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## **ACCOUNTING SYSTEMS IN NEWLY-INDEPENDENT NATIONS**

The April 2, 1997 session of the Washington International Financial Management Forum heard a report on "Accounting Systems in Newly-Independent Nations" given by Bert T. Edwards, retired partner of Arthur Andersen LLP. Mr. Edwards was introduced to the meeting by Denise Dombay, Manager, Arthur Andersen LLP. Following is a transcript of the remarks of Mr. Edwards together with a resume of the question and response period which followed.

### Remarks of Mr. Edwards

One of the things I always like to do is recognize friends. Ali Tazi of IMF who is here today has heard me speak in Gaza at a late conference starting at six o'clock at night because you never know when you go to Gaza when you are going to get in and when you are going to get out. I have always felt that any presentation such as this should cover my grandmother's philosophy of training which is "any person who knows 'how' will always have a job, and the person who knows 'why' will be that person's boss." Most of you are bosses, but you can be even more important bosses. This is an actual presentation I will be doing in about two weeks, if the timing works out, in Viet Nam. Arthur Andersen is involved in Viet Nam on the design of an accounting system which will be tendered by the Vietnamese Government and the World Bank.

To just give you an idea, Viet Nam has 76 million people, which is a little more than twice California, and it is the tenth largest nation in the world in population. I was in Hanoi. Ho Chi Minh City, which used to be called Saigon, is 1,000 miles away. You don't realize how big Viet Nam is. If you laid it out from Delaware, the end of Viet Nam would probably hit somewhere in eastern Oklahoma stretching it out across the U.S. So Viet Nam is a very large country, rapidly going to a free enterprise economy within the constraints of the Communist party. That will be a very interesting thing. I think they have let the genie out of the bottle, and I am not sure it could ever get stuffed back in. So that's the background of Viet Nam and I will be giving a very similar presentation in Palestine, and probably most of the words will be the same. We will be talking about development of accounting in the public sector and the migration from a cash to an accrual accounting (which I call "CRAP to GAAP", CRAP being "creative regulatory accounting principles"), some comments on why the migration occurred and some experts going way back in history, the case for accrual accounting in Viet Nam (or in Montgomery County, Maryland or any other government you want to go to). Incidentally, Montgomery County is about as large as

the government of Palestine.

One of the things when you have a big government such as the Roman Empire--and sadly we don't know how the Romans controlled their empire, that is one of the tragedies in the loss of the records and knowledge in the Middle Ages was how the Romans did it--but certainly in the tax records the Romans did know how to collect taxes.

Obviously, any business has to have timely and accurate financial data. The Romans had a remarkable financial reporting system with runners coming from England and Spain into Rome with information. Modern accounting as we know it started in 1494 with the Italian monk, Fra Luca Pacioli, who developed double entry bookkeeping. Fortunately the printing press occurred at almost the same time, and this technique and knowledge quickly spread through the world and was rapidly adopted. Most people and governments have learned that they have to have accounting records if they are going to be effective.

One of the things is that, as governments started to develop, they had to finance their activities and we know that the kings of England and the kings of France went to the Rothschilds and other financiers to finance their ventures. It wasn't too long after entities like the East India Company went to the public to finance commercial ventures as the world started to shrink with international trade and commerce. Then the public got Spartan and said "we won't give you the money unless you tell us something about yourself", and borrowers began to demand information. About the middle part of the 19th century, we started to get the beginnings of general acceptance of generally accepted accounting principles or GAAP.

GAAP was somewhat neglected by standard-setters, accountants and others in the governmental sector until suddenly we had the world depression starting in the 1930's, and the U.S. SEC, England and other countries started to regulate the sales of securities and banking. By the 1960's, this had spread into many of the countries in the public sector, largely with the IMF after World War II, starting to make standardized reporting available. I am sure all of you are familiar with the IMF data book which has a tremendous amount of very useful information, but, if it is not compared on the same basis, you have apples and oranges instead of a real comparison among countries.

