

The International Consortium on
Governmental Financial Management

Public Fund Digest

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International Consortium on Governmental Financial Management

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

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

1. Providing, on an international scale, comprehensive professional development activities in the fields of accounting, auditing, budgeting, information systems, cash management, debt administration, and financial management;
2. Contributing to the advancement of government financial management principles and standards, and through educational events, promoting appropriate utilization of government financial methods and techniques to improve management control and accountability to the public;
3. Researching, disseminating, and promoting to its members and to the public throughout the world, knowledge and information concerning government financial management;
4. Promoting the observance of professional standards in the accomplishment of government financial management activities;
5. Sponsoring meetings worldwide in order to educate members and others as to the practice of government financial management as it exists throughout the world; and
6. Bringing together government financial managers from all countries to share information and experiences in government financial management and promoting professional development activities in government financial management.

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

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

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International Consortium on Governmental Financial Management General Information

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

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

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

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

- 1. Sustaining Members:** organizations promoting professional development, training, research or technical assistance in financial management; willing to assume responsibility for and to actively participate in the affairs of the Consortium. Each Sustaining Member has a seat on the ICGFM’s Board of Directors and receives 10 copies of all ICGFM publications to be distributed within their organization. (Dues: \$1,000)
- 2. Organization Members:** government entities with financial management responsibilities, educational institutions, firms, regional and governmental organizations, and other professional associations. Six organization members serve on the ICGFM’s Board of Directors and organization members receive 5 copies of publications to be distributed to their members. (Dues: \$250/\$125*)
- 3. Individual Members:** persons interested in or dedicated to activities directly related to financial management and who wish to be members in their own right. Six members of the ICGFM Board of Directors will be selected from among all individual members. Each individual member will receive a copy of all ICGFM publications. (Dues: \$100/\$50*)

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

Foreword

It is always an exciting time when I collect the information for each issue of the *Public Fund Digest*. There is so much excellent work being done by the government financial managers throughout the world. Yet, many are so overwhelmed by their tasks that they do not have the time to put their experiences on paper so that others can benefit from those experiences. We are fortunate in this issue to have three excellent case studies. The first deals with the experiences of putting an integrated information system in a regional government. The second explains the actions taken to implement good financial management practices in a governmental agency. And the third identifies the efforts toward accounting reform for a European country. Each provides excellent insight into their operations and the authors are to be complemented on their efforts to further knowledge in their areas of expertise.

Since it is difficult to have good financial management practices without good accounting procedures, I have included three articles on accounting issues. The first deals with a plan to implement International Public Sector Accounting Standards in developing countries and countries in transition. The next explains the meaning of intergenerational equity. And the third provides a requirements model for successful implementation of accrual accounting. Hopefully, these articles will assist those that are involved in making the transition to accrual accounting.

The world continues to be in turmoil in the fight against corrupt activities and terrorism. A Financial Action Task Force has pulled together some excellent recommendations that assist in combating corruption and terrorism financing. Implementation of these recommendations will, hopefully, lessen the tensions throughout the world and contribute to a more peaceful future.

A prior author (Artemenko Maksym) has co-authored a book titled "Investing Management in Municipalities." The authors present the theoretical basics of the management of investing as well as practical aspects of its application to municipal project assessment and implementation. The practical employment of computer software in the decision-making process is stressed as well as how to find funds needed for the implementation of projects. Although the book is written in Ukrainian, Professor Artemenko has graciously agreed to respond to inquiries in English at his email address: *max_art@ukr.net*.

Following this Foreword, I have also included some references that you might find beneficial in your work. As always, we invite your comments on these papers and any issue of the *Public Fund Digest*. Contact us by telephone, facsimile, or on the Internet at *www.icgfm.org*.

Jesse W. Hughes
Publications Editor

Relmond Van Daniker
President

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100. Recommendations to Combat Money Laundering and Terrorism Financing

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Some Reference Material

(email – jhughes@odu.edu)

2003 book on *Reforming Government Accounting and Budgeting in Europe*, edited by Klaus Luder and Rowan Jones published by Fachverlag Moderne Wirtschaft, Frankfurt, Germany:

3 countries (Finland, Spain, & Sweden) have completed the move to full accrual.

1 country (UK) has essentially completed the move to full accrual except no whole-of-government financial statements are yet in place.

2 countries (France & Switzerland) have begun the reform process

3 countries (Germany, Italy, & the Netherlands) have not yet begun the reform process

2002 summary of five African countries on Budget Transparency and Participation in the Budget Process (www.internationalbudget.org/resources/africalaunch.htm).

	Participation	Legal	Transparency
South Africa	good	moderate	moderate
Ghana	moderate	weak	weak
Kenya	moderate	weak	weak
Nigeria	weak	weak	weak
Zambia	weak	weak	weak

OECD / World Bank 2003 Survey of Current Budgetary Practices for 30 OECD countries and 30 non-OECD countries (ocde.dyndns.org)

Treasury Reference Model in 2001 by Ali Hashim (World Bank) and Bill Allan (IMF) – www1.worldbank.org/publicsector/pe/trmodel.htm

IMF Code of Good Practice on Fiscal Transparency – (www.imf.org/external/np/fad/trans/index.htm)

GFOA (US) Best Practices in Public Budgeting with 4 principles and 12 elements (www.gfoa.org/services/nacslb/budgetmenu.htm)

UNDP Key Factors in Budget Preparation Process (magnet.undp.org/Docs/efa/CONTAC~1.htm)

World Bank Country Financial Accountability Assessment (www1.worldbank.org/publicsector/cfaa.htm)

OECD Best Practices for Budget Transparency (www.oecd.org)

Information Systems for Government Fiscal Management by Ali Hashim & Bill Allan, The World Bank, 1999

The Government Finance Statistics Manual, 2001 (IMF)
(www.imf.org/external/pubs/ft/gfs/manual/index.htm)

International Federation of Accountants (www.ifac.org) where International Public Sector Accounting Standards and studies can be downloaded free.

International Consortium of Government Financial Managers (www.icgfm.org) for case studies published in the *Public Fund Digest* and announcement of conferences.

Implementation of SAP at the Greater Wellington Regional Council

By Nigel Hutt
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Nigel Hutt is the Manager, FIS & Special Projects at the Greater Wellington Regional Council, a position he has held since 1998. Previously he was Finance Manager and earlier the Chief Accountant at the Council.

Prior to joining the GWRC, Nigel had been a senior financial accountant for several commercial organisations based in the service industries.

Nigel is a commerce graduate from Victoria University of Wellington, and a member of the Institute of Chartered Accountants of New Zealand.

1. Introduction

In 1998 the Greater Wellington Regional Council (GWRC) undertook a review of its Financial Information Systems (FIS), culminating in the selection of SAP as the Council's preferred FIS solution.

Greater Wellington Regional Council helps manage and monitor the natural environment, and is also responsible for the provision of public transport services and water supply. It employs around 380 fulltime staff and has annual expenditures of NZ\$ 114 million p.a. The Council is a "medium sized" organisation in New Zealand terms.

This paper provides an overview of the process that GWRC followed in developing our FIS Strategy, selecting the SAP financial applications and our experiences with SAP since that time.

2. Financial Information Systems Strategy

The selection process began in 1998 with a "current state assessment" of the legacy financial systems that were then in place. The next step was the development of a detailed user requirements document, leading to a gap analysis that concluded the replacement of the legacy systems was warranted. From the information gathered, an overall FIS Strategy was developed that defined the goals and objectives of the FIS having regard to:

- the strategic direction of the GWRC
- the organisation's structure and management reporting framework
- the desire to implement "good practice" and sound financial information system principles
- the scope of the FIS and its relationship to other management information systems
- future state requirements and the ability to realise improvement opportunities and,
- the potential impacts on operational areas

The FIS Strategy represents the long-term vision and direction for the Council's FIS.

FINANCIAL INFORMATION SYSTEMS STRATEGIC VISION

- Maximise the achievement of the Council's business objectives by aligning the Financial Information Systems with the decentralised management structure and reporting processes, while maintaining a strong central control. This involves the provision of a comprehensive suite of interrelated information systems.
- Provide easy access to information in the most appropriate form at all levels of the Council, and allow information to be readily analysed in a variety of ways.
- Maintain the integrity of the FIS by minimising the number of reconciliation points between systems and have well defined interface standards.
- Provide systems that can cater for future organisational changes which may cause the activities of the Council to expand or contract, without placing the Council at risk.
- Optimise opportunities that are provided by modern systems and technologies to achieve system enabled process efficiencies.

Strategies for achieving the FIS vision statements were identified as a result of the gap analysis and recognised certain improvement opportunities. These are:

FIS STRATEGIES

- Provision of highly integrated financial applications
- Provision of flexible reporting tools
- Automation of processes using technology
- Implementation of best of breed software packages for specialist functions
- Promotion of entry of data directly into the FIS
- Development of FIS training programme
- Selection of FIS with localised software support & proven success in New Zealand
- Development of FIS interface standards

2.1 Strategic Vision Statement for FIS

The Financial Information Systems should directly support the GWRC's organisational goals and strategic priorities as stated in the Long Term Council Community Plan (LTCCP).

The provision of financial information is an essential part of the Council's decision making process, in both monitoring current performance against plans and budgets, and forecasting the financial consequences of any business decisions impacting the future. The information should be easily obtained, timely, accurate and reliable so that Council and management can be confident in the source data on which decisions are based.

Our FIS vision is to have a modern, reliable and robust financial system that is easy to use and allows managers and staff to easily interact with the system from the desktop. The FIS should support the reporting processes within the Council, such as the Quarterly Management Reviews, Annual Report and

Annual Plan, and should enable the presentation of information utilising modern styles and graphical reporting techniques. The corporate FIS should capture the relevant detail required by staff to monitor and report on their activities and avoid the need for the majority of existing “off-line” systems. Budgets should be entered once and captured within a common system that interfaces with the ledgers to facilitate information sharing. Coding protocols and the structure of the chart of accounts should be common across the corporate FIS system and the FIS should provide gateways and open interface standards for sharing data with other computer systems within the Council.

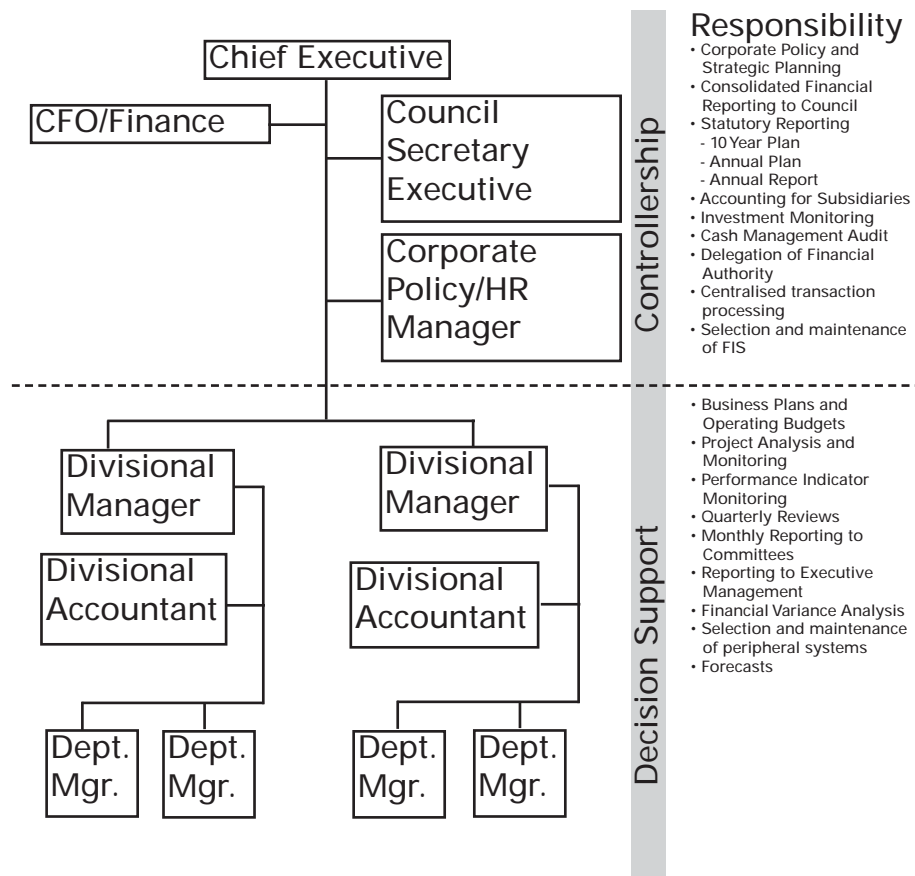
The management reporting process has to be effective in monitoring progress against the organisational objectives defined in the strategic plan. However, there needs to be sufficient “corporate glue” to maintain the integrated nature of the Council, and to promote responsible management and corporate consistency.

The Council’s FIS should support the overall outcomes pursued by the Council and its success will be reflected in the results of the operating activities through efficient and effective decision-making.

2.2 Organisation Structure and Reporting Framework

The functional areas of the Council are organised into Divisions with a relatively high degree of autonomy and delegation. Employees are empowered to make decisions within the bounds of the overall operational and financial parameters established through the business planning process. The management structure parallels the political structure to ensure a consistency between service delivery and elected members’ responsibilities for outcomes.

The decentralised management structure of the GWRC is illustrated below. The FIS needs to support the management control and reporting framework of this organisational structure.



2.3 Financial Information Systems Principles

The financial systems implemented by the GWRC must be consistently aligned with the organisation's FIS principles. These are as follows:

1. The financial systems must be "business driven" and must not be determined or constrained by the GWRC's current information technology systems and platforms.
2. "Data Integrity" must be the cornerstone of any financial systems. The Council must have absolute confidence that the data provided by the financial systems is complete and accurate. Core financial information provided for all levels of reporting must be sourced from one database and should be easily auditable. There should be "one version of the truth" with the validity of data backed up by good accounting practice and internal control procedures.

3. Local Government in New Zealand is a product of Central Government and the powers and functions of the Greater Wellington Regional Council can be amended at any time. As such the GWRC's systems must be able to cater for the impact of influences that may either expand or contract the activities that the GWRC is involved in. The Council itself has initiated internal reorganisations that have altered the shape and structure of the organisation. For example, it is possible that Water Supply could be separated from the core Council activities through the creation of a subsidiary company. The ability to "unplug" business activities that are currently encompassed within the GWRC, from the corporate financial systems is a key requirement of the financial systems.

4. Interface standards and interconnectivity standards of the corporate FIS with peripheral or "satellite" systems must be governed by the principle of never compromising the integrity of the whole. Levels of integration vs interconnectivity will be based upon the degree of financial integrity required in each system.
5. As a general principle financial information will be sourced from the corporate FIS. The corporate financial system will be the system against which GWRC managers and organisational units will be held accountable. Where subsidiary or peripheral systems, such as asset management, consent processing and rating systems, interact with the corporate systems it will be the responsibility of the subsidiary system owner to ensure that any financial data is reconciled and is auditable.
6. "Keep it simple" is a basic principle of the FIS system. Reliability and trustworthiness of the systems is of key consideration. The GWRC will only consider systems that are proven in the New Zealand corporate environment and where the vendor can provide strong local service support. The desired system should be uncomplicated in terms of user friendliness and ongoing systems maintenance. Preferably, systems will be "mainstream" and the suppliers of any potential system must be able to demonstrate an existing base of domestic users.

2.4 Financial Information Systems Assumptions

The following assumptions have been made in respect of the future role of FIS within the GWRC.

1. The FIS will be provided from a centralised Corporate System managed by the Finance Department. There will be a single financial database from which management reports are generated. Core financial data (accounts receivable, accounts payable, resource costing, cash and accrual transactions) will be captured on a common accounting system in order to produce consolidated reporting across all the Council's functions.

Separate financial systems will not be utilised elsewhere within the Council. The need for corporate financial reporting and the critical requirement to maintain the accounting system's integrity means that devolving of some FIS functions into the Divisions is not likely to be effective. In addition it is felt that the cost of replicating staff, systems and computing resources makes devolution a more expensive alternative.

2. Divisions/ departments shall be free to choose the most appropriate "best of breed" applications, outside of the corporate FIS, that they need to carry out their responsibilities. The Financial Information Systems will dictate the interface standards for all peripheral systems.
3. Responsibility for the corporate FIS applications will continue to reside with the GWRC corporate departments. This includes the following activities:
 - Selection, implementation and development of FIS applications;
 - Provision of FIS training; and
 - Provision of functional and technical support.

2.5 Financial Information Systems Scope

The Financial Information Systems scope covers the processes and systems that support the Council's financial transaction processing and decision support operations. These are illustrated in the diagram below.

* "Consents" are permits issued to people that govern their activities that might impact upon natural features or resources, e.g. discharges to air, building near streams and waterways.

2.6 Financial Information Systems Applications

Through investigating the users' needs and taking into consideration what commercial financial information systems normally provide, we have identified that the FIS should incorporate the following applications:

- Job/Project Costing
- Purchasing
- Accounts Payable
- Accounts Receivable/ Invoicing
- General Ledger
- Resource (activity) costing
- Fixed Asset Register
- Financial Reporting - Executive Level
- Financial Reporting - Operational Level
- Budgeting
- Human Resources
- Payroll

These financial processes are typically provided for in any standard financial information system. Systems which deal with property management, asset management, consents management, treasury and other such processes typically tend to require a higher degree of specialisation and as such are not often incorporated within the functionality of a financial system. Often organisations seek "best of breed" packages to meet these needs and concentrate on developing integration or interfacing capabilities, as appropriate, with their financial information systems. This approach is preferable to implementing one system which covers all processes, as often financial and/or specialist functionality is compromised in order to find one solution that fits all. This has been the basis for defining which financial processes fall within the scope of the Financial Information Systems.

2.7 Best of Breed "Point" Solutions

Although the need for tightly integrated systems is important in the consideration of any replacement system, it is widely recognised that the trade off for full integration is often a lack of functionality. For example, it would be exceedingly difficult to find a totally integrated package that satisfies the required level of functionality for financials, asset management, project management and consents processing. It is more likely that these requirements would be satisfied by a highly integrated financial application, which had the ability to interface with other specialist systems, such as those previously mentioned. The functionality required of specialised systems should not be compromised for pre-delivered integration with financial systems.

Best of breed packages are anticipated for all processes that fall outside the FIS scope and include:

- Rates Collection
- Works Order & Billing Management
- Treasury Management
- Property Management

- Asset Management
- Consents Management

3. The selection and implementation of the SAP Financial Applications

Several systems were identified as having the potential to meet our requirements. These included software products targeted at medium sized businesses, as well as some larger ERP systems. Following an initial vetting process, a shortlist of vendors was asked to pilot their systems in a detailed “proof of concept” phase, carried out over a three day period.

3.1 Why choose SAP?

Following the detailed evaluation and selection process, the Council decided on SAP as the best candidate solution to meet the organisation’s needs. The weighting criteria used for the financial modules in the selection process are illustrated in the diagram below (HR/Payroll had a separate set of weighting criteria):

The main reasons for choosing SAP were:

- SAP had the best functional fit to the Council’s operational requirements. The Council struggled to find any comparable system in the medium sized enterprise range that could deliver the breadth of functionality we required.
- SAP was a clear favourite with GWRC personnel attending the product demonstrations. As such, this solution enjoyed the most support from staff and, therefore, provided the better platform for success.
- The modern client server technology and hardware platforms were consistent with our Information Technology environment, and were easily scalable.
- SAP had an established and growing client base in the New Zealand public sector, including three other councils. SAP could, therefore, demonstrate a proven track record within New Zealand with organisations of similar size and business requirements to ourselves.
- The SAP implementation partner had proven experience and success in installing SAP. The success of the project was seen as being largely dependent on the skills of their personnel, and the implementation risk was assessed as being low.
- The time and effort of implementing the product could be fast tracked by using a “pre-configured” model. This template approach was successfully used at other sites, and without it, it was extremely unlikely that SAP would have been financially viable for an organisation of our size.
- SAP had a Human Resources/Payroll system customised to NZ conditions, whereas the competitors did not. This fitted in with our strategy of preferring integrated systems rather than products for point solutions, sourced from different suppliers.
- We saw SAP as providing us with a system that would not only suit our current needs but would provide us with improvement opportunities in the future. SAP continues to invest in its products and will keep up with technology.
- SAP was fairly firm on insisting on most of its standard contract terms, but was willing to agree on some contract principles proposed by the GWRC. Most importantly, we were able to secure a fixed price/prime vendor implementation contract.

On all fronts, except price, SAP emerged with the higher evaluated scores and was clearly the preferred product in terms of functionality, proposed implementation approach and ability to demonstrate a proven track record.

However, GWRC chose a separate solution from SAP for our budgeting and financial modelling needs (Hyperion Essbase). The Council has a requirement for long-term financial planning (10 years) and it was recognised that the SAP financial application was not a sophisticated modelling tool. The operational budgets are downloaded from the budgeting system into SAP on an annual basis.

The SAP modules implemented by GWRC are listed in the following table.

SAP "R/3" Module	Functionality used by GWRC	Active Users (approx)
FI-AA Asset Accounting	Fixed asset registers	2
CO Controlling	Cost centre and project accounting	80
BC Basis Components	System monitoring and report writing	4
EC Enterprise Controlling	Profit centre accounting	50
FI Financial Accounting	Accounts receivable & payable, general ledger and inter-company accounting	14
PA Personnel Administration & Payroll Accounting	Employee master records & payroll	5
PD Personnel Planning & Development	Organisation structure and position control	5
MM Materials Management	Purchasing	50
CATS Time recording	Resource (activity) costing	200
TR Treasury	Bank reconciliation & desktop banking interface	2
PS Project System	Master data – linked to CO	8
SD Sales and Distribution	Job costing/ customer invoicing	4
DW Development Workbench	System maintenance and customising	1

Interfaces have been built with the Consents system that automates the customer creation and invoicing processes, and periodically synchronises customer contact name and address details between the two systems.

Batch interfaces were also written to download annual budgets from our financial modelling/planning system (Essbase) and upload these into SAP. A project is currently underway to extend the interface to include forecasting and extracting actual data from SAP into a new forecasting model.

3.2. Lessons Learned

The implementation of the SAP system began in February 1999 and went "live" in August 1999 for the Financial applications and October 1999 for the HR/Payroll modules. The project was delivered on budget, but it was originally planned that the modules would all go live simultaneously. The main reasons for the delay in the HR/Payroll component were the unfortunate illness of some key project team members, additional time required to resolve some software issues around the NZ annual leave functionality, and resolution of some employment contract issues that the implementation of SAP had highlighted.

Overall, we were satisfied with the SAP implementation, given the relatively

tight deadlines and timetable. However, a consequence of the rapid implementation approach is some things were left to do later. The implementation put us in the position to leverage off the system in the future, which was our initial goal, but the realisation of some FIS objectives has taken longer than anticipated. The main lessons learned from our SAP implementation experience were:

- Having good project management skills and processes is essential. For a project of this size and importance you must have the appropriate structure, management controls and reporting disciplines in place.
- A fixed price implementation agreement certainly helps mitigate the financial risks involved in a project such as this, but is an approach that puts a lot of emphasis on getting the scope of the project right and having the project deliverables well defined up front. The implementation partner and external consultants are motivated to deliver what is provided for in the contract document, so it pays to put time and energy into getting this right.
- Selecting competent personnel from across the organisation to form the project team is vital. Shoulder tap and solicit the best people, rather than ask for volunteers. Good people, with good reputations, who know your business processes will provide the best result and will help secure buy in from the rest of the business.
- Step up to any issues early, particularly if they relate to staff performance. You are better off going through some short-term pain re-establishing the project team rather than trying to persevere with situations that may never get better. Don't accept substandard performance from your own employees or contractors – your implementation is too important.
- Managing expectations is the key. Communicate frequently beyond just the management team – we did not do this enough with the wider organisation.
- The original project plan was for a “big bang” approach with the HR/Payroll and Finance modules to go live simultaneously. In hindsight we should have taken a staged implementation approach from the start so we could provide better focus and resources for each application.
- Vanilla is the flavour—avoid customisations as much as possible (many requests to “change the system” are to cater for personal preferences rather than a genuine business need). Besides the expensive development costs of modifications, there is real ongoing expense and effort in maintaining customisations through the software patch and upgrade cycles.
- Spend more time investigating and identifying the real “ongoing cost of ownership” issues. Functional versatility comes with the consequence of software complexity. ERP products, such as SAP, offer enormous choice as to how they can be set up, but there are hundreds of tables and thousands of switches within the system that turn the options on and off. The knowledge required to support the product for a small to medium sized business is extensive, thus placing reliance on third party consulting firms to provide system support. The cost of keeping up with patch levels and software versions is very high.
- Define your goal and be ruthless about scope, otherwise project creep will put the achievement of deadlines at risk.
- Spend as much time as possible on defining reporting needs and report writing. Most organisations have specific information requirements and, although SAP comes with hundreds of standard reports, not all of these will meet the business needs.

- Document your business processes and the system functionality as part of the implementation project – it is very hard to go back and fill in the gaps later.
- SAP is very rule driven and, once configured, the system will tend to lock in your standard business processes. The implementation exposed that we had a multitude of employment contract terms and conditions (that we weren't necessarily aware of) and a myriad of different purchasing practices across the organisation. Although the project was not about any process re-engineering, we were forced to take additional unplanned time to evaluate and address a range of issues that arose during the implementation.
- A disadvantage with highly integrated systems is you can't upgrade interrelated modules individually. This is an issue with ERP systems generally and is very evident in the SAP product. The Financial modules of SAP have performed very well. However, the NZ payroll module was originally developed as a "bolt on" to SAP's international Human Resources system. There were major issues with how the system accounted for employee leave to meet the domestic NZ employment legislation. SAP recognised the payroll system needed a major overhaul and responded by virtually re-writing the leave components, and integrated NZ payroll back in with the international HR system, but this was only available in the then latest software release. We found ourselves forced to upgrade. In the end SAP made the right call to re-write the NZ leave module, rather than continue to patch things, and the new version is much improved and very stable, but we hadn't counted on the disruption, or planned for the upgrade so early.

3.3 Realisation of Objectives

The introduction of SAP has been relatively successful, although the achievement of some of the original goals has taken longer than expected. The main reason for this was having to undertake an upgrade of the SAP software about eighteen months after the original implementation, caused by the need to improve the performance of the NZ payroll module. This stalled our initial momentum and was a major distraction from pursuing incremental improvement opportunities.

Our first objective was:

"The achievement of the Council's business objectives by aligning the FIS with the decentralised management structure and reporting processes, while maintaining a strong central control. This involves the provision of a comprehensive suite of interrelated information systems."

In this regard SAP has been very successful. Much of our energy has been put into ensuring SAP supports and enhances our financial and management reporting and internal control processes.

This is evidenced by the fact that, for the past three years, Audit New Zealand has given the Council five excellent grades out of five for its financial and service performance management. The Finance team must take most of the credit for this achievement, but SAP has been an essential tool in attaining, and maintaining these ratings.

Management Aspect*	Assessment
Financial control systems	Excellent
Financial management information systems	Excellent
Financial management control environment	Excellent
Service performance information and information systems	Excellent
Service performance management control environment	Excellent

*Source: Greater Wellington Regional Council Audit for the year ended 30 June 2003.

