Prepare Budget to Actual Comparative Statement per IPSAS ED 27 for Entities Involved in the Pilot Tests</td>
<td></td>
<td></td>
<td></td>
<td>Includes original as well as final budget</td>
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<td>22</td>
<td>X.</td>
<td>Implement Part 1 (Required) of the Cash Basis IPSAS for Entities Involved in the Pilot Tests</td>
<td></td>
<td></td>
<td></td>
<td>Start with Entities Involved in Pilot Tests and roll out to others in phased approach</td>
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<tr>
<td>23</td>
<td></td>
<td>A.</td>
<td>Prepare Statement of Cash Receipts and Payments from own sources for each entity</td>
<td>Each pilot entity</td>
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<tr>
<td>24</td>
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<td>B.</td>
<td>Research areas to determine if initial Statement is complete</td>
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<td>25</td>
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<td>C.</td>
<td>Update initial Statement (if appropriate) for each entity</td>
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<td>26</td>
<td></td>
<td>D.</td>
<td>Combine (add together) Statements of Cash Receipts and Payments</td>
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<tr>
<td>27</td>
<td></td>
<td>E.</td>
<td>Identify cash transfers between entities and eliminate offsetting transactions</td>
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<td>28</td>
<td></td>
<td>F.</td>
<td>Prepare Consolidated Statement of Cash Receipts and Payments from own sources on all Entities Involved in Pilot Tests</td>
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<tr>
<td>29</td>
<td></td>
<td>G.</td>
<td>Contact donors and identify cash payments by third parties</td>
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<td>H.</td>
<td>Prepare Consolidated Statement of Cash Receipts and Payments from all sources on all Entities Involved in Pilot Tests</td>
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<tr>
<td>31</td>
<td></td>
<td>1.</td>
<td>Include explanatory notes on accounting policies, cash restrictions and access to borrowings</td>
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<tr>
<td>32</td>
<td>XI.</td>
<td>Implement Part 2 (Optional) of the Cash Basis IPSAS for Entities Involved in Pilot Tests</td>
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<tr>
<td>33</td>
<td></td>
<td>A.</td>
<td>Current Liabilities</td>
<td>Debits under one year term</td>
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<tr>
<td>34</td>
<td></td>
<td>1.</td>
<td>Prepare initial Schedule of Current Liabilities for each entity</td>
<td>Each pilot entity</td>
<td>Include finance leases (IPSAS 13) and any liabilities in arrears</td>
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<td>Research areas to determine if initial Schedule is complete</td>
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<td>Update initial Schedule (if appropriate) for each entity</td>
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<td>4.</td>
<td>Combine (add together) Schedules of Current Liabilities</td>
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<td></td>
<td>5.</td>
<td>Identify and eliminate offsetting transactions between entities</td>
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<td>6.</td>
<td>Prepare Consolidated Schedule of Current Liabilities on all Entities Involved in Pilot Tests</td>
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<td>B.</td>
<td>Non-Current Liabilities</td>
<td>Debits over one year term</td>
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<td>41</td>
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<td>1.</td>
<td>Prepare initial Schedule of Non-Current Liabilities for each entity</td>
<td>Each pilot entity</td>
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<td>42</td>
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<td>Research areas to determine if initial Schedule is complete</td>
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</table>
### Appendix 3. Phased Implementation Plan For Cash Basis IPSAS and Transition to Accrual IPSAS

