COMPARATIVE ISSUES IN LOCAL GOVERNMENT ACCOUNTING

COMPARATIVE ISSUES IN LOCAL GOVERNMENT ACCOUNTING

edited by

Eugenio Caperchione
Università Bocconi

Riccardo Mussari
Università di Siena

SPRINGER SCIENCE+BUSINESS MEDIA, LLC

Library of Congress Cataloging-in-Publication Data

Comparative issues in local government accounting / edited by Eugenio Caperchione, Riccardo Mussari.
p.cm.
Includes bibliographical references and index.
ISBN 978-1-4613-7069-7 ISBN 978-1-4615-4581-1 (eBook)
DOI 10.1007/978-1-4615-4581-1
1. Local finance—Accounting. 2. Finance, Public—Accounting.
I. Caperchione, Eugenio, 1960- II. Mussari, Riccardo, 1963-

HJ9773 .C5 1999
657'.835'0973—dc21 99-047415

Copyright © 2000 by Springer Science+Business Media New York
Originally published by Kluwer Academic Publishers in 2000
Softcover reprint of the hardcover 1st edition 2000
All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher, Springer Science+Business Media, LLC

Printed on acid-free paper.

CONTENTS

CONTRIBUTORS

Eugenio Anessi-Pessina	Università Cattolica del Sacro Cuore, Milan ITALY
Elio Borgonovi	Università Commerciale Luigi Bocconi, Milan ITALY
Anatoli Bourmistrov	Bodø Graduate School of Business NORWAY
Eugenio Caperchione	Università Commerciale Luigi Bocconi, Milan ITALY

James L. Chan University of Illinois at Chicago
U.S.A.

Rita H. Cheng University of Wisconsin at Milwaukee
U.S.A.

Johan R. Christiaens University of Gent
BELGIUM

Hugh M. Coombs University of Glamorgan, Wales
UNITED KINGDOM

Iluminada Fuertes Universitat Jaume I, Castellón
SPAIN

Amparo Gimeno Ruiz Universitat de València
SPAIN

Jean E. Harris Penn State University at Harrisburg
U.S.A.

Evelyne Lande Conservatoire National des Arts et Métiers, Paris
FRANCE

Irvine Lapsley University of Edinburgh, Scotland
UNITED KINGDOM

Frode Mellemvik Bodø Graduate School of Business
NORWAY

Vicente Montesinos Julve — Universitat de València, SPAIN

Riccardo Mussari — University of Siena, ITALY

June Pallot — University of Canterbury, NEW ZEALAND

Mahamad Tayib — University Utara Malaysia, Sintok, MALAYSIA

G. Jan van Helden — University of Groningen, THE NETHERLANDS

José Manuel Vela — Universitat Jaume I, Castellón, SPAIN

Kiyoshi Yamamoto — Okayama University, JAPAN

FOREWORD

For some years now, a large number of European and extra-European countries have been implementing highly significant reforms to their accounting systems both at central and local government levels. The innovative scope of these changes cannot be fully understood by simply describing what has happened or by making a solely technical appraisal of the solutions adopted.

These accounting reforms are part of far-reaching and complex processes of social change, that in many cases stem from the need to define new grounds for the role that the Government at all levels is called upon to play in modern economies and thus, in other words, for the relationships between Government and citizens.

This is the reason why it is not possible to fully grasp the underlying causes leading to accounting innovations in local governments and, consequently, to assess their effectiveness, unless an effort is made at relating these innovations to the ongoing changes in the social, economic and political environments in which governments at all levels have to operate. This is exactly the aim of this volume.

Obviously enough, it is very difficult to identify and suggest one single key to the interpretation of the changes under way when reference is being made to such a large group of countries as those observed throughout this book. Differences can be found in the stages of economic development, in the forms of government, geographic sizes, history, accounting traditions, legal culture, State and government models, the roles ascribed to central and local government levels, and in how accounting standards are set out and reviewed.

Nonetheless, despite all these difficulties, we believe that the changes introduced into local government accounting in every country – even if for different reasons and at different paces – may be read and interpreted as a qualifying step in a modernisation and re-invention process aimed at furthering a different way of understanding and managing public administration from the so-called "traditional" way.

In particular, at local government levels, we seem to notice some growing awareness of the need for suitable accounting systems to generate information on the results produced in terms of effectiveness, efficiency and economy.

All this is of course something new. As long as there wasn't any social pressure strong enough to orientate the behaviour of government officials towards the attainment, measurement and disclosure of results, both politicians and managers of local governments did not feel the need for useful tools to recognise and monitor economic quantities.

On the contrary, though for manifold and different reasons depending on the various socio-economic contexts under analysis (fiscal crisis, globalizing economy, technological advance, introduction of forms of competition, political changes), when this "innovative thrust" came to the fore, it automatically led to the current need to modify the object of control and, consequently, the logic and tools used to this aim.

Among the events that are somehow responsible for change, the financing mechanism of local governments takes on the utmost importance.

Until only recently, the almost exclusive interlocutor of every local government was the Central Government, that guaranteed most of the income of local authorities and even aid in cases of financial distress. In this context, the higher level of government also applied stringent legitimacy checks.

From the management point of view, this entailed the prevalence of cash accounting, that is by nature unsuited to provide the measures of the effects of actions undertaken. Moreover, public employees were driven to spend all available resources, without paying particular attention to the actual usefulness of their outputs. Finally, the fact that resources came from the outside made any investments in management control systems little appealing.

However, when the appropriation logic of cash means changed in the various countries, and when the fiscal pressure exerted by local governments upon their citizens became stronger, control systems acquired greater economic significance and were oriented towards measurable or, at least, assessable quantities (effectiveness, efficiency and economy). In particular, a growing need was perceived to show to both families and businesses the outputs of the resources provided by them.

Exactly on the basis of these cultural premises, we started long ago to plan the collection of a set of contributions that could account for the "state of the art" of local government accounting at an international level and that, above all, allowed scholars, students and anybody interested in these issues to also have a comparative framework of the accounting innovation processes that have been affecting many countries for some years now. We believe we have achieved our goal.

While we were actively participating in the Italian and international scientific and operative debate on the issue of local government accounting, we soon noticed that, despite the quantitative and qualitative wealth of available contributions, there still were very few publications with some comparative flavour on issues of local government accounting. This dearth largely helps to explain the lack of a profitable exchange of ideas, proposals and experiences that could surely be useful not only to the scientific debate but also to the operative debate. Just think of the adoption of accounting solutions that have already been rectified in some countries as they proved little effective.

Therefore, since both theoretical and action research had reached an acceptable degree of ripeness, we believed that the publication of a book could be a very fine occasion to understand the prevailing trends in ongoing processes of change, and to help to fuel a critical debate on the difficulties and limits to be encountered by the "new" accounting systems applied to local governments in various countries.

Every scientific project needs a chance to be realised.

"Our chance" was the Sixth Biennial CIGAR (Comparative International Governmental Accounting Research) Conference, that was held at Bocconi University in Milan on June 5-6, 1997.

On that occasion, 24 papers were presented and discussed by scholars and qualified professionals coming from 15 different countries.

The richness and interest of the papers presented at the Conference allowed us to gather a considerable group of authoritative colleagues around our project, who generously shared our methodological approach.

We asked them to update and investigate thoroughly the accounting issues they had chosen to deal with on the occasion of the Conference and which seemed fully consistent with our own scientific project.

The result of this effort is an extensive and in-depth overview of matters of topical interest concerning local government accounting in many countries.

The style of the papers is mainly critical and not simply descriptive. There are many possible keys to the reading of the texts, well beyond the brief hints that are offered in this foreword, which is by no means exhaustive.

Therefore, this volume presents readers with the key challenges that local government accounting must face, and with the technical and interpretative problems stemming from the adoption of some specific accounting solutions.

In particular, many of the contributions hosted in this volume chiefly describe and analyse the need to integrate cash accounting with accrual accounting, also following the adoption of New Public Management approaches (**Caperchione**, **Christiaens**, **Gimeno Ruiz**, **Vela-Fuertes**, **Yamamoto**). At the same time, the scope and number of accounting documents has been enlarged (no longer limited to the traditional statements of receipts and payments) (**Coombs-Tayib**, **Mussari**, **van Helden**), and so has the scope of auditing (performance audits are thus increasingly applied) (**Montesinos**).

Nonetheless, the recognition, control and disclosure of economic performances are impelling not only in the relationship between peripheral authorities and local communities, that is in the relationship between an individual local government and the families and businesses living on its territory.

Orientation towards the production of measurable outputs and the need for available and suitable measurement and disclosure tools generates important changes also within Local Authorities. A sort of "convergence of interests" should arise over time between politicians (Mayors, councillors) and managers towards monitoring the performance of internal management.

For these reasons, **Borgonovi** and **Anessi-Pessina** state that "LG accounting should become a component of a wider information system covering cash flows, costs and revenues, assets and liabilities, but also activities, outputs, needs, customer satisfaction" and "what we need is no longer (or not solely) *government accounting* but rather *accounting for governance*."

In some contributions (**Chan**, **Lapsley-Pallot**, **Coombs-Tayib**, **Caperchione**, **Vela-Fuertes**) the comparative analysis of accounting systems is immediate, as the similarities and differences that characterise the accounting approaches adopted in various national contexts are clearly pointed out. All other papers concentrate on highly important issues in the current stage of accounting innovations, and their analysis is focused on individual countries.

In this regard, a specification should be added. Local government accounting is a very vast field of study that also includes budgeting, financial accounting and reporting, managerial accounting, cost accounting, auditing, and performance evaluation.

Precisely in order to avoid a solely descriptive approach, that would be lacking in discernment, and given the need to offer readers with the widest possible overview of countries analysed, we expressly asked the Authors not to deal with all or most of the issues that are related to the mainstay of local government accounting in each country.

If this choice may seem at first sight to somehow limit the scope of the volume, it actually proved a point of strength.

It allowed the various Authors to address in a detailed and critical way the issues that are deemed the most relevant in the light of the accounting innovations introduced in a single country or, by means of a comparative analysis, in more countries (which also explains why some of the issues that are dealt with throughout the volume may seem to have been valued more than others).

Some of the explicitly comparative papers are centred on a bilateral comparison, at times even between distant countries (not only from the geographical point of view), that is carried out with reference to a specific, important element in the accounting system.

For instance, **Chan**'s paper focuses on the issue of covering the central government budget in China and the USA. **Coombs** and **Tayib** extensively analyse the different reporting practices of two countries (the UK and Malaysia) that, up to a certain point, shared a common administration path, which has not however impeded a growing divergence of behaviour between the two countries (and in particular, due to a certain lack of involvement of professional bodies, a lesser capacity for innovating). **Lapsley** and **Pallot** analyse how Public Sector capital is treated in the UK and New Zealand.

The other comparative papers are aimed at bringing forth some methodological considerations about comparative analysis of local governmental accounting systems in Europe (**Vela-Fuertes**) and at identifying uniform features and open issues in the recent reforms to governmental accounting systems in some market economy countries (**Caperchione**).

As already stated, a number of papers mainly discuss important issues of public sector accounting from the particular perspective of a specific country where local government accounting reforms are currently being implemented.

They supply food for reflection and further in-depth studies.

Christiaens's contribution highlights how the introduction of accrual accounting does not always and not immediately produce beneficial effects in terms of the quality of information available to managers, especially when budgetary accounting continues to prevail over business-like accounting, that has *de facto* been introduced without intensive debate.

Van Helden's paper offers some interesting views on the organisational difficulties in introducing cost allocation systems, and on the consequent need to flank any accounting innovations with a consensus-reaching process.

Yamamoto considers the Japanese accounting system reform as part of the wider modernisation process introduced by New Public Management. He also devotes his attention to intergovernmental relationships. This latter aspect is crucial in Russia too, where local governments have been gaining more freedom and more independence from the federal state throughout the Nineties (**Bourmistrov** and **Mellemvik).**

In the countries where Local Authorities have been asked to adopt accrual accounting, one of the thorniest problems to tackle lied in the measurement and recognition of long-term assets and, more specifically, of infrastructure assets and national heritage.

The contributions gathered in this volume clearly pinpoint the different solutions to this issue that are being devised. The ongoing trends are not always uniform. Some solutions recently adopted in some countries have already been abandoned in others – for instance, the measurement of infrastructure assets on the finance capital basis that has recently been adopted in Italy (**Mussari**) has already been set aside in Great Britain (**Lapsley** and **Pallott**).

Moreover, if it is true that a growing analogy between the accounting practices of the private and public sectors can be inferred from most of the studies, i) on the one hand, the degree of convergence is not uniform in all countries and, ii) on the other, the trend towards uniformity of business and governmental accounting systems is not always considered a satisfactory solution.

For instance, with regard to the first point, **Lapsley** and **Pallot** show how this convergence is stronger in New Zealand than in the UK because the accounting profession is organised in a different way. In New Zealand there is one single body that sets out accounting standards, while in the UK there is an *ad hoc* body that publishes the rules for governmental accounting.

With regard to the second issue, many Authors doubt whether a conceptual framework conceived for the private sector, and its related accounting practices can be truly satisfactory for the public sector too.

In this regard, **Lande** discusses how to conceptually ground consolidation, and clearly highlights the need to draw a distinction among the various concepts of "entity" in the private and public sectors, whilst **Cheng** and **Harris** offer thorough reflections on the meaning and informative value of the depreciation of durable public goods by pinpointing their specificity compared to the private sector.

On the other hand, agreement on the need to devise a new accounting system with a view to increasing accountability and transparency does not necessarily mean that the options traditionally implemented in the private sector automatically lead to attaining such results.

Yamamoto writes that "any accounting system for local governments must promote democracy in addition to improve performance and strengthen accountability in democratic states". However **Christiaens**, when he comments on the first results of the implementation of the accounting reform in Flanders, complains that the "financial accounting system is not ensured to last since up to now financial accounting is not deemed necessary in order to manage a municipality and since there is a very limited use of the annual accounts by stakeholders and citizens".

In any case, the introduction of any changes generates costs, and the cost-benefit ratio between accounting adjustments and expected results should be taken into due consideration. Thus, **Cheng** and **Harris** point out that the "cost of producing information about capital assets values and charges must be considered" and that "it can be expensive and impractical to obtain such information for old assets, particularly infrastructure assets".

In more or less the same way, **Coombs** and **Tayib** recommend examining closely the costs required to improve the quality of reports, before taking any decisions about innovations.

Now we are at the end of this work, we are well satisfied with our methodological approach, as we believe that the countries that are dealt with in the volume are highly significant not only and not so much because they make up a considerable number (12 countries from 4 continents are systematically dealt with, while hints and comments are extensively made on many other countries), but also because of the diversity of the political, economic and social contexts they represent.

The book gives an account of local governmental accounting in countries (USA, UK, New Zealand, Spain, France) on which there already exists ample and consolidated literature in the English language, but also in countries (Russia, China, Japan, Malaysia, Italy, the Netherlands, Belgium) on which information is not so easily acquired but which still represent very interesting case studies.

Therefore, we are confident that this material can be of help to anybody wishing to go into further detail on issues of comparative international governmental accounting research, both because this volume documents the state of the art of local government accounting systems in a significant number of countries, and because the various contributions clearly pinpoint some of the key issues that research will have to concentrate on in the near future (the refinement of Lueder's contingency model, the challenge of dealing with "incomparables", the scope of harmonisation, the importance of institutional systems, the accounting literacy of politicians and citizens).

ACKNOWLEDGEMENTS

We would like to thank many other people besides the authors of the papers, who made a significant contribution to the compilation of this volume.

Professor Elio Borgonovi strongly believed in the importance of comparative studies and guaranteed the financial support of the SDA Bocconi School of Management at Bocconi University to the realisation of the CIGAR Conference, that proved an excellent occasion for open debate and discussion.

On that occasion, the effort made by Roberta Aresu in taking care (alone!) of every organisational and administrative aspect was unrivalled. We cannot even forget the disinterested help offered by Antonio Mastrangelo, chartered accountant in Milan.

On the other hand, the realisation of the book greatly benefited from the collaboration of Jackie Madden and Elena Rossetti in Milan, who provided a valuable linguistic support to the authors whose mother-tongue is not the English language, and of Antonella Casamonti in Siena, who assembled the book in a camera-ready format with praiseworthy patience and accuracy, whilst carrying out her activities at the Department of Business and Social Studies. We are also very grateful to Roberto Bertoli for being so kind and helpful.

Everyone from their workstation, 19 Authors (and two editors) were involved in this project. We are sure they had to change more than once their agendas in order to keep up with the project schedule whilst keeping up the standard of their contributions. We thank them for this, and hope the publication of this volume will reward them for their efforts.

Lastly, special thanks to our friends, Professors Jim Chan, Rowan Jones and Klaus Lueder, who supported our work, both by convincing us of the need to bring out books of this kind and by helping us in the hard and thankless task of selecting papers.

Obviously enough, the final responsibility for the book as a whole is entirely ours. This is why we invite anybody that can offer suggestions on how to improve the text, also with a view to updating, to contact us without hesitation.

Milan and Siena, June 1999
Eugenio Caperchione and Riccardo Mussari

For further information please contact:

Eugenio Caperchione
Università Commerciale L. Bocconi
Istituto di Economia aziendale
Via Bocconi, 8
I - 20136 Milano MI
<ecaperchione@uni-bocconi.it>

Riccardo Mussari
Università di Siena
Faculty of Economics
Department of Business and Social Studies
Piazza San Francesco 17
I - 53100 Siena SI
<mussari@unisi.it>

1

ACCOUNTING AND ACCOUNTABILITY IN LOCAL GOVERNMENT: A FRAMEWORK

Elio Borgonovi and Eugenio Anessi-Pessina

INTRODUCTION

Jones and Pendlebury (1992) have emphasised that "accounting is a purposive activity", i.e. it is "directed towards a specified end" and "must above all be useful". Lüder (1992) has shown that the existing cross-country variations in government accounting models stem from environmental pressures and from the needs of external and internal users. This paper focuses on the relationship between the goals assigned to local government (LG) accounting systems over time and their technical features, and aims at identifying the main methodological issues concerning such relationship.

WHAT IS ACCOUNTING?

Accounting can be defined as:

- a system of principles, methods and techniques
- to record and organise financial data concerning an entity's operations (where the term "entity" is intended to encompass private firms as well as other socio-economic organisations such as government entities, government-owned enterprises, families, non-profit organisations)
- in order to generate and provide information
- on the economic rationality of decisions.

The basic rules of an accounting system can be summarised as follows (Masini 1978):

- identify the set of "relevant" operations. Only a subset of the operations carried out by the entity will be recorded by the entity's accounting system. The boundaries of this subset must be clearly defined;
- organise such operations based on an "appropriate" classification;
- for each class of operations, define the most "appropriate" timing of recognition. In principle, a given operation may be recorded at any of its stages. A purchase, for instance, may be recorded when the decision is made to purchase a good, when the order is placed, when the goods are received, when the invoice is received, when the invoice is verified and found consistent with the order and the goods received, when the goods are used in the entity's production process, and/or when cash is disbursed to pay for the goods. For each class of operations, therefore, a choice must be made as to when the operation will be recorded;
- create a control system to ensure reliability. This control system will have both formal and substantial components. A formal component is double-entry bookkeeping: accounting mistakes are revealed whenever the sum of all credits differs from the sum of all debits. A substantial component is the "conflict-of-interest" mechanism: accounting mistakes are revealed when they negatively affect third parties. If payables are not properly recorded, for instance, the amounts paid to suppliers will differ from the amounts that suppliers expect and that appear as receivables in their accounts; and
- "count" (i.e. measure) the effects of each operation.

The frequent use of the words "relevant" and "appropriate" clearly emphasises the relative nature of accounting rules. More specifically, accounting rules will depend on the goals assigned to the accounting system. The subset of "relevant" operations, the "appropriate" classification and the "appropriate" timing of recognition, for example, will be different according to whether the accounting system is intended to:

- keep track of receivables and payables;
- measure and provide information on the entity's financial equilibrium;
- measure and provide information on the entity's impact on its environment; or

- limit expenditure.

GOVERNMENT ACCOUNTING OVER TIME

Government accounting was initially viewed as a key element in the transition from the "absolute-power" model of government to a "relative (controlled, shared) power" model of government.

Under this latter model, government accounting was used by Parliament to limit the monarch's power to (i) spend public money; (ii) raise taxes to cover such expenditure; (iii) determine the nature and purpose of such expenditure. The same mechanism was applied at the local level. In other words, government accounting forced the executive to (i) state the amount, nature and purpose of its planned expenditure and the taxes it consequently needed to raise; (ii) ask for and obtain approval from the legislature; (iii) comply with the expenditure authority granted by the legislature and demonstrate such compliance.

This use of government accounting remained virtually unchanged during the transition to modern democratic systems. Modern democracies, however, are characterised by:

- a wider gap between the voting population and its elected representatives (e.g. due to the extension of voting rights to the entire adult population);
- the development of large government bureaucracies. This, in turn, has led to the development of two separate components within the executive branch: a political component, either elected or appointed (henceforth identified with "the cabinet") and a professional component, supposedly rational, neutral and expected to implement policies (henceforth identified with "the bureaucracy");
- an increasing importance of the ability to control economic resources and their allocation in the "power game" and in the creation of a balanced system of formal powers.