Many developing nations--and sadly many small businesses throughout the world--still use cash accounting, and cash accounting is not bad as long as you have no credit and no borrowing, and you are paying everything as bills come due. But, most of us realize that, in any type of operation, you quickly start getting things like leases, debt and pension plans where you get services now and pay later. Of course, this is a major problem in the public sector where you get money now and pay back the bonds over the years. So the problems with the cash basis is that bonds are payable in the future, you get the money now, pensions are payable 20, 30 or 40 years later, and services are rendered now, and you have long-lived public works, roads, schools, hospitals, etc. Peter Aliferis was telling us at lunch today that he visited in Cairo a church built in 300 and it is now nearly 2000 so that church has been around 1700 years; Peter observes that the church was well built by whoever those masons and architects were to have a church lasting that long!

So, as economists, accountants and others started looking at problems with the cash basis, accrual accounting began to develop and certainly by the start of this century it was pretty well in place in the major nations of the world. Accrual accounting records revenue when it is earned or when it is due versus when it is received--and expenditures when goods and services received versus paid. Of course, government was very quick to learn why you need to do this and that is where the concept of withholding taxes started because governments learned that people spent the money in their pay checks and didn't have any money on April 15th, so they started making the employers take it out of pay and getting it in advance.

Governments very quickly learned if you are going to have an economy with a big public sector such as the U.S., (Federal, State and local governments with about 40 percent of gross domestic product), you better make sure people are going to pay their bills, so they began to extract it from us before we even got it. But, the accrual basis deals with when the economic occurs and not when the cash changes hands and that means if you record a bond payable, the bonds are liabilities, and you record your pensions and OPEB (a new word which is beginning to show up). I know Virginia Robinson and others in the Federal government here today have been working on this--OPEB, other post employment benefits. You need to realize that, in government, OPEB is a bigger liability than pensions because instead of retiring at 65 you are going to retire maybe in your middle to late 50's, you have had good health care along the way so you are going to live ten years longer than the average. So in the government you pay health benefits to your retirees for 30 or more years whereas in the private sector you retire at 65 and, let's say pass away at 72, you only pay those benefits for seven years. If you take a typical government and quantify the OPEB liabilities for life insurance and health care, they are a bigger liability than pensions. GASB is just beginning to focus on this. Those of you who are shareholders in companies here in the United States know that FASB required private companies to deal with OPEB a couple of years ago and many companies have wiped out more than half of their net worth--this unreported liability for services rendered but not paid for because people are going to get it years down the road. And then long-life assets of course you record them and write them off over their life if you can determine what that life is.

The 1960's were a day of reckoning for governments, the late 1960's and the early 1970's and, certainly in this country in 1976, when New York City essentially became insolvent, we learned that governments could, indeed, go bankrupt. And this triggered a major confidence in crisis government as a result. At the time New York City went bankrupt I would say less than five states in the United States were audited, none of the 50 largest cities were audited. That is all water over the dam because Federal legislation involving Federal funds coming into state and local governments--the Federal Single Audit Act was passed and all governments in the United States of any size are now audited. The Canadians have been audited for years, there are many national governments that have been audited. I note that there are GAO people here today. This is the year--fiscal year 1997 that we are now in--and whoever the new Comptroller General may be, he or she will give an opinion on the U.S. Government financials for 1997. New York City was certainly the "wake-up call" in this country that governments had to get organized and organized they did get. Nations began accrual basis financial statements. The U.K. and New Zealand have been the leaders in this, the U.S., Canada and some of the European countries. Then interestingly many of the countries began to require their political subdivisions to follow GAAP accounting and

that's basically one of the projects that I have been working on in Palestine--a uniform accounting system for roughly 30 municipalities--because if you take a new nation and there is no confidence in their numbers they are at ground zero in terms of trying to borrow money for electric utilities, water and sewer and other health care facilities. In many

nations now probably their political subdivisions are closer to GAAP accounting than maybe the sponsoring government is itself.

Taking a look at what people say about governmental accounting, the unanimous consensus of all of the quotes we will be going through is that you need accrual accounting--GAAP, you need simple, understandable financial statements, and they have to be timely. Justice delayed is justice denied in the legal profession, and we have the same in the accounting profession. There is certainly a major trend toward audits being done and certainly once the U.S. gets its audit report out, which is due March 31, 1998, if you can get it done in the U.S., you can get it done anywhere. I used to say, if you land a spaceship ten feet from where it is supposed to come down on the moon, we can figure out the debits and credits. The technology isn't that complicated.