<table>
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<tr>
<th>Component</th>
<th>Phase</th>
<th>Activity</th>
<th>Task</th>
<th>Description</th>
<th>Target Completion Dates</th>
<th>Primary Project Support</th>
<th>Comments</th>
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<td>3. Update initial Schedule (if appropriate) for each entity</td>
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<td>4. Combine (add together) Schedules of Non-Current Liabilities</td>
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<td>5. Identify and eliminate offsetting transactions between entities</td>
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<td>6. Prepare Consolidated Schedule of Non-Current Liabilities on all Entities Involved in Pilot Tests</td>
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<td>59</td>
<td></td>
<td></td>
<td></td>
<td>C. Current Assets</td>
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<td>Can convert to cash in one year</td>
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<td></td>
<td>a. Include Accounts Receivable</td>
<td>Each pilot entity</td>
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<td>b. Include Inventories (IPSAS 12)</td>
<td>Each pilot entity</td>
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<td>c. Include Investments (IPSAS 16)</td>
<td>Each pilot entity</td>
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<td>2. Research areas to determine if initial Schedule is complete</td>
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<td>3. Update initial Schedule (if appropriate) for each entity</td>
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<td></td>
<td>4. Combine (add together) Schedules of Current Assets</td>
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<td>5. Identify and eliminate offsetting transactions between entities</td>
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<td></td>
<td>6. Prepare Consolidated Schedule of Current Assets on all Entities Involved in Pilot Tests</td>
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<td>68</td>
<td></td>
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<td>D. Property, Plant and Equipment (PP&amp;E) (IPSAS 17)</td>
<td>Long lived (over one year) assets</td>
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<td>1. Prepare initial Schedule of PP&amp;E for each entity</td>
<td>Each pilot entity</td>
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<td>2. Research areas to determine if initial Schedule is complete</td>
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<td>3. Update initial Schedule (if appropriate) for each entity</td>
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<td>4. Combine (add together) Schedules of PP&amp;E</td>
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<td>5. Identify and eliminate offsetting transactions between entities</td>
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<td>74</td>
<td></td>
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<td></td>
<td>E. Prepare Consolidated Cash Flow Statement on all Entities Involved in Pilot Tests</td>
<td>Includes operating, investing, and financing sections (IPSAS 2)</td>
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<td>F. Disclose list of administered transactions as an agent for another agency</td>
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<td>76</td>
<td></td>
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<td>G. Disclose Related Parties (IPSAS 20)</td>
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<td></td>
<td></td>
<td></td>
<td>H. Disclose proportion of ownership interest in controlled entities and proportion of voting power held</td>
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<td>78</td>
<td></td>
<td></td>
<td></td>
<td>XII. Determine compliance with IPSAS 8 for each Joint Venture and correct any deficiencies that exist</td>
<td>Jointly controlled operations, assets or entities with binding agreement</td>
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</table>

### Appendix 3. Phased Implementation Plan For Cash Basis IPSAS and Transition to Accrual IPSAS

<table>
<thead>
<tr>
<th>Component</th>
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<td>80</td>
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<td></td>
<td>XII. Determine compliance with IPSAS 7 for each Associate and correct any deficiencies that exist</td>
<td>Ownership with significant influence usually over 20%</td>
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<td>81</td>
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<td></td>
<td></td>
<td>XIV. Determine compliance with IAS for each GBE and correct any deficiencies that exist</td>
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<td>XV. Implement Accrual IPSAS 1-21 for all Entities Involved in Pilot Tests</td>
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<td>83</td>
<td></td>
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<td></td>
<td>A. Identify and correct deficiencies between current practices and full accrual standards for each entity involved in the pilot tests</td>
<td></td>
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<tr>
<td>84</td>
<td></td>
<td></td>
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<td>B. Statement of Financial Position (IPSAS 1)</td>
<td>Similar to Balance Sheet</td>
<td></td>
<td></td>
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<tr>
<td>85</td>
<td></td>
<td></td>
<td></td>
<td>1. Prepare initial Statement of Financial Position for each entity involved in the pilot tests</td>
<td>Each pilot entity</td>
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<td>86</td>
<td></td>
<td></td>
<td></td>
<td>2. Research areas to determine if initial Statement is complete</td>
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<tr>
<td>87</td>
<td></td>
<td></td>
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<td>3. Update initial Statement (if appropriate) for each entity</td>
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<td>88</td>
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<td>4. Combine (add together) Statements of Financial Position</td>
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<td>5. Identify and eliminate offsetting transactions between entities</td>
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<td>6. Prepare Consolidated Statement of Financial Position on all Entities Involved in Pilot Tests</td>
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<td>C. Statement of Financial Performance (IPSAS 1)</td>
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<td>92</td>
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<td>Each pilot entity</td>
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<td>4. Combine (add together) Statements of Financial Performance</td>
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<tr>
<td>97</td>
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<td></td>
<td>6. Prepare Consolidated Statement of Financial Performance on all Entities Involved in Pilot Tests</td>
<td>Similar to Net Change in Equity</td>
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<td>D. Statement of Changes in Net Assets (IPSAS 1)</td>
<td>Similar to Net Change in Equity</td>
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<td></td>
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<tr>
<td>99</td>
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<td>Each pilot entity</td>
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<tr>
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<td>3. Update initial Statement (if appropriate) for each entity</td>
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<td>4. Combine (add together) Statements of Financial Performance</td>
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<td>103</td>
<td></td>
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<td></td>
<td>5. Identify and eliminate offsetting transactions between entities</td>
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</table>

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### Appendix 3. Phased Implementation Plan For Cash Basis IPSAS and Transition to Accrual IPSASs