Under these circumstances, government accounting still played its original role, i.e. it allowed the legislature to steer and control the behaviour of the executive. Furthermore, it took on two additional functions:

- provide the population with information on the behaviour of its political representatives;
- allow the cabinet to steer and control the behaviour of the bureaucracy.

The technical features of government accounting were chosen on the basis of their consistency with these goals. Some of these features are still found in the LG accounting systems of many countries. More specifically:

- budgets must be balanced;
- actual outflows should not exceed budgeted outflows;
- budgets are organised by items. Items usually reflect the nature (e.g. personnel, supplies) and/or the purpose (e.g. education, transportation) of expenditure. The constraint whereby budgeted outflows should not be

exceeded applies to each and every item. Specific procedures exist to modify the budget during the fiscal year;

- the budget is given much greater importance than the year-end financial statement. This is true in practice and sometimes explicitly stated by law. If an Italian city council fails to pass the budget by October 31 (e.g. October 31, 1997 for the fiscal year beginning January 1, 1998), for instance, the council is dissolved, the mayor is removed from office and new elections are held. If the council fails to pass the financial statement by June 30 (e.g. June 30, 1999 for the fiscal year ending December 31, 1998), on the contrary, a temporary administrator is appointed by the central government to prepare and publish the statement, but both the mayor and the council remain in office;
- the main function of the financial statement is to show budgetary compliance;
- inflows and outflows are recognised according to the cash and/or the obligation bases of accounting. As a consequence, the budget shows budgeted disbursements and/or obligations, the financial statement shows actual disbursements and/or obligations, and neither include accruals of any kind. This is consistent with the goals assigned to government accounting. The obligation basis constrains spending decisions. The cash basis constrains actual disbursements and is highly objective. The accruals basis, on the other hand, (i) is rather complex, (ii) recognises outflows only after they have been decided, and (iii) is rather subjective. In addition, when production processes are short and simple (as they used to be in LGs), the operations carried out in different fiscal years are fairly independent of one another, and accruals accounting does not provide any major information gains vis à vis the other accounting bases;
- bookkeeping is based on the single-entry system, which records the monetary side of each transaction and disregards its nonmonetary side. In the purchase of an asset, for instance, single-entry accounting records the monetary outflow (cash is or will be disbursed) but ignores the nonmonetary inflow (a new asset is acquired).

When the model of government evolved towards the “welfare state”, the role of government accounting was significantly modified. More specifically, government accounting became a tool (i) to evaluate the macroeconomic viability, compatibility and implications of different social policies, and (ii) to acquire and maintain voter consensus. Its technical features, however, were often left unchanged. This created a major inconsistency. On the one hand, the technical features of government accounting were consistent with its original purpose, i.e. to limit expenditure. On the other hand, this purpose was losing much of its importance. In many countries, this inconsistency produced increasingly unrealistic budgets and frequent budget overruns.

Italy provides a very effective example of this evolution. The technical features of the system remained virtually unchanged, with the only exception of budget items. These items were reorganised to better reflect the nature and size of public policies. Many accounting rules and constraints, however, were increasingly circumvented. For example (Borgonovi 1994):

- capital appropriations (especially for infrastructures) were often higher than feasible to back up electoral promises. In many cases, these appropriations were not followed by actual cash inflows, with obvious negative effects on the investments they were supposed to fund;
- budgeted operating expenditure was often underestimated in order to (i) balance the budget and (ii) acquire public consensus on alleged "rationalisation policies";
- actual operating expenditure was often over or under-reported in order (i) for LGs to affect the amount of transfers and contributions received from the central government, and (ii) for central and local governments to provide a biased view of their ability to control expenditure.

Later, as the state of public finances worsened, LG accounting was used to impose constraints (typically cash constraints) on policy decisions. The basic assumptions were as follows: (i) the central government could use government accounting rules to impose expenditure ceilings and pursue the financial equilibrium of the public sector as a whole; (ii) the financial equilibrium of each LG would then follow automatically. This approach, however, was not always effective.

Once again, Italy is an interesting example. The central government's cost containment policies led to a process of intergovernmental bargaining whereby (Borgonovi 1985):

- each LG received an initial appropriation from the central government for a given fiscal year;
- deficits began to emerge during the same fiscal year;
- LGs predicted dire consequences on their capacity to provide adequate services;
- the central government conceded supplementary funding during the fiscal year or covered LG deficits after that fiscal year had closed, at times even considerably long afterwards.

Appropriations, moreover, were often granted on the basis of past expenditure, which obliterated all incentives for LGs to rationalise their operations. The extreme uncertainty of funding, finally, created further inefficiencies.

It is significant to notice that the basic conceptual framework remained unchanged during the entire evolution described in this Section, despite the different goals assigned to government accounting over time. More specifically, government accounting was a key element in a top-down power model (figure 1).

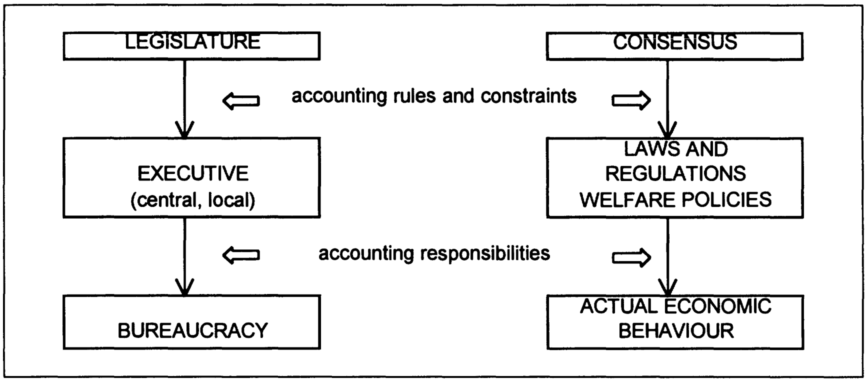


Figure 1. *Government accounting as a key element in the top-down power model*

CURRENT TRENDS IN THE ROLE AND STRUCTURE OF LOCAL GOVERNMENT

In the past two decades the role and structure of LGs have been subject to strong pressures for change. The main sources of these pressures can be summarised as follows:

1. worsening public finances, forcing LGs to either (i) pursue greater efficiency or (ii) reduce the volume and scope of services they provide. Hood (1992), for instance, found a negative correlation between macroeconomic performance and the degree of emphasis on new public management (NPM);
2. technological innovations creating alternative ways of producing and delivering public services. Technology, for instance, has transformed a number of natural monopolies (e.g. television, telephones, electricity, railways) into potentially competitive industries; the competitors of the public mail service include private delivery services but also faxes and electronic mail; credit cards can potentially be used to make payments to government offices; official documents can potentially be issued by automatic teller machines;
3. as a consequence, an increasing public awareness of the efficiency and effectiveness implications of each alternative;
4. a weakening of ideological positions in the public v. private debate. In the past, the choice between public and private provision was often based on pure ideological motivations. Nowadays, individuals seem to be less concerned with the "public property of the production and delivery processes" or the "existence of formal controls on the administration". Much greater attention is paid to the quantity, quality and cost of the services provided;
5. the development of (i) new ways of managing economic systems to prevent market failures, and (ii) new ways of managing social behaviour and social

relationships to ensure an increasing level of substantial democracy (e.g. containment or reduction of dominant positions; self-regulation by specific groups such as advertising agencies and journalists; growth of non-profit organisations);

6. increasing (or, at least, increasing pressures for) decentralisation, defined as (i) the breakdown of large government bureaucracies into smaller corporatised units (as in the British "Next Steps" programme); (ii) the devolution of power from the central to the local levels of government (as in the Italian debate on federalism); (iii) the delegation of power and responsibilities within individual organisations (as in the Italian civil-service reform).

For politicians, these developments imply a greater importance of efficiency and effectiveness in the acquisition of consensus. Civil servants, in turn, are no longer expected to simply follow rules and implement decisions, but are increasingly assessed on the results of their actions. LGs are consequently developing into professional organisations which must be kept accountable to a large number of highly heterogeneous stakeholders. The implications on LG accounting are discussed in the next Section.

IMPLICATIONS ON LOCAL GOVERNMENT ACCOUNTING

Under these circumstances, LG accounting should no longer be aimed at imposing a given allocation of resources or preventing the abuse or misuse of formal powers, nor should it simply be expected to report inflows, outflows, assets, liabilities, surpluses and deficits.

Rather, it should increasingly be expected to provide internal and external stakeholders with a "true and fair" view of the entity's performance; to become one of the tools for a more rational decision-making process among stakeholders; to help stakeholders to understand how the entity's inflows, outflows, assets, liabilities, surpluses and deficits affect their own interests and expectations.

Given these premises, the next step is to identify the main stakeholder groups and their information needs (Anthony 1978; Drebin, Chan and Ferguson 1981).

External stakeholders include:

1. citizens (and their organisations) as consumers of public services;
2. citizens (and their organisations) as taxpayers, both where taxes are levied directly by the LG and where taxes are levied by another government body (e.g. the central government) and then transferred to the LG;
3. firms and other socio-economic organisations using public services as inputs for their own activities;
4. upper levels of government and other oversight agencies;
5. banks, individuals and international institutions as lenders;
6. foreign investors and country analysts;
7. future generations, with respect to the intertemporal distribution of consumption, the creation and reimbursement of government debt, the creation, purchase and sale of government assets.

Internal stakeholders, on the other hand, include:

1. institutional bodies (e.g. the cabinet and the legislature) and political groups (e.g. political parties);
2. public managers, i.e. the new top and middle-level bureaucrats;
3. government employees, especially when salaries and careers are performance-related;
4. public-sector trade unions.

Their information needs can be summarised as follows:

1. citizens as consumers of public services require information on the costs, prices and quality of services;
2. citizens as taxpayers (and funding agencies when taxes are not levied directly by the entity) need to know where, how and to what extent tax money is spent;
3. firms and other socio-economic organisations using public services also require information on the costs, prices and quality of services. In addition, the efficiency and effectiveness of the public sector can significantly affect the productivity and competitiveness of individual firms and of the country or region as a whole. As a consequence, firms also require information on the entity's contribution to productivity and competitiveness;

In general, for these three groups of stakeholders, the value-for-money principle has become increasingly important;

4. upper levels of government and other oversight agencies are particularly interested in LGs' fiscal discipline. A related issue of great relevance is the need to prevent creative accounting;
5. lenders and other creditors need information on solvency and liquidity;
6. foreign investors and country analysts need information to evaluate the riskiness of their investments;
7. future generations must have their interests protected. To this end, LGs should provide data on interperiod and intergenerational equity, that is, on the creation of surpluses or deficits that will benefit or burden future periods and on the future benefits and costs of current investments;
8. for institutional bodies and political groups it is particularly important to prevent a biased representation of the entity's financial conditions, which could be used to exercise an undue political influence;
9. public managers view financial accounting as a component of a wider management information system. Management information systems should help public managers to guide their organisations towards their objectives;
10. when the salaries and careers of government employees are performance-related, accounting systems are needed which correctly reflect individual contributions in terms of commitment, productivity and professional competence;
11. public-sector trade unions, finally, need information to formulate their claims and assess their margins of negotiation.

CONCLUSIONS

This paper has emphasised the existence of a relationship between the goals assigned to government accounting systems over time and their technical features, with specific reference to local government (LG).

In the past two decades the role and structure of LGs have once again been subject to strong pressures for change. LGs are developing into professional organisations which must be kept accountable to a large number of highly heterogeneous stakeholders. LG accounting should evolve accordingly.

The introduction of accruals accounting is certainly a key factor in this evolution. More in general, however, LG accounting should become a component of a wider information system covering cash flows, costs and revenues, assets and liabilities, but also activities, outputs, needs, customer satisfaction. In this information system, the absolute precision of figures should not be the only objective. On the contrary, greater attention should be paid to the quality of the information provided, its validity and its relevance for the entity's internal and external stakeholders. In other words, interpretation models should be given greater importance than pure accounting technicalities.

These conclusions can be summarised using a catch-phrase: what we need is no longer (or not solely) "government accounting" but rather "accounting for governance".

REFERENCES

Anthony, R.N. *Financial Accounting in Nonbusiness Organizations.* Stamford CT: Financial Accounting Standards Board, 1978.

Borgonovi, E. "Modello Istituzionale, Modello Gestionale e Logica di Cambiamento nell'Esperienza del Servizio Sanitario Nazionale." In *Processi di Cambiamento e di Programmazione nelle USL,* E. Borgonovi E. and M. Meneguzzo eds. Milano: Giuffrè, 1985.

Borgonovi, E. *Accounting, legitimisation, consensus.* Paper presented to the 17th congress of the European Accounting Association, Venice, Italy, 6-8 April 1994.

Drebin, A.R., Chan, J.L. and Ferguson, L.C. *Objectives of Accounting and Financial Reporting for Governmental Units: A Research Study.* Chicago: National Council on Governmental Accounting, 1981.

Hood, C. *Reflections on variations in 1980s public management reform.* Paper presented to the workshop on "Accounting, Accountability and the New European Public Sector", Helsinki, 27-29 September 1992.

Jones, R. and Pendlebury, M. *Public Sector Accounting.* London: Pitman, 1992.

Lüder, K. "A contingency model of governmental accounting innovations in the political-administrative environment". In *Research in Governmental and Nonprofit Accounting.* Chan, J.L. ed. Greenwich, CT: JAI Press, 1992.

Masini, C. *Il Sistema dei Valori d'Azienda* Milano: Giuffrè, 1978.

2

A SINO-AMERICAN COMPARISON OF BUDGET AND ACCOUNTING COVERAGE

James L. Chan

INTRODUCTION

A central purpose of comparative international government accounting research (CIGAR) is to describe and explain the similarities and differences in the government accounting - including budgetary - practices of countries. To the extent such differences are due to the nature of their political and economic systems, variability in the environmental factors will help to explain these differences. During the Twentieth Century, the public sector environment of accounting in many countries underwent radical changes. Nowhere have changes been more profound than in China and Russia. The October Revolution in Russia created a vastly enlarged public sector for the Soviet Union and World War II expanded the Soviet empire into Eastern Europe. The next global expansion took place in 1949 when a half billion people came under communist rule in China. In spite of the significance of such a vast expansion, the Western English-language literature is sparse on socialist government accounting. By the time the first CIGAR conference was held in 1987, democratization was emerging in Eastern Europe and market reform was well underway in China. In this context, Alicja Jaruga and Lu Ting-gang reported on how reforms began to affect public sector accounting in Poland and China, respectively (Chan and Jones, 1988). Since then, Jaruga and Novak (1995) continued to monitor developments in Poland, while the author began to seriously study Chinese public sector accounting a few years ago.

China merits further research from the CIGAR perspective for several reasons. First, in part due to the language barrier, Chinese government accounting publications are not easily accessible to most Western scholars, resulting in a vast void in our knowledge about China. Second, China could be a fertile ground for a country study in many ways. For example, one could trace the extent of foreign and ideological influences (Chan, 1995); one could compare government accounting during the socialist era with its role in the emerging market economy (Chan, 1996). There are still other possibilities in studying this complex and dynamic nation that is engaged in perhaps the largest economic and institutional experiment in human history. The present study was motivated by the alarming observation (e.g. Wang, 1994) that the budget of the Chinese central government had dropped precipitously to a level that threatened its ability to effectively govern the country and conduct macroeconomic policy. Chinese policy makers, apparently sharing a similar concern, soon launched a campaign to restore the vitality of public finance. In support of this policy initiative, some analysts (Yu and Wang, 1996) noted the relatively small amount of the Chinese central government's revenues in comparison with those of some developing and developed nations. Critics (Long, 1997) questioned the validity of such comparisons on the grounds that governments under different political and economic systems performed different functions.

This paper focuses on the issue of the coverage of the central government's budget. It too inquires into whether a public budget covers all public institutions and activities. In the course of research, even what is "public" or "government" becomes problematic. In the United States, for example, there exist many off-budget entities (OBEs) that are in some sense public or at least quasi-public. The definition becomes even more murky when an entire public sector is being transformed in China. Since definitions are ultimately tautological, it would be more fruitful to identify entities that are excluded from the budget.

The paper is structured as follows: Section I points out the economic and political significance, as well as the analytical significance of budget coverage. Section II will describe the transformation of the Chinese state budget during the reform period. Section III illustrates how the American federal government applies the unified budget principle; it will identify exceptions to the rule and draw some

Sino-American comparisons. A brief concluding section identifies possibilities for further research.

THE IMPORTANCE OF BUDGET COVERAGE

Economic and Political Significance

A public budget allocates the government's resources and is its instrument of control. Thus the budget status of an entity - be it a whole sector of the economy, an organization, a program - has both real and symbolic significance. Being in the budget gives it - and its beneficiaries – an authoritative claim on future resources. For example, large Chinese state enterprises rely on government subsidies to make up for their losses even though reformers advocate the separation of business and politics. Americans - and probably people in other countries as well – compete for shares of government budgets to secure tangible economic benefits - money, jobs and services. Not only do they want their programs in the budget, they seek to keep their shares of the budget for as long as possible through multi-year appropriations and entitlement programs (Schick, 1995; Wildavsky and Caiden, 1997).

The power of the budget carries with it the ability to control. For instance, American local governments receive billions of dollars in grants and contracts from the federal government, but they complain about the conditions and red tape - otherwise termed accountability provisions - that are attached to the federal money. Receiving Federal aid subjects the recipients to federal policy influence and control. Similarly, when local governments in China were required to send most of their taxes to Beijing and await their allocations, they were almost totally beholden to the central government. Once local officials were able to levy and keep tax revenues and generate substantial off-budget resources, their economic and political power grew, leading to greater independence. Thus the budget is a two-edge sword: it provides resources but requires reciprocity.

A public budget also conveys information thereby making government more transparent. When a government entity or program is moved out of the budget, or incompletely reported therein, it becomes part of Leonard (1986) calls "the quiet side of public spending." Even if there exists only a modest level of financial discipline in a country, it is more likely to affect the on-budget resources more than off-budget resources. In other words, the budget is the first line of defense for the public treasury. To the extent bureaucrats maximize their budgets as assumed by William Niskanen (Chan and Rubin, 1987), they are still subject to the control measures. In other words, a budget creates accountability, which is enforced by the accounting system. Accountability is weakened when resources go off the public budget or are left out of the books of the state. That would allow public officials to use resources at will. The absence of disclosure creates the temptation to abuse power. As a counter measure, American government accounting standards require all funds - regardless of their budget status - be brought under accounting control (NCGA Statement 1 as codified in GASB, 1996). Accounting - including financial reporting and auditing - constitutes the second line of defense for the public treasury.

In short, budget coverage has both economic consequences and political significance.

Analytical Significance

Budget coverage also has significance for social commentators and professional analysts. The size of the budget is often used as a surrogate measure of the size of government. In the West, liberals want the government to be bigger to do more good; conservative's want governments to be smaller to do less harm. They all turn to the government's budget for evidence to justify their positions. Unfortunately, there do not exist generally accepted criteria on what a government budget should cover. Analysts and politicians alike are fixated on budget deficits, but with only a few notable exceptions (e.g. Eisner, 1986), most people do not take the trouble to probe the assumptions behind the numbers. After reviewing two hundred years of budget deficit debates among economists, legal scholar Daniel Shaviro (1997, jack inside cover) concludes that budget deficits do not matter because "the deficit is an accurate measure with little economic content."

If the budget data and analytical problems in the U.S. are non-trivial (Ellwood, 1985 and Meyers, 1994), they are severe in China. There, fundamental structural changes modify the scope and composition of the state budget. It is very difficult, even without the structural changes to interpret public finance data in statistical compilations. Definitions are often so brief that it is hard to tell what the numbers purport to measure. Besides, some practices (e.g. the inclusion of debt proceeds as budget receipts) are at variance with international norms.

The analytical problems are compounded in the international context (Easterly, Rodriguez and Schmidt-Hebbel, 1994), where the temptation to compare is almost irresistible. Unfortunately international comparisons are fraught with difficulties that arise from (1) varying scopes of government functions, (2) a lack of a common yardstick and fluctuating exchange rates; (3) differing definitions of revenues and expenditures; and (4) the reliability of GNP measures. The exclusions of certain receipts and expenditures from the state budget is only one of the adjustments required to make public finance statistics meaningful for international comparisons (Long, 1997). Unfortunately inadequate information about public sector functions makes such adjustments difficult if not impossible. Even after the boundary line of the public sector is drawn, there remains the fundamental issue of how to measure the public sector. There is no international consensus on whether it should be measured by the amounts of resources it uses, spends, owns, controls or produces (Gemmel, 1993, pp. 2-3).

This paper adopts a positive approach to studying budget coverage. There is no presumption as to what the budget should encompass in terms of sectors of the economy, institutions, programs, etc. Rather, it compares the scope of the budgets of two national governments and inquires into the nature and the reasons for exclusions from those budgets.

It is argued that the coverage of a government budget in a country at any point in time reflects the extent to which government plans and controls that nation's political, economic and social institutions. Consider two extreme scenarios. In a pure communist state, the private sector does not exist and the state owns all the means of production and runs the economy and controls the society. In that case, the state budget is all-inclusive. At the other extreme is the laissez faire capitalist state, in which the state plays the irreducible internal governmental function of maintaining law and order and external function of providing for national defense. Here the state budget would minimally cover the core governmental functions, and would likely be very small relative to the size of the economy - around 3% of GNP according to economist Milton Friedman. These scenarios are obviously unrealistic but they serve as benchmarks for judging real-world budgets.