The Council has initially concentrated on getting the fundamentals in place, which has now provided us with a sound foundation to build upon. In December 2002 an amended Local Government Act came into force that has changed the long-term planning and financial reporting processes for local authorities in New Zealand. The Council is now beginning to look more closely at how we can use SAP for enhanced non-financial and performance objective reporting.

On the second objective to:

“Provide easy access to information in the most appropriate form at all levels of the Council, and allows information to be readily analysed in a variety of ways.”

SAP has its pros and cons. The system captures and stores a wealth of information, but developing reports from the base product is not user friendly. SAP has been described as a “data vault”—it’s all in there but it is not that easy to break out. The drill down reporting from high-level numbers to the lowest level transaction is very powerful, but building user defined reports is technical and beyond the skills of the “average” user.

The Council has developed a suite of reports that meet most of our managers’ reporting needs, but these work in a very structured way. For analysing data on the fly, adhoc reporting and “camera” quality presentation you really need a tool to supplement the base R/3 software. Although our principal reporting needs are being met, the Council is investigating how reporting can be improved, including an evaluation of SAP’s “Business Warehouse” information system and reporting tool that integrates with the core system.

The user take up of SAP has been mixed, with some managers accessing the system regularly, whilst others are still being provided with hard copy reports from office administrators. Achieving our vision of user self-help has not yet been fully achieved.

The third objective was:

“The maintenance of the integrity of the FIS by minimising the number of reconciliation points between systems, while having well defined interface standards.”

The process has worked well. As mentioned earlier the Council has built interfaces with SAP for the consents and budgeting systems and the key to its success is having a policy of using the same master data coding protocols (e.g. customer numbers and general ledger codes). This minimises the need for any translation of data in interface files or when exporting or importing information between systems.

As time progresses and we review other systems in the Council, the question of what applications fall within the scope of the FIS has to be reconsidered, and what role SAP may have in this regard. Providing centrally managed corporate systems makes sense where there is a common organisational need and an emphasis on compliance monitoring and reporting. It’s fair to say we have been largely using SAP as a financial system and it is meeting the current scope of

activities but can it be expanded? There is potential to include employee health and safety systems, treasury, asset management, real estate and property management, strategic planning and balanced score card reporting. SAP has solutions available, either within the core system or in new components that can be purchased separately but the key question is “do the benefits of integration mean we have to forgo any functionality?” Reviewing the scope of the FIS and how we use SAP has to be a continuous process. Drawing other modules into the core FIS, however, has to be balanced by the need to avoid compromising the primary role of SAP and integrity of the system.

The fourth objective was the

“Provision of systems that can cater for future organisational changes (which may cause activities of the Council to expand or contract) without placing the Council at risk.”

SAP is quite effective in catering for changes in organisational structures. The integrated nature of the product dictates that you need to be aware of master data dependencies (e.g. the relationship between profit centres, project and cost centres, employee and asset master records) but as these links can be date delimited and are time dependent, it is relatively simple to change reporting from a point in time whilst maintaining historical reporting structures. Recently the departments in our Landcare and Transport divisions were restructured. This occurred over a balance date when transactions were still being posted into two financial years. The process only took a few days to complete whereas in our previous legacy systems it would have taken weeks.

In 2002 the Council was involved in a proposal to integrate the Council’s Water Supply activity with the similar functions of four other local authorities in the region, which would have formed a new separate entity. Although the proposal has not been put into effect, a study undertaken at the time identified three viable and relatively easy options to assimilate the new organisation into SAP. The main issue related to software licensing.

The last objective was the

“Optimisation of opportunities which are provided by modern systems and technologies to achieve system enabled process efficiencies.”

The project to replace the Council’s FIS was never about cost reductions or business re-engineering – the main goal was to get more muscle behind our management reporting. The basic premise was that a modern system would provide improved transaction processing and, from that, efficiencies would naturally come. In this respect SAP has enabled us to retire several legacy systems and many off-line spreadsheets and reporting databases. There has been a net staff reduction in accounting support staff, but the biggest impact for a lot of people has been the shift in focus of their roles away from processing paper at the back end of the process, to ensuring information is complete and accurate at the time of data creation. This is particularly true for purchasing where we now have fewer accounts payable staff but more purchasing co-ordinators than before the SAP implementation.

However, we have not yet rigorously pursued our strategy of promoting entry of data directly into the FIS, and it is felt that this is where we can make some real gains and get further leverage out of SAP. An obstacle in achieving this is the difficulty occasional users have with the standard SAP screens. For example, the complexity of the SAP purchasing screens has caused us to abandon our original strategy of having employees raise purchase orders on-line. A more user-friendly interface is required, which could be delivered via a web

browser on the GWRC's intranet or via SAP's employee "portal." However, both of these options would require additional capital investment and a cost benefit exercise has to be completed before pursuing any further.

4. Conclusion

SAP has proven to be a robust and successful FIS solution. Our initial focus on internal controls and data integrity has been effective and has enhanced our standing with elected councillors and the local government community generally. However, user "up-take" and management reporting can be improved, and there is a feeling of some unfinished business.

SAP is largely regarded within the Council as just a financial system and it has served us well in this regard. However, we are yet to fully explore what else it can do for us. As a public entity we are naturally risk averse and the Council will continue to be cautious about any future system developments.

The ongoing cost of ownership of SAP has been relatively high. SAP has recognised this and has provided improved tools and introduced new product upgrade strategies to assist their customers. However, smaller organisations such as GWRC will find the maintenance and development costs of an ERP system to be higher than mid range financial software.

SAP will see us into the future but it can be a continuous escalator – the trick is deciding on your destination and determining on what floor to get off.

5. Appendix 1 Organisational Overview

5.1. Who we are

Greater Wellington Regional Council promotes Quality for Life by ensuring our environment is protected while meeting the economic, cultural and social needs of the community.

Our specific responsibilities include environment management, flood protection and land management, provision of regional parks, public transport planning and funding, and metropolitan water supply.

Regional, city or district?

Local government in New Zealand is represented by regional and territorial (city or district) councils. Regional councils like Greater Wellington cover larger areas than territorial councils. Natural resources, and their use, often cross local boundaries so regional councils manage these resources for the benefit of the whole region. City and district councils are responsible for essential community services within their own areas, such as road maintenance, land-use and subdivisions, community health, and community services (libraries, swimming pools and recreation areas).

Various acts of Parliament, such as the Local Government Act 2002 and the Resource Management Act 1991, provide the framework to enable Greater Wellington to undertake its activities. Councillors decide the overall policies while management decide how the activities should be carried out.

WWW.GW.GOV.T.NZ

5.2. What we do

Biosecurity

Biosecurity is about protecting our environment, economy and way of life from the harmful impacts of pests and diseases. Greater Wellington works with landowners to target regional pest plants and animals and helps the rural economy by controlling the spread of Bovine Tb.

Emergency management

We co-ordinate the Civil Defence Emergency Management Group for the region. We work together to minimise the potential effects of emergencies, prepare ourselves and the community, respond to emergencies and help the community to recover.

Environment

The region's natural resources – land, water, air, energy – sustain our lives. We help people to use these resources appropriately and sustainably.

Flood protection

The region's many rivers mean homes, farmland, jobs, livelihoods and property can be at risk from flooding. We help communities protect themselves from the effects of flooding.

Harbours

We look after the navigational safety of all vessels in the harbours of Wellington and around the regional coastline. We encourage safe boating behaviour and are ready to respond in case of a marine oil spill.

Land management

About 40 per cent of the Wellington region is erosion-prone hill country. Soil erosion can be prevented or reduced by improving the way the land is used, perhaps by planting trees, by changing management systems, or by allowing native bush to grow in areas that are at risk from erosion. We work with landowners to control soil erosion.

Parks & forests

We maintain a network of regional parks and forests, enjoyed by thousands of people every year. We also look after their environmental and historical features.

Pollution control

We maintain a 24-hour incident response service, conduct environmental assessments of industrial and commercial sites, and maintain a register of sites with hazardous industries or activities.

Transport

We fund bus and train services, we plan the roading network and we build public transport infrastructure. Greater Wellington spends about \$30 million each year subsidising public transport.

Water supply

Greater Wellington collects and treats all the drinking water used in the four Wellington, metropolitan cities. We are the region's 'wholesale' water supplier, delivering high-quality treated water to the main reservoirs in each city, from where the city councils supply homes and businesses.

5.3. Some facts about the Wellington Region

- The region covers a land area of 813,005 hectares and a maritime area of 786,700 hectares. There are 497 kilometres of coastline.
- The population of the region is 445,400 (Statistics NZ, estimated resident population, June 2002).
- Greater Wellington manages 320 kilometres of river channels and 280 kilometres of stopbanks. We are responsible for one of the largest flood protection schemes in New Zealand.
- Around 30 million passenger journeys are made on the region's public transport system each year.
- Greater Wellington collects, treats and delivers about 150 million litres of high quality water each day, on average, to the city councils of metropolitan Wellington.
- Greater Wellington manages plant and animal pest control programmes on approximately 500,000 hectares of land in the region each year.
- Greater Wellington manages 50,000 hectares of parks and forests.
- The Council has around 380 full time employees, and engages a variety of contract staff to help deliver our work programs each year.
- Greater Wellington manages Total Assets of NZ\$ 575 million and had budgeted annual Total Expenditure of NZ\$ 114 million for the 2003 financial year.

A Case Study from South Africa on a Department Financial Management Issue

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Alan Mackenzie, a Chartered Accountant, was previously the CEO of Business Against Crime. He spent some fifteen years in business after leaving the academic world as an Associate Professor of Financial Management. A regular guest speaker on public sector re-engineering, he has in recent years been frequently interviewed by the media in South Africa.

Overview

In 2001, the Department of Justice and Constitutional Development in South Africa (DoJ&CD) approached business through an organization called Business Against Crime (BAC) to assist in improving their financial management capability. BAC was created in 1996 at the request of then President Mandela to assist in the fight against crime. BAC (see www.bac.co.za) seconded their CEO to the Department as their full-time CFO and he launched a Performance Enhancement Programme (PEP).

Extensive financial management problems were addressed on a number of fronts, one of which covered budget formulation, execution and reporting. The project jolted mindsets at the outset, but now has widespread acceptance. A review of this project is set out below.

A budget framework called the "Base 80" was created and implemented as part of the PEP. It is, in essence, a variant of a Zero Based Budget (ZBB). A number of principles are embedded in the process. It empowers choice through debate on cost benefit matters; after presentation of functional decision packages and a suggested prioritization thereof to the responsible Parliamentary Justice Cluster Portfolio Committee (PPC). The PPC is thus offered information that enables them to debate money supply realities with National Treasury.

Due to a lack of time and skills, ZBB was not implemented immediately. Otherwise, the needs of 747 court locations, 518 cash halls etc. that were financially accounted for in 2001 for the first time on a monthly basis would need to be unpacked! Less than 50 of these budget locations were computerized. In 2002, a ZBB was promised in 2004 and for each successively elected government at the start of their five year term of office. The functionality of the Department was divided into core and support business processes and these were presented to the PPC and to National Treasury with decision packages representing the marginal 20% of funding provisionally available within the MTEF. In addition, cost estimates for unfunded functionality was presented for consideration. The process is depicted in figures 1 and 2 on the next page.

Against a possible budget of some 4 billion Rand (excluding the management of trust funds that exceed this figure) unfunded needs approached an extra 5 billion Rand. The budget proposal at first shocked most, but once explained, was enthusiastically received by the PPC and after substantial press coverage and debate by the committee, was unanimously proposed for adoption by all political parties in the National Assembly of Parliament. Memorable debates followed the realization that much of the legislation passed by Parliament had never been implemented. Legislation such as the "Equality Act" and "Maintenance Investigation Act" (Alimony) had never been implemented as no funding was available. This surprised many as "poverty alleviation" was promoted as a national priority. An interesting debate on prioritization surrounding the appointment of equality officers versus the implementation of the "Child Justice Bill" saw agreement that ensuring the future of our children was to be a priority funded initiative and that dealing with the legacy of apartheid could be rolled forward for future implementation. Meeting the needs of divorced women was to be met by the allocation of the Director General's policy reserve fund etc. For the first time the budget vote debate showed what was and what was not affordable by activity and thus crisply set out what could be expected. All this was the result of a somewhat different "Budget Report" that expanded the information provided into the realm of non-financial information, promises of what could and what could not be done, unfunded needs etc.

In a "Footprint" project, the core service delivery functionality was determined, right sized and costed at current costs. Productivity matters such as promoting efficiency, effectiveness and economy were dealt with as separate matters to be measured against defined measurable objectives. In this way the 0-80 baseline of recurring expenditure is separated from marginal 80-100 matters that mostly tend to be non-recurring projects covering desperate needs, productivity improvements and functionality growth. The latter is tracked to monitor the release of baseline funds to unfunded initiatives. Unfunded initiatives communicate needs for consideration and align expectations with reality. The effect of the new budget framework was that, following introduction, allocations received included a massive budget increment with allocations ring fenced for specific selected decision packages in line with the prioritization directives from Parliament. Previously, budget allocations were globally negotiated on an incremental basis without any of the parties having a deep understanding of what was and what was not funded. In the past, Parliamentary questions often saw a flurry of budget shift to accommodate perceived new priorities and, in addition, budget dilution across an increasingly broad front of initiatives led to ineffective service delivery.

The Base 80 approach moots a MTMF (Medium Term Management Framework) that clearly presents the "reverse promise." The reverse promise is, in essence, a service level agreement that sets out what will be done and, most importantly, it also sets out what will not be done. Thus given the confirmation of a budget allocation, budget sub allocations are split between the base 80 recurring amount and the base 80-100 non recurring amount. The base 80-100 amount is listed by way of activity based decision packages, each of which is fully funded to ensure the success of the initiative. Unfunded initiatives are also listed by activity to reflect what will not be done. Prioritisation is done by way of rating activities against value scores awarded to strategic objectives. Thus activities that score highly against meeting strategic objectives receive funding priority. In reporting on the budget, measurable objectives are offered and measured in subsequent periods for reporting to stakeholders.

In Government, as a generalization, all Departments want more rather than less. This is a result of the emphasis placed on the approach that creates winners out of those that get the most, rather than those that deliver the most. The monitoring of measurable objectives ensures that surplus funding is not requested and, in addition, it ensures the principle of budgeting for success: The making of hard choices to avoid the allocation of diluted budgets, across a broad front, thus ensuring that failure is not a self fulfilling prophecy.

The budget reporting project has been an unqualified success. Essential subsets to this success include vision and strategy. These were critically needed to align stakeholders and service providers. The vision and strategy document written to underpin the PEP was restricted by design to be a "one page" document. The simplicity of this statement ensured communication and "buy-in." A copy of the vision and strategy is set out below. It is felt that another reason for the success of the budget project lay in the fact that it filled a definite gap that was determined by way of a visioning framework that was used in conjunction with a balanced scorecard and a project management reporting approach, devised to meet the needs of developing intellectual capacity rather than for determining when to "put glass in windows." The creation of a public sector variant of the "Kaplan and Norton" Balanced Scorecard was found to be useful as a benchmark and as a mechanism to generate and report upon productivity versus functionality growth. The simplified budget reporting approach, balanced scorecard, readily understandable visioning framework and project management reporting approach meant that non-financial stakeholders understood how the various projects were conceived, why they were needed and, most importantly, they could follow project progress in a matter of minutes. "Keeping it simple" enhanced credibility which in turn secured the funding, against measurable objectives, without which it would all not have been possible in the first place. The following tables illustrate the above.

Detailed actual to budget, average spend and available spend information is made available per budget unit on a monthly basis. The next phase dependent upon the filling of posts and capacity building, sees the regular re-evaluation of projected cash flow estimates. The project management approach has a focus upon non-financial project driven progress over time. The budget reports focus upon financial aspects. This specialized snapshot approach has been well received and has been preferred to the traditional written reports that take longer to analyze.

Financial actual to budget reports have not been presented in this case study as they are not unique. At the outset the entire process was managed with Microsoft Office programs and more recently the process has migrated to a dedicated Oracle database and report writer with multi-user access to enable "what if" scenario planning, etc.

The case study relates to the Budget sub-program within the PEP of the DoJ&CD but may equally be escalated to a national level reflecting functional productivity improvement, growth and core service delivery improvement projects that provide non-financial information to meet the needs of stakeholders on the question of value for money and progress against preset measurable objectives.

See the ICGFM website at www.icgfm.org for more information.

A Plan for Implementation of the International Public Sector Accounting Standards in Developing Countries and Economies in Transition

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Introduction

In many countries, the method of budgeting used in the public sector has determined which accounting basis (cash or accrual) to use. Budgets may be prepared on the cash, obligation/commitment, or the accrual basis. Most governments in developing countries or economies in transition will prepare their budgets on the cash basis since such budgetary information is more easily comprehended by users. In addition, it is simple to implement and costs are low due to the lower level of accounting skills required. These fixed budgets are approved by legislative bodies within governments in order to prioritize their revenue and spending plans. As governments transition to the accrual basis of accounting, many prepare their budgets on the modified accrual basis of accounting (which includes current assets and liabilities) in order to plan for the use of financial resources. As the full accrual basis of accounting (which includes total assets and liabilities) is achieved, some governments are moving to the accrual basis of budgeting so that they can plan for the use of total resources.

In the private sector, the International Accounting Standards Committee (IASC) previously accepted the challenge of establishing accrual-based International Accounting Standards (IASs) for application to commercial enterprises throughout the world. The International Accounting Standards Board (IASB) has recently replaced the IASC and is in the process of replacing the IASs with International Financial Reporting Standards (IFRSs). However, like the IASC, their charge does not apply to the public sector. To fill the void, the Public Sector Committee (PSC) of the International Federation of Accountants has been given the responsibility to develop programs aimed at improving public sector financial management and accountability including developing accounting standards and promoting their acceptance. In order to achieve its

objectives, the PSC is developing a set of accounting standards for public sector entities worldwide. Initially, these International Public Sector Accounting Standards (IPSASs) are being developed by adapting IASs issued by the IASB to a public sector context. In undertaking that process, the PSC attempts, wherever possible, to maintain the accounting treatment and original text of the IASs unless there is a significant public sector issue which warrants a departure. In its ongoing work program, the PSC also intends to develop IPSASs to deal with public sector financial reporting issues that are either not comprehensively dealt with in existing IASs or for which IFRSs have not been developed or are not planned to be developed by the IASB. Examples of these issues include the nature of the governmental reporting entity and recognition principles for tax revenue.

The IPSASs apply to all public sector entities other than Government Business Enterprises (GBEs). GBEs include both trading enterprises, such as utilities, and financial enterprises, such as financial institutions. GBEs are, in substance, no different from entities conducting similar activities in the private sector and they are expected to comply with the IASs and IFRSs. A GBE means an entity that has all the following characteristics:

1. Is an entity with the power to contract in its own name;
2. Has been assigned the financial and operational authority to carry on a business;
3. Sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery;
4. Is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and
5. Is controlled by a public sector entity.

International Public Sector Accounting Standards

IPSASs deal with issues related to the presentation of annual general purpose financial statements. General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their specific information needs. Users of general purpose financial statements include taxpayers and ratepayers, members of the legislature, creditors, suppliers, the media, and employees. In democracies, political accountability of government to the electorate should take precedence. Their elected representatives act on their behalf and use the financial statements to hold the government and the civil service to account for the resources that they were allocated to provide the agreed level of goods and services. General purpose financial statements include those that are presented separately or within another public document such as an annual report. The objectives of general purpose financial statements are to provide information useful for decision-making, and to demonstrate the accountability of the entity for the resources entrusted to it.

In addition, general purpose financial statements can have a predictive or prospective role since they provide information useful to predict the level of resources required for continued operations. Further, these statements provide users with information indicating whether resources were obtained and used in accordance with the legally adopted budget. To assist users in this area, governments are encouraged to include in the financial statements a comparison of the actual results of operations with the approved budget for the reporting period.

IPSASs permit the presentation of annual general purpose financial statements on the cash or the accrual basis of accounting. The accrual basis is preferred for the following reasons: improved resource allocation, strengthened accountability over all resources, enhanced transparency on total resource costs of government activities, and more comprehensive view of government's impact on the economy. The cash basis is permitted in those instances where the countries have not yet developed the capability among their accounting staff to prepare their financial statements on the accrual basis or the costs are prohibitive. If their statements are prepared on the cash basis, the countries are encouraged to transition to the accrual basis as soon as their accounting staff is adequately trained on the requirements of an accrual accounting system and funding can be arranged. The balance of this article discusses the IPSASs and suggests a plan for implementation of these IPSASs in developing countries and economies in transition.

Cash Basis Standard

This is a comprehensive IPSAS on financial reporting under the cash basis. It establishes requirements for the preparation and presentation of a Statement of Cash Receipts and Payments, as well as notes to support accounting policy. It also encourages disclosures to enhance the cash basis report.

The IPSAS on Cash Basis Financial Reporting identifies the requirements applicable in all entities that prepare cash basis general purpose financial statements. It has been under development since an initial draft was issued in November 2000, and was finally issued in January 2003. The effective date of this Standard is 1 January 2004, though earlier implementation was recommended. For those entities that should present consolidated financial statements for the reporting period, this Standard will be applicable three years following the date of its initial enactment.

According to the PSC, the application of this Standard is an important step towards financial reporting improvement in terms of consistency and comparability, as well as serving as a basis for enhancement and shift to the accrual basis of accounting. In April 2002, the PSC published Study 14 entitled "Transition to the Accrual Basis of Accounting: Guidance for Government and Government Entities" for entities intending to adopt the accrual basis. The aim of this IPSAS is to describe the way in which cash basis general purpose financial statements should be presented. This Standard comprises two parts. The first part is mandatory and contains requirements for cash basis financial statement presentation. The second part is not obligatory and contains additional requests and explanations about the accounting policies, disclosures, and alternative methods of information presentation. The objective of this IPSAS is to promote and enhance financial accountability and financial statement transparency.

Within the first part, the requirements in connection with financial statement structure and content, and the reporting entity identification are explained, as well as requirements for disclosing movements of cash and cash equivalents generated from business, investment and financial activities. In addition, the cash basis of accounting is defined, as well as all terms associated with it, such as cash, monetary resources equivalents, reporting entities, and cash controlled by the reporting entity.

Financial reporting means that entities should prepare and present general purpose financial statements which include a Statement of Cash Receipts and Payments along with accounting policies and explanatory notes. All cash receipts and payments are recognized in the Statement of Cash Receipts and

Payments, as well as cash balances controlled by the entity and payments by third parties on behalf of the entity. Notes to financial statements include narratives, more detailed tables and analyses, as well as additional information on the purpose of fair presentation necessary to such information users. An illustration of the required Statement of Cash Receipts and Payments is an Appendix to the Cash Basis IPSAS and is included as Attachment 1.

The information presented in the general purpose financial statements should be understandable, relevant and truthful. Their quality will affect the report usefulness for the users. In that sense, in the second part of Annex 4 of this Standard, certain qualitative features of information are presented aimed at better financial reporting. The accounting policies and remarks offer an explanation for better understanding of financial reports.

General considerations explain the treatment of the reporting period for preparation and presentation of financial statements, date of authorization, entity-related information, information in connection with the monetary balances constraints and access to loans, consistency in presenting, disclosing comparative information, identifying financial reports, error correction, consolidated financial reports and foreign currency (i.e. treatment of foreign exchange cash flows). Within the consolidated financial statements, the Standard gives an explanation about the entities, the range of the consolidated financial reports, all related to the goals, reporting entity, as well as procedures and ways of preparing consolidated financial reports on public sector entities. The section on foreign currency explains the treatment of cash inflows, outflows and balances in foreign currencies resulting from foreign currency transactions. The first part of this Standard is expanded by particular annexes in order to help explain the meaning of the Standard through illustrations for its easier application in preparing and presenting general financial reports on cash basis using examples of Government Consolidated Financial Statements, additional financial reports, as well as examples of remarks in the financial reports.

The second part of the IPSAS on Cash Basis Financial Reporting refers to additional disclosures encouraged, as well as to a treatment of public sector entities intending to shift towards the accrual accounting. The following additional disclosures are encouraged:

- Reservations about Going Concerns
- Identification of Extraordinary Items
- Extent of Administered Transactions (i.e., “pass-through” cash flows and transfers)
- Major Classes of Cash Flows
- Related Parties
- Assets and Liabilities
- Comparison with Budgets
- Consolidated Financial Statements
- Joint Ventures
- Financial Reporting in Hyperinflationary Economies

Cash basis government financial reporting is characteristic of the budget in developing countries and economies in transition. Including a budgetary column in the financial reports allows for direct comparisons between the planned and actual amounts. This information is useful for external users interested in government accountability in view of approved budgets, as well as for internal users who monitor the current spending against actual expenditures.

The second part of this Standard contains guidelines for those public sector entities that wish to switch to the accrual basis in terms of presenting a Statement of Cash Receipts and Payments using the same form (see Attachment 3) required by IPSAS 2 on the Cash Flow Statement. Certain appendixes are provided containing illustrations that should help explain how to present cash flow reports classified by operating, investing and financing activities, as well as how to disclose cash flows generated from interests and dividends. Also, there are appendixes that describe the qualitative characteristics of financial reporting (comprehensibility, relevance, truthfulness and comparability), certain constraints for relevant and truthful information, as well as the treatment of the issues with regard to establishment of control over another entity for the purposes of financial reporting.

Budgetary Reporting

Most governments prepare budget to actual comparative statements during the fiscal period in order to maintain budgetary control. However, these comparative statements are not presently a part of the prescribed end of year general purpose financial statements. Guidance in the present IPSASs1 is as follows:

“Public sector entities are typically subject to budgetary limits in the form of appropriations or budget authorizations (or equivalent), which may be given effect through authorizing legislation. General purpose financial reporting by public sector entities may provide information on whether resources were obtained and used in accordance with the legally adopted budget. Where the financial statements and the budget are on the same basis of accounting, this Standard encourages the inclusion in the financial statements of a comparison with the budgeted amounts for the reporting period. Reporting against budgets may be presented in various different ways, including:

- a. the use of a columnar format for the financial statements, with separate columns for budgeted amounts and actual amounts. A column showing any variances from the budget or appropriation may also be presented, for completeness; and
- b. a statement by the individual(s) responsible for the preparation of the financial statements that the budgeted amounts have not been exceeded. If any budgeted amounts or appropriations have been exceeded, or expenses incurred without appropriation or other form of authority, then details may be disclosed by way of footnote to the relevant item in the financial statements.”

An example of the optional Budget to Actual Comparative Statement is an Appendix to the Cash Basis IPSAS and is included as Attachment 2.2

Accrual Basis Standards

In addition to the Cash Basis IPSAS, there are 20 accrual IPSASs and these are summarized in this section (with the corresponding IASs shown in parenthesis).³ The accrual basis means a basis of accounting under which transactions and other events are recognized when they occur (and not only when cash or its equivalent is received or paid). Therefore, the transactions and events are recorded in the accounting records and recognized in the financial statements of the periods to which they relate. The elements recognized under accrual accounting are assets, liabilities, net assets/equity, revenue and expenses.