Thomas Jefferson, our third president, in 1802 wanted the records of government to be "as clear as a merchant's ledgers". He made this speech in 1802 and sometime in the next 12 months we are going to get there with respect to the United States. So, this wish of the Chief Executive, certainly one of our great presidents, if you are a student of American history, it took nearly 200 years for his desire of having governmental accountability to get accomplished. We have a law that was passed unanimously a year or two ago and the Comptroller General will issue an opinion on audited financial statements in the U.S. for the year ended September 30, 1997, on or before March 31, 1998. I can tell you that will happen because there is a vacancy in the office of the Comptroller General and I don't think we will get a new candidate confirmed unless he or she is going to buy into what was passed unanimously by Congress. Whoever is going to be considered for that job is going to have to make that law happen.

Thomas Jefferson said "I think as an object of great importance...to simplify our system of finances, and to bring it within the comprehension of every member of Congress...the whole system (has been) involved in impenetrable fog. (T)here is a point...on which I should wish to keep my eye...a simplification of the form of accounts...so as to bring everything to a single center(;) we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently control them."

I was privileged ten years or so ago to be involved with the Auditor General of Canada and the Comptroller General of the United States in a joint Federal Government Reporting Study. Following are some quotes out of the report issued by Ken Dye, who was then the Canadian Auditor General, and Chuck Bowsher who was then the U.S. Comptroller General. "An issue often debated in government account is whether governments should report on a full accrual basis. Only full accrual provides a measure of the full cost of government operations."..."Almost all users wanted accrual accounting for the basic reporting of assets and liabilities and revenues and expenses, as discussed in the previous sections on recognition of physical assets, actuarial

liabilities for employee pensions, accrual of tax revenue, and measures of deficit." This was a massive study of users in both Canada and the United States. So that's a more recent thorough conclusion, and if you don't have that report, you can still get it from the GAO. It's an excellent report and I know that it is in the FASAB library because Virginia Robinson (who is here today) and I worked on an Association of Government Accountants project and we put it in the FASAB library. This was issued on March 21, 1986.

GASB, which deals with the 82,000 units of local government in the United States, says, "The accrual basis is the superior method of accounting for the economic resources of any organization. It results in accounting measurements based on the substance of transactions and events, rather than merely when cash is received or disbursed, and thus enhances their relevance, neutrality, timeliness, completeness, and comparability." And that goes back to the predecessor of GASB in 1979, so that is going on 20 years old.

International Accounting Standards Committee is a group based in London. There are about 50 countries now that work with the IASC. I took this quote out of the handbook that Professors Harry J. Epstein and Abbas Ali Mirza put together. "Most developing nations do not have their own national accounting standards. The generally accepted accounting principles (GAAP) that they follow are either the UK, US, or international standards. In certain countries, governments and central banks have made the IAS mandatory. Rather than reinventing the wheel, international 'due process,' seems to be a step in the right direction, as it will help the process of uniformity in international financial reporting." There are about 32 current IASC standards, so here are world renowned experts on international accounting endorsing GAAP accounting.

I was privileged to co-author two studies that my firm, Arthur Andersen, has done. One which we did in 1975 which led to Treasury publication and another we did in 1986 led to the conclusion that, in the United States, if you have to use accrual accounting and you should use performance measures which we now have in the Government Performance and Results Act. In 1970, the U.S. Congress passed a law requiring overall CFOs and agency CFOs. That was done by the CFO Act which was enacted during the Bush Administration.

You all have an annual report for the U.S. for 1995 that we haven't gotten to. I should point out that the press run of this report was about 2,000 copies and about 40 people in this room received it. So a significant percentage of all the reports that the U.S. printed are resident with people who are here today. We will talk about what's in this report because it stuns me. I bought about 800 of the 2,000 "Consolidated Financial Statements", and I give them to what I call the FBI--friends, brothers and insiders. But this report that Arthur Andersen did resulted in the 20 plus years of the CFS's. If you want to get trial historical CFS's, they are also in the FASAB library, and you can see how they have developed over the years. The two Arthur Andersen reports are "Sound Financial Reporting in the Public Sector" issued in 1975 and "Sound Financial Reporting in the U.S. Government" issued in 1986.