BUDGET COVERAGE IN CHINA

During the last fifty years, especially the last twenty years, China radically transformed its economy while maintaining essentially the same political system. How has this historical event affected its state budget and its coverage? The first part is answered in general terms in an earlier paper (Chan, 1996). This section addresses the changing boundary line of the Chinese State budget.

The Evolving Circles

The coverage of the state budget in China kept on changing in keeping with economic reform and the alignment of central-local fiscal relationships between central and local governments. In the early years of the People's Republic of China, the classical socialist budget model prevailed. At that time, the state budget was all encompassing, both vertically and horizontally. Vertically, it included the central government and all local governments. Horizontally, at each level of the government structure, the budget covers governmental institutions and their auxiliary enterprises. Such a highly integrated budgeting system corresponded to China's institutional structure as a unitary state with a centrally planned economy. The theory was that these organizations were owned by the people, and since the state represented the people, the state owned these organizations (Tang, Chow and Cooper, 1992, p. 140).

Horizontal Relationships

Market reforms have profoundly altered the horizontal relationships between the Chinese State and its economic institutions. In particular, the income tax reform introduced in 1984 changed the nature of their budgetary transactions. Prior to that time, all state enterprises were required to remit their profits to the state treasury and were in turn allocated funds for operations. Under the new system, the state budget receives income taxes from these state enterprises, which are permitted to retain after-tax income. In the event of a loss, the government is reluctant to let unprofitable large state enterprises fail and the state budget subsidizes unprofitable enterprises in order to maintain production and employment, and promote social stability.

The budgetary relationships between the state budget and the state-owned or supervised service institutions depend on the extent to which the latter receive government subsidies. Some were completely self-sufficient and require no state subsidies. Some were partially subsidized; still others were fully subsidized (Chan, 1996). The trend is for service producing organizations to become market-oriented and charge for their services, thus becoming increasingly independently of the state budget.

These developments have led to a paradigm shift in the China's governance structure (Chan, 1996, pp. 170-171). Instead of the former rigid hierarchical structure, Chinese institutions at each level (central, provincial, municipal, etc.) are gradually reconfigured as a series of concentric circles. At the core are the policy making and administrative units of the state. State owned enterprises and institutions surround the inner most circle, and are in turn encircled by quasi-state organizations. Finally, the new emerging private sector envelopes the public sector. In this arrangement, the state budget loses its power of planning and control toward the outer circles of the institutional structure, as they reduce their dependency on the state budget.

Vertical Relationships

Vertical relationships link between the Center and local governments. Structurally the state budget has a central government component and a local government component. The local budget component results from successive consolidations of budgets from village governments upward to provincial governments. The state budget is therefore a symbol of the primacy of the central authority. In recent years, while the symbol has been maintained, there has been a major realignment of the fiscal relationships between the Center and local governments. Until the early 1990s, local governments were essentially the fiscal agents of the Center: they mostly collected taxes and sent the money to the central government and looked to the Central government for their budgetary allocations. Later, local governments obtained more taxing authority under the new system of separate and joint taxation. In this system, some taxes are the exclusive jurisdiction of the central government; some are exclusively local taxes, while others are subject to joint jurisdiction. The formal structure tells only half of the story, however. The other half is local collection and control over the non-tax revenues and other sources of financing, especially borrowing for investment projects. In principle, the larger and the more strategic the project, the greater is central control. In practice, local governments exercise considerable discretion over many investment projects. The growing economic strength of the provinces, especially those in the coastal region, during the almost 20-year reform period have led some analysts to characterize China as evolving into a system of de facto fiscal federalism (Huang, 1997).

In summary, the coverage of the Chinese government budget results from two types of tension: (1) the tension between the centrifugal pull of the Center and local officials' desire for greater autonomy, and (2) the tension between the political authorities and the managers of economic enterprises. During the period of economic reform and governance reconfiguration, the "master budget" of the Chinese State has loosened up. Chinese policy makers now face a dilemma: can a smaller state budget exert great economic influence in a market economy, and exercise effective control in a decentralized governance structure? Only the future can tell.

Budget Coverage Policy

At the level of national budget policy, China seeks to strike a delicate balance between contending forces mentioned above. The Budget Law in effect since January 1, 1995 enunciated a number of basic principles:

First, the state budget should correspond to the government structure. That is, within the hierarchy of five levels of government, the budget of a government at a given level covers not only itself, but also the combined budgets of all the governmental units reporting to it at the next lower level. The legislature (i.e. the people's congress) at a level of government will review and approve the budget proposals of the government at the same level, but will only review (and presumably cannot modify or disapprove) the combined budgets of the lower level governments.

Second, a public budget should include government agencies and other institutions accountable to them. Thus, the Central Government budget covers the various national ministries and departments, and all the units reporting directly to them. These ministries and departments include not only administrative agencies of the state, armed forces, but also political parties and civic associations. The direct reporting units refer to their business enterprises as well as service institutions. The same principle operates at the lower levels of government.

Third, under the system of separate taxation between the Center and local governments, each government includes in its budget its own exclusive tax revenue sources and its share of joint taxation, as well as inter-governmental transfers.

Fourth, off-budget resources are allowed, but should be effectively managed. This last point will be discussed in detail in the next section.

To what extent have these principles departed from the high degree of political and economic integration discussed previously? In theory, the 1994 Budget Law has retained the form of a "state budget", but the system of separate taxation between the Central Government and local governments has effectively redefined their fiscal relations. In the face of rising prosperity of the coastal provinces, the Center strains to hold them accountable. Local officials have the institutional incentive to pursue economic development agendas, but not at the risk of jeopardizing their career advancement in the hierarchy of the party and government (Huang, 1997).

Managers have been given more operating responsibilities and decision-making authority. But the issue of how much autonomy state enterprises should have - and conversely, how much the state should interfere or intervene - remains a hotly debated issue in China today. The government has an interest - both from an ownership and macroeconomic perspective - in the performance of state enterprises, many of which are unprofitable partly because of the burdens (e.g. underemployed workers, social welfare benefits) they are not allowed to unload. Despite of the enactment of a bankruptcy law, the Chinese government is influenced by the "too big to fail" doctrine, which has compelled even governments in some Western capitalist countries to bail out large *private* corporations. Thus, despite the nominal change in the organization's name and titles of its managers, state enterprises remain inside the enlarged socialist market economy. The government's businesses, when they falter and fail, remain the business of government.

In conclusion, the Chinese State budget has lost some of potency as an instrument for economy-wide resource allocation, but has kept its significance as a symbol of the integrity of the Chinese public sector.

Off-budget Resources

The structural problem of the Chinese economy and government are manifested by the issue of "off-budget resources" (OBR). Designating something as on or off budget is not merely a technocratic exercise, but is a significant public policy decision. Indeed OBR has been declared a "cancer" (Ting, 1996, p. 3) and a "hot bed of [official] corruption" (Jiang, 1996, p. 3).

A Brief Semantic Analysis

The term "off-budget resources" is translated from the Chinese phrase *yusuan-wai zhejing,* which literally means "financial resources outside of the budget." Huang

(1996, p. 47) call it extra-budgetary or quasi-budgetary revenues. The "extra-budgetary" characterisation stresses the additional and supplementary nature of these resources with respect to the on-budget tax revenues. The "quasi-budgetary" label carries the implication that such resources are not truly government revenue. There is some validity in both characterisations.

Definition

Off budget resources have co-existed with the state budget since early days of the People's Republic of China (PRC) when the socialist doctrine reigned supreme. "Off-budget resources," according to the State Council (1996, p. 3), "refer to the various financial resources which are excluded from state budgetary control and which are collected or otherwise obtained to be spent by state organs, institutional units and civic associations in the course of carrying out, or acting as agents of the state in carrying out, governmental functions." In other words, public policy sanctioned the accumulation of some resources outside of the state budgets.

Off-budget resources were allowed to exist in several situations. First, local governments were sometimes allowed to keep the surcharge taxes, assessments and fees. Second, administrative units and service institutions were often authorized to collect and retain fees for their own use. Finally, state enterprises were permitted to keep their after-tax earnings in different funds for specific purposes, e.g. new product development, major renovations and repairs, and employee welfare benefits and bonuses (Public Fiscal Science Research Institute, August 1995, p. 43; Xu and Zhu, 1990, p. 10).

The Magnitude of Off-budget Resources

If OBR are legitimate, why have they become a major issue? One problem is that they have become too large in both absolute and relative terms. In the PRC's first decades, when Soviet-style socialist central planning was earnestly practiced, the amounts of off-budget resources were less than 10% of on-budget resources in the 1950s. As soon as economic reform started in 1978, OBR abruptly rose to one-third of on-budget amounts, and virtually doubled every five years until 1993. In that year, a new system for enterprise financial management was implemented. Under the new system, after-tax profits are no longer allocated into various special funds, which were previously deemed off-budget resources (Table 1).

The OBR numbers in Table 1 refer to what may be called *legitimate* OBR, i.e. their *origin* can be traced to the policy adopted long before reform started. That policy however, cannot be credited or blamed for the *magnitude* of OBR during the reform period (explanations will be suggested in a later section). These reported OBR numbers represent the lower bound of total OBR in China because of the existence of *illegitimate* OBR. These are OBR of dubious legality and are kept off the books. Alternatively, if they are accounted for, they are not recorded in

***Table 1**. The Growth of Off-Budget Resources*
(Amounts in Billions of Yuan)

	Off-budget	On-budget	Off/On
1980	55.7	108.5	51%
1985	153.0	186.6	82%
1990	270.9	331.3	82%
1992	385.5	415.3	93%
1993	143.3	508.8	28%

Source: Excerpted from Table 8 "State Fiscal Receipts and National off-budget Resources - Receipts," Expert Group on China's Reform and Economic Development Report, 1978-1994 (1995), pp. 274-275.

the official accounts. Judging from the persistent complaints about "two sets of books" and "little treasuries" by the top Chinese official in charge of the economy (Zhu, 1995), it seems reasonable to infer that they are a sizeable amount.

Categories of OBR

In spite of the loud condemnations of fiscal misconduct, actually the amounts of OBR in the hands of local governments, and of administrative agencies and service institutions were relatively small - 2% and 23%, respectively - of the total in 1992. In that year, most of the total OBR was in the form of retained after-tax earnings of state enterprises (Table 2).

***Table 2**. Off-budget Resources by Type*
(Amounts in Billions of Yuan)

	1980	1985	1990	1992
Local Govt.	4.1	4.4	6.1	9.1
Admin. & Inst.	7.4	23.3	57.7	88.5
State Enterprises	44.2	125.3	207.1	287.9
Total	55.7	153.0	270.9	385.5

Source: Excerpted from Table 8 "State Fiscal Receipts and National Off-budget Resources - Receipts," Expert Group on China's Reform and Economic Development Report, 1978-1994 (1995), pp. 274-275.

Table 3 shows what these off-budget resources were used for. Approximately 40% of the off-budget resources were invested in fixed assets, and another 20% in construction projects. Thus, slightly more than half was used for capital expenditures. Another 10-15% was used for employee welfare benefits and

Table 3. *Expenditure of Off-Budget Resources*

Expenditure Categories	1985	1990	1992
Total amount in Billions of Yuans	137.5	270.7	365.0
Investment in fixed assets	42%	34%	37%
Major repair expenditures	11	11	14
Minor construction expenditures	-	-	-
Road repair expenditures	5	5	5
Urban renewal expenditures	2	1	1
Remittance to the national energy source and transportation major construction funds	9	7	4
Welfare benefit expenditures	7	9	7
Bonus expenditures	7	4	3
Science and technology expenditures	1	1	1
Supplemental revolving funds expenditures	1	2	1
Service institution expenditures	4	6	7
Administrative expenditures	1	1	1
Other	12	20	19

Source: Derived from data in Table 9 "State Fiscal Expenditures and National Off-budget Resources - Expenditures," Expert Group on China's Reform and Economic Development Report, 1978-1994 (1995), pp. 276-277.

bonuses. The rest was basically for the operations of administrative agencies and service institutions. As was remarked earlier, these official statistics do not purport to disclose the wasteful and illegitimate spending financed by fees and assessments, which are often unaccounted for.

Attitude Toward Off-budget Resources

Off-budget resources have led an uneasy co-existence with the state budget. On the one hand, there is a grudging acknowledgment that these are "mobile resources" (Hubei, 1995) that compensate for the rigid control inherent in the state budget. A group of researchers at the Public Finance Scientific Research Institute (August 1995, p. 44) put it this way:

> *"It should be recognized that the continuous growth of off-budget resources is the expected results of reforming a highly centralized planned economy to effect administrative separation of powers. This has produced certain positive effects. Within a particular historical period, it has mobilized the initiatives of government agencies in managing their own finances. Because of this, different regions, department and units can*

> *judge their particular circumstances and flexibly proceed with their production, construction and development of service enterprises. This has also solved the problem of the all-embracing reaches of the state budget, thus enabling some service institutions to gradually move to business-like management."*

In other words, off-budget resources both reflect and foster decentralization, delegation of authority and an entrepreneurial spirit. These are elements of economic reform in progress in China since the late 1970s. If off-budget resources have these positive features, why has the Chinese government repeatedly tried to bring them under control? For example, in 1983, the Chinese Ministry of Finance issued tentative regulations on managing off-budget resources. Notwithstanding this regulation, off-budget resources (OBR) almost quadrupled between 1983 and 1992, suggesting the earlier measure had not been effective.

Explaining OBR

In order to understand why off-budget resources grew so rapidly during the reform period, one should examine the dynamics behind the three types of OBR identified previously. First, the growth of state enterprise OBR is accounted for by the robustness of the Chinese economy in general (Overholt, 1993) and by a new relationship between the state and state-owned enterprises. A variety of incentive schemes were tried to stimulate the performance of these enterprises, including the use of tax policy (Cong, 1994). In 1993, new rules governing enterprise management and accounting were promulgated to virtually disconnect state enterprises from the state budget. The state enterprise OBR was formally transferred over - at least on paper - from the gray area of overlapping jurisdiction to the exclusive control of state enterprises. Suddenly almost 300 billion yuans of OBR vanished from the OBR receipts. That move was significant in terms of the amount - the off-budget/on-budget percentage dropped from 90% to 30%! But it also had a profound ideological significance: the state budget gave up its claim to the retained profit of state enterprises.

Second, local fiscal autonomy in conjunction with market reform helps to explain the increase of OBR associated with provincial and local governments. It is not enough for policy to permit OBR to exist, there had to be an economic base to generate OBR and the incentive to tap into the base. By 1994, a system of separate taxation was officially promulgated. One issue was how to treat the OBR in the custody of finance bureaus at the local level. Do these resources belong to the central government? Are local government officials merely the fiscal agents of the Center? Currently OBR are being identified and centralized in special bank accounts. It is anticipated that approximately 15 billion yuans of local government OBR will be returned to local governments. This development would be consistent with the devolution of service responsibility and fiscal resources. A logical extension of this concept is to place the local finance bureaus' OBR in the budgets of local governments.

By 1996, when the State Council issued its Decision on tightening the management of OBR, the main target was the OBR in the hands of administrative agencies *and* service institutions (such as hospitals and educational institutions). The following summary shows the remarkable growth of this class of OBR in recent years (amounts in billions of yuan):

1980	1985	1990	1991	1992	1993	1994
7	23	58	70	89	131	166

Unfortunately, official statistics do not separate OBR at administrative agencies charged with carrying out governmental functions, and OBR at public service institutions. This distinction is crucial because these two types of organizations are different in terms of their governmental function, the nature of services and means of financing (Table 4).

Table 4. *Comparing Government Agencies and Public Service Institutions*

	Government Agencies	**Public Service Institutions**
Function	Governmental	Quasi-governmental service
Nature of goods	More like public goods	More like private goods
Sources of financing	Mostly taxes, with supplemental assessments and fees	Combination of user fees and taxes as subsidies

The term "government agencies" (or department, bureaus, offices, etc.) is used for xinjen danwei instead of "administrative agencies" because the Chinese concept of government agencies encompasses all organs of the states (i.e. executive agencies, legislative bodies and the courts), the armed forces and political parties; all of which are involved in exercising the sovereign power of the state. Their "products" are consumed by the whole society and, as such, should be financed mostly by taxes to prevent the ability to pay to dictate the distribution of such services. Sometimes governments impose assessments to pool resources for financing common-goods projects, or charge fees for regulatory services. But these should be supplemental to taxes as the main financing source. When such supplemental revenues grow to the point of complementing the tax revenues, it is fair to ask whether the government has become a business, and government officials have become businessmen.

Under the socialist principle, the Chinese public sector includes a vast network of public service institutions. Prior to market reforms, they used to provide services - e.g. health care, education - mostly free of charge. The extent to which these institutions are "governmental" in nature depends, in part, on ownership, control and financing. However, since they produce private goods, it is technically possible for them to charge for services rendered to specific individual customers. The extent to which they do so is a function of political ideology: public financing under socialism, and private payment in a market economy. As the burden shifts to customers, the state budget is relieved of the financial responsibility, and resources go off the state budget.

Off-budget resources were officially permitted in China to generate resources to *supplement* the state budget. However, officials did not have the necessity and incentive to take advantage of this provision prior to economic reform in the late 1970s. Economic reform in China has been credited with the delegation of authority, fostering individual initiatives and professional management. When the state budget is insufficient to meet spending requirements, government officials resort to revenue diversification and enhancement devices to make up for the difference. Some of the earlier free government services now require fees. Since government agencies are often monopolies, they can charge amounts higher than competitive prices, and keep them off the official budget. The growth of this type of off-budget resources is a by-product of market reform.

The emergence of the market economy has relaxed the ideological prohibition against transactions outside of the budget. Market reform has also led to debates and redefinition of the functions and scope of government. It has also encouraged entrepreneurial activities of government officials, thus creating the problem of "three chaos" - chaos in selective assessments, fees and fines. All of these are associated with the emergence of a new social norm of demanding fees for services.

Freed from the ideological constraint, government officials began to behave rationally as utility maximizing individuals, as public choice theory predicts. They desire to maximize their budgets in general, and discretionary budgets in particular. Since on-budget resources are subject to greater control, government officials prefer off-budget resources instead. Government officials maximize off-budget resources when (a) it can be done legally, or (b) the benefits exceed the costs. Recent policies attempt to thwart such tendencies by putting some OBR on the budget and declassify others.

In short, the policy that initially permitted the collection of revenues for own use and the exclusion of such revenues from *the* budget opens the door for off-budget resources. However, under the regime of central planning and control, the norm was to rely on the common-pool budget for financing virtually all needs. Furthermore it was politically incorrect for the government to raise resources through market mechanisms. When the inhibition against market transactions was lifted in 1978, local governments and public officials seized the legal loophole to tap resources from the burgeoning market. This led to the mistaken charge that off-budget resources are the product of market reform, which however, is indeed responsible for the *growth* of off-budget resources.

In the next section, we will see that the boundary issues also exist for the federal budget of the United States, but "off-budget" has a very different meaning in the American context.

COVERAGE OF THE U.S. GOVERNMENT BUDGET AND SINO-AMERICAN COMPARISONS

As in China, the scope of government budgets in the United States is also shaped by political ideology and economic forces. The line between the private and public sector is relatively clear - at least more clear than in China - and it is a settled principle that public (government) budgets do not cover private sector entities. (The secondary issue of commercial activities of government will be addressed later.) Federalism is also a firmly established constitutional order so that the budgetary separation between the federal government and state governments (including local governments therein) is uncontroversial. (While an American *state* corresponds to a Chinese *province* in the jurisdictional hierarchy of government, they are significantly different). With these basic boundary lines so clearly set, defining the budgetary contour of the American federal government became a matter of applying a settled principle.

Federal-Local Relations

The United States was conceived as a federal system. A consequence of federalism is that, despite their fiscal interrelationship - with 15% of federal outlays in assistance to state and local governments - there does not exist a national budget for the United States. The Federal Government administers its tax laws and directly collects revenues from throughout the United States. Each one of the 50 states has separate taxation, budgeting and financing systems (Aronson and Hilley, 1986; Sbragia, 1996). The approximately 80,000 local governments, being the legal creatures of the states, are subject to state laws, including finance-related laws and regulations on budgeting and accounting matters. Quite simply, unlike China, the United States does not have a national budgeting system. There exists the Budget of the United States Government, commonly called the federal budget; but it is not a budget of the United States. The diversity of state financial practices is itself an area of research. The large and complex federal budget is also a substantive area of scholarship (e.g. Schick, 1995; Cogan, Murin and Schick, 1994; Wildavsky and Caiden, 1997). In this section, we shall compare the scope of the budgets of the two national governments, with the understanding that the Chinese Central Government's budget concepts and structures are replicated at lower levels of government, while that is not the case in the United States.

Criteria for Federal Budget Boundary

The twin principles of capitalism and federalism limit the federal budget to covering the activities of the United States Government. The budget coverage issue was carefully studied thirty years ago by the President's Commission on [Federal] Budget Concepts. Believing that the federal budget should be a "more useful fiscal policy statement," the President's Commission on Budget Concepts enunciated the principle of a unified budget, one that would "as a general rule, be comprehensive of the full range of Federal activities" (1967, p. 25). The commission went on to argue that "[b]orderline agencies and transactions should be included in the budget unless there are exceptionally persuasive reasons for exclusion"(p. 25).