IPSAS 1 and 2. Presentation of Financial Statements (based on IAS 1 and IAS 7, respectively)

These IPSASs set out the overall considerations for the presentation of financial statements, guidance for the structure of those statements and minimum requirements for their content. A complete set of financial statements includes the following components (comparable statements in the private sector are identified in parenthesis):

1. Cash flow statements (same title)—see Attachment 3;
2. Statement of financial position (balance sheet)—see Attachment 4;
3. Statement of financial performance (income statement)—see Attachment 5;
4. Statement of changes in net assets/equity (statement of changes in equity)—see Attachment 6; and
5. Accounting policies and notes to the financial statements.

IPSAS 3. Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies (based on IAS 8)

All items of revenue and expense recognized in a period are included in the determination of the net surplus or deficit for the period. If fundamental errors occur, the benchmark treatment requires that the amount of the correction that relates to prior periods should be reported by adjusting the opening balance of accumulated surpluses or deficits. Further, if there has been a change in accounting policies, it should be applied retrospectively with the resulting adjustment reported as an adjustment to the opening balance of accumulated surpluses or deficits. If the amount of any resulting adjustment that relates to prior periods is not reasonably determined, the change should be applied prospectively.

IPSAS 4. The Effects of Changes in Foreign Exchange Rates (based on IAS 21)

A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction. At each subsequent reporting date:

1. Foreign currency monetary items should be reported using the closing rate;
2. Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and
3. Non-monetary items which are carried at fair value denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

Exchange differences should be recognized as revenue or as expenses in the period in which they arise, with the exception of exchange differences as a result of net investment in a foreign entity. For these exceptions, exchange differences arising on a monetary item that forms part of an entity's net investment in a foreign entity should be classified as net assets/equity in the entity's financial statements until the disposal of the net investment, at which time they should be recognized as revenue or as expenses.

IPSAS 5. Borrowing Costs (based on IAS 23)

This IPSAS prescribes the accounting treatment for borrowing costs and requires either the immediate expensing of borrowing costs or, as an allowed alternative treatment, the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

IPSAS 6. Consolidated Financial Statements and Accounting for Controlled Entities (based on IAS 27)

A controlling entity should present consolidated financial statements for controlled entities (foreign and domestic). Control is presumed to exist when at least one specified power condition and one specified benefit condition exists. Minority interests should be presented in the consolidated statement of financial position separately from liabilities and the controlling entity's net assets/equity. Minority interests in the net surplus or deficit of the economic entity should also be separately presented.

IPSAS 7. Accounting for Investments in Associates (based on IAS 28)

An associate is defined as an entity in which the investor has significant influence (generally 20% or more) and which is neither a controlled entity nor a joint venture of the investor. The investment in an associate should be accounted for in consolidated financial statements under the equity method, except when the investment is acquired and held exclusively with a view to its disposal in the near future. In this case, the cost method is required.

IPSAS 8. Financial Reporting of Interests in Joint Ventures (based on IAS 31)

A joint venture is defined as a binding arrangement whereby two or more parties are committed to undertake an activity that is subject to joint control. In its consolidated financial statements, a venturer should generally report its interest in a jointly controlled entity using the reporting format for proportionate consolidation.

IPSAS 9. Revenue from Exchange Transactions (based on IAS 18)

This standard distinguishes between exchange and non-exchange transactions. An exchange transaction (i.e., sale of goods or services) is one in which the entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value to the other party in exchange. Revenue from exchange transactions is measured at the fair value of the consideration received or receivable and is recognized when earned. (Non-exchange transactions, such as taxes, are not included in this standard and are being addressed in a separate standard to be published at a later date.)

IPSAS 10. Financial Reporting in Hyperinflationary Economies (based on IAS 29)

This IPSAS describes the characteristics of a hyperinflationary economy and requires financial statements of entities that operate in such economies to be restated. In general, the restatement of financial statements is considered if the cumulative inflation rate over three years is approaching, or exceeds, 100%.

IPSAS 11. Construction Contracts (based on IAS 11)

Since many construction contracts may exceed one or more fiscal periods, revenue and expenses should be recognized in the period incurred by reference to the stage of completion of the contract activity at the reporting date.

IPSAS 12. Inventories (based on IAS 2)

Inventories should be measured at the lower of cost and net realizable value or, under specific circumstances, current replacement cost. The cost of inventories should be assigned by using the first-in, first-out or weighted average cost formulas. (Note—The last-in, first-out method used in the private sector is not permitted for use in the public sector.)

IPSAS 13. Leases (based on IAS 17)

Each lease should be classified as a finance lease or an operating lease. A finance lease is a lease that transfers substantially all risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred. Lessees should recognize assets acquired under finance leases as assets and the associated lease obligations as liabilities. Lessors should recognize lease payments receivable (at an amount equal to the net investment in the lease) under a finance lease as assets in their statements of financial position. The recognition of finance revenue should be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease. An operating lease is a lease other than a finance lease and should be recognized as revenue to the lessor or expense to the lessee in the period to which it applies.

IPSAS 14. Events After the Reporting Date (based on IAS 10)

The reporting date is the date of the last day of the reporting period to which the financial statements relate. Events after the reporting date are those events that occur between the reporting date and the date when the financial statements (including the audit opinion) are authorized for issue. An entity should adjust the amounts recognized in its financial statements to reflect adjusting events after the reporting date depending on the government's intention in relation to certain matters. In most cases, the announcement of government intentions will not lead to the recognition of adjusting events but would qualify for disclosure as non-adjusting events.

IPSAS 15. Financial Instruments: Disclosure and Presentation (based on IAS 32)

The issuer of a financial instrument should classify the instrument as a liability or as net assets/equity in accordance with the substance of the contractual arrangement on initial recognition and the definitions of a financial liability and an equity instrument.

IPSAS 16. Investment Property (based on IAS 40)

Investment property is defined as property (land or building) held to earn rentals or for capital appreciation rather than use in the production or supply of goods or services, or for sale in the ordinary course of operations. It should be recognized as an asset when it has future economic benefit and the cost or fair value can be reliably measured.

IPSAS 17. Property, Plant, and Equipment (based on IAS 16)

This standard applies to property, plant and equipment including specialist military equipment and infrastructure assets. It does not apply to forests or minerals. Subsequent to initial recognition as an asset, the benchmark treatment permits an item of property, plant and equipment to be carried at its cost less any accumulated depreciation and any accumulated impairment losses. The depreciable amount should be allocated on a systematic basis over its useful life and recognized as an expense. It does not require or prohibit the recognition of heritage assets.

IPSAS 18. Segment Reporting (based on IAS 14)

A segment is a distinguishable activity of an entity for which it is appropriate to separately report financial information for the purpose of evaluating the entity's past performance in achieving its objectives and for making decisions about the future allocation of resources. In most cases, separate reporting will reflect the segments for which information is reported to the governing body and the most senior manager of the entity.

IPSAS 19. Provisions, Contingent Liabilities and Contingent Assets (based on IAS 37)

A provision is a liability of uncertain timing or amount. It should be recognized when an entity has a present obligation as a result of a past event, it is probably that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Contingent liabilities and contingent assets may be disclosed in the financial statements, if considered beneficial.

IPSAS 20. Related Party Disclosures (based on IAS 24)

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions or if the related party entity and another entity are subject to common control. Related party relationships where control exists should be disclosed irrespective of whether there have been transactions between the related parties.

Steps for Implementation of IPSASs

IFAC proposes step-by-step implementation in the transition from the cash basis to the accrual basis of accounting.⁴ The following steps suggest an approach to implementing the IPSASs in developing countries and economies in transition:

Step 1. Identify all government owned enterprises that operate to make a profit or to break even. These enterprises should be on the accrual basis of accounting and should comply with the IASs and IFRSs.

Step 2. Identify all other government activities (including off-budget government activities) and prepare a Statement of Cash Receipts and Payments for each entity that has a separate bank account. These governments will generally be on the cash basis (or a modified cash basis) of accounting and should comply with the IPSASs. For greater efficiency in overall cash management for the whole-of-government, a Treasury Single Account should be established if that has not already been accomplished.

Step 3. Prepare a Consolidated Statement of Cash Receipts and Payments (Attachment 1) as specified in the Part 1 requirements of the Cash Basis IPSAS. This would include collecting pertinent receipt and payment data from third parties for reflection in the Consolidated Statement. This Statement (with the appropriate audit opinion) should be issued within six months of the end of the reporting period.

Step 4. As encouraged by IPSAS 1 and illustrated in the Cash Basis IPSAS, a Budget to Actual Comparative Statement (Attachment 2) should be prepared on the same basis as the budget and issued at the same time as the Consolidated Statement of Cash Receipts and Payments. Where possible, it should be broken out by the segments used for authorizing the budget (IPSAS 18).

Step 5. Start migrating to the Part 2 disclosures in the Cash Basis IPSAS as time and capacity permits:

- a. Prepare Cash Flow Statement (Attachment 3) in the format prescribed by IPSAS 2.
- b. Disclose the value of all financial assets in the notes to the Statement of Cash Receipts and Payments. Cash is included in the body of the Statement and would not need to be included in the notes. Financial assets would include all receivables generated as a result of exchange transactions (IPSAS 9) and

non-exchange transactions, as well as all other financial assets including financial instruments (IPSAS 15).

- c. Disclose the value of all financial liabilities in the notes to the Statement of Cash Receipts and Payments. This would include borrowings identified in IPSAS 5, as well as other financial liabilities identified in IPSASs 13 (finance leases), 15 (financial instruments), and 19 (provisions).
- d. Disclose the value of all non-financial assets in the notes to the Statement of Cash Receipts and Payments. The following priority order of disclosure is suggested: inventories (IPSAS 12); investments (including IPSASs 7, 8, and 16); finance leases (IPSAS 13); and property, plant, and equipment (IPSAS 17).

Step 6. Implement all remaining IPSASs (1, 3, 4, 6, 10, 11, 14, and 20) when sufficient Part 2 options have been met. The complete set (Attachments 3-6) of the general purpose financial statements, along with the audit opinion, should be issued within six months of the end of the reporting period.

Conclusion

A specific time period for accomplishing the above steps has not been identified since much will be contingent on the automated system in effect and the degree of top-level management support, as well as the support of the legislative body. In any event, it will probably take most developing countries and economies in transition at least five years (and, in some cases, much longer) to implement the full set of IPSASs and move from a cash or modified cash basis of accounting to an accrual basis. In addition, a specific chart of accounts has not been proposed since it will be dependent on the financial structure adopted. Further, statistical data will need to be extracted from the financial system to meet the needs of the International Monetary Fund as specified in the Government Finance Statistics Manual. Although it is recommended that the steps be accomplished in the order prescribed, local conditions may dictate a different sequence than that identified above.

When the transition to the accrual basis has been completed, the governmental agency will know how much it owns and how much it owes (not just where cash came from, where cash went, and the remaining cash balance). Consequently, government will be in a much better position to manage total resources rather than just the cash available to them.

**Attachment 1. Illustrative Required Consolidated Statement of
Cash Receipts and Payments**

(pp.38-39, Appendix 1a, Cash Basis IPSAS)

Attachment 2. Illustrative Optional Budget to Actual Comparative Statement

Appendix 2, p. 78, Comparison with budgets (paragraph 2.1.33(b)), Cash Basis
IPSAS

Attachment 3. Statement of Cash Flows

(p. 111-112, Appendix, IPSAS 2)

PUBLIC SECTOR ENTITY — CONSOLIDATED CASH FLOW STATEMENT FOR YEAR ENDED 31 DECEMBER 20X2 (IN THOUSANDS OF CURRENCY UNITS)

	20X2	20X1
Cash Flows From Operating Activities		
Receipts		
Taxation	X	X
Sales of goods and services	X	X
Grants	X	X
Interest received	X	X
Other receipts	X	X
Payments		
Employee costs	(X)	(X)
Superannuation	(X)	(X)
Suppliers	(X)	(X)
Interest paid	(X)	(X)
Other payments	(X)	(X)
Net cash flows from operating activities	X	X
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of plant and equipment	(X)	(X)
Proceeds from sale of plant and equipment	X	X
Proceeds from sale of investments	X	X
Purchase of foreign currency securities	(X)	(X)
Net cash flows from investing activities	(X)	(X)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from borrowings	X	X
Repayment of borrowings	(X)	(X)
Distribution/dividend to government	(X)	(X)
Net cash flows from financing activities	X	X
Net increase/(decrease) in cash and cash equivalents	X	X
Cash and cash equivalents at beginning of period	<u>X</u>	<u>X</u>
Cash and cash equivalents at end of period	<u>X</u>	<u>X</u>

Attachment 4. Statement of Financial Position

(pp.75-76, Appendix 1, IPSAS 1)

Public Sector Entity — Statement of Financial Position as of 31 December 20X2 (In Thousands of Currency Units)

	20X2	20X2	20X1	20X1
ASSETS				
Current assets				
Cash and cash equivalents	X		X	
Receivables	X		X	
Inventories	X		X	
Prepayments	X		X	
Investments	X		X	
		X		X
Non-current assets				
Receivables	X		X	
Investments	X		X	
Other financial assets	X		X	
Infrastructure, plant and equipment	X		X	
Land and buildings	X		X	
Intangible assets	X		X	
Other non-financial assets	<u>X</u>		<u>X</u>	
		<u>X</u>		<u>X</u>
Total assets		<u>X</u>		<u>X</u>
<hr/>				
LIABILITIES				
Current liabilities				
Payables	X		X	
Short-term borrowings	X		X	
Current portion of borrowings	X		X	
Provisions	X		X	
Employee benefits	X		X	
Superannuation	<u>X</u>		<u>X</u>	
		X		X
Non-current liabilities				
Payables	X		X	
Borrowings	X		X	
Provisions	X		X	
Employee benefits	X		X	

	20X2	20X2	20X1	20X1
Superannuation	<u>X</u>		<u>X</u>	
Total liabilities		<u>X</u>		<u>X</u>
Net assets		<u>X</u>		<u>X</u>
NET ASSETS/EQUITY				
Capital contributed by other government entities	X		X	
Reserves	X		X	
Accumulated surpluses/(deficits)	<u>X</u>		<u>X</u>	
		X		X
Minority interest		<u>X</u>		<u>X</u>
Total net assets/equity		<u>X</u>		<u>X</u>

Attachment 5. Statement of Financial Performance

(pp. 77-79, Appendix 1, IPSAS 1)

Public Sector Entity — Statement of Financial Performance for the Year Ended 31 December 20x2 (Illustrating the Classification of Expenses by Function) (In thousands of currency units)

	20X2	20X1
Operating revenue		
Taxes	X	X
Fees, fines, penalties and licenses	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other operating revenue	<u>X</u>	<u>X</u>
Total operating revenue	<u>X</u>	<u>X</u>
Operating expenses		
General public services	X	X
Defense	X	X
Public order and safety	X	X
Education	X	X
Health	X	X
Social protection	X	X
Housing and community amenities	X	X
Recreational, cultural and religion	X	X
Economic Affairs	X	X
Environmental protection	<u>X</u>	<u>X</u>
Total operating expenses	<u>X</u>	<u>X</u>
Surplus/(deficit) from operating activities	X	X
Finance costs	(X)	(X)
Gains on sale of property, plant and equipment	<u>X</u>	<u>X</u>
Total non-operating revenue (expenses)	<u>(X)</u>	<u>(X)</u>
Surplus/(deficit) from ordinary activities	X	X
Minority interest share of surplus/(deficit) ⁷	<u>(X)</u>	<u>(X)</u>
Net surplus/(deficit) before extraordinary items	X	X
Extraordinary items	<u>(X)</u>	<u>(X)</u>
Net surplus/(deficit) for the period	<u>X</u>	<u>X</u>

**Public Sector Entity — Statement of Financial Performance for
the Year Ended 31 December 20x2 (Illustrating the Classification
of Expenses by Nature) (In Thousands of Currency Units)**

	20X2	20X1
Operating revenue		
Taxes	X	X
Fees, fines, penalties and licenses	X	X
Revenue from exchange transactions	X	X
Transfers from other government entities	X	X
Other operating revenue	<u>X</u>	<u>X</u>
Total Operating Revenue	<u>X</u>	<u>X</u>
Operating expenses		
Wages, salaries and employee benefits	X	X
Grants and other transfer payments	X	X
Supplies and consumables used	X	X
Depreciation and amortization expense	X	X
Other operating expenses	<u>X</u>	<u>X</u>
Total Operating Expenses	<u>X</u>	<u>X</u>
Surplus/(deficit) from operating activities	X	X
Finance costs	(X)	(X)
Gains on sale of property, plant and equipment	<u>X</u>	<u>X</u>
Total non-operating revenue (expenses)	<u>(X)</u>	<u>(X)</u>
Surplus/(deficit) from ordinary activities	X	X
Minority interest share of surplus / (deficit)*	<u>(X)</u>	<u>(X)</u>
Net surplus/(deficit) before extraordinary items	X	X
Extraordinary items	<u>(X)</u>	<u>(X)</u>
Net surplus/(deficit) for the period	X	X

Attachment 6. Statement of Changes in Net Assets/Equity

(p. 80, Appendix 1, IPSAS 1)

Public Sector Entity — Statement of Changes in Net Assets/Equity for the Year Ended 31 December 20x2 (In Thousands of Currency Units)

	Contributed Capital	Revaluation Reserve	Translation Reserve	Accumulated Surpluses/ (Deficits)	Total
Balance at 31 December 20X0	X	X	(X)	X	X
Changes in accounting policy	(X)			(X)	(X)
Restated balance	X	X	X	X	X
Surplus on revaluation of property		X			X
Deficit on revaluation of investments		(X)			(X)
Currency translation differences			(X)		(X)
Net gains and losses not recognized in the statement of financial performance		X	(X)		X
Net surplus for the period				X	X
Balance at 31 December 20X1	X	X	(X)	X	X
Deficit on revaluation of property		(X)			(X)
Surplus on revaluation of investments			X		X
Currency translation differences			(X)		X
Net gains and losses not recognized in the statement of financial performance		(X)	(X)		(X)
Net deficit for the period				(X)	(X)
Balance at 31 December 20X2	X	X	(X)	X	X

End Notes

1. Paragraph 22, IPSAS 1, Presentation of Financial Statements (May 2000).
2. Appendix 2, Cash Basis IPSAS, p. 78.
3. For detailed information on each standard, the reader should obtain the *Handbook of International Public Sector Accounting Pronouncements from the International Federation of Accountants* (New York) or they can be downloaded at no charge from the www.ifac.org website.
4. See para. 2.22, Study 14—Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities (IFAC Public Sector Committee), April 2003.
5. For more information, see Treasury Reference Model by Ali Hashim (World Bank) and Bill Allan (IMF), www1.worldbank.org/publicsector/pe/trmodel.htm (3/14/2001).
6. Government Finance Statistics Manual, International Monetary Fund, 2001.
7. The minority interest share of the surplus/(deficit) from ordinary activities includes the minority interest share of extraordinary items. The presentation of extraordinary items net of minority interest is permitted by paragraph 57(c) of IPSAS 1 "Presentation of Financial Statements." Disclosure of the minority interest share of extraordinary items is shown in the notes to the financial statements.
8. The minority interest share of the surplus/(deficit) from ordinary activities includes the minority interest share of extraordinary items. The presentation of extraordinary items net of minority interest is permitted by paragraph 57(c) of IPSAS 1 "Presentation of Financial Statements." Disclosure of the minority interest share of extraordinary items is shown in the notes to the financial statements.

Public-Sector Accounting Reforms in Germany—Developments and Demands

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Introduction

Reforming public-sector accounting has been discussed in Germany since the start of the 1990s. This debate has its roots in the increasing financial problems at a federal, state and municipal level - after the successful reunification on October 3, 1990. During this period, public authority debt increased dramatically, making it pertinent to bring a more rational use of budget funds into public debate.

In Germany, this discussion was pioneered by the municipalities and here, in turn by the Kommunale Gemeinschaftsstelle (KGSt - Local Government Association), which recommended output-oriented budget control as a new control model (Neues Steuerungs Modell - NSM) in view of the past and present international debate. This fell headlong into an across-the-board budgetary culture of cash accounting, which until then had never dealt with costs or the consumption of resources. This meant that it was suggested to initially start by establishing cost accounting based on cash accounting, on which in turn a budget process was based. Thoughts about migrating from cash to accrual accounting initially tended to be the exception and were increasingly brought into the discussions on rational, public-sector accounting by theorists (including Lüder, Brede, Buschor, Reichard, etc.).

Budgetary reform in the federal state

Germany is a federal state with two state levels, which in turn have either one or several tiers of local government. Under applicable budgetary law, the Federal Republic has the possibility to stipulate which budgetary specifications the states must use as part of its concurrent legislative powers. The Federal Republic availed itself of this opportunity in 1969 with the Haushaltsgrundsatzgesetz (Law on Budgetary Principles) and, at that time, specified that cash accounting be used as the binding style of accounting.

As a result of budgetary reform activities at all administrative levels, an amendment to the Law on Budgetary Principles was passed at the end of 1997 which, for example, legally allowed accrual accounting to be introduced in par-

allel to the cash accounting system (section 33a of the HGrG). The initiative to reform the Law on Budgetary Principles stemmed primarily from the state of Hesse. Both the parliament and the government supported the idea of budgetary reform and did not regard accrual accounting as a supplement to cash accounting, but as an alternative system. However, Hesse was not able to have its request accepted by the Federal Ministry of Finance and the Bundestag and have them pass an amendment to the law, which Lüder referred to as a "missed opportunity." The budget was to be made more flexible at a federal and state level, however it was to remain basically based on cash accounting.

Despite the retention of the cash oriented system as required by the Law on Budgetary Principles, Hesse continued its own reforms—and at the start it was the only state to do so. In 1998, the state's government decided to introduce commercial accounting as the main system for both the entire state administration as well as for the Hessian municipalities within ten years. In December 1999, the government decided to introduce corresponding standard software. Hesse is currently in the implementation phase and is restructuring the management of its entire budget based on the new accounting system - and this process is bringing with it a certain amount of friction. The city states of Bremen and Hamburg are pursuing a similar course. They are also in the process of implementing accrual budgeting and accounting. In contrast, other states have decided to retain cash accounting, however with the possibility of output-oriented budgeting and making resource management much more flexible.

As the Federal Republic has only given the states a binding framework for how to design their budgetary law and thus their budget management with the Law on Budgetary Principles, the latitude for reform at a municipal level was greater than that given to the states. This meant that the discussion - which was initiated by the municipalities - on the introduction of a resource consumption concept was taken up and on October 26, 2000 the Conference of Interior Ministers and Senators of the States resolved to grant the municipalities an option to choose between the two styles of accounting.

Just one month later (November 24, 2000) the same Conference passed key elements for a municipal budget and accounting system based on accrual accounting. In view of accounting, these key elements set out that - when accrual accounting is introduced - the annual financial statements must be prepared in line with the principles of proper accounting and that they must show a true and fair view of the financial position, performance and changes in financial position. In addition, the annual financial statements must be discussed in the notes and a management report.

Budgetary reform with the introduction of accrual accounting is already in progress in many municipalities in various states. Meanwhile, select municipalities are working with a full resource consumption concept (accrual) as pilot projects. In North Rhine-Westphalia the closing report for the model project has just been published. This state will make the necessary changes to municipal budgetary law by 2004 so that accrual accounting can be introduced across the board in all NRW municipalities by 2008. The state of Lower Saxony is taking a similar approach, and also aims to introduce accrual accounting throughout the state. The transition period in Lower Saxony is scheduled for 2005 to 2010. An option model is frequently to be found in other federal states, i.e., the municipalities can decide whether to use the accrual or expanded cash (partial resource consumption concept) system. As activities to further develop municipal budgeting and accounting often focus on the introduction of cost accounting

and the associated budgeting, many municipalities decide to take the latter path.

But these days there is a draft for a generalized municipal budgetary law presented by a working group of the Conference of Interior Ministers and Senators of the States planned to pass the Conference. On the one hand, this paper will bring an additional push on the way to implementing accrual accounting in municipalities, but on the other hand it is still far away from a formulation of uniform accounting standards. It still gives the states a wide range to define their own priorities.

In contrast to the municipal and state levels, the Federal Republic as a centralized state has a defensive attitude to accounting reform. At this level, accounting remains based on the cash accounting system with certain easements regarding budgetary resources' eligibility to serve as collateral and their transferability. Based on this, some administrative departments have resolved to introduce cost accounting and budgeting.

Overall, activities to introduce accrual accounting are still the exception rather than the rule. However, in view of Germany's distinctive federalism, it would be surprising if there were functional agreements in favor of uniform accounting rules.

Non-uniform accounting

The disparities in the development of budgeting and accounting mean that in the near future Germany will have a very mixed administrative landscape. This irregularity concerns styles of accounting and accounting, and thus makes comparing - at least in part - the performance of individual states and municipalities problematic: in Germany, it can be seen that public accounting is, to some extent, growing apart. This may be due to the introduction process. However, as this progresses further we should expect there to be increased moves towards making accounting styles and standards more uniform.

With regard to accounting styles (double entry or cash), there will be parallel systems (both styles run in parallel), staggered systems (state and municipalities use different systems), and integrated systems. Irrespective of the style of accounting, cost accounting and forms of budgeting will be found at all levels.

Agreement among local authorities regarding the characteristics of uniform standards for new public-sector accounting (use of a uniform chart of accounts, uniform measurement criteria for opening financial statements, uniform amortization/ depreciation modalities) has not yet been realized, although efforts can be seen at a state level to bring about uniformity. Although benchmarking is desirable for public authorities, the various accounting styles and standards make this difficult - although it is needed in order to be able to simulate competition between various regional authorities.

Requirements for the definition of uniform standards

There are various activities in progress to define uniform standards for public-sector accounting. This is to be welcomed. Particular mention should be made of IDW's work on public-sector accounting and the publications in this context by Bolsenkötter and Vogelpoth, as well as the publications by Brixner and Körner resulting from the Hessian model. It is still too early to comprehensively evaluate the results of the introduction of accrual accounting for regional

authorities at various levels. Many projects are currently still being introduced or are pilot projects just about to be completed.

Uniform chart of accounts

There is already a great deal of variety in the proposed charts of accounts - many of the versions currently on the market are basically similar but do not have uniform classification. A proposal on this matter is currently being discussed in the Federal/Länder working party for cost accounting as requested by the Federal/Länder working committee for budget law and budget systems which is in charge of this issue. Hesse and Baden-Württemberg have prepared a draft to be used as a basis for discussions based on their practical experience to date. Even though the chart of accounts only defines method-related and not content-related standards for accounting, the chart of accounts is still a key requirement for meaningful comparisons of accounting data from various administrative departments. The chart of accounts should thus be defined just as bindingly as currently applies to the grouping and function plan.