<table>
<thead>
<tr>
<th>COMPONENT</th>
<th>ACTIVITY</th>
<th>TASK</th>
<th>DESCRIPTION</th>
<th>Target Completion Dates</th>
<th>Primary Project Support</th>
<th>Comments</th>
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<tr>
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<td></td>
<td>6. Prepare Consolidated Statement of Changes in Net Assets on all Entities Involved in Pilot Tests</td>
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**XVI. Prepare initial Whole of Government Financial Statements on those entities involved in the pilot tests**

<table>
<thead>
<tr>
<th>COMPONENT</th>
<th>ACTIVITY</th>
<th>TASK</th>
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<td>A. Statement of Cash Flows (IPSAS 2)</td>
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<td>1. Combine Consolidated Statements of Cash Flows from Entities Involved in Pilot Tests, Communities and GBEs</td>
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<tr>
<td></td>
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<td>114</td>
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<td>1. Combine Consolidated Statements of Financial Position from Entities Involved in Pilot Tests, Communities and GBEs</td>
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<td>2. Identify and eliminate offsetting transactions between entities</td>
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<td></td>
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<td></td>
<td>C. Statement of Financial Performance (IPSAS 1)</td>
<td></td>
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<tr>
<td></td>
<td>117</td>
<td></td>
<td>1. Combine Consolidated Statements of Financial Performance from Entities Involved in Pilot Tests, Communities and GBEs</td>
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<td></td>
<td>118</td>
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<td>2. Identify and eliminate offsetting transactions between entities</td>
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<td></td>
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<td></td>
<td>D. Statement of Changes in Net Assets (IPSAS 1)</td>
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<td></td>
<td>121</td>
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<td>2. Identify and eliminate offsetting transactions between entities</td>
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<td></td>
<td></td>
<td></td>
<td>XVII. Interact with Steering Committee to assure that initial accounting data is ready to be loaded when system is implemented</td>
<td></td>
<td>MOF</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>XVIII. Interact with Internal Auditors to assure that internal controls are effectively applied and that each government entity is operating efficiently and effectively</td>
<td></td>
<td>MOF</td>
<td>Assures that quality control procedures have been implemented by budget users</td>
</tr>
</tbody>
</table>

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### Appendix 3. Phased Implementation Plan For Cash Basis IPSAS and Transition to Accrual IPSASs

<table>
<thead>
<tr>
<th>COMPONENT</th>
<th>ACTIVITY</th>
<th>TASK</th>
<th>DESCRIPTION</th>
<th>Target Completion Dates</th>
<th>Primary Project Support</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>130</td>
<td></td>
<td></td>
<td>XIX. Interact with Supreme Audit Institution to assure that financial statements are sufficiently supported by documentation</td>
<td></td>
<td>MOF</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>XX. Start rollout to each government entity not included in the pilot tests as soon as each of Components IX through XVI above is completed</td>
<td></td>
<td>Permit an unqualified audit opinion to be expressed</td>
<td></td>
</tr>
</tbody>
</table>
1. Introduction

Many are familiar with the role and responsibilities of private sector auditors. Some may be less familiar with the work of auditors in the public sector and with the different, but related, roles of external and internal auditors.

Likewise, readers may not realize that the nature of audit differs considerably from that of inspection and control activities. These and related issues will be outlined in this paper.

2. What is audit?

Essentially, audit is a service. It is a service that provides an independent and professional assessment and report on the reliability of information prepared by one party for use by another party.

Critical aspects of this description are that the auditors are independent from those preparing the information and that the nature of the work is professional.

Being professional involves carry out work in a systematic manner using audit standards prepared by the governing profession. Being professional requires that those who qualify to be auditors must:

   a. have followed a rigorous academic program of studies and have a university degree at the bachelor’s level or higher;

   b. have gained a specified type and period of professional on-the-job experience; and then

   c. be successful in passing professional admission examinations.

This academic and professional training may involve a total time period of about six years.

Auditors carry out work and report in accordance with agreed-upon terms of reference. With a positive audit report, users are then able to rely on the information. In other words, auditors provide, and users receive, assurance and comfort from an auditor’s report. This is referred to as positive assurance.

Regarding annual financial statements of a private sector organization, audit work is designed to provide 95% assurance that there are no material misstatements in the financial statements prepared by management. Other related work of auditors at lower levels of assurance would include ‘review engagements’. Review engagements are distinguishable from audits in that the scope of a review is less than that of an audit and therefore the level of assurance provided is lower.

The audit of financial statements is fairly well understood and appreciated by the owners, creditors, tax authorities, investors and other users. However, auditors do provide assurances on other types of information. In fact, this broader perspective has contributed
to the term ‘assurance’ being used increasingly to replace the term ‘audit’.