It should be noted that the American federal government's unified budget is far less all-encompassing than the Chinese socialist state budget. The commission was unifying what were then three disparate federal budgets: (1) the administrative budget for operating federal government agencies; (2) the credit budget for federal loans and loan guarantees; and (3) the consolidated cash budget used by the Treasury. The commission subsumed all these budgets as components of a unified framework so that the attention of policy makers and the public alike would be directed to one single federal budget surplus or deficit figure.

In drawing the outer boundary of the whole federal government, the commission (1967, p. 25) decided the budget status of borderline cases by asking several questions:

- Who owns the agency?
- Who supplies its capital?
- Who selects its managers?
- Do the Congress and the President directly control the agency's programs and budget?

While the answer to any one of these questions is not inconclusive and multiple considerations have to be weighed, these questions framed the coverage decisions in terms of *ownership, financing and control.*

Applying the Criteria

This section looks at how the boundary criteria have been applied in practice.

Government Corporations

Federal government corporations are in the federal budget because in general (1) they are owned in whole or in part by the federal government, (2) the federal government provides the financing, (3) their boards of directors are appointed by the federal government, and (3) their annual budgets are subject to presidential review and/or congressional approval. While they are akin to state-owned enterprises or service institutions in China, they are much fewer in number - only forty-five active ones according to a study by the U.S. General Accounting Office (1988). Moreover, U.S. Government corporations hardly match Chinese state-owned enterprises (SOE) in terms of the resources they command or the liabilities they bear. Regulated by the [U.S.] Government Corporation Control Act, they are required to prepare projected financial position and income statements for listing in the budget documents. However, their impact on the budget totals is presented on a net basis in terms of projected net incomes (which belongs to the U.S. Government) or net losses (which may require subsidy). As an example, while the U.S. Postal Service had $50 billions in gross outlays in 1993, only $1.4 billions of net outlays was included in the unified budget (Schick, 1995, p. 16). On a technical note, the Postal Service was given the statutory designation of "off-budget" to insulate it from deficit reduction measures. But this does not mean its financial results are not included in the unified budget totals.

Government-Sponsored Enterprises

There are a dozen federally chartered financial institutions which borrow money in capital markets for lending to farmers, homeowners and college students. These government-sponsored enterprises (GSEs) are excluded from the federal governments on the grounds that, in spite of the public policy objectives they serve and the federal agency oversight they are placed under, they are owned by non-federal entities, they borrow capital in their own name and are run by boards of directors not appointed by the government. Furthermore, their budgets are not subject to presidential review or congressional approval. Nevertheless, despite the federal government's disclaimer of liability and its lack of equity investment in these institutions, the capital market regards GSE obligations as implicitly guaranteed by the federal government. This creates a risk exposure to the federal government and has led to calls for greater budgetary discipline (Eisenbeis, 1996). Therefore the federal budget document contains information about the financial performance of GSEs, but the federal government's economic subsidies to GSEs are not recorded in the budget nor controlled through the federal budget process. Recently a group of financial experts suggested that such subsidies be recorded in the federal budget in a way similar to other federal credit subsidies (OMB, 1996, p. 124).

The case for or against including federal subsidies to GSEs in the federal budget is not clear cut. The argument against inclusion relies on the private ownership of GSEs and the fact that their policies and operations are determined by boards of directors elected mostly by private owners. Others argue that GSEs were established by the federal government to achieve public policy objectives to making credit available in situations where private lenders deem unprofitable. The market perception of implicit federal government is based on the assumption that the federal government will probably bail out weak or failed GSEs in order to ensure the flow of credit to target populations (OMB, 1996, p. 124). When the "too important to fail" argument is added to "too big to fail" doctrine, the federal government faces the persistent thorny issue of whether to "book" the estimated costs of federal subsidies to GSEs.

The issue of dealing with quasi-public enterprises is particularly relevant to China. The narrow technical issues relate to (1) the measurement of budgetary implications of government subsidies to unprofitable state enterprises, and financial exposure in risky investments and lending, and (2) the budget presentation of the government's large and growing investments in private sector firms at home and abroad. It is clear from this brief discussion of American GSEs that the complex nature of these entities does not lend itself to clearcut solutions. It is part of the broader policy issues of the restructuring of state-owned and quasi-public institutions to improve their performance (Zhang, 1995; Tseng, et. al 1995; Broadman, 1996; Muir and Saba, 1995; King and Zhang, 1992; The World Bank, 1988).

Trust Funds, Especially Social Security

The President's Commission on Budget Concepts (1967) recommended the federal budget should cover federally owned funds (now commonly called federal funds) as well as trust funds. Most of the federal government's trust funds are actually earmarked taxes or fees to finance specific programs, e.g. the interstate highway system and civil aviation. Indeed, the commission (1967, p. 26) alerted: "There has never been a question of the Federal Government's responsibility for determining the size and shape of the major trust fund programs or for altering or redirecting these programs by appropriate changes in legislation." The trust funds are clearly under the policy direction and budgetary control of the federal government. In reaction to the practice of excluding the trust funds from the administrative budget, the commission recommended that they be brought into the unified budget.

The largest trust funds are the Old Age Survivors Insurance and Disability Insurance trust funds, together known as the social security program. Social security is the federal government's social insurance program financed by payroll taxes (Weaver, 1990; Steuerle and Bakija, 1994; Diamond, Lindeman and Young, 1996). Following the budget concept commission's recommendation, social security is *in* the federal budget. However, in 1985 Congress declared social security as "off-budget" to prevent the resources of the social security trust funds from being used for deficit reduction (U.S. Senate Committee on the Budget, 1991). Consequently, the receipts and outlays of social security are excluded from the budget totals and from deficit calculations for reaching deficit reduction targets required by budget laws (Chan, 1999). Because of this legal requirement, social security transactions are separately identified in the budget, and on-budget and off-budget amounts are added together. As Table 5 shows, the current cash surplus of the social security trust funds offset the general fund cash deficits, resulting in a small federal budget deficit on a unified basis. The U.S. Treasury borrows the cash

Table 5. *Comparison of On-, Off-budget and Total Deficits*
(Amounts in billions of U.S. Dollars)

Fiscal Year	On-budget Deficit (-)	Off-budget Surplus or Deficit (-)	Total Deficit (-)
1970	-9	6	-3
1975	-55	2	-53
1980	-73	-1	-74
1985	-222	9	-212
1990	-278	57	-221
1991	-322	52	-269
1992	-340	50	-290
1993	-300	45	-255
1994	-259	56	-203
1995	-226	62	-164
1996	-174	67	-107
1997	-103	81	-22
1998	-106	96	-10
1999 (Estimated)	-96	105	9.5

Source: Excerpts from Table 21-1 Comparison of Total, On-budget, and Off-budget Transactions, Analytical Perspectives, *Budget of the United States Government*, Fiscal Year 1999, p. 353.

balance of the social security trust funds and "pays" interest via bookkeeping entries. These practices have led to the twin charges that the federal government diverts social security money and hides its true deficit.

At the heart of the confusion and controversy is whether social security payroll deductions are fundamentally (a) earmarked special taxes or (b) individual retirement contributions. The term "trust fund" hardly helps the matter because it reinforces the perception that the federal government is merely acting as a trustee for the beneficiaries. The logical conclusion of this line of reasoning is that the off-budget status is not just a statutory technicality, but that the resources in the trust funds do not belong to the federal government. Few would carry the argument so far, but federal accounting standards, after long and contentious deliberations, have declined to recognize future benefits as the federal government's long-term liabilities (Chan, 1998).

Federal Reserve System

The Federal Reserve System, being the central bank of the United States, is unquestionably a federal government operation. It is responsible to Congress for executing monetary policy and reports the results of its operations to Congress annually. Its board of governors are appointed by the President subject to the advice and consent of the Senate. As an independent agency, its budget is included in the federal budget but is not subject to the President's review or approval. Its excess profits, turned over to the U.S. Treasury, is scored as a federal budget receipt. The system's revenues and expenditures, however, are not included in the federal budget in gross terms. The budget concepts commission (1967, p. 28) explained this method as follows:

> *... Inclusion of the Federal Reserve banks in the Federal budget might jeopardize the vital flexibility and independence of the monetary authorities. Moreover, projections of System operations for a forward period - as would be required if included in the budget - do not appear feasible at the present time. The nature and economic significance of Federal Reserve bank "receipts" and "expenditures" are different from those of most other government programs and activities.*

One can understand the strategic reason for not revealing the Federal Reserve System's future plans through budget disclosure. The budget concepts commission did not concern itself with historical reporting of the Federal Reserve System. To my knowledge, no one has argued that historical reporting would jeopardize the system's flexibility and independence. It appears that federal accounting simply follows this budget policy and excludes the Federal Reserve System from the Consolidated Financial Statements of the United States Government (U.S. Treasury, 1998).

In summary, whether a federal program or agency is included in the federal budget depends on a combination of factors indicating ownership, financing and direct budgetary control. The unified budget concept requires that the federal budget includes virtually all organizations and programs in the executive, legislative and judicial branch of the federal government, as well federal government corporations. The monetary authority of the United States is excluded for special reasons.

Off-setting Receipts

It is of some interest to note that the off-budget administrative agency fees in China are called *off-setting receipts* in the American federal government. Often federal agencies are authorized by law to collect and spend taxes and fees related to the services they render. These revenues are on the budget in a nominal sense, because budget-scoring rules allow them to be used to off-set these agencies' appropriations (U.S. Office of Management and Budget, 1997; Colgan, Muris and Schick, 1994, pp. 81-87). In this way, the federal government outlay comes closer to reflecting the cost of government to taxpayers. However, accountants tend to prefer the gross method - treating earmarked taxes and user fees as revenues - which reveals the total revenues and total expenditures of the government.

CONCLUSION

"A full discussion of issues involved in delineating the outer boundaries of the Federal Government," stated the Report of the President's Commission on Budget Concepts (1967, p. 25), "could easily carry into quite esoteric matters of philosophy and political theory." That is because this seemingly technical issue brings to the fore such fundamental questions as: What is government? What does the government do? What does it own? What does it control? The commission found its task easy once it settled on the basic principle of a unified or comprehensive budget for the federal government and solved a few borderline cases by resolving doubts in favor of inclusion. The ease with which the Commission disposed of the issue was helped by the clearer delineation of institutional structure in the United States. The fundamental constitutional principles of federalism and private property have long been settled.

In contrast, the first principles of economics and politics are far from being a settled matter in China. China revised its constitution four times, reflecting the convulsive political and economic transformations in the last fifty years (Chan, 1997). It is still articulating what constitutes a socialist market economy with Chinese characteristics. One of those characteristics must be the ability to contain the contradictions of socialist planning and a free market. Similarly the Chinese State budget exhibits the paradox of political control and economic decontrol. As a political document, it displays central authority; as an economic document, it reveals the draining of resources away from the Center to the provinces and from the public to the private sector. This uneasy tension and the attendant ambiguity is reflected in the shifting coverage of the state budget.

It is clear from this study that a major challenge of comparative international government accounting research lies in dealing with the "incomparables." Incomparability is often traceable, as in this inquiry, to differences in institutional structure. If one were to peel away the institutional veneer, would there be more comparability - or universality - in human behavior? We have already seen some indirect evidence that budget (resource) maximization is shared by Chinese as well as American public officials. Are there other common traits? It is hoped that future CIGAR research will try to uncover such similarities as well as differences.

REFERENCES

English Language References

Aronson, J.R., and Hilley, J.L. *Financing State and Local Governments, 4th ed.* Washington, DC: The Brookings Institution, 1986.

Broadman, H.G. *Policy Options for Reform of Chinese State-Owned Enterprises.* Washington, DC: The World Bank, 1996.

Chan, J.L., "The Evolution of Governmental Accounting in China." In *International Research in Public Sector Accounting, Reporting and Auditing*, V. Montesinos, and J.M. Vela eds., Valencia, Spain: Instituto Valenciano de Investigaciones Economicas, 1995, pp. 119-128.

_______, "Budget Accounting in China: Continuity and Change." In *Research in Governmental and Nonprofit Accounting*, Vol. 9, 1996, pp. 146-174.

_______, "Two Paradigms for Governing China." In *Advances in International comparative Management*, L.R. Jones, K. Schedler, and S. Wade eds. 1997, pp. 203-217.

_______, "Accrual Basis of Budgeting and Accounting." In *Handbook of Government Budgeting*, R.T. Meyers ed. 1998, pp. 357-380.

_______, "Major Federal Budget Laws of the United States." In *A Global Perspective on Budget Deficits and Debt*, Shojai S. 1999, pp. 17-25.

Chan, J.L. and Rubin, M.A. "The Role of Information in a Democracy and in Government Operations: The Public Choice Methodology." In *Research in Governmental and Nonprofit Accounting*, Vol. 3, Part B, 1987, pp. 3-27.

Chan, J.L. and Jones, R.H. *Governmental Accounting and Auditing: International Comparisons.* London: Routledge, 1988.

Cogan, J.F., Murris, T.J. and Schick, A. *The Budget Puzzle: Understanding Federal Spending.* Stanford, CA: Stanford University Press, 1994.

Diamond, P.A., Lindeman, D.C. and Young, H. eds. *Social Security: What Role for the Future?.* Washington, DC: National Academy of Social Insurance, 1996.

Eisenbeis, R.A. Regulation: Bringing Budget Responsibility to GSEs. Journal of Retail Banking Services 1996; Summer: 61-64.

Eisner, R. *How Real Is the Federal Deficit?.* New York: The Free Press, 1986.

Ellwood, J.W. *Frequently Made Errors in Budgetary Research: A Critique and a Suggested Time-Series to Bring About More Accurate Models of Budget Behavior at the National Level,* paper prepared for delivery at the annual meeting of the Association for Public Policy Analysis and Management (Washington, DC, October 25, 1985).

Easterly, W., Rodriguez, C.A. and Schmidt-Hebbel, K. eds. *Public Sector Deficits and Macroeconomic Performance.* New York: Oxford University Press, 1994.

Gemmell, N. ed. *On the Growth of the Public Sector: Theories and International Evidence.* Aldershot, England: Edward Elgar Publishing, Limited, 1993.

Governmental Accounting Standards Board, *Codification of Governmental and Financial Reporting Standards.* Norwalk, CT: GASB, 1997.

Huang, Y. *Inflation and Investment Control in China: The Political Economy of Central-Local Relations During the Reform Era.* Cambridge, UK: Cambridge University Press.

Jaruga, A. Governmental Accounting, Auditing and Financial Reporting in East European Countries. In *Governmental Accounting and Auditing: International Comparisons,* J.L. Chan and R.H. Jones, eds. London: Routledge, 1988, pp. 105-121.

Jaruga, A. and Nowak, W.A. Governmental Accounting in Transition: The Polish Experience. Financial Accountability and Management 1995; February: 75-94.

Leonard, H.B. *Checks Unbalanced: The Quiet Side of Public Spending.* NY: Basic Books, 1986.

Lu, T. "Governmental Accounting and Auditing in China: Evolution and Current Reform." In *Governmental Accounting and Auditing: International Comparisons,* J.L. Chan and R.H. Jones, eds. London: Routledge, 1988, pp. 105-121.

King, T. and Jiping, Z. eds. *Case Studies of Chinese Economic Reform.* Washington, DC: Economic Development Institute of the World Bank, 1992.

Meyers, R.T. *Strategic Budgeting.* Ann Arbor, MI: University of Michigan Press, 1994.

Muir, R. and Saba, J.P. *Improving State Enterprise Reform: The Role of Internal and External Incentives.* Washington, DC: The World Bank, 1995.

Overholt, W.H. *The Rise of China: How Economic Reform Is Creating a New Superpower.* New York: W.W. Norton & Co, 1993.

Sbragia, A.M. *Debt Wish: Entrepreneurial Cities, U.S. Federalism, and Economic Development.* Pittsburgh: University of Pittsburgh Press, 1996.

Schick, A. *The Federal Budget.* Washington, DC: The Brookings Institution, 1995.

Steuerle, C.E. and Bakija, J.M. *Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform.* Washington, DC: The Urban Institute, 1994.
Tang, Y. et. al. *Accounting and Finance in China.* Hong Kong: Longman, 1992.
U.S. Department of the Treasury. *Consolidated Financial Statements of the United States Government, 1997.* Washington, DC: USGPO, 1998.
U.S. General Accounting Office. *Profiles of Existing Government Corporations.* Washington, DC: USGPO, 1989.
U.S. Office of Management and Budget. *Budget of the United States Government, Budget Systems and Concepts.* Washington, DC: USGPO, 1997.
U.S. Office of Management and Budget. *Budget of the United States Government, Analytical Perspectives.* Washington, DC: USGPO, 1997.
U.S. President's Commission on Budget Concepts. *Report of the President's Commission on Budget Concepts.* U.S. GPO, 1967.
Weaver, C.L. *Social Security's Looming Surplus: Prospects & Implications.* Washington, DC: The AEI Press, 1990.
Wildavsky, A. and Caiden, N. *The New Politics of the Budgetary Process, 2nd ed.* Longman: 1997.
World Bank, The, *China Finance and Investment: A World Bank Country Study.* Washington, DC: The World Bank, 1988.

Chinese Language References

Chinese Reform and Development Report Expert Group, *Chinese Reform and Development Report.* Beijing: China Finance and Economic Publishing House, 1995.
Cong, S. *An Inquiry into Chinese Public Finance.* Shanghai: Shanghai People's Publishing House, 1994.
Hubei Province Public Finance Scientific Research Team. Restoring and Combining Off-budget Resources: The Time Has Come. Research in Public Finance 1995; Octoer: 32-35, 42.
Jiang, J. Further Recognition and Really Strengthening the Management of Off-budget Resources. Research in Public Finance 1996; September: 2-4.
Long, F. Comparability Is Indispensable in International Comparisons. Economic Highlights 1997; Januaray 24.
People's Republic of China, Ministry of Finance, Bureau of Law and Regulations. *Handbook of the Budget Law of the People's Republic of China.* Beijing: China Finance and Economics Publishing House, 1994.
People's Republic of China, Ministry of Finance, Bureau of the Budget. *Budget Law of the People's Republic of China: A Special Compendium.* Beijing: China Finance and Economics Publishing House, 1996.
People's Republic of China, Ministry of Finance, Coordinated Planning Bureau. *Questions and Answers on Public Finance Knowledge: The State Budget.* Beijing: China Finance and Economics Publishing House, 1987.
People's Republic of China, National People's Congress. *The Budget Law of the People's Republic of China.* March 22, 1994 - English translation available in J.L. Chan and Y. Kang, *The Budget Law of the People's Republic of China: Original Text and Unofficial English Translation*, Center for Governmental Accounting Research and Education, University of Illinois at Chicago (May 1996). Unpublished report available upon request from the author.
People's Republic of China, State Council. *The Implementation Regulations for the Budget Law of the People's Republic of China.* PRC State Council Order No. 186, November 22, 1995.
People's Republic of China, State Council. *Decision Concerning the Management of Off-budget Resources,* issued on July 6, 1996. *Budget Accounting 1996;* September: 2-5.
Public Finance Scientific Research Institute. Off-budget Resources: Status, Issues and Policy Response. Research in Public Finance 1995; August: 42-44.
Xu, T. and Ping, Z. *Public Finance Policy and Economic Development.* Shanghai, China: Fudan University Press, 1990.

Ting, X. On the Necessity and Feasibility of Raising the Ratio of China's Revenue from an International Comparative Perspective. Research in Public Finance 1996; May: 3

Tseng, W. and others. *Economic Reform in China - a New Phase.* Beijing: China Monetary Publishing House, 1995. - Chinese translation of an International Monetary Fund publication.

Wang, S. *Report on the State Capacity of China.* Hong Kong: Oxford University Press, 1994.

Yu T. and Xe-sheng, W. International Comparison of the Scope of Central Government Fiscal Receipts. Economic Highlights 1996; November 29.

Zhu, R-J, Vice Premier Zhu Rong-ji's requirements for financial management in this year (1996), *The People's Daily*, quoted in *Budget Accounting* (March 1996), inside cover.

3

PUBLIC SECTOR CAPITAL: POLICY REFORMS AND ACCOUNTING MUTATIONS

Irvine Lapsley and June Pallot

INTRODUCTION

The United Kingdom and New Zealand are two countries with considerable commonalities in terms of accounting, culture, and governmental systems. In recent years, both have been to the fore in public sector reforms, including reform of their similarly modelled local governments (Guthrie et al., 1998). Accounting has assumed a significant role in these reforms and this paper therefore examines their comparative experiences, in the context of local authority capital accounting. Despite a great deal of similarity in terms of what Lüder (1992) describes as societal, political and administrative variables, the two countries have chosen to reform capital accounting in local government in markedly different ways.

The public sector has attracted the attention of critics of the reforms taking place in this part of the economy, in the name of accounting and accountability. One distinguished critic, Hopwood (1985, p.375), has described this reform process in the following terms:

> *"The public sector increasingly is utilising the accountings of the private sector. Cost, efficiency, economy and effectiveness have entered into the political discourse. Organizations are being reformed in the name of the accountings of them. Accounting thereby still remains an active and significant instrument of social and political as well as economic mobilisation".*

The above critique implies a ***convergence*** of the accounting practices of the public and private sectors of the economy. However, this paper demonstrates, for local government, that this outcome is not inevitable. An examination of the reform of local authority capital accounting in the UK reveals a system which was distinctive from private sector practice. However, the reform of this local government capital accounting has resulted in a system which is different from its predecessor, but it is also different from private sector practice: an ***accounting mutation***. Nevertheless, a contrasting situation has emerged in New Zealand, where reforms have been in the direction of increasing convergence with the private sector. This paper investigates the respective approaches adopted in the UK and New Zealand, and concludes with reflections on the experiences of those two approaches and the prospects for a convergence of private and public sector capital accounting.