Standards for measurement of assets

Measurement requirements are a key factor for accounting and meaningful comparisons. Different methods are of significant importance in this regard and a binding requirement issued by the responsible Conference of Finance Ministers could avoid erroneous trends. Whereas there is agreement that measurement should be based on cost for ongoing measurements (secondary valuations), and that reductions in value should be deducted over the asset's useful life via amortization/depreciation, various carrying amounts have been put forward for the initial measurement when preparing the opening financial statements (primary valuations):

- In its fundamental methodological concept for the state and municipalities, Hesse calls for consistent measurement at cost less any write-downs.
- North Rhine-Westphalia is basing its rules prepared for municipal accounting on the DM-Eröffnungsbilanzgesetz (DM Opening Balance Act), and prefers "cautiously estimated" fair values for the initial measurement of assets.
- With regard to measurement, Lüder differentiates between realizable and non-realizable assets and proposes that realizable assets be measured at their fair market value (fair repurchase value) and other assets be measured at cost.

Accounting aims to present a true and fair view of the financial position, to avoid artificially "accounting oneself rich" for public institutions, and to create the basis for performance comparisons. There is some competition between the various objectives—all of the targets cannot be equally realized, so that only an optimum solution can be aimed for with regard to the meaningfulness of the accounts.

Provisions for pensions and maintenance

The principle of the formation of provisions, i.e., recording an expense which will only lead to an outflow of funds in later accounting periods, is unknown in cash accounting. Together with recording the reductions in value resulting from amortization/depreciation, provisions are one of the central issues in an accounting system that aims to record the consumption of resources. As a corre-

sponding accounting system is currently under construction in Germany, various concepts for the disclosure of provisions are also being discussed. In addition to provisions that could be due to uncertain liabilities or threatened losses, in the public sector it is, in particular, necessary to form provisions for pension commitments and deferred maintenance for properties.

Whereas it is unanimously agreed that provisions must be disclosed for new pension commitments irrespective of their actual treatment, there are differences in opinion concerning the necessity to include existing commitments in the opening financial statements. The majority believes that these should be disclosed. However, the Hessian Hochschulfinanzverordnung (University Finance Directive) takes a different approach. This only requires new commitments to be included that occur after the balance sheet date. This means that it is forbidden to account for existing commitments, however these must be disclosed in the notes to the balance sheet. Compared to this solution, the more generous regulation for comprehensive accounting treatment of future pension payments has the advantage of greater transparency and adequate accruals for the expenses. On the other hand, full disclosure brings with it the danger of possible over-indebtedness.

Various paths have also been taken regarding provisions for maintenance. Whereas the HGB prescribes a tight time limit for these measures to be completed (maximum one year), periods of between three and five years are scheduled for the public sector. Hesse's methodological concept also differentiates between administrative and infrastructure assets, and includes a "methodically unlimited" requirement to carry provisions for deferred maintenance for infrastructure assets as a liability "until the maintenance is actually performed." This comprehensive formation of provisions aims to ensure that deferred maintenance does not lead to resources being rededicated from the investment to consumption. As such, this does justice to the principle of intergenerational justice set out in Article 115 of the German Constitution.

In the case of both pensions and deferred construction maintenance it must be noted that, even without provisions being included in the opening financial statements, simply booking ongoing provisions would create significant problems for many municipalities as it is generally not permitted to finance these "additional" items via borrowing.

Budget equalization and balance sheet

The financial constitutions of German regional authorities stipulate that budgets must be balanced. Of course this is currently based on cash accounting and is thus geared towards cash flows. In the accrual system the principle of equalization not only relates to the cash-flow statement (where equalization by borrowing is always possible), but in the accrual system the balance sheet is at the heart of equalization. In this connection, two treasurers from major German cities recently asked the question: "Accrual accounting - a clean-up or destruction?"

First of all, we must ascertain that if the income statement remains balanced the amount of equity on the balance sheet remains constant. However, many municipalities may find it difficult to keep income and expense balanced given substantial provisions and write-downs - in particular if significant infrastructure assets have to be written off. This can result in equity being consumed. This means that we have to ask ourselves the question of how much equity can be

consumed, or how much equity should be disclosed in view of budgetary equalization.

If we assume the borderline case under constitutional law that investments are exclusively financed by borrowing (which, however, would not be a pleasing situation), then equity of zero is conceivable. Any further imbalance in the income statement would then lead to the public authority becoming over-indebted as a result of consumption and would have to result in - for example in the municipal sector - the involvement of state supervision for the municipal authority.

Ensuring a balanced budget must be paid greater attention in future. This calls for rules to limit the reduction of equity, or the definition of requisite equity ratios that must be ensured in view of financial solidity and stability.

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The Meaning of Intergenerational Equity in Governmental Financial Management

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ABSTRACT

This paper focuses on the meaning of Equity depending on the accounting basis and, furthermore, on the accounting standards adopted in the recognition of some transactions and assets. I will analyze how the full accrual basis should be applied and how the assets should be recognized depending on the Equity concept that governments want to show in their financial statements. Questions such as what citizens should support the cost of the assets, those who purchased, built, and are using them, will be analyzed. The Equity meaning will determine the accounting standards that should be adopted and vice-versa. The accounting standards adopted determine, among other things, the recognition of assets and their depreciation, which determines the meaning of the surplus/deficit of the period and, therefore, the meaning of Equity.

Keywords: Governmental accounting, financial statements, accounting basis, assets and equity.

Introduction

It is important to know the Intergenerational Equity (also named Interperiod Equity, Net Assets or simply Equity) of a government, which is a significant part of accountability. Equity and changes in it help citizens to know whether revenues are sufficient to pay for the services provided, and whether future taxpayers will be required to assume burdens for services previously provided. Equity reflects the capacity of a government to provide goods and services in the future and is mostly defined as the residual interest in the assets of the entity after deduction of its liabilities. However, this definition needs to be qualified. It depends on which and how an accounting basis has been adopted.

This paper focuses on the meaning of Equity depending on the accounting basis and, furthermore, on the accounting standards adopted in the recognition of some transactions and assets. I will analyze how the full accrual basis should be applied and how the assets should be recognized depending on the Equity

concept that governments want to show in their financial statements. The accounting basis adopted and the accounting policies applied have more effects rather than in the Equity concept. However, in this paper only the effect in Equity concept is analyzed.

The Equity meaning chosen determines the accounting standards that should be adopted and vice-versa. The accounting standards adopted determine, among other things, the recognition of assets and their depreciation, which determines the meaning of the surplus / deficit of the period and, therefore, the meaning of Equity. Firstly, we will see the concept of Equity and how it is shown in the financial statements. Secondly, its relationship with the accounting bases will be analyzed. Afterwards, the paper focuses on issues such as the treatment of infrastructures, heritage and environmental assets, depreciation, donations, measurement criteria, maintenance expenses and useful life. All of them need to be taken into account when governments choose the meaning of Equity and their Entity concept. Finally, the paper concludes summarizing the effects of accounting policies on the meaning of Intergenerational Equity.

1. INTERGENERATIONAL EQUITY IN THE GOVERNMENTAL FINANCIAL STATEMENTS

One of the main objectives of Governmental Financial Reporting is to allow an evaluation of accountability over the use of public resources. Intergenerational Equity is a significant part of accountability and it is fundamental to public administration (FASAB, 1993, par. 137; GASB, 1987, par.61). Public finance literature refers to the concept of Intergenerational Equity (Equity), both in a broad and a narrow sense. An example of a broad view is the one expressed by Richard A. Musgrave and Peggy B. Musgrave:¹

“Those now living may affect the welfare of future generations in various ways. Thus advances in science and technology made by this generation will be at the disposal of the next. Similarly, the capital stock accumulated by the present generation is bequeathed as a legacy to the next one. In many ways the present generation thus benefits the future one. On the other hand, exploitation of irreplaceable natural resources and destruction of environment place a burden upon the future. All these relationships –the asymmetrical fact the present can affect the future but not vice-versa- pose questions of ‘intergenerational equity’.”

An example of a narrow view may be the one expressed by Frances Oakey:²

“The ease with which money may be borrowed on the public credit has often led governments into the error of meeting an undue proportion of expenditures out of the proceeds of the sales of bonds, with the result that a portion of the burden that should be borne by the present generation is continually shifted to later years. Under these conditions each generation is recipient of a burden of debt which does not belong to it and which, nevertheless, must be carried in addition to meeting the needs of the current period. On account of the assumption of such a burden each generation is not inclined to, and in some cases cannot, meet the current needs of the year without the issuance of more bonds. The result is that the financial condition is very likely to become less favorable every year until a point is finally reached at which drastic steps must be taken to restore the financial condition to its former favorable state.”

Equity and changes in it help citizens to know whether revenues are sufficient to pay for the services provided and whether future taxpayers will be required to assume burdens for services previously provided. The term Intergenerational Equity has been used to express this concept. However, due to the fact that a generation is defined as approximately 30 years and the term

intergenerational equity has implications that go beyond financial reporting, some standard-setting bodies and authors believe the term Interperiod Equity may be more appropriate in financial statements, expressing the concept of yearly balance. In governmental financial statements other terms such as Equity, Net Worth, Net Position or Net Assets are also used. Along this paper the term Intergenerational Equity or Equity will be used to express this concept, i.e. to know what past citizens leave to future citizens. It represents a net investment by society in an entity that is available for use to enhance the safety, welfare and overall living standards of society.

The most common definition of Equity in the financial statements is (IASB, 1989, par.49; AARE, 1995, par. 78): "Equity is the residual interest in the assets of the entity after deduction of its liabilities." This definition can also be adopted in the Public Sector. It represents the residual interest of the community in the net resources controlled by governments. An excess of assets over liabilities may mean that the current generation of taxpayers has funded activities that will benefit future taxpayers, whereas an excess of liabilities over assets may suggest that the current generation of taxpayers has benefited from government services at the expense of future generations. However, according to this definition, Equity has different possible meanings depending on the accounting basis adopted. The Equity concept chosen determines the accounting basis and vice-versa. Therefore:

- Which assets and liabilities should be reported in financial statements.
- When transactions should be registered.
- Which no-cash transactions should be included in the financial statements.
- How assets should be measured.

Rather than being interested in information about the Equity value, users are more likely to find information about changes in the equity of governments useful. Changes in equity over time provide an indication of the extent to which a government's wealth and its ability to provide services has increased or decreased. Changes in Equity are mostly due to the surplus/deficit of the period. However, as in the private sector, there are other reasons possible. For example, in Spain transfers and donations are considered a direct increase of the Net Worth, in Australia certain transfers may also be considered direct increases of the Equity, as well as the revaluation of the assets. Some of these issues will be treated afterwards. In some countries as New Zealand there is a Statement of Movements in Equity, in others as Australia and the Federal government of the United States this information appears as a note.

FIGURE 1. BALANCE SHEET		
ASSETS	EQUITY	<ul style="list-style-type: none"> • Accumulated surplus/deficit • Direct changes
	LIABILITIES	

2. ACCOUNTING BASES AND INTERGENERATIONAL EQUITY

Now I analyze the Equity concept depending on the accounting basis adopted. I focus on the meaning of the period surplus/deficit, and which assets and liabilities are reported under each basis. We will see that Equity reporting requires adopting accrual basis. Knowing the cost of services that the community has received during the period requires that long-term assets are capitalized and amortized over the period during which their services benefit society. In this way Equity may mean the community's investment in the entity.

2.1. ACCOUNTING BASES

Accounting basis refers to the body of accounting principles that determine when the effects of transactions or events should be recognized for financial reporting purposes. Public sector accounting literature commonly has identified two bases:

- Cash basis. Effects of transactions or events are recognized when cash is paid or received.
- Accrual basis. Effects of transactions or events are recognized when they take place.

These two bases are the extremes of the spectrum of possible accounting bases. The variations of them have been named (IFAC, 1991, par. 095) Modified Cash and Modified Accrual. The more GAAP (Generally Accepted Accounting Principles) are applied the nearer the basis is to full accrual basis.

- Cash and modified cash bases are useful for a cash control and the compliance with legal adopted budgets and other legal requirements, but they do not provide any information about the economic situation of the entity.
- Modified accrual basis focuses on the financial condition of the entity. It provides information on the sources, allocations and uses of financial resources in order to know the entity's ability to finance its activities and meet its liabilities and commitments. However, it does not produce the information needed to measure performance because it does not recognize capital assets. If financial reports do not include physical assets there is not sufficient disclosure of the resources for which the government is accountable.
- Accrual basis, besides all the information provided by the other bases, provides information about all the resources controlled by the entity, the cost of providing services and other information useful in assessing whether the entity is operating economically an efficiently.

2.2. ASSETS AND LIABILITIES REPORTED IN THE FINANCIAL STATEMENTS

Recognition and reporting of capital assets depend mainly on the basis of accounting adopted. Then, as long as one moves along the spectrum, from cash to full accrual basis of accounting, more assets are reported in the financial statements. Under a full accrual basis all significant assets should be recognized. However, particularly when the full accrual basis is first adopted, many significant assets may be unrecognized for pragmatic reasons or because recognition criteria cannot be met.

- Under cash basis the main financial statement is the Statement of Cash Flows. Then, only information about the cash amount at the end of the period is reported. Under modified cash short-term accounts are also reported.

- Under modified accrual basis only financial resources are recognized. When a physical asset is acquired the cost is recognized as expenditure in the surplus/deficit of the period. The closer it is to full accrual basis the more physical assets are recognized.
- Under full accrual basis all the assets and liabilities are recognized in the financial statements.

Table 1 shows the assets and liabilities reported depending on the accounting bases adopted.

TABLE 1. ASSET AND LIABILITIES REPORTED				
ASSETS	CASH	MODIFIED CASH	MODIFIED ACCRUAL	FULL ACCRUAL
	CASH	CASH ACCOUNTS RECEIVABLE WITHIN X DAYS	CASH FINANCIAL ASSETS • Investments • Inventories for sale • Loans Outstanding • Revenues and other receivables	TOTAL ASSETS
LIABILITIES		ACCOUNTS PAYABLE WITHIN X DAYS	LIABILITIES AND CERTAIN PROVISIONS	TOTAL LIABILITIES Including employee pensions obligations and accrued interest

Source: IFAC, 1993 and Montesinos, 1998

2.3. SURPLUS/DEFICIT OF THE PERIOD

2.3.1. Cash basis

Cash basis only reports the difference between cash receipts and payments in the period. Therefore, the surplus/deficit shows either if cash obtained is sufficient to face up future payments (positive) or if payments were done with cash from past periods (negative).

2.3.2. Modified cash basis

Under modified cash basis the surplus/deficit is the difference between the amounts received or that which are recovered in short-time, and the payments or amounts that are paid in short-time. It shows the increase or decrease of the current financial resources.

2.3.3. Modified accrual basis

Under modified accrual basis revenues are recognized when they occur, and expenditures represent the goods and services acquired during the period regardless of the timing of associated cash receipts or payments. However some revenues such as taxes may be recognized when they are collected. The surplus/deficit indicates if revenues have been sufficient to finance the acquisitions of long-life assets and the consumption of goods and services. In other words, it represents the changes in Net Debt. No distinction is made between outflows

that benefit future periods, and those used during the reporting period.

2.3.4. Accrual basis

Under accrual basis revenues and expenses are recognized according to GAAP. Therefore, expenses represent resources consumed during the period, including provisions and depreciation of assets. The surplus/deficit results from the difference between the revenues and the cost of services provided.

ACCOUNTING BASES	SURPLUS/DEFICIT
CASH	Receipts—Payments
MODIFIED CASH	Receipts and Receivables—Payments and Payables
MODIFIED ACCRUAL	Revenues—Expenditures Net citizen contribution (consumption) of financial resources
FULL ACCRUAL	Revenues—Expenses Net citizen contribution (consumption) of economic resources

2.4. EQUITY AND ACCOUNTING BASES

2.4.1. Cash basis

Net Assets are only the available cash at the end of the period. Therefore, they only would mean the cash that past taxpayers leave to future taxpayers.

2.4.2. Modified cash basis

Net Assets are the difference between cash, accounts receivable in short-term and accounts payable in short-term. The financial situation in short-term and changes in it are the only information available. An increase (surplus in the period) means that present taxpayers have contributed current financial resources for payments in the future.

2.4.3. Modified accrual basis

Net Assets represent the Net Debt (financial assets less liabilities of the entity). On the one hand, if it is positive, it means that past generations leave financial resources to acquire goods and provide services in the future. On the other hand, if it is negative, future financial resources have been used by past generations to pay services and goods previously acquired.

2.4.4. Accrual basis

Net Assets represent the Entity's Net Worth (all assets less liabilities). They show the resources left by past generations to future ones, which means the community's investment in the entity. It is a measure of the government's ability to provide services in the future. If it is negative, it implies that future resources will fund services and goods consumed in the past.

Nevertheless, it should be taken into account that Equity will be influenced by the policies of capitalization of expenditure on assets, and recognition of the cost of assets consumed during the period. The accounting policies adopted will determine the meaning of the surplus/deficit and therefore the meaning of Equity.

TABLE 3. NET ASSETS

ACCOUNTING BASES	NET ASSETS
Cash basis	Cash disposable
Modified cash basis	Financial situation in short-term
Modified accrual basis	Net Debt
Accrual basis	Net Worth, Community's investment

When full accrual basis is adopted Net Assets express the broadest concept of Intergenerational Equity. Accrual basis places emphasis on the points of earnings and using resources rather than on the points where spendable resources are received and expended. Other benefits of adopting accrual basis are the following ones:

- allows the government to demonstrate accountability for its use of all resources
- allows the government to demonstrate accountability for its management of all assets and liabilities recognized in the financial statements
- is useful in evaluating the government's performance in terms of its service costs, efficiency and accomplishments
- may lead governments to take a longer term view when making financing decisions

Although all significant assets should be recognized, many significant assets may be unrecognized due to pragmatic reasons or due to the fact that recognition criteria cannot be found. Capital assets are the most problematic and there usually are transitory periods for the complete reporting of all the assets, especially for those acquired before the adoption of accrual accounting basis. Nevertheless, it is necessary to decide what form of accrual accounting will be adopted. The policy of reporting non-financial assets and recognition of the cost of assets consumed is the main topic that influences the concept of Equity and on the meaning of the surplus/deficit of the period. In the next section different accounting techniques and their influence on the Equity meaning are analyzed.

3. ACCOUNTING STANDARDS AND EQUITY

The policy of reporting assets and the consumption of their potential service has an important influence on the meaning of surplus/deficit and Equity. In this section, the following issues are analyzed:

- Recognition of "problematic" assets
- Measurement basis adopted and its influence on the meaning of depreciation and sale profits
- Maintenance expenses and other recognition of use of assets
- Useful life and restoration expenses of some heritage assets

- Assets acquired by donation
- Armament

3.1. RECOGNITION OF ASSETS

3.1.1. Problematic assets

The most problematic assets in public sector are.

- Infrastructures
- Heritage assets
- Defense assets
- Environmental assets

Many governments do not recognize these assets, mainly heritage and environmental assets, although they have adopted accrual accounting basis. The IFAC, in its study no. 2 (IFAC, 1993, par. 065) summing up the most accepted international definitions, indicates that the fundamental characteristics of assets are:

1. The existence of service potential or future economic benefits;
2. The service potential or future benefits must arise from past transactions or events; and
3. The service potential or future benefits must be controlled by the reporting entity as at the reporting date.

The expression “service potential future or economic benefits” must not be understood only as future positive flows of box. The term is used with a broader meaning—namely (AARF, 1995, par. A10 (a)), the capacity to provide goods and services in accordance with the entity’s objectives, whether those objectives are the generation of net cash inflows or the provision of goods and services of a particular volume and quality to beneficiaries.

In the same sense, Pallot (1992) indicates that two recurring themes can be identified in most of the definitions of assets. Firstly, assets are economic resources. Secondly, there are property rights and obligations (aspects of ownership or control) attached to them. Next, these two characteristics are analyzed for problematic assets.

Some authors such as Mautz (1988) argue that certain assets, such as infrastructures and heritage assets, cannot be recognized as assets for accounting purposes because they do not contribute revenues to the entity, but require heavy outflows of resources for their maintenance instead.

Other authors such as Pallot (1990), with whom I more closely identify, consider that the traditional definition of assets must be extended. These assets provide social rather than commercial advantages for the whole community. In the same sense, Rowles (1992) indicates that if existence of an asset for accounting purposes were to be determined solely by the ability to generate cash inflows, most assets of not-for-profit entities, and not only infrastructure and heritage assets, must be regarded as not being assets.

Regarding property concept, it usually refers to a group of rights including:

- Custody rights, i.e. authority to use, control and manage the asset.
- Fruit rights, i.e. authority to claim the fruits from the utilization of the asset.

- Alienation rights, i.e. authority to transfer the ownership through sale or bequest to another subject and destruction.

Most problematic assets are property of governments in the sense above mentioned. However, in some cases this property concept may need to be extended, since the beneficial use of the problematic assets accrues to the community, not only to the nominal or titular owner. If all assets are not recognized, financial statements do not show all the resources that are left to future generations. For example, if the construction of infrastructures is recognized as expense, Equity decreases. However, since more useful goods are left to future generations and the welfare of society gets better, the Equity actually increases.

Not to capitalize infrastructures implies that the first users support entirely the whole cost. It suggests that all benefits are received in the year of acquisition. It seems more logical to recognize a depreciation expense over the periods in which infrastructure is used. Therefore, all users over its useful life receive the benefits of the use of the asset. Deciding whether these assets should be recognized in financial statements involves also understanding the government either as an organization or as a community. Moreover, it is the recognition of environmental assets that really determines the scope of the entity concept.

TABLE 4. GOVERNMENT AS ENTITY	
Organization	Assets whose titular or nominal owner is the government. Government is accountable of their use and maintenance. Infrastructures and heritage assets would be included.
Community	All the assets of public property controlled by the government. Environmental assets as national parks and the majority of land would be included.

In my opinion, governments should be accountable for all resources under their control and the results of their deployment of those resources, irrespective of the form in which those resources are held. Then, all assets controlled by the entity should be recognized in the financial statements. If so, Net Assets will represent better the concept of Intergenerational Equity.

3.1.2. Heritage and Environmental assets

Heritage assets are also an important part of the assets owned by governments. Not only are the ones already owned important, but also the new acquisitions. Many governments control a major portion of the environmental resources in their countries. In most cases, these assets were acquired at little or no cost. However, in other cases they have been purchased like other governmental assets. For instance, the Federal Government of the United States has obtained part of its territory by purchasing it. Other governments, as the government of the Balearic Islands in Spain, are purchasing environmental areas of great value for the community in order to preserve them.

Environmental assets must be reported in the financial statements since they are one of the principal assets possessed by the community. It can be said that our forbears have bequeathed us beaches and other land. These lands could be either private property or could be in worse condition. When they lost value (e.g., Community was not interested in them, they were contaminated, etc.), the loss would be recognized.

From my point of view, heritage and environmental assets should be capitalized because, like infrastructures, their acquisition means an increase of the Intergenerational Equity. On the other hand, if it is recognized as expense what is reflected in financial statements is quite opposite, a decrease. If they were not capitalized, the benefits derived from acquiring heritage assets would be all received in the year of purchase. It would misrepresent to the community the huge investment it has in the heritage and environmental assets held in the stewardship of government. The main problem in the recognition of environmental and heritage assets is how they may be valued. However, most governments use historical cost as measurement basis. Only those assets acquired are recognized in financial statements and then, the problem decreases.

Regarding heritage assets, Clark (1994) indicates that valuing them is an essential element in the process of introducing accrual accounting into the public sector and ultimately implementing whole-of-government reporting. Full accrual accounting will also allow an intergenerational perspective to be achieved, indicating whether a government has added to the net worth of the state, and whether the current generation has increased or decreased the worth of what it is leaving for the next generation. As well, it enables more informed decision-making on funding for maintenance and conservation of the assets.

Harris (1995) thinks that not only should new collections be valued, but also collections purchased in the past. If it did not, it would distort the surplus/deficit of the period. Finally, Micallef and Peirson (1997) indicate that the public has a beneficial interest in the assets that governmental entities control because it is the public that provides the funds required by those entities acquire assets and to fund operations. Already in 1986 the Economic Committee of Victoria's parliament noted that:³ "Government, Parliament and the public have the right to know the value of the Gallery's collection given that it is part of the cultural heritage of the State...Valuation of cultural and heritage assets for financial reporting purposes is very beneficial, necessary, possible and not prohibitively costly."

3.1.3. International practices

3.1.3.1. Recognize all controlled assets

It is the case of Australia, New Zealand and also the policy adopted in the elaboration of National Accounts. In these cases the Entity is identified as Community.

3.1.3.2. Environmental and heritage assets as stewardship assets

Standard-setting bodies, such as Federal Accounting Standards Advisory Board (1996) in the United States and Intervención General de la Administración del Estado (1994) in Spain, and authors as Barton (1998) consider that these assets are the nation's assets rather than the government's assets, and should be separately reported on by the government in its role as trustee. Rather they are better classified as assets held by the government in trust for the nation. The assets reported are those that provide directly services. Expenditures to acquire, construct, reconstruct, or improve heritage and environmental assets is reported as a cost in the period incurred. The Federal Government of the United States provides information about these assets in the

Supplementary Stewardship Reporting, which supplements the basic financial statements.

3.1.3.3. Do not recognize problematic assets.

Other governments do not recognize any problematic assets in their Balance Sheet. In most cases it is due to the fact that accrual accounting basis is not yet adopted. The accounting of problematic assets is curious in Spain. Assets that are going to be destined to public use, especially infrastructures, are included in the balance only while they are in construction. Nevertheless, when the citizens can use them they are written-off and become a negative item of Net Assets. In the case of Spain, the surplus/deficit reflects the use (contribution) of economic resources during the period, without taking into account the depreciation of assets for public use. The assets reported are only those in which the government is the nominal owner and the direct user. There is no influence on the surplus/deficit of any period in relation with these assets. Only when they are bequeathed to the citizens there is a direct decrease of Net Assets. Table 5 compares the meaning of surplus/deficit and changes in Equity among accounting bases and the Spanish case.

Acquisition	Modified Accrual Expenditure	Full Accrual Assets	Spanish case Assets
Transfer	--	Equity decrease or expense	Equity decrease
Depreciation	--	Expense	--
Surplus/deficit	Expenditure	Depreciation	--
Changes in Equity	Surplus/deficit (Expenditure)	Surplus/deficit (Depreciation)	Asset value

In case of non-depreciable assets (for example, land) the meaning of the surplus/deficit is the same in the case of Spain as in full accrual basis.

3.2. MEASUREMENT

3.2.1. Measurement criteria

There is a number of bases upon which the government's non-current physical assets could be measured. Historical cost is the criterion most used by the governments, but it is not the only one. New Zealand entities in the public sector assess fair values every three years, at a minimum. Many Australian public sector entities adopt deprival values⁴ for the valuation of their non-current assets. Public sector bodies in the United Kingdom are required to record tangible assets at their net current cost of replacement. Many authors, like Micafell et al. (1994), consider that in public sector where historical cost is not the criterion adopted, deprival value represents better the value of an asset. The measurement criterion adopted influences the Equity concept.

- If it wants Equity to mean the effort of past generations, the historical cost may be the best solution. Intergenerational Equity would indicate how much Net Assets cost (to current prices, if it is indexed) to past generations.
- If Intergenerational Equity means the value, the usefulness, of what past generations have left to the current one, deprival value may be suitable.

