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Improving Government Financial Reporting: The Window to Good Governance

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Governments traditionally ignore basic bookkeeping and financial reporting requirements because they consider themselves different from commercial entities. They provide various reasons for not preparing proper financial statements—presenting government finances in a balance sheet and operating statement would not reflect the different public interest roles of government; private sector accounting standards do not apply to governments because they are not for profit; governments are too big and complex, making it difficult to summarize financial information; and full financial statements are too expensive to produce for the benefit gained, among others.

Fortunately, countries like Australia and New Zealand now publish consolidated financial statements on an accrual basis that include all public bodies, thereby effectively dispelling such excuses and proving it can be done. People are now demanding proper financial information from their governments. Accounting is accounting is accounting—and governments are no different from any other entity in reporting how money is spent. The financial failures of Argentina or Orange County in California are proof that governments are also not immune from going broke.

Financial statements for the whole of government show the financial status of the entire public sector in a few pages. Income and expenditures are summarized; the balance sheet gives a one-page picture of assets, liabilities, capital, and reserves; and a cash flow statement and notes, providing more detailed information that support main statements, are presented in a standard, easy-to-follow format. People can therefore understand government finances. Legislators can make rational decisions about how to allocate scarce public funds using financial statements, and public sector managers can manage public resources more effectively.

So why don't all governments provide such financial statements now? Among other reasons, users have not demanded them; government financing (the budget) is dominated by economists, who report finances in an arcane way; governments have too few professional accountants to prepare real financial statements. The fact is, however, that most governments fail to be transparent. They delay or divert any attempt to improve their financial reporting. All citizens in both developing and developed countries must demand proper accounting from their representatives, consistent with professional accounting standards.

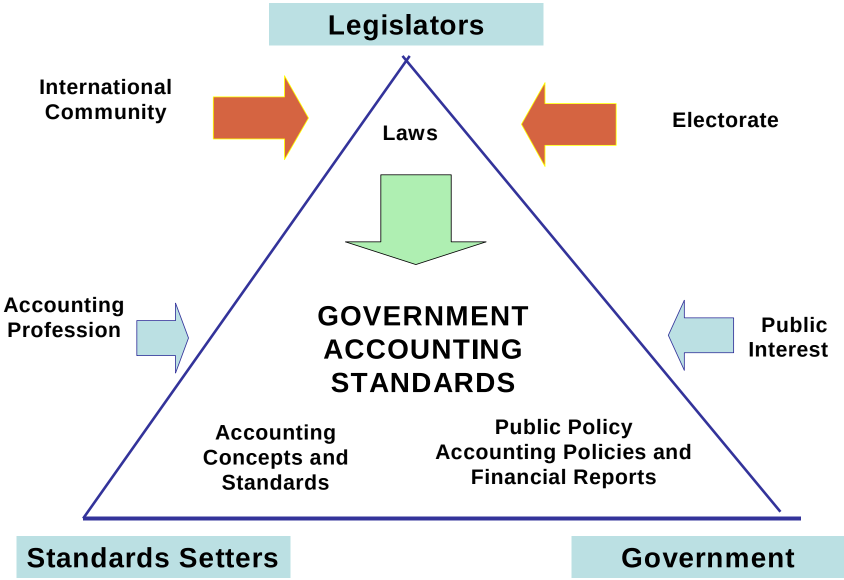
Most governments still equate accountability with reporting cash transactions under the budget. But cash reports do not provide information about assets held, liabilities incurred, or capital invested. Besides, many activities of governments now occur outside the budget either through government business enterprises that are supposedly for profit, or through transactions that simply bypass government accounting records altogether. The trend worldwide has been to extend proper accounting to all reporting entities (economic units) in the private, public, and social sectors. These reporting entities must now prepare general-purpose financial reports, or financial reports with all the financial information that the general reader would want to know about the entity.

Why should governments seek to improve their financial reporting? Is this a luxury reserved only for developed countries with a strong economy and accessible computers? The answer is no. All governments, especially those in developing countries, need good financial statements to manage their public sectors. At the very least, governments must maintain a good cashbook and record every transaction involving public funds. By recording and reporting all cash transactions in compliance with International Public Sector Accounting Standard (IPSAS) Cash Basis, governments can demonstrate their ability to manage.