THE REFORM OF UK LOCAL AUTHORITY CAPITAL ACCOUNTING

The reform of UK local authority capital accounting is considered here in three stages, by (1) an evaluation of the traditional finance capital approach in local authorities, (2) a brief historical overview of attempts at reform, and (3) an examination of the most recent capital accounting reforms. This discussion outlines the distinctive nature of local authority capital accounting which persisted for decades, despite well known defects. It also shows that, after extensive debate, the reformed capital accounting system is itself novel and distinctive – an accounting mutation. For example, it is very different from the practices of other parts of the UK – notably the private sector. Indeed, it can be argued that while the new local authority capital accounting system is different from what happened previously in local authorities, it nevertheless remains different in kind from other capital accounting practices in the UK.

Finance Capital

The traditional approach to accounting for capital in the UK local authorities has been *finance capital* so called because the source by which the acquired asset was financed was the key determinant in the accounting treatment of that asset and the cost (if any) to be charged to revenue account. Where the capital asset was financed by borrowings, the cost to the revenue account is the amount of the principal repayment and related interest ('debt charges'). As far as the balance sheet is concerned the fixed asset often appeared at an amount equal to the undischarged amount of debt. When the debt has been fully paid off, no charge for the use of the asset is made to the service revenue account and the asset may not have appeared in the balance sheet. Alternatively, assets may be disclosed at historic cost, with loans discharged shown separately. Where the capital expenditure was financed from revenue, this expenditure was charged to revenue account in the year in which it was incurred. This meant that, in the year of write-off, there was an abnormal burden and, in future years, no charge was made. The asset may/may not have been shown in the balance sheet. This has resulted in accounting anomalies. Kilgour and Lapsley (1988, p.17) cite the example of a local government with ample revenue funds which sought to build new headquarters. However, this was not feasible within one year. To prevent this acquisition being classed as capital expenditure, two buildings were constructed in two phases – one in each year. The two buildings were subsequently joined to form a District Council headquarters – all financed from revenue and not disclosed as an asset in its accounts.

An exemplification of this traditional approach to capital asset accounting is shown in table 1. This is based on a local authority with two assets: (a) property, which cost £100,000 and was financed by a loan repayable over 10 years, with interest on the loan charged at 10% per annum on the outstanding amount at the beginning of the year, and (b) equipment which cost £30,000 which was financed by revenue. The exemplification shown in table 1 is based on the second year of this local authority.

A number of reservations have been expressed over this system of capital accounting, which can be summarised as follows:

(a) The *costs* of services were linked to financing decisions and not to the actual use of assets. This was exacerbated where the useful lives of assets did not coincide with borrowing periods where the capital was financed by loans.
(b) Meaningful comparisons of the operating costs of local authorities could not be made because of (a) above.
(c) These practices encouraged, or at least, facilitated variability of accounting practice e.g. the non-capitalisation of revenue financed assets.
(d) An incomplete statement of assets held is likely, which undermines the stewardship of local authority assets.

(e) The debt charges which appear in the revenue account may be notional (based on the operation of an internal loans fund) rather than actual, and may be less precise, as a result.

The above criticisms of the finance capital approach are well known and have led to numerous attempts to reform local authority capital accounting in the UK. These various attempts are outlined below, prior to discussion of the latest capital reforms.

Historical Overview

The first significant attempt at replacing the finance capital approach to capital asset accounting in local authorities was the exposure draft on; 'Local Authority Accounting Principles' published by CIPFA in 1975. This advocated the adoption of historic cost depreciation accounting to achieve a matching of the cost of assets consumed and revenues of the period and to enhance comparability of the costs of local authorities. This was rejected by the members of CIPFA. There was little enthusiasm for these proposals and consequently they were never adopted by the Council of CIPFA.

However, the chairman of the working party which drafted the exposure draft, Woodham, advocated the adoption of current cost accounting by local authorities. The basis upon which Woodham illustrated his case for the adoption of CCA was that of housing. The major difficulty which he identified was the problem of opening values, where no records had been kept of assets held or their acquisition

Table 1. *Finance Capital: An Exemplification*

1.1	Revenue Account (Year 2)				(Notes)
	Debt Charges				
	Property		£19,000		(1)
	Equipment		-		
1.2	Balance Sheet (Year 2)				
	Capital: Property		£100,000		
	Less: discharged		20,000		(2)
			£ 80,000		
	Notes:	(1)	Loan outstanding, beginning of year 1	£90,000	
			Interest at 10%	£ 9,000	
			Annual capital repayment	£10,000	
				£19,000	
		(2)	Capital repayment for years 1 and 2		

costs (particularly where they were financed from revenue). Woodham advocated the proxy of taking existing debt less debt redeemed as the valuation of the net book value of assets. Clearly this had major difficulties with the omission of assets. This made this a particularly controversial proposal, in policy terms, as it had the implication that, for the major assets of most authorities (i.e. housing stock), the additional costs of CCA depreciation had to be recouped through increases in rents. For many local authorities this would have been a matter of extreme sensitivity. These reports preceded the current proposals for reform discussed below.

The Reform of Capital Accounting

The successful reform of capital accounting started with a report on Capital Accounting in Local authorities by CIPFA in 1989. This provided the basis and the impetus for the acceptance of the need for reform of this aspect of local authority accounting, even if it did not survive, unscathed, when it came to the actual detail of the reforms which were adopted.

There were two sets of ideas in this respect, the most radical of which affected the revenue account. This report envisaged that depreciation would be charged in all service accounts. This would be current replacement cost depreciation for all assets, with the exception of land. In addition, there was to be a cost of capital charged for the holding of assets in that service. The cost of capital advocated was that provided by HM Treasury as an opportunity cost of capital rate for investment decisions by public corporations, viz 5%. Both of these (CCA depreciation, plus the cost of capital) determined the 'economic cost' of capital to a given local authority. However this 'economic cost' was to be credited out of the revenue account in a 'below the line' adjustment. This economic cost was then to be replaced by the financing costs for the authority i.e. (a) interest paid to external borrowers (less interest received), and (b) any corporate provision to meet the cost of capital expenditure (i.e. the taxpayers contribution to capital finance). An illustration of this is shown in Table 2.

The purpose of this netting off of the economic cost of the capital employed was to ensure that the actual capital cost as determined by financing needs) did not distort the burden on taxpayers. Thus the major aim of this innovation was to make managers more sensitive to individual service capital costs. This particular proposal has survived, while other parts of these proposals did not. It remains to be seen if this enhances the decision making of managers and the accountability of elected officials, or whether it merely confuses.

As far as the balance sheet was concerned, the 1989 report advocated the adoption of current replacement cost or market valuation for assets. The depreciation charge in the revenue account was to be linked directly to the balance sheet figure for assts. This scheme met a lot of opposition, mainly on the grounds of its practicality, but the 1989 report was revised, and a final report of the Capital

Table 2. *The Capital Reforms: An Outline Local Authority Summary Revenue Account*

	By Service e.g. Education, Social Services	Total for all Services
Operating costs (including provisions)		x
Capital Charges		
Depreciation		x
Cost of Capital		x
Gross current operating costs*		x
Income		
Fees and charges		x
Specific Grants		x
Net economic cost of each service	Service a b c d....	x
	(credit) service capital charges^Ø	(x)
Corporately – "below the line" of service costs	net external interest	x
	contribution to capital	x
	other items, e.g. precepts	x
	needs grant	x
	community charges	x
	Authority deficit or (surplus) for the year	x

* Typically the summary revenue account may begin here. If so, the capital charges would be shown as a note to the accounts

Ø Alternatively, the depreciation charges may be netted off the "contribution to capital" below.

Accounting Steering Group was published in 1990. This relaxed the proposals of the 1989 report in two marked ways: (a) it offered a comprehensive set of asset categories with different accounting treatments for these and (b) more flexibility in the determination of asset charges in revenue accounts. The 1990 Report persisted with the idea of a capital charge in the revenue account which was a combined item of depreciation and notional interest, based on the current values of assets (or the historic cost, in the case of infrastructure). It recognised the need to remain with debt charges (loan interest and debt redemption) as requested by legislation on housing.

Following the final report of the Capital Accounting Steering Group of CIPFA of 1990, CIPFA established a Capital Accounting Working Group (CAWG) to report on the implementation of the 'final report'. This made two changes (a) local authorities did not have to amortise operational buildings, other properties, infrastructure or community assets where the local authority had a policy of extending the assets useful economic life by regular repairs and maintenance and (b), it introduced the possibility of market rents of property and hire charges for plant and vehicles being used as asset charges, with the general provision that, as a minimum, asset charges should cover the annual provision for depreciation, where appropriate, plus a capital financing charge determined by applying a specified notional rate of interest to the net amount at which the asset is included in the balance sheet.

An exemplification of capital accounting reforms is shown in Table 3. This is based on a hypothetical situation in which a local authority has four main assets (a) a housing estate, (b) a sports leisure complex, (c) roads and street lighting and (d) a new school. The ***housing estate*** cost £60 million to build 5 years ago, and was financed by a 30 year loan, which is repayable in equal annual instalments at the beginning of each financial year, with annual interest of 10% payable on the outstanding amount of the loan at the year end. The market value of this estate is £65 million. The estimated useful economic life of the estate is 50 years. The ***sports complex*** was financed by revenue contributions to capital five years previously. It has a current estimated replacement cost of £488,000 and an estimated useful life of 20 years. The ***roads*** and ***lighting*** have current accumulated capital outlays of £14,936,000, financed by loans which have been repaid in full. In addition, £800,000 has been incurred on ***school*** construction in the current year, financed by a 40 year loan which approximates to the useful life of this asset. This loan is repayable in equal annual instalments, commencing in the year in which the loan was raised, with 20% interest on the outstanding loan, payable at the end of each financial year.

As Table 3 shows, the capital accounting reforms lead to a more complete set of financial statements. There is also greater relevance in statements which capture current values. However, there is the major difficulty of the aggregation of the mixed asset valuation bases – finance capital, historic cost, possible omitted assets (e.g. permanently maintained assets such as infrastructure), and net current replacement cost or net realisable value. The use of current cost accounting does entail the use of mixed bases of asset valuation, but these reforms exacerbate this with the inclusion of historic cost and finance capital. Also, in this example the cost of housing dominates these accounting statements. While this example is purely illustrative, it does demonstrate the importance of housing to many local authorities. Indeed, this is often their major capital asset, but it remains outside these reforms.

There is also the difficulty of including infrastructure assets at historic cost or at all. This may be pragmatic, but may lead to greater variability of accounting practice. There are also issues in here about the meaningfulness of the figures in the revenue account. For example, in the case of the notional cost of capital, 5% has been recommended. This is likely to clash with the actual cost of capital to any given local authority, and there is a case here for the actual costs to be used. There is also the issue about the 'above and below the line' adjustments (see Table 2) for the so-called 'economic cost'.

Table 3. The Capital Accounting Reforms: An Exemplification

3.1	Revenue Account					
		Finance Capital		**Reforms**		
		£'000	**£'000**	**£'000**	**£'000**	Notes
	Housing finance charges	7,000		7,000		(1)
	Sports leisure complex	-		43		(2)
	School	176		59		(3)
	Roads and street lighting	-		-		(4)
	Total	7,176		7,120		
3.2	Capital Accounting					
	Housing	60,000		60,000		(1)
	Less: capital discharged	(10,000)		(10,000)		
			50,000		50,000	
	Sports leisure complex	-		488		(2)
	Less: depreciation	-		(122)	366	
	School	800		800		(3)
	Less: capital discharged/	(20)		(20)		
	Depreciation		780		780	
	Roads and street lighting	-	-		14,936	(4)
	Total		50,780		66,082	

Notes:

(1) Housing finance charges in the revenue account represent debt charges (loan interest and debt redemption) under both regimes. The housing stock is shown in the balance sheet at acquisition cost less capital repaid on the loan which financed it. A note on the market value £65M is disclosed in the 'reformed' balance sheet.

(2) Sports leisure complex was revenue-financed in a previous year and is excluded from both revenue and capital account, under finance capital, but is recorded at depreciated replacement cost under the reforms, with a notional capital charge added to the current year's depreciation in the revenue account.

(3) The school is included in revenue account as debt charges (loan repayment and loan interest) for finance capital, but at amortisation cost, based on useful life, plus notional interest charge of 5% in the reformed revenue account. In the capital account, there is a similar result because the borrowing periods and the useful life coincide

(4) In revenue account there is no charge for roads and street lighting, but for different reasons. The finance capital approach has no charge because the loan finance is fully repaid: the reformed approach does not depreciate infrastructure assets which can continue to be used if regularly maintained. The finance capital approach does not include this as an asset in the balance sheet as its finance is fully repaid: it is included in the reformed balance sheet at historic cost which recognises an asset in continuing use through regular maintenance.

The findings of the pilot studies were that this was understood by councillors and managers. However, on the face of it, it is at least counter-intuitive, and it remains to be seen if this does assist management decision-making. It is the case that these reforms have taken some twenty years to produce a revision of accounting practice, but there remain questions over the efficacy of the chosen model of reform.

THE REFORM OF NEW ZEALAND LOCAL AUTHORITY CAPITAL ACCOUNTING

As in the UK, there has been considerable debate about capital accounting in New Zealand local authorities and similar calls for full accrual accounting including depreciation and measures of the cost of capital. While New Zealand local authorities, in contrast to the UK, are not very active in housing, they do have significant levels of investment in infrastructure assets. Because of the consequences of this significant investment for intergenerational equity, not to mention their indeterminate life and other network characteristics, accounting for infrastructure assets has been particularly problematic. While network assets are not unknown in the private sector, they are relatively more significant in the public sector. For example, they comprise approximately 70 per cent of the value of the assets held by New Zealand local authorities. It was therefore local government which was first to try and tackle the issues of accounting for such assets as, in their view, appropriate accounting solutions had not been developed in the private sector.

Historical Overview

Traditionally, local authorities in New Zealand prepared their annual financial statements on a cash accounting basis with an emphasis on accountability for funds. The cash basis was also the prevalent method of accounting for day to day internal financial management. Fixed and infrastructural assets were not valued or disclosed in the financial statements, nor was depreciation recognized as a cost. In many ways it was a very simple system as there was no UK-style "finance capital" regime either.

The first serious challenge to traditional cash accounting came from Auditor-General, A.C. Shailes in his 1978 report on financial management in central government departments (Audit Office, 1978). Shailes argued that focus on the cash cost of inputs and failure to develop meaningful performance measures meant that managers focused on budgetary and legal compliance rather than managing efficiently and effectively. He advocated an accrual-based accounting system to ensure cost responsibility, encourage ongoing monitoring of assets, and enable systematic costing and charging for services. At the same time, the Audit Office also had responsibility for the audit of local government. Here, the Office considered that the legal requirements for disclosure and reporting were often badly drafted, vague, ambiguous and contradictory. In some cases they were overly detailed and prescriptive; in others virtually non-existent. Even the most recent regulations - the Local Government Accounting Regulations 1979 - were considered to be so badly designed that they failed to meet even elementary standards of public accountability (Gilling, 1994). A Public Sector Study Group was set up within the New Zealand Society of Accountants to examine these matters.

The Public Sector Study Group quickly persuaded itself that there was a need for authoritative pronouncements similar in nature to the accounting standards developed by the NZSA for the private sector. An early commitment was made to two basic principles: non-financial as well as financial performance measures, and a shift to full accrual accounting. However, infrastructure and heritage assets (called "community assets" because of their significance to the public) were thought to possess distinctive characteristics which warranted special accounting treatment. For example, if the intention was to maintain them in perpetuity, then straight line depreciation based on finite economic lives might not be appropriate. It was suggested that such assets (and also human resources) be reported in a separate Statement of Resources in physical (and only where relevant, financial) terms.

In 1985 the Public Sector Study group was formally reconstituted as the Public Sector Accounting Committee with a clear mandate to develop accounting standards for the public sector. Its exposure drafts published during 1986 were favourably received and in July 1987 a Statement of Accounting Concepts (SPSAC), together with Public Sector Accounting Statement Number 1 (PSAS-1), were released. These required non-commercial public sector entities to produce statements of the following: objectives, accounting policies, service performance, cash flows, cost of services, financial position, resources, and commitments. The PSAC then went on to develop a series of Technical Guidance Bulletins to assist public sector entities in preparing the statements required.

By this time, however, wholesale restructuring of the New Zealand public sector was under way (for a description see Boston et al., 1991). The importance attributed to accounting can be seen in the attention given to it in the *Public Finance Act 1989*, which together with the *State Sector Act 1988,* radically transformed central government departments. The underlying model was designed by the Treasury so as to closely paralleled the private sector; for example, government was now viewed as an "owner" of government departments and a "purchaser" of outputs (good sand services) produced by those departments. The accounting requirements in the Public Finance Act specified the same set of statements that had been advocated by the PSAC with the notable exception of the Statement of Resources. This meant that if infrastructure and heritage assets were to be reported for accountability purposes, it would have to be in financial terms in the Statement of Financial Position (balance sheet).

The Reform of Capital Accounting

In a parallel fashion to central government, legislation was used to induce radical transformation of local government. Under the *Local Government Amendment (No.2) Act 1989*, the number of local authorities was reduced from over 700 to just

85 and a new regime of accountability to the public was introduced. Part XIIA of the act is devoted to "Accountability and Accounting". While the term "accrual accounting" is not specifically mentioned, there are several provisions which induced reform of capital accounting practices in local government.

First, section 223E of the *Local Government Act* requires the following statements to be produced:

(a) A statement of financial position;
(b) An overall operating statement;
(c) One operating statement in respect of each significant activity;
(d) A statement of cash flows; and
(e) Such other statements as may be necessary to fairly reflect the financial position of the local authority, the resources available to it and the financial results of its operations.

Second, the legislation required local authorities to report in their annual plan, for each significant activity, "the indicative costs including depreciation and a return on capital employed." At the end of each year the local authority must report actual results against plan. Following an outcry that the notion of "return on capital" was inappropriate for non-commercial activities, the legislation was amended in 1991 to "cost of capital employed." The term was not defined in the legislation, but has been interpreted as a notional cost of capital which seeks to measure the opportunity cost of having assets tied up in local government services as compared to a marginally profitable alternative in the public sector. The approach is analogous to that adopted in the UK and illustrated in table 2.

Third, the legislation required local government to "adopt financial systems and reporting and record-keeping procedures that are consistent with generally accepted accounting practices recognized by the New Zealand accounting profession as appropriate and relevant for the reporting of financial information in the public sector." Prior to 1989 it was widely accepted that the pronouncements of the PSAC governed financial reporting in the public sector. Following the passage of the Public Finance Act in 1989, and the consequential state sector reforms, however, the Treasury began to argue that differences between the public and private sectors had all but disappeared and there was no longer a need for a separate standards setting committee for the public sector. At the end of 1992 the PSAC was disbanded and in 1996 the *Local Government Amendment (No.3) Act* required local authorities to follow standards approved by the Accounting Standards Review Board, a statutory body set up primarily to approve standards for public companies and on which there is no local government representation.

In the wake of the 1989 legislation, local government in New Zealand had attempted to follow the financial reporting standards of the New Zealand Society of Accountants (now the Institute of Chartered Accountants of New Zealand). To assist councils in the interpretation of financial reporting standards, or in cases where accounting standards developed for the commercial sector were incomplete or inappropriate, the Society of Local Government Managers (SOLGM) prepared guidelines for its members.

Most of the standards were able to be adopted without difficulty but, in the case of infrastructure assets, the standard on accounting for fixed assets (SSAP-28) and the standard on depreciation (SSAP-3) presented problems. SSAP-28 was heavily dependent on notions of "fair value", "net current value" and "recoverable amount" which assume an ability to sell the assets in question. Infrastructure assets in the public sector are not generally for sale and, because the majority were constructed under a cash accounting regime, historical costs have tended not to be available. In regard to SSAP-3, local government managers argued strongly that infrastructure systems provided essential services and had an indefinite life, although individual components did wear out and require replacement.

In 1992, the NZSA confirmed that SSAP-28 did apply to infrastructure stated assets but stated that they would accept valuations other than fair value, net realisable value or recoverable amount provided the valuation was performed by an independent valuer with the necessary expertise and conformed with New Zealand Institute of Valuers' standards (NZSA, 1991). The NZSA also signalled an intention to revise SSAP-28 and SSAP-3 as a new combined standard on accounting for property, plant and equipment.