When auditors provide a report on information prepared by others, that form of audit reporting is called ‘attestation’ – that is, auditors are attesting to certain attributes of the information. Regarding annual financial statements of an organization, auditors report on the attribute of ‘fair presentation’ in accordance with generally accepted accounting principles. The standard, one page, form of audit report is called ‘short-form reporting’.

In the absence of a report prepared by others, auditors may prepare reports themselves, and this form of reporting is referred to as ‘direct reporting’ and usually involves ‘long-form reporting’ that is non-standard.

In the public sector, the external audit office is usually called a National Audit Office, Auditor General’s Office or, as is common in former Soviet states, a Chamber of Control or Chamber of Accounts.

The head official is referred to as an Auditor General (as is the case in many commonwealth countries like England, Australia, New Zealand, and Canada), or Chairman (as is the case in Kazakhstan, Kyrgyzstan, Armenia and other neighboring countries).

Because this organization is the auditor of Government with reporting to the Parliament, it is the highest audit organization in the country and is likely to be a member of the International Organization of Supreme Audit Institutions (INTOSAI). INTOSAI has about 180 member states and it provides guidance (audit standards, methodology and training) for the various Supreme Audit Institutions (SAIs) throughout the world.

It should be noted there may be private sector audit organizations that carry out audits of the annual financial statements of some public bodies, such as the central bank and some state owned entities.

3. Types of audit

The work of public sector external and internal auditors usually involves a scope of audit that is broader than the audit of financial statements, involving these following three types of audit:

   a. **Compliance audit** which primarily involves carrying out audit work to establish whether or not laws, regulations and government policies are being complied with. It addresses the question: Are authorities being followed?

   b. **Financial audit** involves carrying out audit work to establish whether financial statements are presented fairly, and whether financial and accounting systems and controls that produce the financial statements are sound. It addresses the question: Are financial statements presented fairly and are financial systems sound?

   c. **Value-for-money, or performance, audit** involves auditing matters relating to economy, efficiency, and effectiveness. **Economy** deals with acquisition at the most economical cost. **Efficiency** deals with productivity. **Effectiveness** deals with the extent to which objectives have been met. It addresses the question: Have objectives been met in an efficient manner?

The following Figure 1 reflects the different focus of each interrelated type of audit. That is, compliance audits tend to focus on transactions, whereas financial audits focus on the financial and accounting systems (systems may be seen as collections of transactions), and value for money audits focus on programs (programs may be seen as collections of systems).

Figure 1: Types of Audit

<table>
<thead>
<tr>
<th>Value for money</th>
<th>Programs</th>
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<tbody>
<tr>
<td>Financial</td>
<td>Systems</td>
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<tr>
<td>Compliance</td>
<td>Transactions</td>
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</table>
In the public sector, it is important that auditors have the right to conduct all types of audits. It is obvious that Parliament, Government and the public could benefit from audit reports that encompass all three of these important questions that deal with issues at three different levels rather than, at present, only one level.

4. What are the differences between external and internal audit?

Three main differences between external and internal audit relate to reporting, degrees of independence and scope of work.

In the public sector, the SAI is external to government and reports to a third party, usually to the President and to Parliament. On the other hand, internal auditors are usually located within individual line ministries and report to the head or deputy head of that line ministry or agency.

While independent of the unit to be audited, internal auditors are still part of that line ministry and are hired and fired by that body, thus decreasing somewhat the independence they enjoy.

While the SAI is usually responsible for auditing all of government, internal audit is usually responsible for auditing all aspects within the individual ministry or body where they are located.

External and internal audit are similar in that they are both professional activities, governed by auditing standards and practiced by those who have followed a professional program of studies and have been successful in passing professional examinations and are members of their respective professional organizations.

The standards followed by SAIs are usually those promulgated by INTOSAI while the standards followed by internal auditors are often those promulgated by the international organization, the Institute of Internal Auditors (IIA). Both sets of standards are reconcilable with each other: The former emphasizes the audit of the government’s financial statements, while the latter emphasizes assisting management.

When internal auditors carry out their work using audit standards, then external auditors are able to reduce the work that they would otherwise have to carry out themselves. That process is referred to as ‘reliance’. The relationship between the two groups should be constructive and cooperative. Usually, where internal audit is doing a good job, external audit should be able to reduce the work they would do in that ministry or agency.

5. Why are audit standards important?

Auditing standards prescribe the basic principles and practices relating to the quality and adequacy of the work performed by auditors. They should be distinguished from the detailed rules and regulations governing audit work. Auditing standards consist of a few generalized principles, which are then supported by more detailed guidance concerning their application to specific circumstances.

Auditing standards are essential for the following reasons:

Auditing standards help to assure the quality and consistency of audit work. Auditing standards also help to strengthen the credibility of auditors.