Once they have control of cash, governments can start presenting information about their assets, liabilities, and investments or equities. For example, without the benefit of a balance sheet that shows the total depreciated value of motor vehicles, a government has no control over their vehicle fleet. If each department and public body were required to produce such a balance sheet, the government may well find that it has invested too much in motor vehicles and decide to build a couple of schools instead. Likewise, a very low amount on the balance sheet for fixed assets would prompt governments to reinvest in replacement assets.

If a developing country has had to borrow large amounts of foreign currency loans to offset the effects of the Asian financial crisis of 1997, it would need to keep track of such loans in domestic currency. To show that the government has its liabilities under control and is keeping tab on borrowings,

Figure 1: Roles and Influences in Setting Government Accounting Standards



the loans must be restated in current exchange rates at each reporting date according to international accounting standards.

Very often, governments invest heavily in government business enterprises (GBEs) but fail to monitor their investment. They should require these enterprises to provide proper financial statements in accordance with international accounting standards for business enterprises and consolidate the GBEs into a whole government financial statement.

In both developing and developed countries, good accounting is required. The accounting community worldwide, through the International Federation of Accountants (IFAC) and the International Accounting Standards Board (IASB) recognizes the importance of good financial statements. IASB provides the International Financial Reporting Standards (IFRSs) and the International Accounting Standards (IASs) for the use of government business enterprises, and IFAC issues the International Public Sector Accounting Standards (IPSASs) for all other government bodies.[2]

Many developing countries are now either implementing these standards or planning to do so soon. Good financial statements must be prepared not only because the country needs strong financial management but also because lenders and funding agencies require information about the country's capacity to borrow and repay debt. The cost of finance is now reflected in the credit ratings of governments and companies worldwide. The better the financial statements, the better the credit rating and the lower the cost of finance.

Responsibility for Setting National Public Sector Accounting Standards: Importance of Independence

The responsibility in setting standards for government financial reporting involves complex relationships revolving around international and national professional accounting bodies and governments. Governments have traditionally set their own reporting standards, usually in terms of budget reporting, and are often reluctant to cede this responsibility to professional accounting bodies. On the other hand, because of the globalization of capital markets, increased reliance on credit ratings, and intervention of international finance agencies, governments need credible, independent, and understandable financial statements.

Ideally, governments should let the accounting profession set accounting standards for all reporting entities in the economy, including the public sector. If governments prefer to be involved in setting standards, they can form an independent committee whose members are chosen for their expertise, experience, and noninvolvement with government management. Due process means all pronouncements of this committee should be treated as exposure drafts, subject to public comment. The roles in setting government accounting standards are outlined in Figure 1.

A Plan for Improving Public Sector Accounting

The issue for governments in many developing and developed countries is how to improve their public sector financial reporting. Too often this is regarded as a complex technical issue instead of a straight management process based on strategic planning principles. Countries like Thailand have used technology and the Internet to spread information about accounting reforms in the public sector. Thailand has set clear objectives, prepared comprehensive technical information, established realistic implementation schedules, and applied a system for monitoring the progress of reforms.

In most large economies, a 5-year plan for moving from cash to accrual accounting would be a minimum. The plan would provide for establishing and maintaining a database for reporting entities, issuing accounting standards, creating a central accounting function, coordinating financial reporting and computer systems requirements, and marketing accounting improvements.

Figure 2 sets out the basic objective and components of building the public sector accounting framework. The three key elements are sustainability, ownership and independence, and responsibility.

IPSASs, IFRSs/IASs, and International Standards on Auditing (ISAs) prepared by the IFAC International Auditing and Assurance Standards Board (IAASB) provide sustainability to accounting reforms. In addition, the reporting of government economic transactions in the system of national accounts (SNA) is determined by the requirements of the United Nations, European Union, Organisation for Economic Co-operation and Development, and World Bank, and the reporting of government financial statistics (GFS) issued by the International Monetary Fund.