Pending the development of a recognised practice over time, the SOLGM guidelines recommended depreciated replacement cost as the most appropriate valuation method for infrastructure assets unless actual cost was known, and was lower, in which case actual cost should be used (SOLGM, 1992, p.23). The SOLGM guidelines also recommended that all fixed assets be capitalised and depreciated in accordance with SSAP-3 but stated that:

> *"in the case of infrastructure assets, some local authorities have established an asset management plan with an engineering based forward estimate of renewals and replacements necessary to maintain the assets in full operation in perpetuity . . . The engineering assessment of physical condition of the asset and the work required to maintain this condition is intended to ensure that depreciation expense and restoration expenditures are equal. . . If the planned expenditure does not occur, the shortfall should be recorded as a provision for deferred maintenance or recognised as a reduction of value of the asset. Any expenditure which increases the service capacity of the asset, should be capitalised". (SOLGM, 1992, p.52)*

The New Capital Accounting in Practice

Although most councils were quickly able to identify, value and report ordinary fixed assets, infrastructural assets presented much more difficult problems. When assets were first required to be included in the statement of financial position, the information of many councils about the original or historic cost of their infrastructure was incomplete. Old information about cost and physical condition lacked relevance. This meant that councils faced the difficult, large and potentially very costly task of valuing infrastructure. Not surprisingly, there was considerable resistance on the part of some councils to the requirement to value infrastructure assets. They argued that the value of infrastructure was irrelevant because infrastructural assets were either not saleable or not ever likely to be sold and that the costs of valuation outweighed any benefits.

Over the next two years the attitude of many councils changed. Although the legislative requirement was the main reason for valuing infrastructure assets, councils started to see some other benefits including the following:

(a) It makes readers of the statements aware of the size of the public investment in infrastructure for which the council is responsible.
(b) It puts into perspective the on-going cost which the council incurs in maintaining and replacing infrastructure.
(c) The process of valuing requires that councils clearly identify the existence, location and condition of infrastructure assets with the result that local government managers and councillors improve their knowledge of the council's infrastructure investment
(d) Annual information about the value of infrastructure is a first step in tracking trends in infrastructure value over time and using that information to hold councils accountable for the way that they manage infrastructure.

By 1991, 40 of the 85 councils had valued their infrastructural assets and included the value in their statements of financial position. This number had increased to 83 by 1993 and to 84 by 1994. Analysis of the annual financial statements of local authorities shows that the majority (55) use depreciated replacement cost as the basis for valuing infrastructure assets. No other single method (for example, historical cost, replacement cost, net current value, replacement cost less an allowance for condition and optimised replacement cost) is used by more than four councils. Fifteen use a mixture of bases and eight have not reported what base has been adopted. Just over half used an independent valuer to value their assets or had internal valuations reviewed independently. When the Audit Office conducted a review in 1994, 31 councils were using conventional straight line depreciation on all assets; 20 used maintenance expenditures in lieu of depreciation; one used annual revaluations and 14 used a mixture of depreciation and maintenance. The remainder either did not value or did not depreciate their infrastructure assets (Audit Office, 1994a).

The legislative requirement to report a cost of capital created considerable confusion within local authorities and a diversity of responses in practice. A survey by the Audit Office in 1994 found that:

(a) Of the 85 councils which had made provision for a cost of capital, 33 applied a zero rate, thereby abiding by the letter of the law, but not the spirit.
(b) For those which did apply a rate, this seemed to be predominantly a rate which was equivalent to an investment or loan interest rate.

(c) No authority recognising a cost of capital did so for all asset categories.
(d) The asset categories which were most likely to have a zero rate applied for the cost of capital were infrastructure and community assets.
(e) There were wide variations in the manner of reporting of this cost of capital in local authority accounts (Audit Office, 1994b).

The Audit Office argued that local authorities should be encouraged to continue using opportunity cost concepts, where relevant, in management decision making but that accounting for a cost of capital in external financial reports was only serving to confuse readers. The legislative requirement to report cost of capital in financial statements has since been repealed.

It was, however, considered worthwhile trying to reduce diversity of accounting practice in other areas of capital accounting. To this end, and to help address the concerns about asset management and financial condition raised in an Audit Office report on local government (Audit Office, 1993), SOLGM convened a working party in late 1993. This working party included public and private sector representatives from the accounting, auditing, engineering and valuation professions.

Draft guidelines on accounting for infrastructure assets were released by the SOLGM working party in 1994. The draft guidelines defined infrastructure assets as "those stationary systems where the system as a whole is intended to be maintained indefinitely at a particular level of service potential by the continuing replacement and refurbishment of its components." Depreciated replacement cost was recommended as the basis for valuation. More significantly, the draft guidelines advocated a renewal accounting approach which recognizes decreases in the condition of an infrastructural asset caused by a deferral of the maintenance needed to keep the asset at its intended operating capacity (Pallot, 1997). Consumption of service potential (depreciation) was to be measured by the dollar amount needed to physically restore the asset and reverse this deferred maintenance. An essential prerequisite for using a renewal approach is the development of an adequate infrastructure asset management plan to support claims that the service potential has been restored. With such a plan, the measurement of expense is arguably not only more relevant but also more reliable than depreciation based on debatable asset valuations and indeterminate life.

As more councils developed asset management plans for their infrastructure, they started to move to a renewals accounting approach as advocated in the SOLGM guidelines. In 1996, 23 councils used straight line depreciation and 27 used renewals accounting. Sixteen used the renewals accounting approach for some infrastructure assets (mainly roads) but conventional depreciation for others. Thirteen did not depreciate infrastructure, recording only maintenance expenditures, and six had a nominal charge such as $15.00. The remainder either had no infrastructure assets or did not disclose their accounting policy for them.

In December 1997 the SOLGM working party issued its completed guidelines. The most significant conclusions in the guidelines are:

(1) Depreciation of infrastructure assets must be calculated and recognized as an expense in a local authority's financial reports.
(2) Two methods of calculating depreciation for infrastructure assets are acceptable, that is, either:
    the traditional method of allocating loss of service potential over the expected life; or
    a "two-step" renewals based approach.

To apply conventional depreciation calculation infrastructure assets requires the identification of groups of similar sub-assets (components), the estimation of expected useful life for each component, and the allocation of service of each component over its remaining useful life. Critics of this approach argue that it is the system as a whole, not components by themselves, that provides the service; the sum of the depreciation calculations for each component fails to recognise their interdependency and synergy. The preferred measure of change in service potential is therefore the *long run average* of future renewals expenditure (over, say, twenty years) as indicated by the asset management plan. The "two steps" are (1) this long-run average of estimated future renewals is expensed (as depreciation) and (2) actual renewals expenditure is capitalised. Repairs and maintenance are items that would not have been included in the renewals plan and should be expensed.

In April 1998 the Institute of Chartered Accountants of New Zealand finally produced its exposure draft of a standard on Accounting for Property, Plant and Equipment. It advocates conventional depreciation i.e. the sum of the (straight-line) depreciation calculations for each separately identifiable component. It remains to be seen whether local government will be able to persist with the two step renewals-based approach in light of this proposed new directive from the accounting profession. One advance in the new Exposure Draft is that depreciation is unambiguously defined as consumption of service potential, whereas the previous SSAPs also persisted with the notion of depreciation as cost allocation, which tended to cause confusion in a public sector context. If it can be accepted that the issue is one of *measurement* (of decline in service potential) rather than *recognition* (whether or not a cost has been incurred in the first instance), some of the heat being generated in the debate may be reduced.

CONCLUSION

This paper has examined the experiences of two countries which chose to undertake much needed reform of their local government capital accounting practices but which approached the problem in radically different ways. Despite an increasing belief that private sector accounting practices are equally applicable in the public sector (for example, implicit in the proposed new standards being issued by the Public Sector Committee of the International Federation of Accountants), convergence is not inevitable. In the UK, the reform of local government capital accounting has resulted in a system which is not only different from its predecessor but also from private sector practice as well – an accounting mutation. Even in New Zealand, where vigorous attempts have been made to align public sector accounting with that of the private sector, some "mutant" practices have emerged from within local government in response to specific problems and management needs in that sector.

There are several other observations which emerge from this study. First, it is not possible to fully understand accounting outcomes through an examination of the technical issues (e.g. the merits of cash versus accrual accounting) alone. Also determining accounting practice are some significant contextual factors including the history of past practices (such as the finance capital approach and the debate surrounding housing in the UK). A major factor in determining the extent of public sector and private sector convergence is the structure of the accounting profession – a single body in New Zealand and a separate public sector body in the UK. A related issue is the relationship between central government, local government and the accounting profession. In the New Zealand case, collaboration between central government and the accounting profession may overrule the preferences of local government. In the UK, the preference is for local government and its arm of the accounting profession to self-regulate and for central government to stay out of the debate. Comparative international research may wish to explore the relationship between central government, local government and the accounting profession in various jurisdictions as a means of better understanding the accounting practices that result.

Second, this study reveals a high incidence of non-compliance within local authorities in both countries. Although some of these effects may be transitional, the New Zealand experience shows that legislating for accounting change does not necessarily result in consistent accounting practice. We cannot expect legal directives to resolve accounting problems. Equally, the UK experience has shown that uniform *guidance* on capital accounting also leaves considerable scope for professional judgement where technical issues are complex. The UK experience shows that ring-fencing (housing) or omission (infrastructure) can be useful in coping with short term political or policy pressures but possibly at the expense of consistency in accounting practice. The New Zealand experience suggests that this option may not be available where there is a single accounting regime across the public and private sectors because of the flow-on implications for the latter. However, a conceptual framework and accounting practices developed primarily for the private sector may not provide complete answers for the public sector where issues of wealth distribution, intergenerational equity and democratic control over the use of funds need to be considered as well.

In summary, what is lacking in initiatives of the kind discussed in this paper is a clear model or framework which identifies the users of this accounting information such that reports can be designed to guide their decisions on capital accounting - maintenance, growth or depletion. In the absence of the kind of modelling framework, we would expect a continuing story of diversity of interpretation and in practice in both of these study settings.

ACKNOWLEDGEMENT

The authors gratefully acknowledge the support of the Institute of Chartered Accountants for Scotland and the University of Canterbury for this comparative research on local government accounting in the UK and New Zealand.

REFERENCES

Audit Office. *Report of the Controller and Auditor-General on the Financial Condition of Regional and Territorial Local Authorities.* Wellington: Audit Office, 1993.

Audit Office. "Accounting for Infrastructural Assets." In *Report of the Controller and Auditor General, Second Report.* Wellington: Audit Office, 1994a, pp. 32-36.

Audit Office, "Reporting the Cost of Capital." In *Report of the Controller and Auditor General, Second Report.* Wellington: Audit Office, 1994b, pp. 24-31.

Boston, J., Martin, J. and Walsh, P. *Reshaping the State: New Zealand's Bureaucratic Revolution.* Auckland: Oxford University Press, 1991.

CIPFA, *Local Authority Accounting Principles.* London: CIPFA, 1975.

CIPFA, *Capital Accounting in Local Authorities, (Pearce Report).* London: CIPFA, 1983.

CIPFA, *Capital Accounting in Local Authorities: The Way Forward.* London: CIPFA, 1989.

CIPFA, *Capital Accounting in Local Authorities: Final Report.* London: CIPFA, 1990.

CIPFA, *Capital Accounting Working Group.* London: CIPFA, 1993.

CIPFA, Institute Statement: Capital Accounting, *Public Finance and Accountancy.* 1993.

Gilling. "The New Zealand Public Sector Accounting Revolution". In *Perspectives on Performance Measurement and Public Sector Accounting,* E. Buschor and K. Schedlereds. Berne: Paul Haupt Publishers, 1994.

Guthrie, J., Humphrey, C. and Olson, O. eds. *Global Warning: International Trends in Public Management and Accounting.* Oslo: Cappelen Akademisk Forlag, 1998.

Hopwood, A. The Tale of a Committee That Never Reported: Disagreements on Intertwining Accounting with the Social. Accounting, Organizations and Society 1985; 10, 3: 361-377.

Kilgour, L. and Lapsley I. *Financial Reporting by Local Authorities in Scotland.* Edinburgh and London: ICAS and CIPFA, 1988.

Lapsley, I. La Comptabilité Publique Locale en Grand Bretagne. Revue Française de Finance Publique 1994; 47: 81-103.

Lüder, K. A Contingency Model of Governmental Accounting Innovations in the Political-Administrative Environment. Research in Governmental and Non-Profit Accounting; 7:99-127.

New Zealand Society of Accountants. *Statement of Public Sector Accounting Concepts.* Wellington: NZSA, 1987.

New Zealand Society of Accountants. "Public Sector Accounting Guidance: Application of SSAP-28 Accounting for Fixed Assets" In *New Zealand Society of Accountants (1994) New Zealand Accounting Standards*, Wellington: NZSA, 1991.

New Zealand Society of Local Government Managers (SOLGM). *Guidelines for Good Accounting Practice in Local Government and Presentation of External Financial Reports.* Wellington: SOLGM, 1992.

Pallot, J. Accounting for Infrastructure: Technical Management and Political Context. Financial Accountability and Management 1997; 13, 3: 225-242.

Parkes, J. Local Authority Capital Accounting - Towards Reform Financial Accountability & Management 1989; 5(2):107-118.

Society of Local Government Managers. *Guidelines for Good Accounting Practice in Local Government Presentation of Financial Reports.* Wellington: SOLGM, 1992.

Society of Local Government Managers, Working Party on Infrastructure and Heritage Assets, *Accounting for Infrastructural Assets in Local Government.* Unpublished, 1994.

4

FINANCIAL REPORTING PRACTICE: A COMPARATIVE STUDY OF LOCAL AUTHORITY FINANCIAL REPORTS BETWEEN THE UK AND MALAYSIA

Hugh M. Coombs and Mohamad Tayib

INTRODUCTION

The paper is concerned with examining the financial reporting practices of local authorities in two divergent economic environments - the UK with its long and well established industrial and financial base and the rapidly emerging 'tiger' economy of Malaysia. There has been little previous research on the issue of comparative financial reporting practices between countries in the public sector in general and, specifically, in the local authority context. There are, however, numerous previous studies on the comparative international financial reporting practices of private sector firms (see, for example, Gray and Roberts, 1986; Benjamin and Stanga, 1977; Tayib, 1987; Choi and Mueller, 1992). Similarly textbooks on international accounting tend to ignore the public sector (Mueller *et al.* (1997), Nobes and Parker (1995), Haskins *et al.* (1996). One example of comparative work between the published accounts of local authorities is the study carried out by the UK researchers Jones and Pendlebury (1982) on reporting practices of UK and European local authorities. This study concentrated primarily on the analysis of the form and content of UK local authority published accounts although some reference is made to continental European local authority accounts. Coombs and Liberman have examined financial reporting in the former Soviet Union and UK local authorities (1990 and 1994) although this work was not strictly comparative.

STRUCTURE OF THE PAPER

The following broad structure is adopted for the remainder of this paper:

(1) Following a brief background section the research methodology section justifies the approach adopted;

(2) An examination follows of the evolution of the financial reporting practices in the two countries;

(3) Reporting practices are then compared in detail between the UK and Malaysia for a sample of local authority published accounts and the accounting requirements adopted by each country for local authorities compared; and

(4) Finally appropriate conclusions are drawn. These conclusions discuss the causes of the differences between the form of financial reporting adopted by the two countries.

BACKGROUND INFORMATION

Historically, a number of well-developed countries have made important contributions to the development of accounting. Britain, for example, has not only imported double entry from Italy and exported this practice to the world but has also exported the concept of a true and fair view, first to the other countries of the British Commonwealth and, more recently, to the other European community countries (Parker, 1989). While there is a *prima facie* case to accept this view if we refer to the development of private sector accounting rather than public sector accounting (see, Nobes and Parker, 1995, Choi and Mueller, 1992) as stated above no attempts have been made to assess and explain internationally the development of local authority accounting.

A closed relationship existed between Malaysia and the UK in the early stages of local authority development in Malaysia. This could provide a foundation to assess the extent that this relationship influenced the development of accounting practices in Malaysian local government as for over 150 years Malaysian local authorities (at that time Malaya) were governed under British style laws. The Municipal Rates Act 1848 was the first statutory requirement that obliged municipal councils of the United Settlement (municipal committees at that time) to publish a statement of accounts for the public. Then, 100 years later, the British extended their style of administration to other Malay States by placing their Resident or Adviser in the government of the State Rulers. Significant powers were concentrated in this role and the pattern of 'traditional local authorities' was substituted by the British for a nexus of government departments in the charge of British appointed officers (Nahappan Report, 1970, 17). A present day comparison between the two countries will help provide some evidence as to what extent local authority financial reporting practices in Malaysia have developed when compared with the UK. Differences may indicate whether the development of local authority financial reporting practices have been influenced by internal or external environmental factors.

RESEARCH METHODOLOGY

The data analysed later in this study is drawn from the financial reports and accounts of ten British and Malaysian local authorities for the year 1994/1995. The UK and Malaysian local authority accounts used in this paper were selected through personnel contacts in both countries. This was seen as providing the potential to make further contact with individual finance officers should the need arise over any points of technical difficulty although, such contacts as did take place subsequent to the gathering of the initial reports and accounts, were limited. The study also does not aim to provide an absolute measure of differences between the accounting practice between the two countries but to indicate what differences exist. It was felt that a detailed analysis could be undertaken on a limited set of accounts and that any comparison that could be drawn on the basis of this information was still valid as the study attempts to show. The local authorities contacted in the UK were Birmingham City Council, Vale of Glamorgan Borough Council, Rhondda District Council, Bridgend Borough Council and Merthyr Borough Council. For Malaysia the authorities were Ipoh City Council, Petaling Jaya Municipal Council, Kangar Municipal Council, Shah Alam Municipal Council and Sungai Petani Municipal Council.

Comparison between statutory and non-statutory requirements of the published financial reports and accounts between the two countries are considered necessary in order to give a clear picture of the differences in published accounting information that are currently applicable to UK and Malaysian local authorities. These differences will lead to the identification of variations in practice between local authorities in both countries. Compliance by local authorities to statutory and non statutory advice in both countries to the requirements imposed on them is another question examined in this work.

EVOLUTION OF REPORTING PRACTICES

This section explores the development in financial reporting in the countries which are the subject of this research. This in order to give the general statutory and non-statutory environment in which local authority accounts are published in both countries. It examines, *inter alia*, the role of statutory regulation, the influence of the professional bodies in the development of financial reporting and the general context in which financial reporting evolved in both countries in determining the content of information disclosed in financial reports and accounts.

United Kingdom

Jones has argued that local authority reporting in the UK *is* a function of statute (1996). Coombs and Edwards have shown the contribution made by the profession, local authority members and a variety of other factors particularly over the period 1835 to 1935 (1996 b). Today's accounting measurement and disclosure framework for UK local authorities is compiled and summarised under the Accounting Code of Practice on Local Authority Accounting for Great Britain issued within a permissive statutory framework. The Accounting Code of Practice was first published in July 1987 and developed as professional guidance by the Chartered Institute of Public Finance and Accountancy[1]. This Code of Practice specifies the principles and practices of accounting required to prepare a Statement of Accounts which "presents fairly" the financial position and transactions of an authority. It sets out the *proper accounting practices* required for the Statements of Accounts prepared in accordance with the statutory framework established for England and Wales by Regulation 7 of the Accounts and Audit Regulations 1983 [AAR 83] (as amended) and by section 66(4) of the Local Government and Housing Act 1989 [LGHA 89]. In Scotland the statutory framework is established by the Local Authority Accounts (Scotland) Regulations 1985.

As regards the term 'proper accounting practice' section 66 of the LGHA 89 defines this as 'those accounting practices which the authority are required to follow by virtue of any enactment; or which, whether by reference to any generally recognised published code, or otherwise, are regarded as proper accounting practices to be followed in the keeping of the accounts of local authorities either generally or of the description concerned'. Section 66 also stated that, in the event of a conflict in accounting practice arising between statute and code, then only those falling within statute (and related regulations) are to be regarded as proper practices. The latest Code of Practice (1998) has been issued under the 1989 Act and is accepted by the regulatory body as providing the basis for proper accounting practice.

Section 66 of the LGHA 89 states that in the absence of specific legislation, the accounting profession is free to develop what it regards as proper practice. More importantly, where the accounting profession has issued recommendations on appropriate standards of financial reporting for local government, they should be followed and, therefore, such guidance now has statutory backing as non-statutory proper practices. This means that the professional body in the UK has the opportunity to play a vital role in promulgating and developing local authority financial reporting standards. This, it can be argued, perpetuates the role established by the Corporate Treasurers and Accountants Institute (CTAI) as one of its key initial objectives was to make a major contribution to the development of the local authority financial reporting (Coombs and Edwards, 1996, 33) [2]. In 1930, for example, the introduction of regulations which were to form the basis of local authority accounting for the next fifty years were 'considered and agreed by the IMTA and the Association of Municipal Corporations before being promulgated by the Minister (Carson Roberts, 1930: p.386). The successor body to the IMTA, the Chartered Institute of Public Finance and Accountancy (CIPFA) has as discussed above made a major contribution to local authority accounting by its development of the Code of Practice on Local Authority Accounting.

Finally, with regard to statutory requirements, local authorities are required to comply with the Citizen's Charter and publish information on standards of performance as required by the Audit Commission while the Commission itself publishes nationally performance indicators for all authorities under the Publication of Information (Standards and Performance) Direction 1992. This information may be financial (unit costs) or qualitative. Local authorities also provide information on budgets, grants levels etc. to council taxpayers in the literature which accompanies council tax bills under the Local Government Act 1992.

Malaysia

The basis for the modern system of local government in Malaysia (at that time Malaya) was introduced by the British in 1801 when a 'Committee of Assessors' was set up at Penang and charged with the responsibility of planning and implementing urban development[3]. The first local government legislation introduced were regulations issued under the East India Company's Charter and these were followed by the Indian Legislation Act and the Municipal Rates Act in 1848 to establish municipal committees in the areas of Penang, Malacca and Singapore (also known as the United Settlement) [4]. It is significant to note that under Section 15 of Municipal Act 1848, the Municipal Committee was required to publish a statement of accounts for the interest and query of ratepayers (Nahappan Report, 1970, 13) replicating similar provisions in the British Municipal Corporations Act 1835. From that time, numerous amendments and new ordinances were gradually introduced by the British with the primary objective being the better administration of local government in Malaya and, covered such matters as, land administration and revenue collection.