The extent and quality of audit and reporting make a significant contribution to enhancing accountability, efficiency and effectiveness in government.
The increasing complexity of government transactions reinforce the importance of audit which, in turn, requires increased competence on the part of those carrying out audits. Auditing standards help in this respect.

Auditing standards may be used as the basis by which the work of an auditor may be evaluated. The standards then become part of the process through which the quality of audit is improved.

The audits carried out by the SAIs and those carried out by internal auditors within government institutions, should be highly supportive of each other and auditing standards are to be used by both.

Auditing standards are usually grouped into categories, such as those standards that relate to:

- the auditor (general standards);
- the conduct of the audit (fieldwork standards);
- audit reporting (reporting standards); and for internal auditors
- management and control of the audit (management and control standards).

While the standards and related guidance is quite extensive, the headings of the standards are:

- **General**
  - Independence and objectivity
  - Proficiency
  - Confidentiality

- **Fieldwork**
  - Planning
  - Supervision
  - Audit Evidence

- **Reporting**
  - Various, including reference in audit reports to the fact that these auditing standards have been followed.

- **Management and Control**
  - Quality Assurance

### 6. Why adopt a modern audit approach?

External and internal audit should both be adopting a more modern approach to their audit/assurance work.

A more modern approach would include the right to conduct all three types of audits, would involve adopting appropriate international audit standards, including a risk-based approach to audit planning. There would be more of a focus – even a changed attitude – towards identifying causes of problems rather than just identifying and reporting them. Control work tends to focus on “who” did it rather on “why” did it happen? While catching and penalizing wrongdoers has merit, it does not get at the root cause of the problem and seldom prevents its recurrence. Also, it does not help the morale of auditors or management to continually find and report the same weaknesses.

It is clearly management’s responsibility to take corrective action. However, the auditor can be more constructive by drawing conclusions on their work and, where appropriate, making recommendations regarding what needs to be done to help ensure that
reported weaknesses are not repeated in the future.

**a. Characteristics of a ‘Control’ approach.** In comparing a ‘Control’ approach used in some jurisdictions with a modern ‘Audit’ approach used in other jurisdictions, **Figure 2** sets out certain disadvantages of following a ‘Control’ approach:

**Figure 2: Disadvantages of following a ‘Control’ approach**

1. Often conclusions are not drawn and assurances not provided.
2. Tendency to focus on the past and excessive focus on transactions and process.
3. Tendency to report all weaknesses found, without separating the significant from the less significant.
4. Staff tend to be qualified as economists, lawyers, and financial experts, not auditors.
5. Tendency not to involve to any great extent the management of the entity subject to audit.
6. Approach is to identify “culprits” (who did what?) rather than “causes” (what caused the problem?).
7. Recommendations, if included in reports, tend not to deal with basic causes or solutions.
8. Work tends to be less systematic, more costly, and reports tend to have little impact.
9. Mandates tend to include administrative activities, such as imposing fines and collecting them, that are really quasi-judicial responsibilities. They are time consuming activities that distract from the basic role, and are best carried out by others.
10. Over time, nothing seems to change or improve.

In jurisdictions where a ‘control’ approach is used by an SAI, serious consideration should be given to transitioning to include a greater proportion of financial and performance audits while reducing compliance work over a reasonable period of time and as internal audit improves.

**b. Benefits of a modern ‘Audit’ approach.** The main benefit derived from adopting a modern audit approach is overcoming the disadvantages associated with the control approach. But, in addition, the following general benefits would result.

1. **Audit assists in the accountability process.** The people’s right to know and control how their taxes are spent is one of the cornerstones of democratic government. For example, in parliamentary democracies, this control is carried out on behalf of the people by their elected representatives, the Members of Parliament.

   The government of the day must obtain the permission of the Legislature before it can collect or spend money. And, after it collects and spends tax money, the government must also be able to show that it received and spent the correct amounts, in accordance with the approvals and purposes set out by the Legislature. This obligation of government to answer for its actions is called accountability.

   In the public sector whether at the government-wide level or within individual ministries, audit services are needed because of the separation of elected and other government officials from society in general. That establishes a responsibility on the part of elected representatives to report periodically to the general public on their stewardship of public resources.

2. **Audit contributes to the change and reform process.** Developing countries and transitional economies are undergoing dramatic internal reforms while, at the same time, trying to address broad issues such as social and economic programs, globalization, technological advancement, and environmental protection.

   The role of SAIs and internal auditors is particularly important in times of rapid and unrelenting change. Why is this so? Because such auditors carry out work in government bodies, they are in an ideal position to assess the degree of compliance within government of new laws, regulations and related authorities and to report on issues relating to economy, efficiency and effectiveness.