Assets reported	Measurement criteria	Equity
All controlled assets	Deprival value	Value of what past generations have left to the current one in order to serve to the community
All controlled assets	Historical cost	Cost of what past generations have left to the current one in order to serve to the community
None		Net Debt (modified accrual)
Only Infrastructures	Deprival value	Value of what past generations have left to the current one to provide directly governmental services
Only Infrastructures	Historical cost	Cost of what past generations have left to the current one to provide directly governmental services

However, in most countries what really determines and influences on the measurement criteria adopted by the public sector are those applied in the private sector. Since the business accounting standards are the main reference, they influence the public sector accounting standards, although not in the same way in all countries.

3.2.2. Depreciation

Recognition of depreciation as a measure of the consumption of assets service potential is a controversial concept, mainly in the public sector. Proponents of depreciation argue that a periodic charge to operations is necessary to communicate the using up of capital assets to be compared with tax revenue for the period in the measurement of interperiod equity. The measurement criterion adopted also determines the meaning of the depreciation of the asset. Historical cost depreciation implies a distribution of the asset cost over the periods it is used.

TABLE 7. DEPRECIATION MEANING

MEASUREMENT CRITERIA	DEPRECIATION
Historical cost	Resources consumed at cost
Deprival value	Consumption of service potential

3.2.3. Sales of assets

If assets are reported at historical cost, the difference between historical cost and sale price is all recognized in the period. On the other hand, if assets are revaluated the Equity increase is progressive. Equity changes when the revaluation is recognized and in the sale period. Revaluation usually does not take place every year. Therefore, it seems better to recognize it as direct increase of Equity than as part of surplus/deficit, because this increase of value has been produced in several periods and not only in one.

3.3. ALTERNATIVES TO DEPRECIATION

All physical assets, including most problematic assets, are subject to decay or loss of economic usefulness, and an expense is associated with their use. To recognize this loss systems of renewal accounting and deferred maintenance have been suggested as alternatives to depreciation. Renewal accounting treats a collection of assets making up a network, or system, as a single asset that is to be maintained in service indefinitely. All expenditures on an asset system are perceived to be in the nature of maintenance of the system, and are expensed as they occur. In essence, renewal accounting is a form of cash accounting. In countries such as New Zealand, United Kingdom or United States (GASB, 1999) renewal accounting may be adopted as long as infrastructure assets are maintained and preserved regularly. If properly maintained, it can have service potential that continues for such a long period that an annual depreciation charge is not necessary.

Deferred maintenance involves recognizing in each period an amount estimated to be the expenditure necessary to make up the decay that has accrued in an asset system. Deferred maintenance requires that amounts that might be expended to restore assets be recognized as an expense and liability. Deferred Maintenance is compatible with both depreciation and renewal accounting. Moreover, deferred maintenance neither can substitute nor is equivalent to depreciation.

- Depreciation recognizes the wearing away of the assets
- Deferred maintenance recognizes the periodic cost for the assets to exist during its expected life.

However, because there is not a liability that meets present recognition and measurement criteria, deferred maintenance is not generally recognized in the public sector. If it is recognized, the information is only reported as a note to the financial statements or as supplementary information (for example, the Federal Government of the United States (FASAB, 1995, par. 77-84)). Reporting deferred maintenance on the Balance Sheet would allow the reader to see the impact on equity. If it is only reported in the notes, this factor can easily be overlooked. Recognition of Deferred Maintenance involves that the whole cost

of a great repair is not supported in a unique period, but as the asset is getting deteriorated.

In other countries, such as Spain, a provision for significant future repairs may be recognized under certain circumstances. In each period, until the future reparation, an amount estimated is recognized as an expense and liability. It requires that the future significant reparation be done due to the current use of the asset.

3.4. USEFUL LIFE AND RESTORATION OF HERITAGE ASSETS

Some heritage assets may have very long useful lives. Asset service potential may be significantly extended with expenditure on maintenance, replacement or restoration. Sometimes such expenditures are held to extend the service life of assets such that the necessity to depreciate assets is avoided. In this sense there may be two possibilities:

a) Infinite useful life

The depreciation of works of art and historical treasures where economic benefit or potential service decreases so slowly that their useful lives are extraordinarily long does not need to be recognized. The assets have a cultural, aesthetic or historical value that is worth preserving to perpetuity and there is no doubt that it is going to be done. In this case expenditures on maintenance and restoration are expenses. It would be equivalent to a form of renewal accounting.

b) Useful life until the next restoration

Supposing the restoration as an improvement. Therefore, an increase of value and an annual depreciation would be reported.

The treatment of restoration expenditures indicates whose citizens should pay for the use of the asset.

- If the cost of restoration is capitalized and depreciated, it is supported by those who enjoy the restored asset.
- If the useful life of the asset is supposed infinite and, therefore, the restoration is an expense, the cost is supported only by the users of the period of restoration. In most cases these users do not enjoy the asset because it has been restoring and has not been accessible to the public.
- If a fund for future restoration is created, users previous to the restoration support the cost. They do not enjoy the restored asset, though it might be said that the asset needs to be restored because they have enjoyed it before.

3.5. ASSETS OBTAINED BY DONATION

When an asset is obtained by donation the entity has a profit. This profit can increase the equity, directly or through the surplus/deficit, or be recognized as revenue as the asset is used. If it is considered that the assets have been obtained thanks to the policies of the period, all profit should be recognized in the surplus/deficit of the period. These assets are left to future generations in a similar way to those purchased. Nevertheless, it cannot be equivalent to a purchase, since it has not supported the same effort for the citizens.

In the second option, all those who use the asset have the benefit (the "gift" was for all of them). In this case, there is no impact on the total surplus/deficit

of the period because the depreciation expense is compensated by the profit. The surplus/deficit would show better the entity effort to provide services. Anthony (1988) believes that depreciation should not affect income because these assets had zero cost to the organization. Depreciation may be beneficial in making cost comparisons and in measuring service effort. Then, if depreciation was recognized, an item of contributed revenue exactly equal to the amount of depreciation expense should be reported.

3.6. ARMAMENT

Diverse accounting policies are adopted in order to report armament. Some countries believe that the cost related to the acquisition of weapons systems should be treated as period expenses. Their reasons include the belief that the consumption of service potential cannot be reliably measured through depreciation, because they have indeterminate or unpredictable useful life. This has been the case of FASAB (1996) in the United States until 2003. Other countries reflect the acquisition costs of the assets when incurred, and recognize depreciation (or loss due to destruction) as the measure of the consumption of service potential.

- If the armament acquisition is accounted for as an expense when, unfortunately, a military conflict takes place and the armament is used, there is no impact in the surplus/deficit (except if more armament is acquired).
- If the armament is capitalized but not depreciated, a unique expense will be recognized when used or dismantled.
- If it is depreciated over its estimated useful life, its cost is distributed among all those who “enjoy” the safety of the armament. If, unfortunately, it were used in a military conflict, the remaining value would be recognized as period expense, since during that period “extra safety” has been needed due to the conflict.

The option chosen depends on the concept of the service that provides the use of the armament, either the safety that it provides or its use. In most cases, armament is acquired more as a preventive and dissuasive measure than to be used. In case of countries in permanent military conflict, it may be suitable to recognize the armament acquisition as period expense due to its brief life.

Acquisition Expense	Depreciation	Meaning of surplus/deficit Armament acquisition, cash basis
	No	War or dismantle
Asset	Yes	Enjoyment of the safety

3.7. A BRIEF COMMENTARY ABOUT THE “POWER TO TAX”

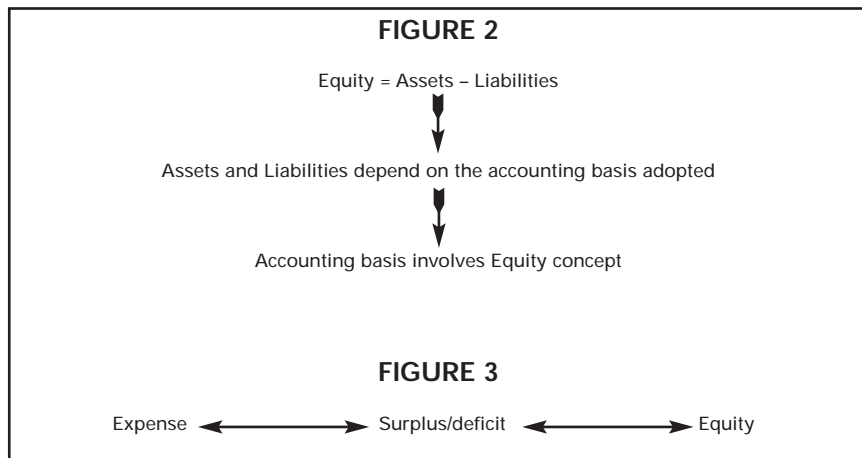
It is usually said that governments have the power to tax in order to raise revenue to fund the provision of public goods and social welfare benefits. There is no doubt that governments will continue to use this revenue-raising power in the future. It may be argued that this power is an asset and if it is not capitalized, the Balance Sheet does not reflect the real situation of the government.

However, there are two main problems. First, there can be measurement difficulties arising from predicting future government taxation policies and movements in the various tax bases. But, more importantly, it can be argued that the asset does not exist at the present time because the liability for taxation only accrues with the happening of specific future events. Hence, it is an ex ante asset only and should not be included in the financial statements as an asset.

In my opinion, it cannot be considered an absolute power, especially in consolidated democracies. Citizens do not tolerate taxes over a certain level. If taxes rose, they would demand more and better services. Moreover, it is not an asset that is left to future generations, since it is an innate faculty of any government (some levels of government even do not possess this “power” and its principal income is the transfers made from other levels of government). The power to tax might be assimilated to the goodwill of a company. If all infrastructures, environmental and heritage assets used to provide services and to enhance the safety and welfare of society are included in the Equity concept, it may be equivalent to recognize the power to tax. If there is not Equity in its broadest sense, there are no arguments to demand higher taxes.

4. CONCLUSION. WHAT DO GOVERNMENTS WANT TO SHOW IN THEIR FINANCIAL STATEMENTS?

Nowadays, Financial Statements of different governments cannot be read in the same way if the same accounting basis is not adopted. Assets and liabilities reported and the measurement criteria vary a lot depending on the basis adopted in each case. If a broad concept of Equity (i.e., net assets reflect community’s investment) is to be shown in financial statements, accrual basis should be adopted. However, not only do accounting basis influence the Equity meaning, but also accounting policies of reporting physical assets and recognition of their use.



Rather than knowing the Equity value, it is more useful to users to know the changes in the equity. Changes in equity over time provide an indication of the extent to which a government’s wealth and its ability to provide services has increased or decreased. Changes in Equity are mostly due to the surplus/deficit of the period. Then, the accounting policy effects on the surplus/deficit are also important.

Policies and their consequences regarding recognition of problematic assets, their consumption, maintenance and useful life, have been treated along the paper. A summary of them can be observed in the following tables.

TABLE 9.SCOPE OF EQUITY	
No physical assets	Financial situation, Entity's Net Debt
No problematic assets	Entity as organization Net Assets of exclusive use of the organization
Add Infrastructures	Inheritance to provide services to the community
Add Heritage Assets	Assets owned plus those which the government in trust of the community holds
Add Environmental Assets	It implies the broadest concept of Equity. All assets that serve to the community

TABLE 10.MEANING OF SURPLUS/DEFICIT AND ASSETS ACCORDING TO THE RECOGNITION OF THEIR USE AND MEASUREMENT CRITERIA		
CONSUMPTION Historical cost / indexed depreciation	SURPLUS/DEFICIT Resources consumed	PATRIMONY Patrimony = historical/ indexed value of heritage diminished by its use
Deprival value depreciation	Consumption of asset service potential	Patrimony = Current value of the assets service potential
Deferred maintenance	Expenses necessary (regardless the expenditures were made or not) for the assets to exist during its expected life	Patrimony = The above patrimony has been diminished by the expenses necessary due to its use, regardless they have taken place or not.
Renewal accounting	Maintenance and renovations when they take place. Infinite useful life. The cost of acquisitionis never recognized on surplus/deficit.	The above patrimony diminished by the expenditures due its use.

We have seen how different accounting policies involve different Entity and Equity concepts. This relationship should be taken into account by governments and standard-setting bodies in order to choose between the possible criteria. Citizens, as providers of funds, require useful and comprehensive financial statements to evaluate the accountability of their governments. Equity and changes in it are a fundamental part of this accountability. Therefore, financial statements should show the broadest sense of Equity. Anyhow, at the end, it is a decision about what governments want to show.

End Notes

1. Musgrave and Musgrave (1984). *Public Finance in Theory and Practice*. Ed. McGraw-Hill, pp. 99. Quoted in GASB (1987) par. 82.
2. Oakey, Frances (1921). *Principles of Governmental Accounting and Reporting*. Ed. Appleton, pp. 214. Quoted in GASB (1987) par. 83.
3. Economic and Budget Review Committee of the Parliament of Victoria, "An Inquiry into Certain Matters Concerning the National Gallery of Victoria," December 1986, p. 13-14, 129, quoted in Micallef and Peirson (1997, p. 34).
4. Under the deprival value basis, assets are valued at an amount that represents the entire loss, both direct and indirect, that might be expected to be incurred by an entity if that entity were deprived of the service potential or future economic benefits of the assets at the reporting date. Generally, non-current physical assets that would be replaced are measured at their written-down current cost, those which held for sale are measured by reference to their market value, and those which would not be replaced are measured at the greater of the present value of the net cash inflows or the net market value.

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Basic Requirements Model for Successful Implementation of Accrual Accounting in the Public Sector¹

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ABSTRACT

This paper proposes a Basic Requirements Model for successful implementation of accrual accounting in the public sector. It is based on an intensive study of the New Zealand, UK and Australia experiences in respect of the implementation of the accrual accounting in their public sector. The main purpose of this model is to specify the basic requirements that should be available if a certain country confirmed its intention (decided) to implement accrual accounting in the public sector. This model consists of the following elements: stimuli, reform decision, basic requirements, outcome, consequences and proposed cost elements. Moreover, the basic requirements model evolves a clear and intellectual implementation framework within which to create conditions appropriate for the introduction of accrual accounting and to put it into practice, further, to attain the target benefits from that implementation. In addition, it discusses whether this model can be used for both developed and developing countries or the developing countries demand additional basic requirements which are not required for the implementation of accrual accounting in the public sector of the developed countries.

1. Introduction

During the past two decades some countries (such as UK, New Zealand and Australia) have made significant reforms in their public sector. These reforms have been made whether to face economic crisis or to meet the challenges that increased globalization has brought. For example, I. Ball (1994) has argued that the economic and fiscal position faced by the incoming government in October 1984 was sufficiently serious to require significant economic reform. One element of the economic reform was public sector reform. The main objectives of the public sector reform are 1- encouraging a culture of performance; 2- making the public sector more responsive to the needs of government. This reform is being implemented by an integrated package of reforms: financial, public service and workplace relations. The key components of the financial reforms are (Boxall 98):

- preparation of accrual based whole-of- government financial statements;
- introduction of accrual based budgeting;
- increased use of market based and financial management improvement tools;
- introduction of streamlined, principles-based financial legislation.

So one of the main public sector reforms is the introduction of accrual accounting in the public sector. Accounting researchers have highlighted possible implications of the application of accrual accounting in the public sector (see for example, Ball 94, Parker 93, Pallot and Ball 96, Guthrie 98, Warren IFAC 96, Richardson IFAC 97, Goldman and Brashares 91, and Miah 1991), and the accounting role in organizational and social changes (see Hopwood 84, and Ryan 98). However, the research in accrual accounting is still very limited and there remains considerable scope for further work. Guthrie has argued that despite the increasing appeal of accrual accounting and its broad ranging implications for the role and functioning of public sector accounting systems, there has been comparatively little study of *its application and consequences* for the wider community. The literature is dominated by official style publications from the profession (AARF/PSASB, 1990 and 1994; Mackintosh 1992) and central agency promoters of accrual accounting reforms (Finance Dept., 1992, 1994a and 1994b; McPhee 1993 and Mellor 1996) in many cases without reference to *problems and issues* that might occur (Guthrie 1998). Yet, in spite of the magnitude and consequences of the accounting reform there has been little sustained research into: In what way accrual accounting has been successfully implemented in the public sector; What the related changes are; What kind of support does it need; To what extent the accounting profession and academics can sustain the implementation process; The existence of collaborated factors behind the implementation process; What factors influenced the implementation decision; What the implementation problems are.

While the current government accounting literature provides some disparate explanations of the factors that can support the introduction of the accrual accounting in the public sector, it provides **no clear implementation framework** within which to create conditions appropriate for its introduction and to put it into practice. In 1992 Professor Lüder developed and published the Contingency Model of Government accounting Innovations. This was an attempt to explain the transition from traditional government accounting to a more informative system. A more informative system performs two functions: it supplies comprehensive and reliable information on public finance, and it provides a basis for improved financial control of government activities (Lüder 92).

Chan (1994) pointed out that the Contingency Model (1992) was not explicit about what constitutes a more informative system. It may, however, be inferred that such a system would call for full disclosure of a government's financial condition and performance, measured under the *accrual basis of accounting*. The basic Contingency Model identified a set of contextual and behavioral variables that were found to be potentially relevant in explaining the outcome of the governmental accounting innovation process (Monsen and Nasi 98). The contextual variables comprise: 1- stimuli, 2- characteristics of social environment (structural variables external to the government), 3- characteristics of the politico-administrative system (internal structure variables) and 4- implementation barriers. It was assumed that the first three types of contextual variables would positively influence the attitudes and behavior of users and producers of government financial information. A combination of conducive contextual conditions and favourable attitudes/behavior would facilitate the innovation process. However, implementation barriers could nevertheless prevent a successful outcome (Chan et al., 1996b, Monsen and Nasi 98). Herein, successful outcome means introducing a more informative public sector accounting system.

Although Lüder's Contingency Model (1992, 1994) has attempted to explain why governmental accounting innovations have taken place in some countries and not in others, it failed to generate answers to such questions as: How can we create conditions appropriate for successful introduction of a more informative public sector accounting system? How can we overcome the implementation barriers? How can we convince others to accept the new accounting system? So in connection with the earlier mentioned literature, we see that the Contingency Model describes how the environment factors influenced the introduction of accounting changes but does not also provide *a clear implementation framework* within which to create a climate fit for successful introduction of the new informative accounting system.

Moreover, it has been argued that even though innovations are the focus of the contingency model, the process of innovation has remained mostly like a black box. Studies have tended to view innovations as an identifiable event rather than subsequent implementation along with the consequences of adopting the innovations (N. Monsen and S. Nasi 1997). Correspondingly, we attempt to develop a *Basic Requirements Model* that goes a step further in researching how to bring the innovation from an identifiable event to the implementation stage and in showing the consequences that can be obtained from the implementation process in the real world. Accordingly, this article attempts to fill a gap in the literature by creating a clear implementation framework.

2. Basic Requirements Model for successful implementation of accrual accounting in the public sector

2.1 Overview and Assumptions

This section proposes a model that specifies the basic requirements that should be available if a certain country confirmed its intention (decided) to implement accrual accounting in the public sector. In other words, it brings the government's attention, from the outset, to the changes and factors that should be made simultaneously and coordinated if it wants to implement the accrual accounting in the public sector in an *efficient, effective and economic* way, to attain the target benefits from that implementation and to avoid the problems which can emerge if these factors or one of them have not been taken into consideration. Moreover, it evolves a clear implementation framework that can assist in overcoming the implementation barriers.

The Basic Requirements Model agrees with the Contingency Model (Lüder Model 1992) that there should be at least one stimulus (driving force) for the accounting changes. The driving forces of government accounting changes can be one or more of the following stimuli: Financial Problems; Financial Scandal; Corruption and Fraud; Globalization; Economic Crisis; and Change Agent. However, irrespective of what the driving forces (stimuli) for the accounting changes are, the role of the basic requirements model starts after the government has taken a *decision* to make these accounting changes. However, we see that the *decision* to implement the accrual accounting system in the public sector is the *starting point* of the basic requirements model, because it could happen that there is a strong stimulus for the accounting changes but the government did not make the decision to reform the accounting system. In Italy, for example (Lüder 1994), the public debt exceeds GNP (107,7 % in 1992). One would expect this to result in a strong stimulus for government accounting reform aimed at better financial control of government and securing administrative efficiency and effectiveness, but this did not happen. Therefore, the govern-

ment's decision to make the accounting changes is of fundamental importance for the basic requirements model. On the other hand, we would like to see how the government can come to the implementation decision, or to answer the question of Chan (1996b): what factors influenced the adoption decision?

Herein, we can indicate some factors that can affect the adoption decision:

1) Anticipated consequences (benefits) from the implementation of accrual accounting in the public sector; 2) Estimated costs of the implementation process; 3) Capability of a country to perform these changes, where not all countries are able to perform changes; 4) Complexity of these changes; 5) Dependency or independence of the changes; in other words, whether the change process can be carried out alone or it depends on carrying out other changes; 6) To what extent the government encourages management performance; 7) Materiality of the accounting changes for the rest of the public sector elements; 8) Implementation barriers; and 9) The degree of government's willingness to accept the change.

However, the Basic Requirements Model has been developed, by reviewing the accounting literature, through an intensive study of the New Zealand, UK and Australia experiences concerning the implementation of accrual accounting in their public sector and based on our study concerning the implementation barriers of accrual accounting in the public sector of developed and developing countries (Ouda 2003). Consequently, we can derive the following **assumptions** that represent the cornerstone of the Basic Requirements Model:

1. The more correspondent the public administrators' culture with the culture upon which the governmental accounting system is premised, the more easily change occurs. In other words, the accounting change in the public sector entails parallel change in the public administration system, in particular at departmental level, which in turn assists in sustaining the adoption of accrual accounting. Accordingly, the implementation of accrual accounting in the public sector without taking into consideration the related changes in the public administration system will not achieve the target benefits from that implementation.
2. Support from leaders in the public sector, both political and within the bureaucracy, is a key factor in the successful implementation of accrual accounting in the public sector;
3. The professional and academic bodies support can play an essential role in facilitating the implementation process;
4. An intensive communication strategy is a key factor in conveying a common understanding of the key principles of the accounting changes to politicians and all other members who will participate in the implementation process;
5. Willingness and qualifications of the staff required to develop and implement the accounting changes are critical for successful implementation of accrual accounting in the public sector;
6. Consultation and co-ordination with the governmental entities that will apply the accrual accounting is fundamental to obtain comments and suggestions from the primary sources for the required improvements and to be well posted with their own internal problems and constraints that may preclude the successful implementation of accrual accounting;
7. Estimation of the adoption costs is critical in determining the financing required for the implementation process and will assist in overcoming the

future financial problems, which considerably deter the implementation of accrual accounting.

8. Overcoming and tackling of some specific accounting issues in initial phase, such as asset identification and valuation, asset registers, identification of accounting entity and its boundaries and opening balances, are of fundamental importance for facilitating the implementation process.
9. Building an appropriate information technology capacity is a booster for successful transition to accrual accounting.
10. Taking into consideration the above-stated factors will assist to a great extent in overcoming the implementation barriers that inhibit the process of implementation.

Based on the above-mentioned assumptions, it can be concluded that the successful implementation of accrual accounting in the public sector and attaining of the target benefits of that implementation demands efforts of different parties to *create conditions appropriate for its introduction and to put it into practice*. In other words, there is a need for a set of factors and changes that can support and justify the introduction of accrual accounting. These factors and changes can be reflected in the following equation:

$$\text{AC (ps)} = f(\text{MC} + \text{PBS} + \text{PAS} + \text{CS} + \text{WC} + \text{CC} + \text{BAC} + \text{SAI} + \text{ITC})$$

Where:

AC (ps) = Accounting Changes (applying of accrual accounting in the public sector (ps))

f = Function

MC = Management Changes (internal management changes/ NPM)

PBS = Political and Bureaucracy Support (legislative and executive support)

PAS = Professional and Academic Support (in accounting and auditing field)

CS = Communication Strategy (includes booklet, journal, conferences, seminars, etc)

WC = Willingness to Change (staff motivation, will, and training and qualification)

CC = Consultation and Co-ordination (with the governmental entities that will apply the accrual accounting).

BAC = Budgeting of Adoption Costs (for the whole implementation period)

SAI = Specific Accounting Issues (asset identification and valuation, asset registers, reporting entity, etc.)

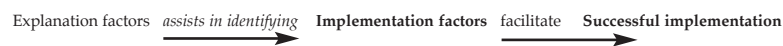
ITC = Information Technology capability

However, the transition from the traditional governmental accounting system to the accrual accounting can be better understood in the light of the following factors:

- Explanation factors: that explain how and why the change process has taken place in some countries and not in other; what are the factors or variables underlying the taking place of the change process. In other words, explanation factors determine the variables that would explain the variation among countries; why do nations differ in their governmental accounting systems.
- Implementation factors: that specify the factors that are required to bring the change process into practice. Or to carry out (implement) the change process

in the real world. In other words, to create conditions appropriate for the introduction of accounting changes and to put them into practice.