One of the things interestingly in Viet Nam is that they have committed themselves to a free economy--at least we think it is going to be a free economy. They recently had their first Congress and it is very important because donor nations are standing around to assist this country. This is a very interesting country. Unlike most Asian countries the one thing the Vietnamese took from

the westerners, from the Spanish and then the French, was a Latin alphabet so their children learned 26 letters whereas the Japanese, Chinese and Korean youngsters learn 100,000 characters, and so Viet Nam has about 98% literacy by the age of eight which is actually better than the U.S. So this is a very vibrant economy just waiting to burst its seams.

The Asian Development Bank has committed itself to a computerized debt management system. This is sort of in line with your speaker next month who is going to talk about debt. The European Commission is installing corporate accounting in the state-owned enterprises--you have got to remember that in Viet Nam until very recently everything was state owned--you had one entity owning the entire productive assets of the country. France has been working on treasury accounting and internal auditing in treasury, Germany has been working on audits of national agencies and in budget management. Sweden has developed a tax system, the World Bank, IDA and UNDP are working on state-owned enterprise monitoring, and the World Bank has a very major proposed loan in process. When I left Viet Nam, the donor nations had just finished their three-day meeting in Hanoi and the pledges from the donor nations came in about 10% higher than the government thought they would. You can see the international interest in making this economy work. Based on what I saw the little street-side enterprises, the Vietnamese will have an economy in five years that will be the "new tiger". Some of the other Asian countries are going to start fading because of the productivity and the enthusiasm of the Vietnamese people and the tremendous degree of literacy which of course is very important.

Here are some of the quotes in the Vietnamese resolution which was passed in 1993. These were just taken out of a hundred or so of them. "We want to meet the basic information demands of public management." They want "to circulate...the essential information in the case of a market oriented economy." And this sounds like it could be United States legislation. "The implementation of government financial management information projects are considered...most important tasks in the economy." "These projects...(will provide)...information in an accurate and timely basis...(for)...decision-making and management..." This is from Resolution 49/CP, but these are right out of what would be the mission statement of the government with respect to financial management. So the Vietnamese have certainly got the right words in there.

This Resolution 49/CP committed Viet Nam to developing and using "Best Practice" in internal financial information--and for reporting that for external purposes. "Best Practice" is obviously accrual accounting and this project, and Arthur Andersen's recommendation was that Viet Nam use accrual accounting. The reason is if you are going to have changed management, why mechanize CRAP? If the people are going to change the procedures they might as well change to be in step with the rest of the world as opposed to going through this crisis twice. I was personally involved in the conversion of New York State. In fifteen months New York State went from cash to accrual accounting. New York State's general fund is about \$40 billion so New York State would be one of the largest companies on the New York Stock Exchange if you just took its general fund revenues. Thus, I know you can do the changed management and get the procedures in--and, if you are going to do it, you might as well do it right the first time because all of us who work in this area know "there is never time to do it right, but there is always enough time to do it over again"! That is the bane of accounting and financial management projects--so what we want to do is to get this thing right from the opening shot and so far we have the top levels of the government committed to it.

Let's now look at the 1995 U.S. prototype "Consolidated Financial Statements".

I just want to call your attention to the fact that there has been a lot of talk about eliminating one of the agencies of the U.S. Government--Commerce. If you eliminate Commerce, Commerce spends the total of about \$4.7 billion...and the deficit was \$310 billion. If you want to eliminate Commerce to save money or to balance the budget you better be ready to talk about 70 agencies of similar size! Since all of you are financially oriented, DHHS itself--that's mostly Medicare, Medicaid and Social Security--if you wanted to save \$4.7 billion do you think it would be easier to save 1.5% of DHHS' numbers or 100% of the Department of Commerce? And also since half of Commerce is the Bureau of the Census and our Constitution says that we have to count the noses every ten years, Congress is going to have to move Census into some other organization. Therefore, you are not going to save the \$4.7 billion. And if the 1995 CFS was available to Members of our own Congress, they wouldn't be focusing on eliminating Commerce. Commerce is simply insignificant. Congress ought to be talking about agencies with three-digit numbers (\$100 billion +)--Defense, and Health and Human Services. You will notice that Defense is going down. Defense is taking a haircut. There was a reduction from 1994 to 1995. Interest on the national debt, sadly, is up and it may be going up even more so with the debt increases we have had in the last year. Social Security is going up. Social Security increased in one year more than the entire budget of half of our Cabinet departments! If you are going to do something about the deficit, you will come up with logical ideas instead of eliminating the Commerce Department. It simply doesn't make sense.