The ownership and independence component refers to the need for each country to understand and implement international accounting concepts and standards within its jurisdiction. Countries are complying with the IPSASs in different ways. Some, like South Africa, have adopted the IPSASs outright. Others, like Mongolia and Viet Nam, have passed laws on public sector accounting that provide for the application of international accounting standards and are gradually adopting the IPSASs. Still other countries continue to practise government accounting as before, but intend to comply fully with all IPSASs and the IFRSs/IASs over the long term.

Responsibility means clear lines of accountability for preparing and authorizing financial statements for each reporting entity within government. Very often, this responsibility is blurred in the public sector because the finance officers who prepare the accounts are not responsible for managing, and managers have no expertise in finance or accounting. In modern public sector management, the chief executive officer or general manager of each public body should be held responsible for meeting all its objectives, including the preparation of financial statements that comply with the accounting policies of the government. Having accountants prepare the accounts or serve as internal or external auditors or as consultants would ensure the quality of financial statements and their compliance with government policies and standards.

Required Guidance

The public sector accounting framework includes resources and instructions to guide the maintenance of accounting records of government and preparation of its financial reports. These resources and instructions would consist of the following.

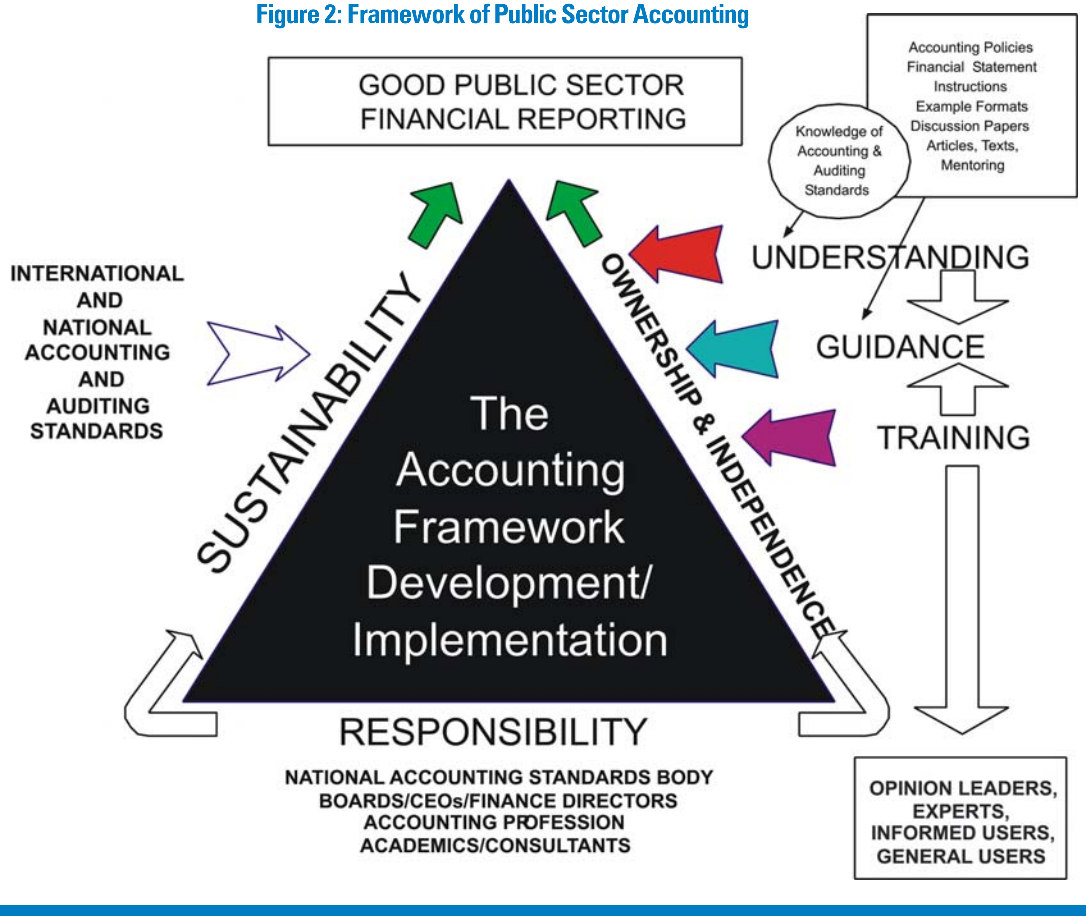
- Statements of accounting concepts—the broad principles followed by standards-setting bodies in establishing the nature, subject, purpose, and content of general-purpose financial reporting. For example, concepts might define the reporting entity and elements to be included in its financial statements (revenue, expenditure, assets, liabilities, and net assets/equity)
- Statements of accounting standards
- Accounting policies—the accounting treatment of transactions and balances in financial statements developed within accounting practices permitted under the accounting standards adopted
- Financial statement instructions—accounting policies and other guidance on accounting treatments like sample accounts, chart of accounts, reporting timetable, and legislation applicable to financial reporting
- Manuals, training materials, and text
- Accountants with the competence and the professional and moral qualifications to produce financial statements
- Competent preparers of accounting standards who can advise governments in matters of accounting policy
- Capabilities in information technology, software and hardware, Internet, and e-government
- Laws and regulations related to financial reporting
- External audit requirements
- Links to international accounting bodies and associations