   Also, by pointing out weaknesses in existing government systems and activities, and by including recommendations for corrective action in audit reports, they serve as “catalysts for change”.

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Public sector auditors have to be aware of changes that parallel, support and even lead government changes, otherwise they may be considered to be part of the “problem” rather than as part of the solution. For example, when governments are adopting a modern accounting system based on international accounting standards, audit work should be focused on whether the new approach is implemented efficiently and as intended, and identifying areas where assistance may be required. Thus, audit offices serve to reinforce implementation of government reform measures.

3. Audit contributes to improving public sector management. Modern audit reports identify instances where laws and regulations have not been complied with, where financial systems need strengthening and, in cases where mandates permit, where value-for-money has not been achieved. Increasingly recommendations are included in audit reports on what actions need to be taken by government officials to rectify reported deficiencies and to prevent their recurrence. In that sense, such audit reports are preventative, constructive and future oriented and, over time, have the effect of improving public sector management.

4. Audit serves as a deterrent. The fact that selected government operations may be audited tends to act as a deterrent to inappropriate behavior, at least at the administrative level. It may be helpful at the higher levels as well.

While the “deterrent effect” is difficult to prove or measure, intuitively, knowing one’s work is subject to review will tend to contribute to greater care being taken.

7. Some factors to consider when establishing a new internal audit function within Government.

a. Control, internal control and internal audit

Control. Achieving control is one of the main functions of management of an organization, along with the functions of planning, and decision-making. It is an objective or ‘end’ to have the organization ‘under control’.

It is not something that an outside organization should be responsible for, since that would split and diffuse the responsibilities of management among different parties.

In some South American countries and elsewhere, governments have established separate public sector control institutions in the hope of achieving improved control. Often those hopes are not realized because of overlapping responsibilities of management and the control institutions, among other reasons. Perhaps what is needed in such situations is stronger public sector management capacity along with professional and modern independent internal audit.

Internal control. The overall system of controls within an organization has been described as “the integrated collection of control systems developed by the organization to achieve its objectives and goals”.

According to this description, the primary purpose of internal controls is to provide reasonable assurance to managers that:

- financial and operating information is accurate and reliable;
- policies, procedures, plans, laws and regulations are complied with;
- assets are safeguarded against loss and theft;
- resources are used economically and efficiently; and
- established program/operating goals and objectives will be met.

That is, management of the organization is responsible for establishing “controls” as the means to achieving the organization’s objectives and goals.
Often there is confusion between “controls” - the means, and “control” - the end. Some believe that by adding more and more controls, often in the form of detailed laws and regulations, ultimate control is improved. Often, the reverse is true. That is, the addition of more and more controls can stifle the organization to the point where it is unable to achieve its objectives. Fewer controls may be preferable. For example, in many countries, the laws establishing a government entity set out, in great detail, the organizational structure, thereby preventing management from reacting to changing circumstances in a dynamic and timely manner when considering organizational changes.

Excessive controls have the potential to become a “bottleneck” in the organization, costing it valuable time and money. Certain controls are essential, but too many controls, or controls of the wrong kind, can lead to a worse situation.

Control institutions and auditors have to be careful that they do not continuously recommend additional controls to overcome identified weaknesses. If they do so, they assume the risk of becoming part of the problem, not part of the solution.

Management of the organization should regularly review the systems of internal control to ensure that only those controls that contribute to achieving objectives are retained and that they are working properly. To assist them in this task, management often establishes an internal audit function.

**Internal audit.** Internal audit is itself an example of an internal control, and forms an important part of the overall system of internal control. As external audit is a service to third parties, internal audit is a service to management of the organization to help management to know that established controls are working as intended. Internal auditors, independent from the activities they audit, report to top management.

The International Institute of Internal Auditors (IIA) is an excellent authoritative source for further information on internal audit. The IIA defines internal audit as an:

> “Independent, objective, assurance and consulting activity designed to add value and improve an organisation’s operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”

Internal audit is a part of an organization’s internal control system and has as it main goal the assessment of all other controls. Its purpose is to assist management of the organization.

**Critical success factors.** Now that there is a better understanding of the difference between internal controls and internal audit, there are ten requirements, which if met, can lead to a successful internal audit function. These critical success factors are self-explanatory and require little discussion. They are set out in **Figure3**, below.