#### Question and Response Period

Ali Tazi of the International Monetary Fund observed that the IMF has been very active in Viet Nam in the budget and treasury area and has worked very closely with that government and the German Technological Aid Agency, and currently IMF has a budget expert there and has been doing this for the last three or four years. He said he had personally visited Viet Nam within the past six weeks and gave seminars on the government's budget in both Hanoi and in the south.

Virginia Robinson, formerly with JFMIP, asked the speaker if he could give more information about the 32 international accounting standards and wondered if they were sufficient or whether they needed additional ones. Mr. Edwards responded that he thought that there are some nations which had some unique kinds of accounting that you don't normally see. Even here in the United States you have a question about how to value nuclear weapons which we are about to destroy. As we speak today, we are destroying weapons in Utah to the glee of the Russians, the Kazachs and the Ukrainians who are watching this go on. How do you value the Continental Shelf? So governments do have problems, but when you go into a city like Nablus in Palestine, that city was incorporated sometime like 1,000 B.C. so the city has been there for something like 3,000 years and the nation of Palestine has been there for a little over one year. You have a real problem in that Nablus has had 1,000 years of the Romans, they had the Turks there for a long time, the 30-year British occupation, and the Israelis for 25 years. The citizens of Nablus have always gotten by with "cheating the boss" and they have been doing it for 3,000 years. I keep trying to tell the Nablus officials that they are the "boss" now and they have to get financially organized and

produce financial statements.

Each country has unique issues, but certainly the international standards in governmental accounting for pension accounting and OPEB is going to be the "blockbuster" because a lot of countries have failed simply because they have used all of their credit. In Czechoslovakia when the communists went home one night and a playwright suddenly became the President--the velvet revolution--no shot was fired, none was necessary. There was nothing to fight over. There was no value left in the country, and people only shoot when they think there is some value. So the problem with bad accounting is if you don't inform the people where they are headed, they don't know what road map to take out--if you don't know where you are going, any road will get you there! What we are trying to do in these various areas, including the United States, if you don't have an informed citizenry, then voting doesn't make any difference. It is whoever saw the five-second spot on TV, they rush out and vote for him. I don't think there is a single person who can stand in front of this hotel who would know how insignificant Commerce is for the totality of the U.S. Government and yet that is the headline day after day in the Washington Post--"let's get rid of the Department of Commerce."

And then when you look at what they do there are some things that can't be gotten rid of like the Census. Somebody else wants to get rid of Education. That's \$30 billion. That's less than the rise in Social Security in one year. And then try to cut Social Security, the third rail of American politics, and probably in Canada, Australia and everywhere else. You are dead! So I can say this--I do not look forward to collecting the Social Security benefits when I get to 62 or 65 that are in existence today. That's a myth. We are going to have to reduce Social Security benefits because the unfunded liability is one-third of the private assets of this nation. In other words, if you want to give Social Security to an insurance company, you would have to have a one-time wealth tax and take one-third of what everybody owns. Nobody looks at these problems on the basis of what I would say normal analysis. The unfunded Social Security liability is about \$8 trillion which is much more than the national debt. Total private wealth from the latest report from OMB is \$23.5 trillion. That's why it would take a one-third wealth tax to make Social Security fully funded on a break-even basis. That isn't going to happen. Does anyone here want to pay a one-third wealth tax this year? Are you going to vote for that person?

But one of the sad things is that, as you look over the years in the U.S., discretionary spending continues to get squeezed and nondiscretionary spending--interest on the national debt, Medicare, Medicaid and Social Security--continue to grow. The Kerry-Danforth Commission on Entitlements concluded that, at about 2010, there is no discretionary spending left. Then what do you do? Are you going to wait for the ship to hit iceberg then or are you going to start to do something now? This is not unique to the United States.