The rules and regulations introduced were not standardised throughout Malaya and varied according to states or territories to which those regulations applied - for example, the Malay States of Perak, Selangor, Negeri Sembilan, Pahang, Kelantan, Trengganu, Perlis, Kedah and Johore had their own rulers and thus, own rules and regulations. As a result of which, there were a wide variety of law and ordinances which applied in the whole country before the 1973 restructuring process was begun by the federal government[5 6]. No clear rules and regulations spelling out the form and content of the statement of accounts that should be prepared by the local authorities were laid down either before or after the independence of Malaya.

After what can be regarded as a period of neglect of local government accounting matters following independence, as a response to the criticisms of the Nahappan Report, the federal government took almost immediate action by restructuring local authorities in Peninsular Malaysia. Following the passage of the Local Government (Temporary Provisions) Act 1973 in Peninsular Malaysia, all the basic laws that regulated the powers, duties, responsibilities and functions of local authorities were reviewed and codified. Three parent laws were enacted for that purpose: The Street, Drainage and Building Act 1974 [SDBA 74]; the Local Government Act 1976 [LGA 76]; and the Town and Country Planning Act 1976 [TCPA 76].

When compared with the UK system, the statutory basis for compiling financial reporting statements by Malaysian local authority financial reporting is not clear. Sections 41 and 42, for example, of the UK LGHA 89 specifically make clear to local authorities what is meant by 'proper accounting practice', but the same thing is not defined in any of the Malaysian regulations. Even though Section 54 (4) of the 1976 Act does require the publication of annual reports it does not make clear to local authorities the potential content of these reports and, what consists of proper practice in compiling, or keeping the records for, the financial statements under-pinning these reports.

Financial accounting reports are not made available to the general public or council taxpayers as there is no such requirement under current Malaysian law. Financial accounts are made available to councillors, the external auditor, the Ministry of Housing and Local Government and the state authority. They are eventually published (in full) in the official government gazette after audit. The time period of the process depends on the speed with which authorities prepare their annual accounts, but on average, is completed about six months after the December year end which is the accounting date for all Malaysian local authorities.

Four different accounting standards were found to have been adopted by Malaysian local authorities. In a study of local authorities in Peninsular Malaysia it was discovered (Tayib, 1994) that at least four different accounting standards had been adopted - International Accounting Standards [IAS], guidance issued by the Ministry of Housing and Local Government [GMHLG], Federal Treasury Circular [FTC] No.15, and self created accounting practices [SCAP]. Of the four practices, the IAS and FTC are the most widely complied with by the local authorities. Even within these two methods of preparing accounts the methods advised by the FTC received the greatest attention by accountants in local authorities. The basic reason for this being that all the financial statement and accounts of the local authorities are audited by the Government Auditor General who makes extensive use of FTC guidance as a main reference point in undertaking the annual audit and has thus had significant influence over the form of local authority published information in Malaysia. Some authorities have also, voluntarily, adopted what they consider to be appropriate international standards e.g. IAS 5 and IAS 20 as a result of pressure following preparation of the financial statements by private sector accounting firms. These statements have then audited by the government auditor general.

ANALYSIS AND DISCUSSION

Analysis and discussion is divided in two main sections:

(1) comparative financial reporting requirements and practices; and,

(2) analysis of the information disclosure in the financial reports and accounts.

Comparative Financial Reporting Requirements and Practices

As discussed above uniformity of the local authority financial reporting practice has a long history in the UK. As early as 1889, the Corporate Treasurers and Accountants Institute began attempts to achieve standardisation of the local authority financial reporting. Local authorities gradually over time accepted these requirements in publishing their financial statement and accounts. Thus local authorities initially voluntarily followed and adopted a standard terminology, a standard framework of presentation and standard definitions in preparing their reports and accounts. Today, all the requirements dealing with local authority published financial accounts have been complied and published in the Code of Practice and as such the environment has changed from one which was voluntary to what can be interpreted as a statutory obligation under the terms of 'proper accounting practice' enforced by the external auditor.

In Malaysia there are no specific requirements, either statutory or non-statutory, currently to monitor or overseeing financial reporting practices in Malaysian local authorities. A general requirement for the preparation of records and accounts by local authority is stated in the LGA 76, although the details of the requirement regarding the form and content of the accounts has been surrendered to each State authority. This could be explained by the fact that local government in Malaysia, by the provision of the Federal Constitution, is a national creation but local authorities provide local services and, as such, their day to day financial transactions should be accounted for and regulated by the state in which they operate.

To date no specific requirement statutory guidance has been issued regarding the form and content of the financial reports and accounts by any of the State authorities. There are 12 states in Peninsular Malaysia and 97 local authorities. Potentially if State authorities responded to the permissive federal legislative requirements, there could be 12 different requirements in local authority practice throughout Peninsular Malaysia.

To develop even within this permissive statutory framework there is a need for expertise. At the State level, however, a major problem faced by these bodies is attracting qualified accountants to work for their local authorities. Tayib (1994) in his study of 77 local authorities in Peninsular Malaysia, discovered that there were only 23 out of 77 local authorities who employed qualified accountants. Some local authorities (those without accountants) are allowed by their state authority to contract-out the process of preparing financial statements to private sector accounting firms. This contrasts with the UK in that accounts are currently prepared in house by local authority staff who would be members of one of the professional bodies. Even if this function was contracted out by local authorities in the UK under current legislation on 'white collar' competitive tendering the accounts would still be prepared by equivalently qualified staff operating within UK accounting standards and enforced by the external auditor.

As an alternative to specific state legislation numerous local authorities in Malaysia have adopted the Federal Treasury Circular No. 15 - Guidance for Preparing and Presenting Annual Report and Financial Statement for Federal Statutory Bodies [GPPARFS], for guidance in preparing their financial reports and accounts. Any federal statutory bodies, covered by the Statutory Bodies (Annual Report and Accounts) Act 1980, have to adopted GPPARFS as their main reference in preparing and presenting the annual reports and accounts, but there is no provisions in any instruction, either statutory or non-statutory, stating that local authorities should adopt the above guidance in preparing their financial reports and accounts. These rules and regulations were developed internally by the federal government and can be regarded as self generated accounting principles.

One of the main reasons that could explain the adoption of GPPARFS by local authorities is the requirement of the external auditor. The Federal Government Auditor General (FGAG) is the main auditor to all government agencies including local authorities. GPPARFS is the only guidance available issued by the government. Local authorities have no alternative guidance or, as discussed below, the necessary expertise to develop their own standards and, therefore, they have to accept the GPPARFS.

Another setback for the potential development of local authority financial reporting in Malaysia is caused by the lack of involvement of the professional bodies as compared to its UK counterparts. The Malaysian Institute of Accountants (MIA) and Malaysian Association of Certified Public Accountants (MACPA) are the two main accounting standards governing bodies in Malaysia. No significant contributions have so far been made, however, by these two professional bodies, or, significant interest expressed, in the development of local authority financial reporting. In the private sector context almost all the accounting standards adopted by these two bodies have come from the International Accounting Standards Committee.

The Malaysian Institute of Public Sector Accounting (IPSAM) is another professional association with the potential to provide a lead to the federal government in the development of public sector accounting and reporting standards. The establishment of the new association with potentially enthusiastic members was considered appropriate and timely with the potential to enhance the development of the public sector accounting standards given the lack of development of public sector accounting and reporting standards and the vacuum not filled by the existing professional bodies. All its members are public sector accountants working in this field and as such have first hand knowledge of the problems and prospects for governmental (including local authority) accounting and reporting. Unfortunately, this association is not particularly active and its establishment has not been widely trumpeted. The unclear direction and low profile taken by this association are clearly factors that contribute to an ineffective professional body. This contrast remarkably with CIPFA which from its early days as the Corporate Treasurers and Accountants Institute was very active in promoting its perceived role (Coombs and Edwards, 1996, 114).

Basically, there appears little significant differences in the minimum disclosure requirements between the two countries. The UK disclosure requirement, however, is more demanding when compared to its Malaysia counterpart by making compulsory the 'explanatory foreword' to be included in the statement of accounts. The explanatory foreword attempts to give users a better understanding of the items reported in the accounts and fulfils a similar purpose to the directors' report in a set of company accounts. The authority should provide in this statement an explanation in overall terms of the financial position (and facts), and aim to assist in the interpretation of the accounting statements (Code, 1992, 4).

In Malaysia, on the other hand, the statement of the chairman and board of directors (equivalent to the Mayor/Chair and councillors of a local authority) and the declaration by the officer (chief accountant or chief financial officer) primarily responsible for the financial management is strongly recommended by FTC No. 15 for all government agencies (as stated above a local authority is seen as broadly equivalent to a government agency in Malaysia). This statement says that the chair (together with the board of directors or councillors) of government agencies are fully responsible for what they are reporting in the financial reports and accounts. This requirement can be interpreted as placing a duty of care on those making the statement that all related records and accounts are properly kept and monitored.

The UK requires more information to be disclosed by local authorities. Whereas the Malaysian local authority faces a very minimum requirement imposed on them and even the above represents the voluntary adoption of FTC.No.15. On the top of that, there is a totally different format or style adopted by the two authorities in presenting their income and expenditure accounts. The content of the UK local authority revenue account aims to provide a fundamental understanding of the financial implications of a local authority's activities by an objective analysis of expenditure by function. It reports the cost for the year of the major functions for which the authority is responsible and compares that cost with the finance provided from charges made by the authority, taxes raised and income from central government grants. The Malaysian counterpart broadly adopts the same practice but no comparison can be made between the cost of local authority activities and sources of income as income in the sample accounts examined was not broken down into its constituent elements.

With regards to the balance sheet requirement, there are no major differences in term of the format and general content of the balance sheet except that the UK local authority has to prepare a consolidated balance sheet as well as an individual balance sheet for any fund which cannot be consolidated[7]. A significant difference, however, lies in the adoption of the new capital assets accounting system introduced in UK balance sheets (with certain specific exemptions) which will be valued on a *current cost* basis. A cash flow statement based on Financial Reporting Statement 1 is required by the UK and adopted by the CIPFA Codes of Practice published in 1995 whereas in Malaysia a statement of sources and application fund is published. However, according the Code of Practice, the content of the Statement of Revenue and Capital Movement prepared by the authority will fulfil the Regulation 7 (3)[e] requirement for a statement of sources and applications of funds required under the UK Accounts and Audit Regulations.

Local authorities in the UK provide and manage major service in their areas and therefore need to account for a significant use of resources. In contrast, local authorities in Malaysia only provide smaller scale activities or service less vital to the wide body of the citizenship if compared to the UK counterpart. Some of the critical services operated by UK local authorities have been privatised in Malaysia, such as refuse collection and disposal and are totally outside local authority control. UK local authorities, also, receive a higher level of government grant in support of their services in comparison to Malaysian local authorities. The *quid pro quo* therefore is significant central government interest in local authority accountability for the use of resources.

In Malaysia the State and Central government are involved in the provision of local authority services as not all of the country is covered by a local authority administration area. Out of 50,806 sq. miles (the total area of Peninsular Malaysia) only 8,760.73 sq. miles are local authority areas, which means that only 17% of the territory in Peninsular Malaysia are under local authority jurisdiction (Phang, 1985). Local authority accounts in Malaysia are thus, from the point of view of local taxpayers, only relevant to a smaller local taxpaying constituency as compared to the United Kingdom and this coupled with low government grants (and even an intention longer term to phase out federal government grants) are thus lower on the scale of priorities for both federal and state government.

As discussed earlier, the UK requirements seem to be more users oriented (at least as seen by the profession) by requiring more information to be disclosed in order to satisfy the needs of all the potentially interested parties. In theory this pressure for more disclosure should have increased as the country has become more economically advanced and taxpayers become better educated needing more sophisticated and better information to make informed decisions. An alternative theory is that the accounting profession and government bodies have decided that this is what should be provided irrespective of user demands. Indeed there does seem a lack of evidence of a wide spread potential user demand especially amongst council taxpayers (see, for example, Collins *et al.*, 1991) although Tayib has found some evidence that council taxpayers in Malaysia may be prepared to pay their local tax demands more quickly if additional accounting information was provided (1997). It also could be argued that the new UK local authority capital accounting arrangements (CIPFA, 1996) are a recognition that what is needed is better *internal* information for the management of assets and further advances the influence of the profession.

Analysis of the information in the Financial Reports and Accounts

As might be expected, the UK local authority financial reporting practice is very much different compared to its Malaysian counterpart in terms of its level of disclosure. It can, however, be commented that the 'devil is in the detail' in that the major differences relate to the extent to which UK practice requires *additional* disclosure. This is related to the continuous monitoring by CIPFA, with its series of updated accounting standards, and is likely to continue to widen the gap between the financial reporting practice followed by the two countries unless Malaysian local authorities decide to alter their approach. It should be noted, for example, that the UK has been constantly revising the Code of Practice since it was first introduced in 1987 in order to reflect changing demands on reporting practice.

It is inevitable that, in a rapidly developing economy, with what seems like a relatively low interest in their financial affairs, Malaysian local authorities still have to explore or generate interest for the exploration of the best solutions to their financial reporting practices.

As stated earlier in this paper UK local authority accounting has recently developed further by requiring local authorities to include new capital accounting transactions in their accounts and to provide further analysis of the apportionment and allocation of overhead in their financial reports and accounts. This compares with the attitude adopted in Malaysia where a comprehensive study on improving local government cost accounting models was carried out by private sector accounting firms in 1992 but no further action was taken on their report by either the federal government or state authorities.

The UK differs from Malaysia by disclosing detailed information regarding income and expenditure of the services provided by their local authorities. Gross expenditure, income and net expenditure of individual services are provided in the financial statements and this can give a better view to the users of where the money was spent - especially useful in analysing a local authority's performance in delivering a specific service. On other hand, local authority in Malaysia provides basic information to the users - where the money comes from (source of income) and where the money goes. The expenditure is classified according to the types of expenditure incurred - i.e. it is a subjective analysis. This tends to make the statements less complex to understand but limits the analysis that can be done on service performance.

There are, however, few significant differences in presenting the balance sheet statement by the two countries although the technical differences are significant given the valuation basis used. In term of format of the balance sheet, local authorities in Malaysia have adopted a very similar format to that which is practised by the private sector companies with only minor amendment. Increasingly the UK local authority balance sheet also resembles that of a private company as the new capital accounting rules are being adopted. This has come about primarily because of the 1988 LGHA as prior to this authorities use to publish information by specific fund and this led to the publication of tremendous detail in extensive financial reports[8]. The significant difference again between the two countries is in the level of detailed analysis particularly with regard to the detailed classification of fixed assets.

The detailed study of local authority published accounts revealed that, although very high, 100% compliance with the Code of Practice in all categories was not achieved by UK local authorities. Malaysian local authorities, obviously, achieved a lower level of compliance with the CIPFA Code but these compliance levels are the result of the accounts not given the equivalent details to their UK counterparts as the same level of disclosure does not apply in Malaysia and the use of a subjective rather than an objective analysis in the revenue account. It was also clear even with the limited sample of UK local authorities that some authorities regarded the document as of more importance than others. This is consistent with findings by CIPFA (Layton, 1992, 4). Some UK authorities choose to build a picture of the overall image of the authority with extensive use of graphs to explain the accounts whereas, for others it seemed purely a technical exercise. Authorities contacted also stated that they used only small production runs for their annual accounts due to a lack of demand from other than members of the authority. Similarly some authorities have tried to generate interest in their affairs by the publication of an epitome or an 'accounts newspaper' as part of the annual report (e.g. Coventry and Cardiff City Councils). The views expressed by officials was that these methods had only limited impact and in some cases had been withdrawn. All the chief financial officers at the local authorities selected in the UK were members of CIPFA and, as stated above, although none of the authorities complied fully with the CIPFA Code their membership, plus the statutory obligation as to proper practice, has the potential to influence the high percentage compliance rate that was achieved. Clearly all these activities place a high compliance cost on UK local authorities (and UK taxpayers) and it should be borne in mind that any move by Malaysian local authorities to disclose significant extra information has a potential agency cost the size of which is related to the extent of any changes.

Analysis of the accounts showed clearly no disclosure by Malaysian local authorities of policies on the provision of pension, the allocation of overheads and the basis of any provisions. It is also worth pointing out that only two out of the five UK local authorities surveyed highlighted the implications of the adoption the new framework for capital accounting in their financial statements despite the fact that this users may expect some explanation for such a significant change. The response by Malaysian authorities on capital accounting is limited to disclosure of the valuation of fixed assets and their depreciation rates where applicable which is directly comparable to their UK equivalents.

The research found high compliance here in both countries with their respective codes in terms of the content of the published revenue accounts. Again it was noted that the main difference is again one of detail. As stated earlier the format is one of significant difference with the UK giving a greater breakdown into detail by service.

Review and Conclusions

Lack of research interest in international public sector reporting could be one of the factors that impedes the development of the public sector accounting. Even though, well-developed countries such United Kingdom, United States, Australia and New Zealand, have good examples of well conducted research on the public sector financial accounting framework within their own countries researchers seem generally less concerned about international issues in public sector reporting. This study, therefore, represents an early attempt to push forward the boundaries in this area particularly with respect to local authority published financial reports

The findings of the study show that the historical relationship between the UK and Malaysia relationship has not influenced to any great extent the present structure and systems of the Malaysian local authority published financial accounting statements. It could be hypothesised while there may have been a general non-specific effect on Malaysian local authority accounting as a result of the UK administration of Malaya the UK standards that were promulgated by CIPFA (beginning effectively in 1955) were too late to be introduced in Malaysia, even if the administration had been interested, given the move to independence in 1957. As shown the most significant influence on Malaysian local authority published accounting reports are those promulgated by the Federal Treasury resulting from their influence over external audit.

It is also true to say, however, that such changes that have been made in Malaysia have been relatively slow. The private sector professional bodies do not show a significant level of interest to further improve public sector financial reporting. In comparison the UK evidence shows that a powerful and influential professional body like CIPFA has played an important role in influencing the development of local authority accounting continuing a role it has seen as important since its foundation. The work of CIPFA has been given a high recognition by the UK government whereby all the accounting standards developed by this bodies has been accepted and implemented through out local authorities within a permissive statutory framework although the bottom line is that central government has the final decision on what is proper accounting practice. The extent of this interest in imposing its own standards is speculated as being related to the extent of its financial support of UK local government. This demonstrates that active participation from government together with a pro-active professional body has made a significant difference to the financial reporting environment of local authorities in the UK. This being despite any apparent demand from a wide body of users as shown by Collins *et al. (1991)*. This situation of close collaboration between the professional body and the federal government does not at present exist in Malaysia nor does there seem significant interest amongst either party to change the situation discovered.

Anyone wishing to use local authority financial information in Malaysia has greater difficulty accessing this information than equivalent users in the UK. Tayib (1994), for example, revealed that easy access to financial reports and accounts is limited to councillors, auditors, the state authority, and the Ministry of Housing and Local Government and that the general ratepayer is not that interested. Any individual, who is interested to inspect the financial reports and accounts of a specific local authority has to wait until the reports are published in the official government gazettes. This means that the process of getting financial information by the public from any local authority inevitably takes time and there is the possibility of a lack of interest as any potential issues fade. No accounting information is provided with the assessment tax bill. Any change in practice would, however, need to recognise that significant agency costs could arise. In contrast in the UK any ratepayer has the right to the information even extending to the right to inspect the accounts (including documents) and question the external auditor (CIPFA, 1995, 214). This right of access even extends to potentially difficult areas such as documents under-pinning the accounts of sensitive competition services.

The structure of local government in Malaysia has been shown in the paper to be one which is not particularly conducive to change given the federal/ state relationship. It can also be argued that the different scale of local government between the two countries has contributed to the present situation with regard to local authority financial reporting. As discussed earlier, local government in Malaysia does not cover the whole country while, at the same time, services provided by Malaysian local authorities are on a smaller scale than their UK counterparts.

As a general conclusion, it can be said that the comparative development of public sector accounting in the two counties studied is very much influenced by the level of interest expressed by central government and professional bodies. In other words, it can be said that the disclosure practices of local authorities are shaped by the complex and dynamic environment in which their reporting practices originated driven by a desire to see change in those financial reports and practices although, whether these developments are in the interests of accountability to users, is a matter left for further research.

ACKNOWLEDGEMENT

Grateful thanks is expressed to the authors' institutions for their support and to Professor Lee Parker for his comments on an earlier draft of this paper.

NOTES

[1] CIPFA is the body which represents the interests of public sector accountants in the UK. It is strongly represented in local government

[2] CIPFA was originally founded as the Corporate Treasurers and Accountants Institute in 1885 with a name change to the Institute of Municipal Treasurers in 1901.

[3] The British East India Company first established trading relationships with the rulers of Western Sumatra in 1658. Independence was granted in 1957 (Allen, 1983,15).

[4] These three states were under the British administration.