Key Role of Training

For public sector accounting requirements to be successfully implemented, the following groups need training.

- Opinion Leaders—senior legislators and members of the government who set strategic directions and authorize

Figure 2: Framework of Public Sector Accounting



the use of accounting standards. Support from this group is essential to sustain accounting reforms.

- Experts—the specialized group in the public sector that develops the technical content of the accounting and financial reporting reforms. Experts need in-depth knowledge of standards within and outside the country, and standards set by the international accounting community. This knowledge must be constantly updated through networking with other standards-setting bodies worldwide.
- Informed Users—agency heads, finance managers and directors, chief accountants, directors of government business enterprises, and others who prepare and authorize financial statements of reporting entities. These executives need constant contact and encouragement to meet reporting timetables and maintain the quality of financial statements. The informed users would, in turn, have to train their staff.
- General Users—bookkeepers, data clerks, systems personnel, internal auditors, and other staff members who prepare data for financial reports.

The External Auditor and Public Sector Accounting

An audit report from a qualified professional accountant adds credibility to financial statements. Auditors of public sector financial statements should assist in implementing the financial reporting framework by providing high-level consulting and technical advice at an early stage to their audit clients. International requirements for the audit of business enterprises and other public sector bodies are contained in IAASB pronouncements on international auditing, assurance, and ethics.

Conclusions and Lessons for Improving Government Financial Reporting

Better financial reporting in public sectors can take different paths. In Mongolia, for example, the Government has produced consolidated accrual financial statements under GFS requirements for the general government sector as a starting point toward adopting the IPSASs. Other countries are considering complying with the IPSAS Cash Basis as the initial step in preparing consolidated financial reports for their governments, then progressively making additional supplementary disclosures on an accrual basis until all assets, liabilities, and equity are recorded and can be included in the statement of financial position.

Yet another approach is to apply the accrual basis immediately utilizing technology. Transitional and developing countries should be aiming at adopting accrual accounting in compliance with the IPSASs in the shortest possible time. The availability of the IPSASs, technical guidance publications, computer software, and the Internet makes the adoption of real accounting easier. The process of how countries can achieve compliance with the accrual IPSASs very much depends on their circumstances, including availability of professional accountants and commitment by the government to reform.

Financial statements, accompanied with an unqualified audit opinion and prepared according to generally accepted accounting principles, are evidence that a government is able to control and manage its finances effectively. Good financial reporting leads to better decisions on how to allocate and use public funds and, hence, to improve delivery of public services. Governments must, therefore, prepare financial statements to become more accountable and more transparent, and be better able to serve their communities.

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2 Copies of the IPSASs and exposure drafts, along with useful studies on the transition from cash to accrual accounting, can be downloaded from the IFAC web site, http://www.ifac.org. Examples of financial reports prepared by the Australian and New Zealand governments can be found at the following web sites, http://www.finance.gov.au/Publications/CommConsFinStatements/index.html (consolidated financial statements of the Australian Commonwealth Government) and http://www.treasury.govt.nz/financialstatements/ (financial statements of the Government of New Zealand).

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