**Figure 3: Critical Success Factors**

- A strong clear mandate
- Support from top management
- Independence
- Access to all needed information
- Appropriate resources to do what is required
- Broad audit coverage
- Reporting to the highest levels within the organization
- Action plans to correct weaknesses
- Timely follow-up
- Value added service
While there is little debate that the above factors are important and necessary, they are insufficient to assure a successful internal audit. Other relevant actions are needed, such as:

- building strong relationships;
- strengthening professionalism (standards, audit manual, code of ethics);
- focus more on higher level, and significant, issues;
- focus more attention on results and less on process;
- adopt a more constructive attitude and approach;
- improve understandability of audit reports;
- keep current on accounting, management, and ethical issues; and
- be proud to be an internal audit professional.

c. Structure

In a number of developing countries, the role of the SAI (external auditor in the public sector) is progressing quite well. Modern legislative mandates are being adopted, the Office is being staffed, international auditing standards are being adopted, and much training is being provided, often with technical assistance being provided by donor institutions.

However, the establishment of a well-functioning internal audit capability is not as advanced and supported. That is not to say that within some individual jurisdictions there are not well-functioning internal audit units. In a number of cases, what seems to be lacking is an overall, coordinated well thought out strategy and action plan regarding internal audit.

This situation may be caused by:

- confusion (regarding the difference between external and internal audit or between internal control and internal audit);
- general lack of awareness of the benefits of establishing modern internal audit functions or lack of resources;
- struggles for power or resources between the SAI and internal audit; or simply
- uncertainty regarding a proper structure for organizing an internal audit function.

In general, there are two main approaches to establishing an internal audit function within the public sector: a centralized approach or a decentralized approach. In between these extremes there are many variations.

Essentially, a centralized approach involves establishing a central internal audit unit, perhaps within the Ministry of Finance or elsewhere. This unit would have a number of internal staff engaged in carrying out internal audits within the various ministries and agencies. The reporting would be to the head of the central internal audit unit, perhaps named a Chief Internal Auditor or Director of Internal Audit (a title suggested by the World Bank).

The Chief Internal Auditor would, in turn, report to the Minister of Finance if located within that Ministry, or maybe even to the Prime Minister’s Office or President. This central unit would play a leadership role in strengthening internal audit, through professional development and training, developing methodology, assisting with technological development, etc. etc.

In Argentina, there is a centralized approach being used, where internal audits are carried out by auditors who are members of the Office of the Controller General, and reporting is by the Controller General to the President.

A disadvantage of this approach is that there may be a reluctance for managers within ministries and agencies to provide all information needed knowing that the audit results may be reported to the President. Also, it is central management that is primarily being helped not management within the individual ministries.

The other extreme is to use a decentralized approach, whereby internal auditors are located within individual government ministries and agencies, and reporting is to the Minister or head of that organization. In this situation, each internal audit unit tends to develop independently, perhaps using different methodologies, and with different levels of knowledge and experience.
Canada tends to have a decentralized approach to internal audit, where most of the internal auditors are within individual government organizations. However, in this case, the functioning of internal audit units is well established. As well, there is a unit within a central body (Treasury Board) that provides direction.

The disadvantage here is that central management may not have information that it needs on the extent to which laws and policies are being implemented appropriately. Also, there may not be adequate consistency and professionalism among the various internal audit units.

The preponderance of practice is towards adopting, or moving towards, a decentralized approach. However, for developing countries, it is suggested that some elements of a centralized approach be considered, at least through a transitional period.

For example, while the majority of internal auditors would be located within individual line ministries and agencies, there might also be a central body with a number of internal auditors who would provide internal audit services upon request from units of government that are too small to warrant their own full-time internal audit function or where the capacity of line ministry internal auditors is weak.

This central unit would also provide leadership by developing standards and methodology, providing training, and even developing criteria for the hiring and promotion of internal auditors throughout the government. It could also carry out ‘quality assurance’ reviews to ensure a high quality of internal audit work is being carried out. In addition, it could provide an internal audit service to those line ministries and agencies that are not of sufficient size to justify establishing their own internal audit functions.

This central unit might also have access to all internal audit reports to be able to be in a position to prepare a general annual report on the status and progress of internal audit work throughout the government, identifying any general weaknesses that government as a whole should address.

Such a central unit could operate through a transitional period of, say, five years until such time as all internal units are operating efficiently and professionally. After this transitional period, the central unit could be reduced in size and power to still be able to provide internal audit services to smaller units of government.

Whichever structure is decided upon, the independence and professionalism of internal auditors should be a paramount concern. The use of audit standards, discussed earlier, contributes to professionalism as does methodology and professional development.

c. Methodology development. The ideal audit methodology would consist of material that would be fully understood and be followed by internal auditors. Should there be parts that are not well understood, auditors would feel free to ask their supervisors to explain matters to them. Any audit needs not covered at present by the methodology would be brought to the attention of the supervisor who, in turn, would inform those responsible for developing methodology so that the needed materials could be developed if justified from a cost/benefit perspective.