The Contingency Model has highlighted the explanation factors (explanation framework) whereas the Basic Requirements Model casts the light on the factors (implementation framework) that facilitate the implementation process. Then there is a relationship between the two models, as the understanding of the explanation factors can assist to a great extent in identifying the implementation factors that in turn ensure successful implementation of accrual accounting in the public sector. Consequently, one can infer that the Basic Requirements Model complements the Contingency Model, where the transition process can fully be understood in light of the contents of the two models. So the relationship of the two models can be reflected as follows:



Basic Requirements Model for successful implementation of accrual accounting in the public sector of the developed and developing countries

2.3 Discussion of the Implementation Framework

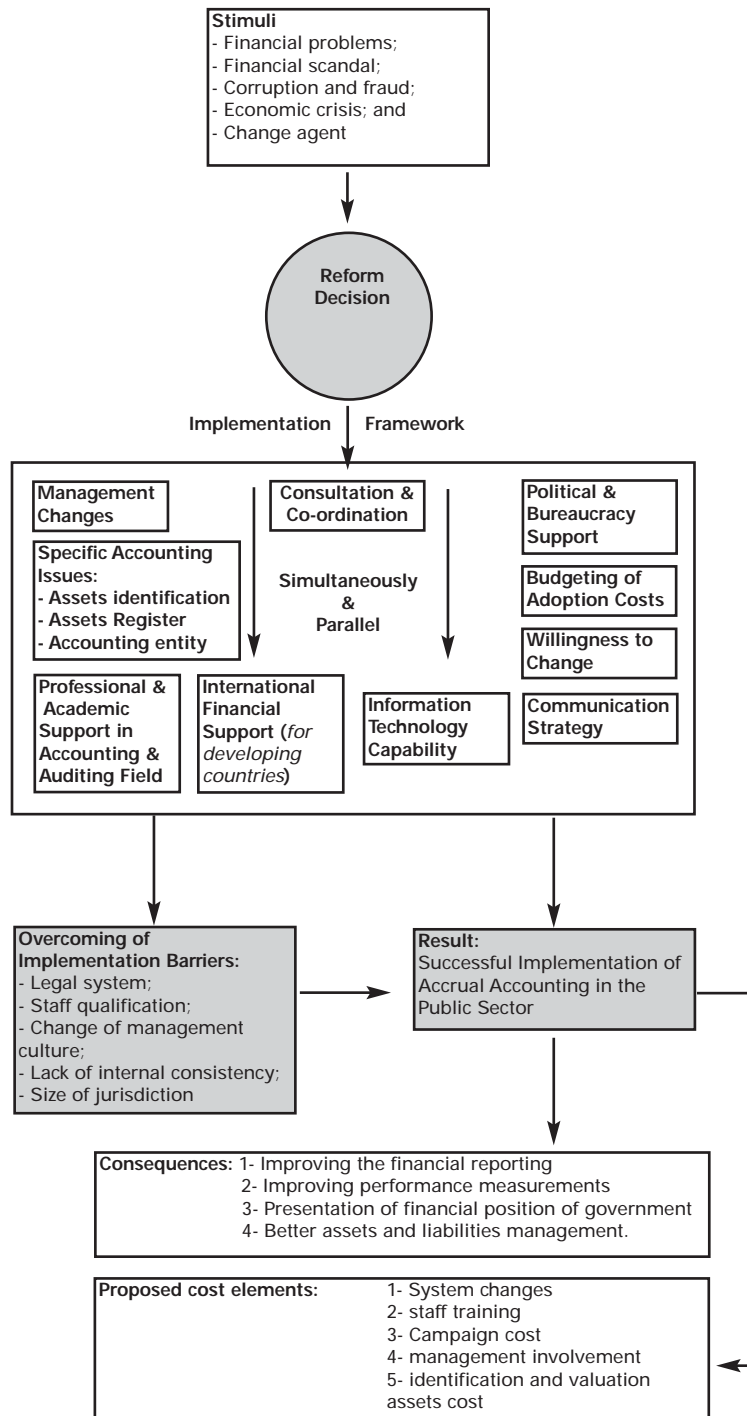
This section discusses the Basic Requirements and ingredients that will contribute in creating a climate fit for successful implementation of accrual accounting in the public sector and justifying the cost of that implementation. In other words, the successful implementation of accrual accounting in the public sector has different dimensions. These dimensions are:

Management Changes (MC)

Are the management changes important in order to implement accrual accounting in the public sector and to fulfil the target benefits of that implementation? In other words, to what extent are the management changes required for the implementation of accrual accounting in the public sector and achieving the targeted benefits?

Public Administration System has a long history in the public sector. This system focuses on a blind-following of the instructions (especially in the developing countries) and a compliance with written rules and regulations aimed at limiting discretion, it rewards compliance and creates incentives to avoid risk, having little freedom and less accountability, and it is a highly centralized management system. So the main feature of the public administration system is the focus on the input and instead of output. Under this system: there is no relationship between the input and the output; managers are not completely responsible for their departments; the expenditures are more important than the costs (expenses); there is lack of a performance measurement system; the incentives to encourage efficiency and effectiveness are absent. Moreover, under the public administration system, the role of the managers is limited to the following of instructions and they have no effective role in improving the efficiency of their departments and their evaluation is not based on the following points: the output, results, total costs, relationship between the input and the output (efficiency) and the relationship between the output and the outcome (effectiveness).

Consistent with the above-stated public administration philosophy, The *Traditional Government Accounting System* is a cash based-accounting system



(cameral accounting) and is widely used. However, the system of funding government expenditure based on annual cash appropriations does not provide the right incentives for public sector managers to make the best use of the resources available. Nor does it encourage them to provide information on the full cost of activities or the outputs achieved using available resources. In addition, cash-based accounting does not provide a full and accurate account of activities, especially when capital assets are used; it does not take accounts of future commitment, or of guarantees and other liabilities; it controls the inputs purchased rather than the output produced; and it fails to provide information on the government's financial condition. A cash-based system distorts incentives by encouraging managers to underestimate the cost of programs; bid for incremental allocations rather than evaluate the use of resources already at their disposal; enter into unbudgeted commitments for future years; spend their full annual appropriation; and to conceal costs by promoting non-cash resources and interventions, such as tax expenditures and regulations (Schick: www.ssc.govt.nz/Spirit/Transforming.asp).

Accordingly, the available information is limited and there is a limited scope to use this information. Then, improving the financial information (as a result of an adoption of accrual accounting in the public sector) has no or little meaningful value under the above-mentioned public administration system, as this information may not be used as it should be, or the scope that is available to use this information is very limited. In other words, the use of accrual accounting will provide information on the total costs of the output and it assists in measuring the performance in terms of efficiency and effectiveness and assessment of results. On the other hand, the information on the outputs, results, efficiency and effectiveness is not required or they are not the main focus under the public administration system. Warren (IFAC 1996) argued "accounting is important and exciting when it generates information that is used by decision makers. Conversely, without decision-makers demanding and using accrual information, the *implementation effort is far less likely to succeed.*" Frankly speaking, the public administrators who spent their lives to administer rules and regulation and formalize procedures are not accustomed to using improved information. Consequently, the implementation of accrual accounting in the public sector will provide superfluous information that will not be used and the costs of generating this information cannot be justified. Hence, the target benefits from its implementation will not be achieved under the public administration system. *So logically, before talking about the production of improved information, we should firstly create the scope, which allows for using this information and to find the right person who can efficiently and effectively using it (Ouda 2003).*

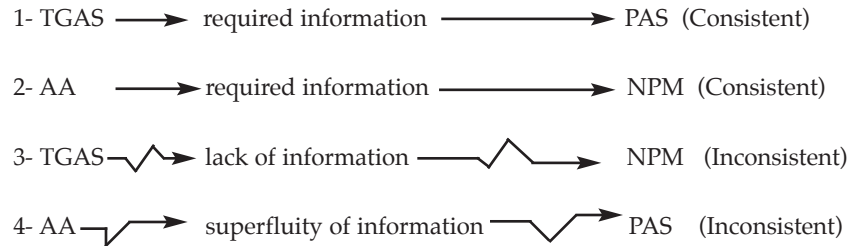
Therefore, the government should shift from the *public administration system* to the *public management system (which is called NPM (New Public Management))*. The latter focuses on output instead of input, increases the individual responsibility, gives the managers extensive discretion in the use of resources, and measures the performance in terms of efficiency and effectiveness. Moreover, the evaluation of the managers is based on the results; and it is a decentralized management system. Keeling (1972) distinguished administration from management. He characterized administration as being associated with time-intensive, risk-avoiding behaviour which focused on adherence to procedure. It was also associated with long organizational hierarchies and limited delegations. By contrast he characterized management as being associated with short (flat) hierarchies, maximum delegation, and time-sensitive and risk-accepting behaviour, the focus on results, not procedures (Ball 1989). Moreover, Aucoin (1990) argued "that the very term 'Management' is one that derives

from private experience denoting as it does a concern from the use of resources to achieve results in contrast to the assumed focus of 'Administration' as the adherence to formalized processes and procedures." Public sector bureaucrats in this comparison are perceived essentially as administrators of rules and regulations and thus are considered inferior to their private sector equivalents that manage their organizations to achieve results (Holmes & Shand 95).

In short, public management means the focus on performance in terms of efficiency and effectiveness rather than compliance with rules and regulations, greater confidence in market mechanism, and linking resources with results. In addition, public management has often been described as "Let the managers manage" and "Make the managers manage," and it aims to change the incentives acting on managers so that they support the changing process rather than oppose it. In other words, public management is grounded on a simple principle: managers cannot be held responsible for results unless they have freedom to act, that is, to spend and hire within agreed budgets as they see fit, to make their own choices respecting office accommodation and other purchases to run their organizations free of ex-ante control by outsiders (Schick 2000). As it is apparent from the above stated, the main feature of public management is the greater emphasis on efficiency and effectiveness. In order to attain a greater level of the efficiency and effectiveness it is necessary to develop the accounting system (through the introduction of Accrual Accounting) that provides the required information for measuring performance in terms of efficiency and effectiveness. Accounting as an information system plays an important role in whatever reform process that any organization would want to undertake. From UK, Australia and New Zealand experiences, it has been found out that the application of accrual accounting in the public sector was a response to the management changes. Yet the UK researchers (for example, Gray and Jinkins 1986 and Humphery et al., 1993); New Zealand researchers (Ball, 1990, 1992, and McCulloch, 1990); and Australian researchers (Guthrie 1994, Parker and Guthrie 1990) all argue that public sector accounting changes are "underpinned" by a "managerialist" philosophy (Ryan 1998). Moreover, Warren (IFAC 96) argued "while the demand for accrual accounting information is likely to increase as *public administration* trends towards *public management*, development of accrual information should be seen as an integral element of this reform and not a stand-alone exercise." The management changes in New Zealand have required that the managers should shift from processes to results and focus on the output instead of the input and they should be completely responsible for the management of their departments (I. Ball – Arthur Andersen 94). This, in turn, required that the managers need an accounting system that can provide them with meaningful information about the economic resources and the total costs of the output. This, in turn, sets forth that the management changes are very related to the accounting changes. Based on the above-mentioned, we could derive the following facts:

- 1- The traditional government accounting system (TGAS) fits well with the public administration system (PAS). Where the TGAS provide information about cash flows and the compliance with rules, and this information is consistent with the philosophy of the PAS.
- 2- An informative accounting system (Accrual Accounting AA) fits well the new public management (philosophy) system (NPM) that requires improved information.
- 3- The use of TGAS with the NPM will lead to lack of information.
- 4- The use of AA with PAS will lead to superfluity of information.

In short:



So it can be concluded that in cases 3 and 4 the target benefits of the changes (whether they are accounting changes or management changes) will not be achieved. In addition, one of the common themes for both management and accounting changes is discharging of the accountability. Accountability is closely associated with the new public management and the application of accrual accounting in the public sector since enhanced accountability has been one of the explicit aims of all management and accounting reforms. Accordingly, the application of accrual accounting in the public sector will not effectively assist in discharging of the accountability unless parallel management changes have been made too. Note that there is a strong relationship between the management changes and the accounting changes, and the changes in management and accounting are not isolated processes. Moreover, it has been argued that any accounting reform will succeed only if the attention of the reform-makers is focused on the consistency of accounting with other elements of the public government, rather than simply on accounting alone (Caperchione 1995).

Based on the above-mentioned, we can say that without making internal management changes in the public sector departments, which focus on the output instead of the input, and on a more strategic or results-oriented (efficiency, effectiveness and service quality) approach to decision-making, and on the linking of resources with results, and on the replacement of a highly centralized management system by a decentralized management environment; the implementation of accrual accounting in these departments has no or little meaningful value. Where the improved information that is produced by an accrual accounting system may not be used as it should be. Therefore, the management changes can be considered as a cornerstone for successful implementation of accrual accounting in the public sector and carrying through the target benefits that are aimed from that implementation. However, it has been argued that the implementation of New Public Management requires the implementation of accrual accounting, whereas the implementation of accrual accounting does not require the implementation of NPM. It should be clear from the outset that whilst technically it may be possible to implement accrual accounting without the adoption of NPM, there is the question as to whether this implementation is worthwhile in terms of achieving tangible benefits in the improvement of the public sector performance. Furthermore, it can be concluded from the experience of different countries such as New Zealand, United Kingdom, Australia, and Spain that the accrual accounting system can really work in the public sector only if parallel management changes are made, too. Should this not take place, the implementation of accrual accounting will not have major effects on the performance of the public sector.

Political and Bureaucracy Support (PBS)

The political support is essential and plays a vital role in making any changes in the public sector in any country, whether these changes encompass the public sector as a whole or only the accounting changes. Notwithstanding, the political support for any changes is important for both developed and developing countries, it is more substantial in the developing countries, especially since the developing countries are countries in which ideas moved in one direction and practice in another. Moreover, the political systems in those countries are often not democratic systems and the politicians have more power and what they want it should be done, in other words, they have the last word. Furthermore, the form of the government, whether it is a unitary government or a coalition government, can influence the implementation process of accrual accounting in the public sector. The unitary government can easily take the reform decision and could move faster and accomplish more by prescribing a course of action than the coalition government that it may be obliged to dilute its program to gain coalition support. However, the political support herein includes:

- Executive bodies support (Political executive support);
- The legislative bodies support (Parliamentary support);

Both of them are important in the change process and they play different roles in this process. *The executive bodies* are responsible for making management decisions to carry out the ongoing activities of the government and report to the legislative bodies concerning financial matters. Moreover, the legislative bodies control their financial operations and the departments, which are managed by them. Therefore, the role that the executive bodies can play is necessary because they are the only official bodies that can take decisions to start and to accomplish the changing process. *The legislative bodies* are responsible for overseeing the activities of the executive bodies. They are also responsible for approving the budget, approving the tax rates, and maintaining the fiscal viability of the government. Moreover, they are responsible for enactment of new acts and changing or adjusting current acts. These acts are essential in the change process, because they make clear the purpose and philosophy of the changes, as well as the technicalities. In the light of this, it is desirable to obtain the enactment of laws for any substantial accounting reforms that have to be put into practice. Thus, the introduction of accrual accounting needs to be supported by adequate legal provision. As practical evidence, the New Zealand government's experience had demonstrated that the legislation of the following acts was necessary to start and accomplish the reform of the public sector:

- State-Owned Enterprises Act-1986;
- State Sector Act 1988;
- Public Financial Act 1989;
- Fiscal Responsibility Act 1994.

Ball (2000) has made clear the role that these acts played in sustaining the New Zealand reform process; for example, he argued that the Public Finance Act of 1989 embedded firmly in legislation the concepts developed in the policy design stage. These included changing the nature of appropriations from an amount of cash able to be spent on a particular program, to an accrual-based measure of resources consumed in the production of a specific set of outputs. The fact that the concepts were captured in the legislation signalled to departments that the government was serious about implementing changes. Result: very little resistance to the reforms. Furthermore, legislative bodies are one of

the key users of the improved information resulting from the accounting changes. However, the lack of parliamentary support could in part account for the treasury's lack of enthusiasm to pursue the further development of performance indication under the accounting changes.

However, it is noticed from the experience of the NZ and Australian reform that the political commitment of both legislative and executives bodies was necessary at key points. UK experience has also shown that political commitment on its own can be very powerful.

Furthermore, OECD experiences suggest that successful reform strategies involve ongoing high level political and management support for reforms, providing leadership and as far as possible consistent signal. (M. Holmes and D. Shand 1995, p. 574) Moreover, the leadership of the Minister and Ministry of Finance in initiating and sustaining the application of accrual accounting is very necessary. The regulation of accounting (such as the issuance of detailed rules and procedures for the tax system, accounting, financial reporting and auditing) is one of the basic functions of the Ministry of Finance. The Ministry of Finance is also responsible for public finance, which results in its dominant influence on accounting policy, its regulation and direction. Also Graham C. Scott (1996) mentioned the following about the NZ reform: "While it may not have been necessary to have commitment of the Prime Minister to the program of reform, it could not have proceeded in the face of his opposition. Nor could reform have been accomplished without the leadership of the Minister of Finance and other key ministers involved in fiscal policy and public administration." Then, the question here is: How can the political commitment (support) be obtained?

Generally, political leaders do not seriously tackle the root cause of their problems until the situation approached crisis conditions and the need for remedial action became evident and broadly accepted by the unions and the population at large (OECD, Paris, 1988). However, the political commitment is obtained, either through politicians becoming aware of a problem (awareness of a problem can occur either by a disaster or by the persistent efforts of actors proactively raising attention to an issue (Kingdon 1984 p. 92) or through a change of administration which alters the political priorities. Once political commitment is obtained, a "policy window" is said to open (Kingdon, 1984, P.173)

However, the political support is necessary but not a sufficient condition for the success of the implementation of accrual accounting in the public sector. There must also be a sustained commitment by the bureaucracy to the accounting changes. The sustained political and bureaucracy commitment encourages most public sector managers to welcome the change. Bureaucracy commitment can be demonstrated by installing an incentive system that motivates the larger bureaucracy to promote the introduction of accrual accounting and to use the performance information following therefrom in decision-making. Also there should be an incentive system for the politicians to obtain their support. This is clear from the New Zealand experience where the public sector reforms were ordered in such a way as to generate early benefits to both bureaucracy and Ministers. Early in the process, bureaucrats received (in exchange for increased accountability for the outputs) the benefits of managing their departments without the need to comply with the extensive detailed procedural requirements. Ministers saw the benefits through their capacity to manage the fiscal situation they faced in preparing the 1991 budget (Warren IFAC 96).

So it can be concluded that if the political (at legislative and executive level) and bureaucracy commitment do not exist, the implementation of accrual accounting in the public sector might not be accomplished. Because the imple-

mentation of accrual accounting in the public sector faces different problems on several occasions, the political support is necessary on those occasions. Hence, the political and bureaucracy support can be considered as a precondition for successful implementation of accrual accounting.

Professional and Academic Support (PAS)

This section discusses to what extent the role and task of the professional and academic bodies can facilitate and support the introduction of accrual accounting in the public sector.

Bear in mind that the nature of the public sector and the characteristics of its environment are essential in determining its financial reporting objectives, and the *principles and standards of the governmental accounting* should be understood in the context of the environment within which they operate, and in view of the objectives that financial reporting is expected to serve (Chan 1988). This means that the government accounting system should be consistent with the nature and objectives of the public sector whether it uses the private sector GAAP or not. The use of the private sector GAAP in the public sector requires that these GAAP should be adapted where appropriate to take into account the public sector context. This entails that the accounting principles, standards, procedures, and practices should be adapted to be consistent with the specific nature and objectives of the public sector. Herein, the professional and academic bodies can play *an essential role* through proposing accounting regulations and comment on the accounting standards proposals and helping in improving the accounting practices and procedures.

For proper understanding, we will present the experiences of some countries that have already applied the accrual accounting system in their public sector, and to see to what extent the professional and academic bodies support was important to create the conditions appropriate for successful introduction of accrual accounting:

The experience of NZ has shown that the NZ Society of Accountants has played an essential role of creating the conditions appropriate for the implementation of accrual accounting in the public sector. The NZ Society of Accountants is the only professional accounting and standard-setting body in the country. As a result of the absence of an adequate financial accountability framework for the public sector entities, the NZ Society of Accountants was motivated to develop professional guidelines with a view of improving the financial control and accountability processes of public sector entities (Miah 91). In August 1981 the Society of Accountants created a public sector Study Group to consider the accounting and reporting problems of public sector entities. The society has delegated to this Group (which was later renamed the Public Sector Accounting Committee (PSAC)) the task of researching and preparing drafts of public sector accounting standards (Miah 91).

The PSAC has published several exposure drafts. These exposure drafts were accompanied by Discussion Papers to promote comment from interested parties within and outside the public sector. The recommendations and comments of the interested parties have played an important role in developing and improving the exposure drafts. The exposure drafts, the discussion papers and the extensive debate in form of conferences, seminars, and workshops have resulted. The NZ Society of Accountants has been able to issue a Conceptual Framework, in July 1987, entitled "Statement of Public Sector Accounting Concepts." This Conceptual Framework was the cornerstone of the accounting

reform in the public sector. The above shows that the NZ Society of Accountants was the professional body and the interested parties (including Academic) were to a great extent supportive to the reforming of the accounting system of the public sector.

In the UK, as a result of dissatisfaction with the use of cash accounting (especially decisions about capital), and an increasing focus on objectives and outputs delivered, performance measurements and value of money (rather than input), the UK government had decided to introduce Resource Accounting and Resource Budgeting in the central government departments. In November 1993, the Chancellor of the Exchequer announced the proposed introduction of resource accounting to the UK central government departments. A consultation paper (Green Paper) in July 1994 (HMSO 1994) specified that resource accounting would be implemented in the majority of government departments by 1 April 1997 and in all departments by April 1998. In this Consultation Paper UK Treasury proposed a conceptual framework for resource accounting and resource budgeting and asked for consultation and comment on the following points:

- The draft framework of accounting principles and conventions based on UK GAAP and the outstanding accounting issues.
- The format and scope of resource accounts, including the suggested definition of departmental boundary, the treatment of non-departmental public bodies (NDPBs) and other bodies supported by government.
- The merits of a systematic approach to charging for the capital employed by the departments.
- The proposed Audit arrangements.

Subsequently, a White Paper was published in July 1995. This paper described the progress made in developing resource accounting (as a result of the comments which are received by the Treasury from the professional and academic bodies) and the government's proposals to introduce resource budgeting. During the consultation period, which followed the publication of the Green Paper, the Treasury received many comments from different parties within and outside the public sector as follows: (White Paper 1995)

- Parliamentary Committee & Auditors such as: Committee of Public Accounts, and Treasury and Civil Service Committee;
- Professional & regulatory Bodies such as: Accounting Standards Board, and Chartered Association of Certified Accountants (ACCA);
- Accountancy Firms and Consultancies such as: Coopers & Lybrand, and Ernst & Young;
- Academics such as: University of Hull, and University of York, and Cranfield University;
- Interest Group such as: Confederation of British Industry (CBI) and Institute of Directors.

The comments and consultations that were received from the above-mentioned bodies were helpful in confirming that all the main issues had been identified. They had provided valuable input to further consideration of these issues (White Paper 95). In addition to the experience of the above-mentioned countries, there are a number of the international professional bodies that are playing a fundamental role in developing the public sector accounting policies. One of the most known professional bodies within the public sector is Public Sector Committee (PSC) of the International Federation of Accountants (IFAC).

PSC-IFAC is formed to address the needs of those involved in public sector financial reporting, accounting and auditing. The objective of IFAC is to develop programs aimed at improving public sector financial management and accountability, includes developing accounting standards and promoting their acceptance. As a result of existence of widely diverse financial reporting practices in the public sector throughout the world, the PSC-IFAC has given the authority to develop and issue a set of accounting standards for the public sector entities worldwide. These standards are called "International Public Sector Accounting Standards (IPSASs).

The issuance of the IPSASs can improve both the quality and comparability of financial information reported by the public sector entities around the world. Moreover, it can assist in overcoming of a great part of outstanding accounting issues regarding the adoption of the accrual accounting in the public sector. This in turn will facilitate the implementation process of accrual accounting in the public sector entities. So in order to facilitate the implementation of accrual accounting system in the public sector, it entails professional and academic bodies support at internal, external and international level. These bodies play an essential role in rendering assistance to the public sector in the development and designing of an accounting system that would meet the needs of the politicians and other users. Consequently, the role of these bodies facilitate the introduction of accrual accounting in the public sector through the undertaking of the following tasks:

- Proposing of accounting standards and procedures;
- Comment on the accounting standard proposals and supply recommendations;
- Submittal of professional consultancy;
- Development and designing of an accounting system consistent with the public sector context.

Communication Strategy (CS)

The initial process of putting into practice a new accounting basis causes extra work for many people whose motivation depends on their understanding of the change process and of the benefits that can be obtained from the new accounting basis for their operations in particular.

One classical reason why many accounting changes in the public sector have failed in the past is that people are not sufficiently informed about the direction of the change and empowered to contribute to the process. On the contrary, the recent experience of the earlier reformer countries has proved that the reason for the success of the change process was the education concerning the change process. Accordingly, not surprisingly, if we use the marketing language and we consider the introduction of accrual accounting as a new good that needs a promotion strategy to set forth the characteristics of this good and to assist the people in changing their behaviour towards the change process. But getting people to change behaviour requires communications upon which they would actually act. To influence behaviour via communication requires very targeted content in messages and careful selection of media. (<http://www.tbs-sct.gc.ca/fin/FIS-SIF/sigs/fiscommunications/framework/32Steps-eh.html>). Then, the introduction of accrual accounting in the public sector needs a communication program (communication strategy/effort) to disseminate objectives and requirements of the change process, to clear up the misunderstandings that exist and to convey a common understanding of the key principles of the accounting changes. This

communication program should comprise different media such as a booklet, a video, journal, articles, seminars, conferences, presentations and case studies. Such communication efforts have taken place in the USA and New Zealand: The Comptroller General of the USA, during the introduction of the accrual accounting in the federal agencies in 1969, became convinced that there was inadequate understanding in the agencies and in Congress as to what was meant by an "accrual basis." Therefore, he prepared and issued in 1970 a booklet entitled "Frequently asked questions about accrual accounting in the Federal Government." That booklet was helpful in clearing up some of the misunderstandings that existed (United Nations 1984). Also New Zealand issued a booklet called "Putting Simply" which was a plain guide to the changes process. Thus, the cost of the communication strategy can be justified as a result of its essential role in convincing the members who will participate in the implementation process by showing the advantages and benefits of the new system in comparison with its predecessor. Therefore, we consider the communication strategy as an important requirement for the successful implementation of accrual accounting in the public sector.

Willingness to Change (WC)

Besides the management changes, political and bureaucracy support, professional and academic support, and communication strategy, the willingness to change (including staff will, staff motivation, and staff training and qualification) is critical for successful implementation of accrual accounting in the public sector. It is essential to involve the human dimension in the reform process. In reality, the motivations, will, training and qualification of the staff, that is going to take part in the change process, are essential and they should be taken into consideration in introducing of accounting reforms. Can you successfully change without dealing with these human aspects? Probably not. However, neglecting or not recognizing of willingness to change has been persistently mentioned as a constraint in implementing the accrual accounting in the public sector.

The implementation of accrual accounting in the public sector is not an easy task due to the additional work that usually accompanies this implementation process. In this context, the implementation of accrual accounting in the public sector faces different problems as follows: (United Nations 1984)

- 1- the lack of qualified human resources (e.g. qualified accountants);
- 2- the opposition to changes;
- 3- The lack of staff motivation and the lack of conviction about the benefits of the new system.

The lack of qualified human resources: it has been noticed from the experience of different countries that the personnel with advanced knowledge in government accounting are scarce.

Especially, developing countries face a serious shortage of qualified trained accounting personnel, even to run efficiently their present systems of accounting (United Nations 1984).

Accordingly, the need for training of accounting personnel should be considered as part of the decision to introduce accrual accounting in the public sector. However, designing an appropriate and adequate training programme for the old staff can solve this problem. Furthermore, recruitment of new staff that has already had experience with the use of accrual accounting and has already been

convinced on its benefits can also assist in solving this problem. Such qualified personnel efficiently ensures the efficient operation of the accounting system, and the introduction of major accounting reforms in the public sector, and the success of the subsequent training programmes (United Nations 1984).

The opposition to change: this problem is one of the most common problems that usually arise during the process of the implementation of accrual accounting in the public sector.

The fear of being burdened with the responsibility of carrying out new procedures that involve additional work, both in quantity and quality, may be the real concern of some government officials who put up such resistance (United Nations 1984). The opposition to change can be overcome by a campaign for the dissemination of the information about the benefits and advantages that can be obtained from the accrual accounting system in comparison with the old system. Moreover it can be solved by holding workshop, seminars, and classes and by publishing articles and booklets explaining the benefits resulting from the accrual accounting. In short, the *communication strategy* will assist in overcoming the opposition to change

The lack of staff motivation and the lack of conviction about the benefits of the new system: It is possible that the staff does not oppose the accounting reforms, but at the same time they are not motivated to carry out the new changes. In this case, if the staff saw that their position could be positively affected through the reform process, they would encourage the reform process. Scott (1996) has mentioned that departmental heads saw the removal of direct control over their inputs as a positive change, and this type of motivation can help to implement the reforms. Chief executives also took note of the fact that the law made them the finance officer of their department. Thus, creating the right incentive system that rewards desirable behaviour by staff is critical. So the overcoming of the aforementioned three problems will be very supportive to the implementation of accrual accounting in the public sector.