Peter Burgess of the World Bank observed that the speaker had presented a very persuasive case for full accounting. You have said it might be a universal model. I would like to consider some facts which may or may not be true. First, many of them have accounts which have not been filed or published for several years or at least the very latest presented. Many of them have untrained accountants and financial staff who find it difficult to operate a cash system let alone an accrual system. They have focused on media specialists who do not understand accrual

accounting. So what I am trying to ask is to what extent would the model which is so persuasive be adaptable to these countries? Why is accrual accounting for this country which has known about it for so long been long in getting here?

Mr. Edwards responded that he thought a lot of the blame goes to the press. Why doesn't the Wall Street Journal run an article when the "Consolidated Financial Statement" report comes out? You know when the State of Maryland issues its audit report, which is the biggest economic entity in the State of Maryland, you don't even see it in the Baltimore Sun. When Virginia issues its report, its not in the Richmond newspapers. And when they do cover it, the political writers cover it instead of the business writers. That's one of the real problems. You have an uninformed citizenry and so they are wandering around with what I would call fairly minuscule issues because those are the things that get publicized. You can't build Rome in a day, you've got to start, but if you are going to spend--in Viet Nam you probably have got 60 provinces, 600 districts and if you are going to have one accounting system for all of them, if you are going to spend billions of dollars, you might as well do it right rather than have a mechanized mess and have to go through this crisis all over again. Mr. Dean agreed. Mr. Edwards said you have made some compromises in some cases. There is no question about it.

The United States accounts for Social Security as a welfare program. And there are Social Security participants in this room who believe they have benefits. The term is if it is a welfare program they should call it a "social security welfare". But when middle class people in this country get things--like veterans, students and retirees--they are called social security benefits, veterans benefits, and student financial aid. When a poor person gets something it is called welfare. Economically it is the same thing. They get "something for nothing", so the whole problem is how the way the things are presented to the public. You are absolutely right. They hear their leaders say things, and if they have a press, either TV or print, they see things there, but their writers are uneducated. In this country it took Pearl Harbor for us to understand that we had a problem in Asia and within 24 hours everybody learned that we had a problem there and it took us five years to get out of that mess. So I am not saying there is a "quick and dirty" answer, but the thing is if you accept compromise, then you ought to say we are going to have a "player to be named later" and we are going to cover that problem. Most of the State and local governments in this country said that fixed assets could not be stolen so we are going to put that last on the agenda and get the rest of the stuff done. The Governmental Accounting Standards Board is just now, as we are speaking, getting around to telling governments that you have to report your streets and highways. That's a standard that is going to come out this year. And yet, that's the single biggest asset the governments have. So it takes a while. You are absolutely right. But if the opportunity in developing nations is if you are going to mechanize things and put big money into systems and hardware and training you might as well train people on something that will last for a period of time and make the country viable in a competitive world. I don't know if that is the answer, but I think it can be done. I have certainly seen it done in state governments. The District of Columbia government had nothing when they were "spun out" of the Federal Government and, in two years, it had audited statements.

Forum Coordinator Ray Einhorn asked what got them to that state. Mr. Edwards replied that there are a number of people working on that. I have a proposal that President Clinton has bought

into to take the pension plans back and that is one is that I proposed to the Senate in 1976 so it has taken 21 years! In totality of time that is a short period, but for others it is a lifetime. So I don't know. However, it is certain that Washington, a hundred years from now will be the capital city of the greatest nation of the world.

ICGFM President Jim Hamilton of the International Monetary Fund said he thought the speaker had hit on the key point on how the populous is uninformed and that it had hit on him during the last election that a lot of the public debate between the two candidates focused on very marginal issues like education which we know is a very small part of our national budget, yet it got a big play in the press. The CFS document which Mr. Edwards had referred to was on the FinanceNet.

Darrell Verner, a private consultant, inquired whether that report was a product of the FAX system. Mr. Edwards responded that there are about 5,000 reporting units sending them in electronically. Some entire departments are audited such as the VA, HUD, and Social Security so it is a combination of entire agencies and pieces of agencies reporting on the standardized reporting forms. There are a lot of people involved in this closing, but the main thing is it has to squeeze down from a year into six months. That will cause financial people in Federal agencies to be like ITT. If you don't send your report in on time there are only two reasons: you are in the hospital or you are under the ground dead. Because that is what will happen to you if you don't send it in on time! The one great thing about the auditing that GAO is doing is it is going to force people to do their job. This audit process is going to put the discipline in the system and tremendous results are going to be achieved from this.