The goal is to make the above ideal situation a reality. Methodology can be described in a broad manner to include all written guidance designed to assist auditors in understanding their roles and responsibilities and the approved manner of carrying out such roles.

Auditors are expected to exercise judgment, and methodology is meant to guide that judgment. Methodology is not intended to replace, but rather guide, an auditor’s judgment.

Usually the types of methodology would include an Audit Manual which is one of the main methodological tools that set out roles, responsibilities, standards, etc. Such an ‘Audit Manual’ would usually include a ‘Glossary’ to ensure that auditors understood technical terms sufficiently to be able to explain them to others.

In addition to the Audit Manual, which tends to be broad, there may also be audit guidance in the form of Audit Guides which reflect the application of standards in particular audit areas (such as procurement, efficiency reviews, investigations, etc.).
To provide more direct guidance on particular topics, there may be a series of Audit Bulletins which can be prepared and distributed fairly quickly. The subject matter of such “Guides” and “Bulletins” may find their way into the Audit Manual when it is next updated and revised.

To foster active participation of auditors in methodology, consideration can be given to starting a Discussion Paper series. Auditors would, on their own, identify subjects of interest to them and write a brief paper setting out the issue, and how best the matter might be audited. The intent would be to generate the interest of other auditors, who would be encouraged to offer their own views on the paper.

Having appropriate audit methodology can produce many benefits, including:

- it requires management to think through very carefully what it wants its auditors to be doing and why;
- it serves as a communication mechanism setting out office norms, policies, and standards for auditors;
- it may also be used to communicate audit approaches to those who are subject to audit thus resulting in better understanding and improved relationships;
- it serves as a basis for measuring actual performance of auditors;
- it helps to assure that auditors are doing their work in a systematic and consistent fashion;
- auditing is a professional activity and, therefore, methodology serves as a basis for demonstrating that audit expectations and standards have been followed;
- it serves as a basis for “continuous improvement”, that is, to obtain regular feedback on what works best and then to incorporate such practices into revised methodology;
- it serves as a basis of sharing ideas and approaches with other similar audit organizations thereby gaining exchanges of methodology prepared by others; and
- it serves as a basis for professional development and training of auditors.

**d. Professional development.** An ideal professional development program for internal auditors would consist of a variety of offerings in various forms that would contribute to having knowledgeable auditors who carry out quality audits and who are well respected by others.

Such auditors would be seen as knowledgeable, both technically and with strong interpersonal skills, and their work would reflect well on them and on audit, in general. Such auditors would be confident of their abilities and proud of their internal audit work.

Professional development may be described in a broad manner to include all forms and types of training to enhance auditors’ understanding of their responsibilities and how best to fulfill them.

The phrase “professional development” is preferred over the term “training”; however both will be used. (Auditing is indeed a profession and, it is said, people are developed, animals are trained.)

Who should receive professional development? Auditors at all levels should receive some form of professional development. The nature, form, frequency of training will, of course, depend on needs and level within the internal audit organization.

Auditors at different levels have different needs. Junior auditors need to develop their technical auditing skills in carrying out audits (for example, public sector accounting concepts, auditing standards, risk analysis, audit evidence).
Audit supervisors and managers need to develop their **managerial** and interpersonal skills to properly manage auditors under their supervision (for example, supervisory skills, communication skills, project management techniques, negotiation skills, ethics).

Top audit management need to develop their **conceptual** skills for they deal with concepts, ideas and long-term planning issues (for example, strategic planning). Professional development is a building process.

All of this is to say that the professional development of internal auditors should be well thought through in advance. While auditors themselves have a responsibility to develop their own careers, employers also have a responsibility.

What can and should be done within financial constraints should be explored fully.

## 8. Conclusion

The above material has been prepared primarily for the purpose of prompting thought and discussion on matters relating to public sector audit and to encourage the adoption, over time, of a more modern audit approach.

The main ideas discussed, include:

- Audit in the public sector is important as a means of strengthening accountability.
- External audit and internal audit are both necessary, it is not a question of one or the other.
- External and internal audit are professional activities and, accordingly, professional standards should be followed.
- A modern audit approach is more beneficial that a traditional control approach, particularly if auditors are able to carry out all types of audits.
- A government should give consideration to an appropriate structure for the growth and development of the internal audit function as a whole;

If the internal audit function is to succeed professionally, responsibility should be assigned for its development, in particular with regards to methodology development and professional development.


Country Financial Accountability Assessment (CFAA), World Bank, 1 March 2004, p. 21
Written guidance is intended to include methodology in electronic form.
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