Consultation and Co-ordination (CC)

Logically, the first step to apply a new accounting system in the public sector is to consult and co-ordinate with the governmental entities that will implement this system. Of course, these entities are well acquainted with their own problems and constraints that may impede the successful implementation of accrual accounting. Accordingly, knowing their point of view regarding the implementation barriers is essential. Moreover, these entities should be consulted in order to obtain comments and suggestions from the primary sources for the required improvements before establishing the new system. Yet, the co-ordination with these entities and within each other is very important in order to fulfill the internal consistency. The lack of the internal consistency may result in development of strongly diversified and non-uniform accounting systems and leads to that these entities may get into conflict with each other. However, the adoption of accrual accounting will require the development of a series of new accounts and records, then, consistency of requirements, classification and measurement will ensure comparability of information and facilitate its analysis and interpretation. Furthermore, a continuing day-to-day working relationship with the governmental entity officials and staff is deemed indispensable to ensure adequate understanding of the new concepts (United Nations 1984). Consequently, consultation and co-ordination with the governmental entities that will implement accrual accounting can be considered as one of the most important basic

requirements for successful implementation of accrual accounting in the public sector.

Budgeting of Adoption Costs (BAC)

Despite the availability of the above-mentioned basic requirements and their role in facilitating the adoption of accrual accounting, the lack of financial means required to carry out the adoption process can considerably deter the whole adoption process. In reality, many countries have attributed their failure of getting accrual accounting adopted in their public sector to the lack of financial means. Therefore, budgeting (estimation) of the adoption costs is critical in determining volume of the financial means that are required for the implementation process and can assist in overcoming the future financial problems by having a staged transition to full accrual accounting and dividing this budget by a number of years. For example, assume that total adoption costs of accrual accounting in X country is estimated to \$150 million, further assume that the adoption process will last five years, then the estimated adoption costs per year is \$30 Million. Accordingly, X country knows in advance the average of the adoption costs per year. This in turn gives the X country the opportunity to arrange the yearly required financial means. In other words, budgeting of adoption costs will give a full picture on the total financial resources that are deemed to be necessarily for achieving the implementation process. Moreover, based on knowing the total adoption costs, a country can unambiguously decide whether to go ahead with the adoption process or to delay it for future periods. Consequently, we consider the budgeting of adoption costs (including the arrangement of the yearly-required financial resources) to be one of the most important basic requirements for successful implementation of accrual accounting in the public sector.

Tackling of Specific Accounting Issues (SAI)

The long history of using the traditional government accounting system (cash-based) in the public sector had resulted in emanating of different accounting problems such as *identification and valuation of fixed assets, lack of asset registers, identification of government accounting entity and determination its boundaries, etc.*

The traditional government accounting makes no difference between expenditures and disbursements and generally no distinction between current and capital expenditures. Accordingly, there are no asset adjustments because the accounts are not concerned with recording usage, only with the fact that cash has been paid for acquisition of those assets. Therefore, no information can be provided about the investment in the total assets; furthermore, no subsequent accounts are taken of whether the assets are still in use and whether they have reached the end of their useful life or have been sold. Moreover, capital purchases are treated in the same manner as personnel expenditure without recognition that they are productive for years. Thus, the main difficulty is that in order to record the physical assets, the governmental entity not only has to know what assets it owns but it must also put a value on them, even if the value is their historic cost. On the other hand, the transition to accrual accounting in the public sector requires the governmental entities to identify and value their assets in order to be able to prepare the balance sheets. Moreover, they should prepare the assets register for departmental and national assets. In addition, the identification of governmental reporting entity and determination of its boundaries are

essential for the implementation of accrual accounting. Tackling these problems in an earlier phase prior to the establishment phase will facilitate the implementation process of accrual accounting.

Information Technology Capability (ITC)

In the era of information technology, the reform process should involve an increasing use of computerized information systems as a key component of accounting, budgeting and financial management. In addition, more complex information technology systems will be required to adopt accrual accounting than those associated with a traditional cash system. For instance, the accrual general ledger would differ from that of the cash system in four main areas:

- it would have additional balance sheet (e.g. depreciation accounts) and different reporting options (e.g. depreciation per category of asset);
- the accruals general ledger would contain a feature for the creation of template batches (skeleton journals) which would be set up to deal with regular accruals and prepayments;
- it would link to the assets register and shows the depreciation charges for the various assets and associated Cost Centers;
- miscellaneous suspense accounts would be grouped in similar categories, (e.g. due to State, during the transfer process). (Treacy et al. 1996)

Generally, there are two options for development of new computerized system: maintaining and expanding the current system, or moving to an entirely new software system. Which option should be used depends heavily on the situation of each country. However, in most of the developing countries, the accounting system is not computerized and they are still doing the accounting work manually. In that case, the second option will be the most suitable one.

The previously suggested and discussed basic requirements have been derived from the experience of some of the developed countries, such as New Zealand, UK and Australia, regarding the implementation of accrual accounting in their public sector. The experience of these countries has demonstrated that the basic requirements were necessary and essential in order to successfully implement accrual accounting in the public sector. However, we can claim that whilst the suggested basic requirements were necessary and essential for successful implementation of accrual accounting in the developed countries, they are far more significant and critical for the developing countries. However, unlike the developed countries, the developing countries are suffering from the following problems: Penetration of the corruption and fraud into the heart of every governmental transaction; Lack of human and technical skills; - Shortage of the financial resources; Lack of the ability to set the required accounting standards for their public sector; Domination of the non-democratic political systems (dictatorial); Non-consciousness of a great part of the public, hence, they can not put enough pressure on their governments to provide information that reveals their own performance. This adds to several major economic, managerial and accounting problems such as: High rates of inflation; Unstable currency; Heavy national debt and deficit spending; Poor internal control; Lack of management accounting concepts; Incomplete, inaccurate and late records; Unauditable systems.

Nevertheless, the aforementioned problems will not all lead to a suggestion of new basic requirements regarding the implementation of accrual accounting in the developing countries. Some of them can be considered as main reasons of

the adoption of accrual accounting in the public sector but on the other hand it will not lead to suggestion of new basic requirements, such as the penetration of the corruption. Moreover, some of these problems have already been tackled in the previous section such as lack of human and technical skills and domination of the non-democratic political systems (dictatorial). On the other hand, we see that the problem of the shortage of financial resources will result in suggestion of a new basic requirement. As previously mentioned, the developing countries are suffering from insufficient financial resources; the availability of domestic financial resources has actually been reduced by adverse economic developments and natural disasters. While most of the developing countries have actively participated in international and regional deliberations on sustainable development and have committed themselves to international and regional legal instruments and undertaken regional initiatives and arrangements, lack of resources has seriously undermined their ability to live up to their commitments (www.unescap.org/mced2000/pacific/background/constraints.htm). Many of the developing countries do not have the financial means to meet their international obligations without adequate financial and technical support from the international community. Consequently, the developing countries with their own financial resources are not able to carry out the required reforms. Hence, the *International Financial Support (IFS)* can also be considered as a basic requirement for the adoption of accrual accounting in the public sector of the developing countries. Therefore, we can say that the implementation of accrual accounting in the developing countries requires:

$$AC (ps) = f (MC + PBS + PAS + CS + WC + CC + BAC + SAI + ITC + IFS)$$

Accordingly the Basic Requirements Model should also comprise the other basic requirement that is deemed to be necessary and essential for the implementation of accrual accounting in the public sector of the developing countries.

4. Benefits of the Basic Requirements Model

- Brings the government attention from the outset to what should be done. This is very helpful particularly for the developing countries since most reforming decisions are loosely taken. Moreover, it gives the reform-makers a total picture about the factors that should be simultaneously collaborated to facilitate the change process;
- Establishes a clear implementation framework to create conditions appropriate for successful introduction of accrual accounting and put it into practice;
- Visualizes the impact of the implementation of accrual accounting in the public sector through showing the consequences of that implementation in the real world;
- Indicates the proposed cost elements of the implementation process.

5. CONCLUSION

As a result of increasing the focus on the objectives and outputs delivered, performance measurements in terms of efficiency and effectiveness, and value for money (rather than input), as well as a dissatisfaction with the use of cash-based accounting system (especially decisions about capital), some countries have confirmed their intention to improve and develop their governmental accounting systems to be consistent with this philosophy. The development of the government accounting system means that this system should be more informative to ensure the supply of comprehensive, reliable, and meaningful

financial information needed for appropriate financial accountability and sound financial management (Luder 94). Accordingly, one of the main accounting changes to make the government accounting system more informative is the implementation of accrual accounting in the public sector. But on the other hand, the implementation of accrual accounting in the public sector is not an easy task due to its specific nature and requirements. Therefore, the implementation of accrual accounting needs collaboration of a set of factors to create conditions appropriate for its introduction and to put it into practice. The Basic Requirements Model has attempted to set forth these factors. These factors (the basic requirements) are reflected in the following equation:

$$AC (ps) = f (MC + PBS + PAS + CS + WC + CC + BAC + SAI + ITC)$$

However, it has been demonstrated that the aforementioned basic requirements are essential and critical for both developed and developing countries. In addition, the successful implementation of accrual accounting in the public sector of the developing countries has required one more basic requirement, which is the *International Financial Support (IFS)*. Consequently, the implementation of accrual accounting in the developing countries requires:

$$AC (ps) = f (MC + PBS + PAS + CS + WC + CC + BAC + SAI + ITC + IFS)$$

Neglecting or not recognizing these factors, which are necessary to set up the initial steps towards the establishment of accrual accounting in the public sector, will hold back the implementation of accrual accounting in the public sector in any country whether it is a developed country or a developing country.

END NOTE

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Recommendations to Combat Money Laundering and Terrorism Financing

Financial Action Task Force¹

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INTRODUCTION

Money laundering methods and techniques change in response to developing counter-measures. In recent years, the Financial Action Task Force (FATF) has noted increasingly sophisticated combinations of techniques, such as the increased use of legal persons to disguise the true ownership and control of illegal proceeds, and an increased use of professionals to provide advice and assistance in laundering criminal funds. These factors, combined with the experience gained through the FATF's Non-Cooperative Countries and Territories process, and a number of national and international initiatives, led the FATF to review and revise the Forty Recommendations into a new comprehensive framework for combating money laundering and terrorist financing. The FATF now calls upon all countries to take the necessary steps to bring their national systems for combating money laundering and terrorist financing into compliance with the new FATF Recommendations, and to effectively implement these measures.

The review process for revising the Forty Recommendations was an extensive one, open to FATF members, non-members, observers, financial and other affected sectors and interested parties. This consultation process provided a wide range of input, all of which was considered in the review process. The revised Forty Recommendations now apply not only to money laundering but also to terrorist financing, and when combined with the Eight Special Recommendations on Terrorist Financing provide an enhanced, comprehensive and consistent framework of measures for combating money laundering and terrorist financing. The FATF recognises that countries have diverse legal and financial systems and so all cannot take identical measures to achieve the common objective, especially over matters of detail. The Recommendations therefore set minimum standards for action for countries to implement the detail according to their particular circumstances and constitutional frameworks. The Recommendations cover all the measures that national systems should have in place within their criminal justice and regulatory systems; the preventive measures to be taken by financial institutions and certain other businesses and professions; and international co-operation.

The original FATF Forty Recommendations were drawn up in 1990 as an initiative to combat the misuse of financial systems by persons laundering drug money. In 1996 the Recommendations were revised for the first time to reflect evolving money laundering typologies. The 1996 Forty Recommendations have been endorsed by more than 130 countries and are the international anti-money laundering standard. In October 2001 the FATF expanded its mandate to deal with the issue of the financing of terrorism, and took the important step of creating the Eight Special Recommendations on Terrorist Financing. These Recommendations contain a set of measures aimed at combating the funding of terrorist acts and terrorist organisations, and are complementary to the Forty Recommendations.²

A key element in the fight against money laundering and the financing of terrorism is the need for countries systems to be monitored and evaluated, with respect to these international standards. The mutual evaluations conducted by the FATF and FATF-style regional bodies, as well as the assessments conducted by the IMF and World Bank, are a vital mechanism for ensuring that the FATF Recommendations are effectively implemented by all countries.

THE FORTY RECOMMENDATIONS³

A. LEGAL SYSTEMS

Scope of the criminal offence of money laundering

1. Countries should criminalise money laundering on the basis of the 1988 United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (the Vienna Convention) and the 2000 United Nations Convention on Transnational Organized Crime (the Palermo Convention). Countries should apply the crime of money laundering to all serious offences, with a view to including the widest range of predicate offences. Predicate offences may be described by reference to all offences, or to a threshold linked either to a category of serious offences or to the penalty of imprisonment applicable to the predicate offence (threshold approach), or to a list of predicate offences, or a combination of these approaches.

Where countries apply a threshold approach, predicate offences should at a minimum comprise all offences that fall within the category of serious offences under their national law or should include offences which are punishable by a maximum penalty of more than one year's imprisonment or for those countries that have a minimum threshold for offences in their legal system, predicate offences should comprise all offences, which are punished by a minimum penalty of more than six months imprisonment.

Whichever approach is adopted, each country should at a minimum include a range of offences within each of the designated categories of offences.⁴ Predicate offences for money laundering should extend to conduct that occurred in another country, which constitutes an offence in that country, and which would have constituted a predicate offence had it occurred domestically. Countries may provide that the only prerequisite is that the conduct would have constituted a predicate offence had it occurred domestically. Countries may provide that the offence of money laundering does not apply to persons who committed the predicate offence, where this is required by fundamental principles of their domestic law.

2. Countries should ensure that:

- a) The intent and knowledge required to prove the offence of money laundering is consistent with the standards set forth in the Vienna and Palermo Conventions, including the concept that such mental state may be inferred from objective factual circumstances.
- b) Criminal liability, and, where that is not possible, civil or administrative liability, should apply to legal persons. This should not preclude parallel criminal, civil or administrative proceedings with respect to legal persons in countries in which such forms of liability are available. Legal persons should be subject to effective, proportionate and dissuasive sanctions. Such measures should be without prejudice to the criminal liability of individuals

Provisional measures and confiscation

3. Countries should adopt measures similar to those set forth in the Vienna

and Palermo Conventions, including legislative measures, to enable their competent authorities to confiscate property laundered, proceeds from money laundering or predicate offences, instrumentalities used in or intended for use in the commission of these offences, or property of corresponding value, without prejudicing the rights of bona fide third parties. Such measures should include the authority to: (a) identify, trace and evaluate property which is subject to confiscation; (b) carry out provisional measures, such as freezing and seizing, to prevent any dealing, transfer or disposal of such property; (c) take steps that will prevent or void actions that prejudice the State's ability to recover property that is subject to confiscation; and (d) take any appropriate investigative measures.

Countries may consider adopting measures that allow such proceeds or instrumentalities to be confiscated without requiring a criminal conviction, or which require an offender to demonstrate the lawful origin of the property alleged to be liable to confiscation, to the extent that such a requirement is consistent with the principles of their domestic law.

B. MEASURES TO BE TAKEN BY FINANCIAL INSTITUTIONS AND NONFINANCIAL BUSINESSES AND PROFESSIONS TO PREVENT MONEY LAUNDERING AND TERRORIST FINANCING

4. Countries should ensure that financial institution secrecy laws do not inhibit implementation of the FATF Recommendations.

Customer due diligence and record-keeping

5.* Financial institutions should not keep anonymous accounts or accounts in obviously fictitious names. Financial institutions should undertake customer due diligence measures, including identifying and verifying the identity of their customers, when:

- establishing business relations;
- carrying out occasional transactions: (i) above the applicable designated threshold; or (ii) that are wire transfers in the circumstances covered by the Interpretative Note to Special Recommendation VII;
- there is a suspicion of money laundering or terrorist financing; or
- the financial institution has doubts about the veracity or adequacy of previously obtained customer identification data.

The customer due diligence (CDD) measures to be taken are as follows:

- a) Identifying the customer and verifying that customer's identity using reliable, independent source documents, data or information.⁵
- b) Identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner such that the financial institution is satisfied that it knows who the beneficial owner is. For legal persons and arrangements this should include financial institutions taking reasonable measures to understand the ownership and control structure of the customer.
- c) Obtaining information on the purpose and intended nature of the business relationship.
- d) Conducting ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the institution's knowledge of the customer, their business and risk profile, including, where necessary, the source of funds.

Financial institutions should apply each of the CDD measures under (a) to (d) above, but may determine the extent of such measures on a risk sensitive basis depending on the type of customer, business relationship or transaction. The measures that are taken should be consistent with any guidelines issued by competent authorities. For higher risk categories, financial institutions should perform enhanced due diligence. In certain circumstances, where there are low risks, countries may decide that financial institutions can apply reduced or simplified measures. Financial institutions should verify the identity of the customer and beneficial owner before or during the course of establishing a business relationship or conducting transactions for occasional customers. Countries may permit financial institutions to complete the verification as soon as reasonably practicable following the establishment of the relationship, where the money laundering risks are effectively managed and where this is essential not to interrupt the normal conduct of business.

Where the financial institution is unable to comply with paragraphs (a) to (c) above, it should not open the account, commence business relations or perform the transaction; or should terminate the business relationship; and should consider making a suspicious transactions report in relation to the customer. These requirements should apply to all new customers, though financial institutions should also apply this Recommendation to existing customers on the basis of materiality and risk, and should conduct due diligence on such existing relationships at appropriate times.

6.* Financial institutions should, in relation to politically exposed persons, in addition to performing normal due diligence measures:

- a) Have appropriate risk management systems to determine whether the customer is a politically exposed person.
- b) Obtain senior management approval for establishing business relationships with such customers.
- c) Take reasonable measures to establish the source of wealth and source of funds.
- d) Conduct enhanced ongoing monitoring of the business relationship.

7. Financial institutions should, in relation to cross-border correspondent banking and other similar relationships, in addition to performing normal due diligence measures:

- a) Gather sufficient information about a respondent institution to understand fully the nature of the respondent's business and to determine from publicly available information the reputation of the institution and the quality of supervision, including whether it has been subject to a money laundering or terrorist financing investigation or regulatory action.
- b) Assess the respondent institution's anti-money laundering and terrorist financing controls.
- c) Obtain approval from senior management before establishing new correspondent relationships.
- d) Document the respective responsibilities of each institution.
- e) With respect to "payable-through accounts," be satisfied that the respondent bank has verified the identity of and performed on-going due diligence on the customers having direct access to accounts of the correspondent and that it is able to provide relevant customer identification data upon request to the correspondent bank.

8. Financial institutions should pay special attention to any money laundering threats that may arise from new or developing technologies that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes. In particular, financial institutions should have policies and procedures in place to address any specific risks associated with non-face to face business relationships or transactions.

9.* Countries may permit financial institutions to rely on intermediaries or other third parties to perform elements (a) – (c) of the CDD process or to introduce business, provided that the criteria set out below are met. Where such reliance is permitted, the ultimate responsibility for customer identification and verification remains with the financial institution relying on the third party. The criteria that should be met are as follows:

- a) A financial institution relying upon a third party should immediately obtain the necessary information concerning elements (a) – (c) of the CDD process. Financial institutions should take adequate steps to satisfy themselves that copies of identification data and other relevant documentation relating to the CDD requirements will be made available from the third party upon request without delay.
- b) The financial institution should satisfy itself that the third party is regulated and supervised for, and has measures in place to comply with CDD requirements in line with Recommendations 5 and 10. It is left to each country to determine in which countries the third party that meets the conditions can be based, having regard to information available on countries that do not or do not adequately apply the FATF Recommendations.

10.* Financial institutions should maintain, for at least five years, all necessary records on transactions, both domestic or international, to enable them to comply swiftly with information requests from the competent authorities. Such records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currency involved if any) so as to provide, if necessary, evidence for prosecution of criminal activity. Financial institutions should keep records on the identification data obtained through the customer due diligence process (e.g. copies or records of official identification documents like passports, identity cards, driving licenses or similar documents), account files and business correspondence for at least five years after the business relationship is ended. The identification data and transaction records should be available to domestic competent authorities upon appropriate authority.

11.* Financial institutions should pay special attention to all complex, unusual large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities and auditors.

12.* The customer due diligence and record-keeping requirements set out in Recommendations 5, 6, and 8 to 11 apply to designated non-financial businesses and professions in the following situations:

- a) Casinos—when customers engage in financial transactions equal to or above the applicable designated threshold.
- b) Real estate agents—when they are involved in transactions for their client concerning the buying and selling of real estate.
- c) Dealers in precious metals and dealers in precious stones—when they engage in any cash transaction with a customer equal to or above the applicable designated threshold.

- d) Lawyers, notaries, other independent legal professionals and accountants when they prepare for or carry out transactions for their client concerning the following activities:
- _ buying and selling of real estate;
 - _ managing of client money, securities or other assets;
 - _ management of bank, savings or securities accounts;
 - _ organisation of contributions for the creation, operation or management of companies;
 - _ creation, operation or management of legal persons or arrangements, and buying and selling of business entities.
- e) Trust and company service providers when they prepare for or carry out transactions for a client concerning the activities listed in the definition in the Glossary.

Reporting of suspicious transactions and compliance

13.* If a financial institution suspects or has reasonable grounds to suspect that funds are the proceeds of a criminal activity, or are related to terrorist financing, it should be required, directly by law or regulation, to report promptly its suspicions to the financial intelligence unit (FIU).

14.* Financial institutions, their directors, officers and employees should be:

- a) Protected by legal provisions from criminal and civil liability for breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision, if they report their suspicions in good faith to the FIU, even if they did not know precisely what the underlying criminal activity was, and regardless of whether illegal activity actually occurred.
- b) Prohibited by law from disclosing the fact that a suspicious transaction report (STR) or related information is being reported to the FIU.

15.* Financial institutions should develop programmes against money laundering and terrorist financing. These programmes should include:

- a) The development of internal policies, procedures and controls, including appropriate compliance management arrangements, and adequate screening procedures to ensure high standards when hiring employees.
- b) An ongoing employee training programme.
- c) An audit function to test the system.

16.* The requirements set out in Recommendations 13 to 15, and 21 apply to all designated non-financial businesses and professions, subject to the following qualifications:

- a) Lawyers, notaries, other independent legal professionals and accountants should be required to report suspicious transactions when, on behalf of or for a client, they engage in a financial transaction in relation to the activities described in Recommendation 12(d). Countries are strongly encouraged to extend the reporting requirement to the rest of the professional activities of accountants, including auditing.
- b) Dealers in precious metals and dealers in precious stones should be required to report suspicious transactions when they engage in any cash transaction with a customer equal to or above the applicable designated threshold.
- c) Trust and company service providers should be required to report suspicious transactions for a client when, on behalf of or for a client, they engage in a

transaction in relation to the activities referred to Recommendation 12(e).

Lawyers, notaries, other independent legal professionals, and accountants acting as independent legal professionals, are not required to report their suspicions if the relevant information was obtained in circumstances where they are subject to professional secrecy or legal professional privilege.

Other measures to deter money laundering and terrorist financing

17. Countries should ensure that effective, proportionate and dissuasive sanctions, whether criminal, civil or administrative, are available to deal with natural or legal persons covered by these Recommendations that fail to comply with anti-money laundering or terrorist financing requirements.

18. Countries should not approve the establishment or accept the continued operation of shell banks. Financial institutions should refuse to enter into, or continue, a correspondent banking relationship with shell banks. Financial institutions should also guard against establishing relations with respondent foreign financial institutions that permit their accounts to be used by shell banks.

19.* Countries should consider:

- a) Implementing feasible measures to detect or monitor the physical cross-border transportation of currency and bearer negotiable instruments, subject to strict safeguards to ensure proper use of information and without impeding in any way the freedom of capital movements.
- b) The feasibility and utility of a system where banks and other financial institutions and intermediaries would report all domestic and international currency transactions above a fixed amount, to a national central agency with a computerised data base, available to competent authorities for use in money laundering or terrorist financing cases, subject to strict safeguards to ensure proper use of the information.

20. Countries should consider applying the FATF Recommendations to businesses and professions, other than designated non-financial businesses and professions, which pose a money laundering or terrorist financing risk. Countries should further encourage the development of modern and secure techniques of money management that are less vulnerable to money laundering.

Measures to be taken with respect to countries that do not or insufficiently comply with the FATF Recommendations

21. Financial institutions should give special attention to business relationships and transactions with persons, including companies and financial institutions, from countries that do not or insufficiently apply the FATF Recommendations. Whenever these transactions have no apparent economic or visible lawful purpose, their background and purpose should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities. Where such a country continues not to apply or insufficiently applies the FATF Recommendations, countries should be able to apply appropriate countermeasures.

22. Financial institutions should ensure that the principles applicable to financial institutions, which are mentioned above are also applied to branches and majority owned subsidiaries located abroad, especially in countries that do not or insufficiently apply the FATF Recommendations, to the extent that local applicable laws and regulations permit. When local applicable laws and regulations prohibit this implementation, competent authorities in the country of the parent institution should be informed by the financial institutions that they cannot apply the FATF Recommendations.

Regulation and supervision

23.* Countries should ensure that financial institutions are subject to adequate regulation and supervision and are effectively implementing the FATF Recommendations. Competent authorities should take the necessary legal or regulatory measures to prevent criminals or their associates from holding or being the beneficial owner of a significant or controlling interest or holding a management function in a financial institution. For financial institutions subject to the Core Principles, the regulatory and supervisory measures that apply for prudential purposes and which are also relevant to money laundering, should apply in a similar manner for anti-money laundering and terrorist financing purposes. Other financial institutions should be licensed or registered and appropriately regulated, and subject to supervision or oversight for anti-money laundering purposes, having regard to the risk of money laundering or terrorist financing in that sector. At a minimum, businesses providing a service of money or value transfer, or of money or currency changing should be licensed or registered, and subject to effective systems for monitoring and ensuring compliance with national requirements to combat money laundering and terrorist financing.

24. Designated non-financial businesses and professions should be subject to regulatory and supervisory measures as set out below.

- a) Casinos should be subject to a comprehensive regulatory and supervisory regime that ensures that they have effectively implemented the necessary anti-money laundering and terrorist-financing measures. At a minimum:
- casinos should be licensed;
 - competent authorities should take the necessary legal or regulatory measures to prevent criminals or their associates from holding or being the beneficial owner of a significant or controlling interest, holding a management function in, or being an operator of a casino
 - competent authorities should ensure that casinos are effectively supervised for compliance with requirements to combat money laundering and terrorist financing.
- b) Countries should ensure that the other categories of designated non-financial businesses and professions are subject to effective systems for monitoring and ensuring their compliance with requirements to combat money laundering and terrorist financing. This should be performed on a risk-sensitive basis. This may be performed by a government authority or by an appropriate self-regulatory organisation, provided that such an organisation can ensure that its members comply with their obligations to combat money laundering and terrorist financing.

25.* The competent authorities should establish guidelines, and provide feedback which will assist financial institutions and designated non-financial businesses and professions in applying national measures to combat money laundering and terrorist financing, and in particular, in detecting and reporting suspicious transactions.

C. INSTITUTIONAL AND OTHER MEASURES NECESSARY IN SYSTEMS FOR COMBATING MONEY LAUNDERING AND TERRORIST FINANCING

Competent authorities, their powers and resources

26.* Countries should establish a FIU that serves as a national centre for the

receiving (and, as permitted, requesting), analysis and dissemination of STR and other information regarding potential money laundering or terrorist financing. The FIU should have access, directly or indirectly, on a timely basis to the financial, administrative and law enforcement information that it requires to properly undertake its functions, including the analysis of STR.

27.* Countries should ensure that designated law enforcement authorities have responsibility for money laundering and terrorist financing investigations. Countries are encouraged to support and develop, as far as possible, special investigative techniques suitable for the investigation of money laundering, such as controlled delivery, undercover operations and other relevant techniques. Countries are also encouraged to use other effective mechanisms such as the use of permanent or temporary groups specialised in asset investigation, and co-operative investigations with appropriate competent authorities in other countries.

28. When conducting investigations of money laundering and underlying predicate offences, competent authorities should be able to obtain documents and information for use in those investigations, and in prosecutions and related actions. This should include powers to use compulsory measures for the production of records held by financial institutions and other persons, for the search of persons and premises, and for the seizure and obtaining of evidence.

29. Supervisors should have adequate powers to monitor and ensure compliance by financial institutions with requirements to combat money laundering and terrorist financing, including the authority to conduct inspections. They should be authorised to compel production of any information from financial institutions that is relevant to monitoring such compliance, and to impose adequate administrative sanctions for failure to comply with such requirements.

30. Countries should provide their competent authorities involved in combating money laundering and terrorist financing with adequate financial, human and technical resources. Countries should have in place processes to ensure that the staffs of those authorities are of high integrity.

31. Countries should ensure that policy makers, the FIU, law enforcement and supervisors have effective mechanisms in place which enable them to cooperate, and where appropriate coordinate domestically with each other concerning the development and implementation of policies and activities to combat money laundering and terrorist financing.

32. Countries should ensure that their competent authorities review the effectiveness of their systems to combat money laundering and terrorist financing systems by maintaining comprehensive statistics on matters relevant to the effectiveness and efficiency of such systems. This should include statistics on the STR received and disseminated; on money laundering and terrorist financing investigations, prosecutions and convictions; on property frozen, seized and confiscated; and on mutual legal assistance or other international requests for co-operation.

Transparency of legal persons and arrangements

33. Countries should take measures to prevent the unlawful use of legal persons by money launderers. Countries should ensure that there is adequate, accurate and timely information on the beneficial ownership and control of legal persons that can be obtained or accessed in a timely fashion by competent authorities. In particular, countries that have legal persons that are able to issue bearer shares should take appropriate measures to ensure that they are not misused for money laundering and be able to demonstrate the adequacy of those

measures. Countries could consider measures to facilitate access to beneficial ownership and control information to financial institutions undertaking the requirements set out in Recommendation 5.

34. Countries should take measures to prevent the unlawful use of legal arrangements by money launderers. In particular, countries should ensure that there is adequate, accurate and timely information on express trusts, including information on the settlor, trustee and beneficiaries, which can be obtained or accessed in a timely fashion by competent authorities. Countries could consider measures to facilitate access to beneficial ownership and control information to financial institutions undertaking the requirements set out in Recommendation 5.

D. INTERNATIONAL CO-OPERATION

35. Countries should take immediate steps to become party to and implement fully the Vienna Convention, the Palermo Convention, and the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism. Countries are also encouraged to ratify and implement other relevant international conventions, such as the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime and the 2002 Inter-American Convention against Terrorism.

Mutual legal assistance and extradition

36. Countries should rapidly, constructively and effectively provide the widest possible range of mutual legal assistance in relation to money laundering and terrorist financing investigations, prosecutions, and related proceedings. In particular, countries should:

- a) Not prohibit or place unreasonable or unduly restrictive conditions on the provision of mutual legal assistance.
- b) Ensure that they have clear and efficient processes for the execution of mutual legal assistance requests.
- c) Not refuse to execute a request for mutual legal assistance on the sole ground that the offence is also considered to involve fiscal matters.
- d) Not refuse to execute a request for mutual legal assistance on the grounds that laws require financial institutions to maintain secrecy or confidentiality.

Countries should ensure that the powers of their competent authorities required under Recommendation 28 are also available for use in response to requests for mutual legal assistance, and if consistent with their domestic framework, in response to direct requests from foreign judicial or law enforcement authorities to domestic counterparts. To avoid conflicts of jurisdiction, consideration should be given to devising and applying mechanisms for determining the best venue for prosecution of defendants in the interests of justice in cases that are subject to prosecution in more than one country.

37. Countries should, to the greatest extent possible, render mutual legal assistance notwithstanding the absence of dual criminality. Where dual criminality is required for mutual legal assistance or extradition, that requirement should be deemed to be satisfied regardless of whether both countries place the offence within the same category of offence or denominate the offence by the same terminology, provided that both countries criminalise the conduct underlying the offence.

38.* There should be authority to take expeditious action in response to requests by foreign countries to identify, freeze, seize and confiscate property laundered, proceeds from money laundering or predicate offences, instrumentalities used in or intended for use in the commission of these offences, or property of corresponding value. There should also be arrangements for coordinating seizure and confiscation proceedings, which may include the sharing of confiscated assets.

39. Countries should recognise money laundering as an extraditable offence. Each country should either extradite its own nationals, or where a country does not do so solely on the grounds of nationality, that country should, at the request of the country seeking extradition, submit the case without undue delay to its competent authorities for the purpose of prosecution of the offences set forth in the request. Those authorities should take their decision and conduct their proceedings in the same manner as in the case of any other offence of a serious nature under the domestic law of that country. The countries concerned should cooperate with each other, in particular on procedural and evidentiary aspects, to ensure the efficiency of such prosecutions. Subject to their legal frameworks, countries may consider simplifying extradition by allowing direct transmission of extradition requests between appropriate ministries, extraditing persons

based only on warrants of arrests or judgments, and/or introducing a simplified extradition of consenting persons who waive formal extradition proceedings.

Other forms of co-operation

40.* Countries should ensure that their competent authorities provide the widest possible range of international co-operation to their foreign counterparts. There should be clear and effective gateways to facilitate the prompt and constructive exchange directly between counterparts, either spontaneously or upon request, of information relating to both money laundering and the underlying predicate offences. Exchanges should be permitted without unduly restrictive conditions. In particular:

- a) Competent authorities should not refuse a request for assistance on the sole ground that the request is also considered to involve fiscal matters.
- b) Countries should not invoke laws that require financial institutions to maintain secrecy or confidentiality as a ground for refusing to provide co-operation.
- c) Competent authorities should be able to conduct inquiries; and where possible, investigations; on behalf of foreign counterparts.

Where the ability to obtain information sought by a foreign competent authority is not within the mandate of its counterpart, countries are also encouraged to permit a prompt and constructive exchange of information with non-counterparts. Co-operation with foreign authorities other than counterparts could occur directly or indirectly. When uncertain about the appropriate avenue to follow, competent authorities should first contact their foreign counterparts for assistance. Countries should establish controls and safeguards to ensure that information exchanged by competent authorities is used only in an authorised manner, consistent with their obligations concerning privacy and data protection.

GLOSSARY

In these Recommendations the following abbreviations and references are used:

Beneficial owner refers to the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.

Core Principles refers to the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision, the Objectives and Principles for Securities Regulation issued by the International Organization of Securities Commissions, and the Insurance Supervisory Principles issued by the International Association of Insurance Supervisors.

Designated categories of offences means:

- _ participation in an organised criminal group and racketeering;
- _ terrorism, including terrorist financing;
- _ trafficking in human beings and migrant smuggling;
- _ sexual exploitation, including sexual exploitation of children;
- _ illicit trafficking in narcotic drugs and psychotropic substances;
- _ illicit arms trafficking;
- _ illicit trafficking in stolen and other goods;
- _ corruption and bribery;
- _ fraud;
- _ counterfeiting currency;
- _ counterfeiting and piracy of products;
- _ environmental crime;
- _ murder, grievous bodily injury;
- _ kidnapping, illegal restraint and hostage-taking;
- _ robbery or theft;
- _ smuggling;
- _ extortion;
- _ forgery;
- _ piracy; and
- _ insider trading and market manipulation.

When deciding on the range of offences to be covered as predicate offences under each of the categories listed above, each country may decide, in accordance with its domestic law, how it will define those offences and the nature of any particular elements of those offences that make them serious offences.

Designated non-financial businesses and professions means:

- a) Casinos (which also includes internet casinos).
- b) Real estate agents.
- c) Dealers in precious metals.
- d) Dealers in precious stones.
- e) Lawyers, notaries, other independent legal professionals and accountants –

this refers to sole practitioners, partners or employed professionals within professional firms. It is not meant to refer to 'internal' professionals that are employees of other types of businesses, nor to professionals working for government agencies, who may already be subject to measures that would combat money laundering.

- f) Trust and Company Service Providers refers to all persons or businesses that are not covered elsewhere under these Recommendations, and which as a business, provide any of the following services to third parties:
- _ acting as a formation agent of legal persons;
 - _ acting as (or arranging for another person to act as) a director or secretary of a company, a partner of a partnership, or a similar position in relation to other legal persons;
 - _ providing a registered office; business address or accommodation, correspondence or administrative address for a company, a partnership or any other legal person or arrangement;
 - _ acting as (or arranging for another person to act as) a trustee of an express trust;
 - _ acting as (or arranging for another person to act as) a nominee shareholder for another person.

Designated threshold refers to the amount set out in the Interpretative Notes.

Financial institutions means any person or entity that conducts as a business one or more of the following activities or operations for or on behalf of a customer:

1. Acceptance of deposits and other repayable funds from the public.⁶
2. Lending.⁷
3. Financial leasing.⁸
4. The transfer of money or value.⁹
5. Issuing and managing means of payment (e.g. credit and debit cards, cheques, traveller's cheques, money orders and bankers' drafts, electronic money).
6. Financial guarantees and commitments.
7. Trading in:
 - (a) money market instruments (cheques, bills, CDs, derivatives etc.);
 - (b) foreign exchange;
 - (c) exchange, interest rate and index instruments;
 - (d) transferable securities;
 - (e) commodity futures trading.
8. Participation in securities issues and the provision of financial services related to such issues.
9. Individual and collective portfolio management.
10. Safekeeping and administration of cash or liquid securities on behalf of other persons.
11. Otherwise investing, administering or managing funds or money on behalf of other persons.

12. Underwriting and placement of life insurance and other investment related insurance.¹⁰

13. Money and currency changing.

When a financial activity is carried out by a person or entity on an occasional or very limited basis (having regard to quantitative and absolute criteria) such that there is little risk of money laundering activity occurring, a country may decide that the application of anti-money laundering measures is not necessary, either fully or partially. In strictly limited and justified circumstances, and based on a proven low risk of money laundering, a country may decide not to apply some or all of the Forty Recommendations to some of the financial activities stated above.

FIU means financial intelligence unit.

Legal arrangements refers to express trusts or other similar legal arrangements.

Legal persons refers to bodies corporate, foundations, anstalt, partnerships, or associations, or any similar bodies that can establish a permanent customer relationship with a financial institution or otherwise own property.

Payable-through accounts refers to correspondent accounts that are used directly by third parties to transact business on their own behalf.

Politically Exposed Persons (PEPs) are individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. Business relationships with family members or close associates of PEPs involve reputational risks similar to those with PEPs themselves. The definition is not intended to cover middle ranking or more junior individuals in the foregoing categories.

Shell bank means a bank incorporated in a jurisdiction in which it has no physical presence and which is unaffiliated with a regulated financial group.

STR refers to suspicious transaction reports.

Supervisors refers to the designated competent authorities responsible for ensuring compliance by financial institutions with requirements to combat money laundering and terrorist financing.

The FATF Recommendations refers to these Recommendations and to the FATF Special Recommendations on Terrorist Financing.

ANNEX

INTERPRETATIVE NOTES TO THE FORTY RECOMMENDATIONS

INTERPRETATIVE NOTES

General

1. Reference in this document to “countries” should be taken to apply equally to “territories” or “jurisdictions.”
2. Recommendations 5-16 and 21-22 state that financial institutions or designated non-financial businesses and professions should take certain actions. These references require countries to take measures that will oblige financial institutions or designated non-financial businesses and professions to comply with each Recommendation. The basic obligations under Recommendations 5, 10 and 13 should be set out in law or regulation, while more detailed elements in those Recommendations, as well as obligations under other Recommendations, could be required either by law or regulation or by other enforceable means issued by a competent authority.
3. Where reference is made to a financial institution being satisfied as to a matter, that institution must be able to justify its assessment to competent authorities.
4. To comply with Recommendations 12 and 16, countries do not need to issue laws or regulations that relate exclusively to lawyers, notaries, accountants and the other designated non-financial businesses and professions so long as these businesses or professions are included in laws or regulations covering the underlying activities.
5. The Interpretative Notes that apply to financial institutions are also relevant to designated non-financial businesses and professions, where applicable.

Recommendations 5, 12 and 16

The designated thresholds for transactions (under Recommendations 5 and 12) are as follows:

- _ Financial institutions (for occasional customers under Recommendation 5) - USD/EUR 15,000.
- _ Casinos, including internet casinos (under Recommendation 12) - USD/EUR 3000.
- _ For dealers in precious metals and dealers in precious stones when engaged in any cash transaction (under Recommendations 12 and 16) - USD/EUR 15,000.

Financial transactions above a designated threshold include situations where the transaction is carried out in a single operation or in several operations that appear to be linked.

Recommendation 5

Customer due diligence and tipping off

1. If, during the establishment or course of the customer relationship, or when conducting occasional transactions, a financial institution suspects that transactions relate to money laundering or terrorist financing, then the institution should:
 - a) Normally seek to identify and verify the identity of the customer and the

beneficial owner, whether permanent or occasional, and irrespective of any exemption or any designated threshold that might otherwise apply.

b) Make a STR to the FIU in accordance with Recommendation 13.

2. Recommendation 14 prohibits financial institutions, their directors, officers and employees from disclosing the fact that an STR or related information is being reported to the FIU. A risk exists that customers could be unintentionally tipped off when the financial institution is seeking to perform its customer due diligence (CDD) obligations in these circumstances. The customer's awareness of a possible STR or investigation could compromise future efforts to investigate the suspected money laundering or terrorist financing operation.

3. Therefore, if financial institutions form a suspicion that transactions relate to money laundering or terrorist financing, they should take into account the risk of tipping off when performing the customer due diligence process. If the institution reasonably believes that performing the CDD process will tip-off the customer or potential customer, it may choose not to pursue that process, and should file an STR. Institutions should ensure that their employees are aware of and sensitive to these issues when conducting CDD.

CDD for legal persons and arrangements

4. When performing elements (a) and (b) of the CDD process in relation to legal persons or arrangements, financial institutions should:

a) Verify that any person purporting to act on behalf of the customer is so authorised, and identify that person.

b) Identify the customer and verify its identity - the types of measures that would be normally needed to satisfactorily perform this function would require obtaining proof of incorporation or similar evidence of the legal status of the legal person or arrangement, as well as information concerning the customer's name, the names of trustees, legal form, address, directors, and provisions regulating the power to bind the legal person or arrangement.

c) Identify the beneficial owners, including forming an understanding of the ownership and control structure, and take reasonable measures to verify the identity of such persons.

The types of measures that would be normally needed to satisfactorily perform this function would require identifying the natural persons with a controlling interest and identifying the natural persons who comprise the mind and management of the legal person or arrangement. Where the customer or the owner of the controlling interest is a public company that is subject to regulatory disclosure requirements, it is not necessary to seek to identify and verify the identity of any shareholder of that company. The relevant information or data may be obtained from a public register, from the customer or from other reliable sources.

Reliance on identification and verification already performed

5. The CDD measures set out in Recommendation 5 do not imply that financial institutions have to repeatedly identify and verify the identity of each customer every time that a customer conducts a transaction. An institution is entitled to rely on the identification and verification steps that it has already undertaken unless it has doubts about the veracity of that information. Examples of situations that might lead an institution to have such doubts could be where there is a suspicion of money laundering in relation to that customer, or where there is a material change in the way that the customer's account is operated which is not consistent with the customer's business profile.

Timing of verification

6. Examples of the types of circumstances where it would be permissible for verification to be completed after the establishment of the business relationship, because it would be essential not to interrupt the normal conduct of business include:

- _ Non face-to-face business.
- _ Securities transactions. In the securities industry, companies and intermediaries may be required to perform transactions very rapidly, according to the market conditions at the time the customer is contacting them, and the performance of the transaction may be required before verification of identity is completed.
- _ Life insurance business. In relation to life insurance business, countries may permit the identification and verification of the beneficiary under the policy to take place after having established the business relationship with the policyholder. However, in all such cases, identification and verification should occur at or before the time of payout or the time where the beneficiary intends to exercise vested rights under the policy.

7. Financial institutions will also need to adopt risk management procedures with respect to the conditions under which a customer may utilise the business relationship prior to verification. These procedures should include a set of measures such as a limitation of the number, types and/or amount of transactions that can be performed and the monitoring of large or complex transactions being carried out outside of expected norms for that type of relationship. Financial institutions should refer to the Basel CDD paper¹¹ (section 2.2.6.) for specific guidance on examples of risk management measures for non-face to face business.

Requirement to identify existing customers

8. The principles set out in the Basel CDD paper concerning the identification of existing customers should serve as guidance when applying customer due diligence processes to institutions engaged in banking activity, and could apply to other financial institutions where relevant.

Simplified or reduced CDD measures

9. The general rule is that customers must be subject to the full range of CDD measures, including the requirement to identify the beneficial owner. Nevertheless there are circumstances where the risk of money laundering or terrorist financing is lower, where information on the identity of the customer and the beneficial owner of a customer is publicly available, or where adequate checks and controls exist elsewhere in national systems. In such circumstances it could be reasonable for a country to allow its financial institutions to apply simplified or reduced CDD measures when identifying and verifying the identity of the customer and the beneficial owner.

10. Examples of customers where simplified or reduced CDD measures could apply are:

- _ Financial institutions – where they are subject to requirements to combat money laundering and terrorist financing consistent with the FATF Recommendations and are supervised for compliance with those controls.
- _ Public companies that are subject to regulatory disclosure requirements.
- _ Government administrations or enterprises.

11. Simplified or reduced CDD measures could also apply to the beneficial

owners of pooled accounts held by designated non financial businesses or professions provided that those businesses or professions are subject to requirements to combat money laundering and terrorist financing consistent with the FATF Recommendations and are subject to effective systems for monitoring and ensuring their compliance with those requirements. Banks should also refer to the Basel CDD paper (section 2.2.4.), which provides specific guidance concerning situations where an account holding institution may rely on a customer that is a professional financial intermediary to perform the customer due diligence on his or its own customers (i.e. the beneficial owners of the bank account). Where relevant, the CDD Paper could also provide guidance in relation to similar accounts held by other types of financial institutions.

12. Simplified CDD or reduced measures could also be acceptable for various types of products or transactions such as (examples only):

- _ Life insurance policies where the annual premium is no more than USD/EUR 1000 or a single premium of no more than USD/EUR 2500.
- _ Insurance policies for pension schemes if there is no surrender clause and the policy cannot be used as collateral.
- _ A pension, superannuation or similar scheme that provides retirement benefits to employees, where contributions are made by way of deduction from wages and the scheme rules do not permit the assignment of a member's interest under the scheme.

13. Countries could also decide whether financial institutions could apply these simplified measures only to customers in its own jurisdiction or allow them to do for customers from any other jurisdiction that the original country is satisfied is in compliance with and has effectively implemented the FATF Recommendations. Simplified CDD measures are not acceptable whenever there is suspicion of money laundering or terrorist financing or specific higher risk scenarios apply.

Recommendation 6

Countries are encouraged to extend the requirements of Recommendation 6 to individuals who hold prominent public functions in their own country.

Recommendation 9

This Recommendation does not apply to outsourcing or agency relationships. This Recommendation also does not apply to relationships, accounts or transactions between financial institutions for their clients. Those relationships are addressed by Recommendations 5 and 7.

Recommendations 10 and 11

In relation to insurance business, the word "transactions" should be understood to refer to the insurance product itself, the premium payment and the benefits.

Recommendation 13

1. The reference to criminal activity in Recommendation 13 refers to:
 - a) all criminal acts that would constitute a predicate offence for money laundering in the jurisdiction; or
 - b) at a minimum to those offences that would constitute a predicate offence as required by Recommendation 1.

Countries are strongly encouraged to adopt alternative (a). All suspicious transactions, including attempted transactions, should be reported regardless of the amount of the transaction.

2. In implementing Recommendation 13, suspicious transactions should be reported by financial institutions regardless of whether they are also thought to involve tax matters. Countries should take into account that, in order to deter financial institutions from reporting a suspicious transaction, money launderers may seek to state *inter alia* that their transactions relate to tax matters.

Recommendation 14 (tipping off)

Where lawyers, notaries, other independent legal professionals and accountants acting as independent legal professionals seek to dissuade a client from engaging in illegal activity, this does not amount to tipping off.

Recommendation 15

The type and extent of measures to be taken for each of the requirements set out in the Recommendation should be appropriate having regard to the risk of money laundering and terrorist financing and the size of the business.

For financial institutions, compliance management arrangements should include the appointment of a compliance officer at the management level.

Recommendation 16

1. It is for each jurisdiction to determine the matters that would fall under legal professional privilege or professional secrecy. This would normally cover information lawyers, notaries or other independent legal professionals receive from or obtain through one of their clients: (a) in the course of ascertaining the legal position of their client, or (b) in performing their task of defending or representing that client in, or concerning judicial, administrative, arbitration or mediation proceedings. Where accountants are subject to the same obligations of secrecy or privilege, then they are also not required to report suspicious transactions.

2. Countries may allow lawyers, notaries, other independent legal professionals and accountants to send their STR to their appropriate self-regulatory organisations, provided that there are appropriate forms of co-operation between these organisations and the FIU.

Recommendation 19

1. To facilitate detection and monitoring of cash transactions, without impeding in any way the freedom of capital movements, countries could consider the feasibility of subjecting all cross-border transfers, above a given threshold, to verification, administrative monitoring, declaration or record keeping requirements.

2. If a country discovers an unusual international shipment of currency, monetary instruments, precious metals, or gems, etc., it should consider notifying, as appropriate, the Customs Service or other competent authorities of the countries from which the shipment originated and/or to which it is destined, and should co-operate with a view toward establishing the source, destination, and purpose of such shipment and toward the taking of appropriate action.

Recommendation 23

Recommendation 23 should not be read as to require the introduction of a system of regular review of licensing of controlling interests in financial institutions merely for anti-money laundering purposes, but as to stress the desirability of suitability review for controlling shareholders in financial institutions (banks and non-banks in particular) from a FATF point of view. Hence, where shareholder suitability (or “fit and proper”) tests exist, the attention of supervisors should be drawn to their relevance for anti-money laundering purposes.

Recommendation 25

When considering the feedback that should be provided, countries should have

regard to the FATF Best Practice Guidelines on Providing Feedback to Reporting Financial Institutions and Other Persons.

Recommendation 26

Where a country has created an FIU, it should consider applying for membership in the Egmont Group. Countries should have regard to the Egmont Group Statement of Purpose, and its Principles for Information Exchange Between Financial Intelligence Units for Money Laundering Cases. These documents set out important guidance concerning the role and functions of FIUs, and the mechanisms for exchanging information between FIU.

Recommendation 27

Countries should consider taking measures, including legislative ones, at the national level, to allow their competent authorities investigating money laundering cases to postpone or waive the arrest of suspected persons and/or the seizure of the money for the purpose of identifying persons involved in such activities or for evidence gathering. Without such measures the use of procedures such as controlled deliveries and undercover operations are precluded.

Recommendation 38

Countries should consider:

- a) Establishing an asset forfeiture fund in its respective country into which all or a portion of confiscated property will be deposited for law enforcement, health, education, or other appropriate purposes.
- b) Taking such measures as may be necessary to enable it to share among or between other countries confiscated property, in particular, when confiscation is directly or indirectly a result of coordinated law enforcement actions.

Recommendation 40

1. For the purposes of this Recommendation:

- _ “Counterparts” refers to authorities that exercise similar responsibilities and functions.
- _ “Competent authority” refers to all administrative and law enforcement authorities concerned with combating money laundering and terrorist financing, including the FIU and supervisors.

2. Depending on the type of competent authority involved and the nature and purpose of the cooperation, different channels can be appropriate for the exchange of information. Examples of mechanisms or channels that are used to exchange information include: bilateral or multilateral agreements or arrangements, memoranda of understanding, exchanges on the basis of reciprocity, or through appropriate international or regional organisations. However, this Recommendation is not intended to cover co-operation in relation to mutual legal assistance or extradition.

3. The reference to indirect exchange of information with foreign authorities other than counterparts covers the situation where the requested information passes from the foreign authority through one or more domestic or foreign authorities before being received by the requesting authority. The competent authority that requests the information should always make it clear for what purpose and on whose behalf the request is made.

4. FIUs should be able to make inquiries on behalf of foreign counterparts where this could be relevant to an analysis of financial transactions. At a minimum, inquiries should include:

- _ Searching its own databases, which would include information related to suspicious transaction reports.
- _ Searching other databases to which it may have direct or indirect access, including law enforcement databases, public databases, administrative databases and commercially available databases.

Where permitted to do so, FIUs should also contact other competent authorities and financial institutions in order to obtain relevant information.

End Notes

1. The FATF is an inter-governmental body that sets standards, and develops and promotes policies to combat money laundering and terrorist financing. It currently has 33 members: 31 countries and governments and two international organisations; and more than 20 observers: five FATF-style regional bodies and more than 15 other international organisations or bodies. A list of all members and observers can be found on the FATF website at www.fatf-gafi.org/Members_en.htm.

2 The FATF Forty and Eight Special Recommendations have been recognised by the International Monetary Fund and the World Bank as the international standards for combating money laundering and the financing of terrorism.

3. Recommendations marked with an asterisk (*) should be read in conjunction with their Interpretative Note at the end.

4. See the definition of “designated categories of offences” in the Glossary.

5. Reliable, independent source documents, data or information will hereafter be referred to as “identification data.”.

6. This also captures private banking.

7. This includes inter alia: consumer credit; mortgage credit; factoring, with or without recourse; and finance of commercial transactions (including forfeiting).

8. This does not extend to financial leasing arrangements in relation to consumer products.

9. This applies to financial activity in both the formal or informal sector e.g. alternative remittance activity. See the Interpretative Note to Special Recommendation VI. It does not apply to any natural or legal person that provides financial institutions solely with message or other support systems for transmitting funds. See the Interpretative Note to Special Recommendation VII.

10. This applies both to insurance undertakings and to insurance intermediaries (agents and brokers).

11. “Basel CDD paper” refers to the guidance paper on Customer Due Diligence for Banks issued by the Basel Committee on Banking Supervision in October 2001.

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State Audit Office – Tonga
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