[5] The existing laws for local authorities are: the Municipal Ordinance S.S Cap. 133, the Town Boards Enactment F.M.S. Cap. 137, the State of Kelantan Municipal Enactment 1938, the Town Boards Enactment No. 188 (Johore), the Town Boards Enactment, Trengganu (Cap. 64), the Town Boards

Enactment F.M.S. Cap 137 as made applicable to Perlis, by the Town Boards (Application to Perlis) Ordinance, 1952, the Town Boards Enactment F.M.S. Cap 137, as made applicable to Kedah by F.M. Ordinance No. 52/56 and the Local Councils Ordinance, 1952.
[6] This restructuring process was limited to local authorities in West Malaysia only.
[7] The best example is probably the superannuation (pension) fund which is a trust fund for the employees.
[8] See for example Bucknell 'Abstract Reflections', Local Government Chronicle, 23 November 1973.

REFERENCES AND FURTHER READING

Statutes and Statutory Regulations and other primary sources

United Kingdom

Poor Law Act 1601, Municipal Corporations Act 1835, The Accounts (Borough and Metropolitan Borough) Regulations 1930, The Local Government Act 1933, Local Government Act 1972, Local Government Planning and Land Act 1980, Accounts and Audit Regulations 1983, Local Authority Accounts (Scotland) Regulations 1985, Local Government and Housing Act 1989, Local Government Act 1992, Publication of Information (Standards and Performance) Direction 1992

Malaysia

Indian Legislation Act 1848, Municipal Rates Act 1848, Street Drainage and Building Act 1974, Local Government Act 1976, Town and Country Planning Act 1976, Federal Treasury Circular No.15

Annual Financial Reports and Accounts 1994/95

Birmingham City Council, Bridgend Borough Council, Merthyr Borough Council,Rhondda Borough Council,Vale of Glamorgan Borough Council, Ipoh City Council, Kangar Municipal Council. Petaling Jaya Municipal Council, Shah Alam Municipal Council, Sungai Petani Municipal Council

Secondary Sources

_______, A Report of the Royal Commission of Enquiry to Investigate into the working of Local Authorities in West Malaysia, Chaired by the Senator Dato; Athi Nahappan, 1970.
_______, Code of Practice on Local Authority Accounting for Great Britain, CIPFA, Various.
_______, Code of Practice on Local Authority Accounting for Great Britain: Guidance Notes for Practitioners in England and Wales, CIPFA, 1994.
_______, Councillor's Guide to Local Authority Finance, CIPFA, 1995.
_______, Financial Reporting in Local Government, Block 2, Capital Accounting, Student Learning Pack, CIPFA, 1996.
Benjamin, J.J. and Stanga, K.G. Differences in Disclosure Needs of Major Users of Financial Statements. Accounting and Business Research 1977; Summer.
Bucknell, B. Abstract Reflections. Local Government Chronicle 1973; 23 November.
Carson R.A. *Local Administration, Finance and Accounts*. London: Harrison, 1930
Choi, F.D.S. and Mueller, G.G. *International Accounting*. Prentice Hall, 1992.

Collins, W., Keenan, D. and Lapsley, I. "Local Authority Financial reporting - Communication, Sophistry or Obfuscation". In *The Chartered Institute of Public Finance and Accountancy and The Institute Chartered Accountants of Scotland* 1991.

Coombs, H.M. and Edwards, J.R. *Accounting Innovation - Municipal Corporations 1835 - 1935.* London: Garland Publishing Inc., 1996.

Coombs, H.M. and Edwards, J.R. *Actives and Passives a study of the causes of accounting change in Municipal Corporations 1835-1935.* unpublished paper presented to the British Accounting Association, Cardiff 1996b.

Coombs, H.M and Liberman, L.V. Local Authority Accounting in England and Wales. Bookkeeping and Accounts Ministry of Finance of the USSR (published in Russian) 1990; 7: 62-66.

Coombs, H.M and Liberman, L.V. "Accounting in Accordance with the Rules and not the Facts - a study of Accounting in Russia". In *Perspectives on Performance Measurement and Public Sector Accounting*, E. Buschor and K. Schedler, eds. Berne: Haupt, 1994.

Gray, S.J. and Roberts, C.B. *Information Disclosure Policy by* 1986*Multinational Corporations*, paper presented to the AAA Annual Meeting, New York, August, 1996.

Haskins, M.E., Ferris, K.R. and Selling, T.I. *International Financial Reporting and Analysis - A Contextual Emphasis.* Chicago: Irwin, 1996.

Jones, R.H. Review of Accounting Innovation Municipal Corporations 1835-1935. Accounting and Business Research 1996; Winter.

Jones, R.H. and Pendlebury, M. Uniformity v. Flexibility in the Published Accounts of Local Authorities. Accounting and Business Research 1982; Spring.

Layton, J. *Code of Practice on Local Authority Accounting for Great Britain - Review of Current Practice in England and Wales*, CIPFA, 1992.

Mueller, G.G., Gernon, H. and Meek, G.K. *Accounting an International Perspective, 4th ed.* Chicago: Irwin, 1997.

Nobes, C. and Parker, R.H. *Comparative International Accounting, 4th ed.* London: Prentice Hall, 1995.

Parker, R.H. "Importing and Exporting Accounting: the British Experience." In *International Pressures For Accounting Change,* Hopwood, A.G. ed. Prentice Hall, 1989.

Parkes, J. *Capital Accounting the Way Forward*, CIPFA, 1988.

Phang, S.N. *The Aftermath of Local Government Restructuring in West Malaysia, The Experience of the Penang Island and Klang Municipalities,* Ph.D. Thesis. ILGS, University of Birmingham, 1985.

Tayib, M. *A Comparative Study of Voluntary Information Disclosures of Multinational Companies between the UK and the United States,* a Master degree dissertation submitted to Glasgow University, 1987.

Tayib, M. *Pengurusan dan Penyediaan Penyata Kewangan Pihakberkuasa Tempatan,* unpublished research report, 1994.

Tayib, M. *The determinants of local tax collection for Malaysian local authorities,* PhD working paper, 1997.

5

TRENDS AND OPEN ISSUES IN GOVERNMENTAL ACCOUNTING SYSTEMS: SOME ELEMENTS OF COMPARISON

Eugenio Caperchione

INTRODUCTION

In the leading market economy countries, the scope of action of public administration is becoming increasingly multifarious and complex. There are manifold indicators in this sense: a steady growth in the volume of resources gathered and consumed, the extension of interventions to various different areas of need, the high number of public employees, and many more.

However, the quantitative growth of public intervention is not always flanked by high quality results, whether they be economic results or social impact results. Proof is that the proposals to modify and improve the functionality of public institutions are being put forward at a faster and faster rate, and are the object of political and scientific discussion in all Western countries (Metcalfe, 1988; Metcalfe and Richards, 1990; Osborne and Gaebler, 1992).

The accounting-information system is one of the most frequently used tools to renew public administration and make it more efficient. This is due to numerous reasons, which are largely plausible. First of all, it is common belief that accounting should be one of the key business management tools in periods of scarcity of resources. On the other hand, there is a widespread search for ways to orientate the behaviour of public management towards the pursuit of efficiency and efficacy. In the lack of market stimuli – which are often non-existent in the public sector – the preparation and disclosure of reliable financial statements, that account for the results attained by a public entity and their underlying reasons, and that can be the object of cross and time comparisons, is conceived as a "surrogate" for the market, a means to put managers and administrators under the typical strains of competitive systems (Ellwood, 1994).

As a consequence, several countries have recently made many an attempt to innovate their governmental accounting systems. In principle, however, these attempts are mostly bitty and independent of one another (even though they share some interesting elements).

This is due to many reasons, all of which can be traced to the fact that national administration systems have developed in different ways in different countries for political and historical reasons – and so have the national accounting systems, that are very dissimilar from one another.

The relative autonomy of country-systems does however run the risk of being inadequate at the present time, for a number of reasons that are largely illustrated in recent literature: the globalisation of economies, the integration of geographic areas (the European area being fundamental due to the creation of a single market and of the monetary union), the outward opening of public systems, including the opening to the suggestions and experiences coming from other countries.

At the same time, the changes to the environmental frameworks and the ever-growing communication opportunities are generating highly converging innovations in the various accounting systems, that could lead to a significant harmonisation of all of these systems within a short time. This could be a positive outcome, provided that harmonisation is not attained in the wake of an "advertising campaign" led by some pressure groups that make cunning use of communication – but rather as the result of an in-depth examination of the pros and cons of different options. In other words, there could be the risk that only partially innovative experiences are put forward as revolutionary, thus limiting the scope of any further debates.

In order to reduce this risk, it is necessary that those in charge of governmental accounting in the various countries try to anticipate some possible evolution patterns, by identifying trends and preparing either to conform to them (if these are agreed with or deemed inevitable) or to oppose them with strong arguments (if these are judged inadequate to the history, needs and peculiarities of one's own country).

From another perspective, the analysis of foreign experiences and the study of their successes and failures allows each individual country to find useful elements to adequately plan any reforms to its accounting system (Nobes and Parker, 1991).

This paper aims at analysing the state of the art of governmental accounting systems in some market economy countries. The guide-lines of the reforms implemented or under discussion in the leading countries are consequently presented and commented, some degree of uniformity is pointed out, and the main trends (and their related application issues) of governmental accounting systems are identified.

From a methodological perspective, the observations made here are based on the analysis of reference material and original documents.

The paper begins by defining precisely the meaning that is attributed to the term "accounting" in the course of the paper itself.

The reasons behind innovation in the accounting field are subsequently discussed and some innovations actually implemented in various countries are reviewed, in order to pinpoint the results achieved, as well as the main trends and uniform patterns of behaviour.

The last section deals with some open issues, and some conclusions are put forward.

INNOVATIONS IN GOVERNMENTAL ACCOUNTING SYSTEMS

The reasons behind innovation

The evolution currently underway in the accounting systems of various countries is generally aimed at re-qualifying accounting-information systems, by rendering them more coherent with the new role taken on by governments in modern societies (Borgonovi, 1994).

This objective is pursued by trying to act on the various steps comprising the accounting system, that are:

- *budgeting*, that concerns the rules to decide what actions are to be implemented and how to finance them, within public administration;
- *book-keeping*, that deals with the rules and practices concerned with keeping an accurate record of the sums of money that are spent and received;
- *financial reporting*, on the basis of which decisions are taken on what documents carrying economic, financial and capital results are to be drawn up and made available, with what format, how to disclose them and who they should be addressed to, and what the general public should be informed of.

Moreover, these elements, which are the typical components of governmental accounting, are flanked by auditing and performance evaluation systems, which are also used as a change tool in many countries. The auditing system concerns the mechanisms to control, monitor, certify and examine the management of public entities. The performance evaluation system concerns, instead, the collection and dissemination of information on the actual results of public action, both in terms of the volume of services delivered and in terms of final outcomes (satisfaction of user needs).

The governmental accounting system of one specific country (or of one specific government level in that country) is the result of how the above-mentioned sub-systems are organised and integrated (Caperchione, 1995). It is thus clear that a comparative analysis cannot be limited to the simple verification of what countries have applied accrual accounting to public entities (with more or less an immediate effect).

In actual fact, in order to fully describe a governmental accounting system from both a static and a dynamic perspective, it is necessary to re-trace the choices made by every country with regard to each single sub-system of governmental accounting, thereby using a complex analysis grid (Chan, 1996). The first results stemming from the use of this research tool are at the basis of the conclusions drawn at the end of this paper.

We now move on to examine the reasons behind the reforms of the accounting systems. Evidently, the reforms of governmental accounting in each country are the result of the present greater awareness of the limits of "traditional" accounting systems. In fact, despite the already mentioned peculiarity of the various national systems that have historically developed in different countries, they however share some common problems:

- short-sightedness of the systems. The time horizon of accounting systems, and more specifically of financial reports, only covers the short term, while no reliable information on the impact of policies in the medium to long term is available;
- poor readability of financial statements and consequent difficulty in assessing results. Some governmental accounting systems date back to periods when the sensitivity to some values, such as the citizens' right to information, was not strongly felt. Every change in this respect entails a lever to introduce different ways to prepare and present financial information, that best respect the citizens' sovereignty and their "right to know" (GASB, 1987, § 56);
- difficulty in assessing intergenerational equity. The incapacity to determine the value of assets and liabilities and to recognise expenses and revenues on the accrual basis" as well as the often immoderate resort to borrowing as a source of income – also favoured by cash basis accounting systems – makes it impossible to assess whether a generation is living "within its means" (Anthony, 1983) or it is consuming resources it is not producing. This situation is by itself an incentive to "non-economic" behaviour, that is "disrespectful for the balance between generations" (Lueder et al., 1991a, p.68, 262-263);
- poor "usefulness for decision-making purposes" of the information generated by the accounting systems. In the majority of the systems

adopted so far, financial resources are allocated to the various organisational units or expense centres of each public entity through the budget, according to a pre-defined framework. Since, due to formal control reasons, this framework cannot be overridden all through the following book-keeping and reporting stages, it takes on a predominant role in the administration system of the public entity. Consequently, the output of the accounting system does not include the production of periodic reports that are organised on the basis of different frameworks, autonomously decided by each single entity and linked to actual management processes (for instance, costs by service unit, costs by project).

It should also be noted that the awareness of the limits of the system is not a sufficient condition for change – for change to take place, many more circumstances must combine together that, on the whole, make a given country-system ready to introduce innovations to its accounting system (Lueder, 1992).

Among the significant causes leading to the reforms examined in this paper, it is obviously worth remembering all the global reform projects of institutional frameworks and public administration procedures that have recently been implemented by various countries and that, in most cases, automatically entail the need to re-think the accounting system in order to make it suitable and functional for the new institutional model (Schedler, 1996; Pallot, 1997).

In brief, whatever the basic, underlying reasons behind the innovation process, every reform meets a certain vision of the information needs of some specific categories of users of financial statements. Similarly to what happened in business accounting, the paradigm of *user needs* is thus implemented.

This approach entails a substantial modification to the way governmental accounting is now conceived. This means that it should no longer simply hold the function of accounting for and showing the "compliance with budgetary and other legal limitations", as there are various individual and group stakeholders that require the information they need in order to make evaluations and take circumstantial decisions.

A working example of this way of operating can lie in the activity carried out by the GASB, *Governmental Accounting Standard Board*, a non-profit organisation that is responsible for establishing accounting and reporting standards valid for all local and state governments in the United States. The GASB (1987, §§ 31-32) defines a list of users and draws up a list of information needs.

However, the reference to the information needs of the users of financial statements is in many cases too generic, and risks begging the question, inasmuch as it is not possible to define a clear hierarchy of the various categories of users so that – not knowing exactly what to privilege – the purposes ascribed to governmental accounting grow out of all proportion: provide managers with information, put the elected representatives of citizens (MPs, Town Councils) in a condition to take conscious decisions, allow the central government to make controls, favour the consolidation of governmental accounts, communicate information to the citizens, allow investors to make evaluations, show accountability towards tax-payers, favour the comparison among entities within the same country, make assessments on the existence of chain effects among generations, and many more.

This does not necessarily take place in every country; on the contrary, there are different priorities and different nuances in every different country. Nonetheless, the study of the documents that illustrate the reforms seems to highlight a number of purposes that are ascribed to the accounting system, all of which should then find an answer in accrual accounting, i.e. the necessary and sufficient means to build an accounting system capable of meeting user needs. Managing to satisfy manifold and diversified needs by means of one single system only, is not very simple at all, and does not comply with the rule "one goal – one tool" (Borgonovi, 1984; GASB, 1997, § 160). Thus, there remains a basic problem, shared by many innovation attempts, and consisting in the fact that an accounting system cannot possibly meet widely divergent information needs at the same time.

On the other hand, the paradigm of user needs is not widely acknowledged. On the contrary, it is the object of some criticism due to its poor empirical foundation, that has led many different organisations (in similar situations) to define different ideal sets of accounting information (Nobes, 1988, p. 200; Jones, 1992).

Uniform features of recent reforms

Before moving on to consider the main innovation paths followed by various countries, it is necessary to make a premise. The examination of different national cases can include many levels of government (central or federal government, regions-states or other entities with legislative autonomy, town councils and so on). However, the observation of the various national contexts cannot homogeneously concern one single and definite level of government. This is due to the fact that the analysis carried out mainly aims at describing the different national contexts and at grasping the dynamic elements within each one of them, rather than comparing horizontally the accounting systems. Consequently, attention is focussed on the level of government that is currently most exposed to evolution thrusts within every single national system.

Undeniably, there is a progressive shift towards accrual accounting. Belgium, France, Spain, Italy, the United Kingdom, New Zealand and other countries that are not mentioned here, have already switched to accrual basis (or are about to do so) at one level of government at least.

The difference lies in the timing of implementation. Some countries introduced the system longer ago, they have already experimented and refined it, and now have consolidated the change. Other countries are only at the beginning of a new process or have simply given life to a hybrid system, in which *cash accounting* and *accrual accounting* coexist.

However, the relatively high number of shifts from cash accounting systems to accrual accounting systems should not be misleading. There are still many countries where the reforms haven't yet affected this issue and no substantial changes are to be expected in the short run.

This is particularly true of large countries. In Germany, for instance, there is a lively debate underway, also following some interesting experiments (Lueder et al., 1991b for the regional level; Lueder et al.,1998 and Lueder, 1999 for the local level), but the introduction of accrual accounting is still a long way off. The same can be said of Japan, except for the measurement of the economic performance of services organised as business companies or semi-business companies (Yoshida, 1994). The situation is even more static (apart from a few exceptions) in the former socialist countries, in Africa (Godfrey et al., 1996), in South America and Asia.

Moreover, the persistence of cash accounting systems is coherent with the observations of those who maintain that there are neither theoretical arguments nor empirical evidence for the usefulness of a generalised shift to accrual accounting, in both developed and developing countries. According to Nobes (1988, p. 203), "simple, uniform cash-based systems might be more effective than elaborate, judgemental, accruals system" in developing countries.

On the other hand, even the institutions that openly support the supremacy of accrual accounting, indirectly recognise that other accounting systems still have some reasons to exist. An example is given by the IFAC (1998) that leaves room for various accounting systems, in the belief that a radical change cannot be forecasted in the short run for some specific situations.

As already stated in the foreword, there is some growing uniformity of policies among the countries that are making an effort to modernise governmental accounting. In particular, the following guide-lines can be pinpointed:

A. introduction of accrual-based accounting systems;
B. modification of the policies and tools to disclose economic and financial performance;
C. introduction of tools to assess actual performance, i.e. the impact on consumer needs, and to adequately disclose it to the various stakeholders (performance evaluation and measures of *Service and Effort Accomplishment*);
D. setting up of a corpus of national accounting standards.

Each of these guide-lines entails some relevant issues.

A. As regards the first item, it should be noted that:

- reference to the accrual-basis accounting standard opens the way to a variety of accounting systems, that can be classified according to their degree of compliance with the standard itself. In this regard, the expressions *full accrual basis* and *modified accrual basis* are adopted. The second phrase refers to a simplified system, in which expenses for tangible assets are recognised in the same accounting period in which these are actually purchased. However, as a consequence of this simplification that reduces the information value of the system, the prevailing trend is to adopt full accrual accounting systems;
- only in some of the most advanced government levels has the shift to accrual accounting led to the production of all of the documents that are generally deemed essential to provide an informative framework – statement of financial position, statement of financial performance, statement of cash-flows and notes to the financial statements;

accrual basis accounting does not necessarily apply to all the activities carried out by a public entity, which are specifically sub-divided into three categories: governmental-type activities, commercial-type activities and fiduciary-type activities (GASB, 1990). In various countries, there are many drives to limit the scope of accrual accounting only to "production services" (that is, the second category), for which it is deemed more immediately useful.

This innovation was not however achieved without any problems, the main ones being:

1. the need to flank the adoption of the *accrual* system with an overall modernisation of public management culture, and some regulations to rule governmental systems;
2. the costs of the system;
3. the reference to cash for appropriations;
4. the need for behavioural homogeneity and for comparability among different entities.

The first point shouldn't need any further discussion. It is obvious that performance information and accrual-based measures are not enough to modify the behaviour of public managers, and that figures alone cannot always and anyhow account for all events. They must be studied, understood and interpreted, which is only feasible in the presence of a suitable management culture. Moreover, it should be noted that any accounting reforms – to be fully effective – require clear and explicit rules to cover deficits and use up any surplus (Lueder, 1996, p. 33), as well as some performance-related funding systems for local entities (see Christiaens hereunder).

As for costs, there is no doubt that the shift to accrual systems requires long implementation times and considerable investments, that should also lead to identifying the property and other assets of each entity and determining their carrying amounts, training the staff of both administrative and other operative units, and setting up a dedicated software. In the face of these costs, the benefit is obviously not immediate, nor can it be taken for granted. This is the reason why some countries prefer to switch gradually to the new system, only after having duly tried it out (Laurent et al., 1995). For this same reason, the adoption of simplified systems for smaller entities is also highly frequent.

The third problem area concerns the choice, made by virtually all countries, to maintain cash as a reference for appropriations, at least in the early reform stage. This choice is explained by the need to strictly control the expense flows, due to their impact on the levels of taxation and the national debt. This however entails the co-existence of values in the accounting-information system of an entity, that refer to heterogeneous accounting policies (cash basis for budget documents and accrual basis for period reports), which generates many a problem in the quality of information. Given the authorising value of budget estimates, there also remains an incentive to use all appropriated resources, which plays down the role of accrual-based reports (Wildavsky, 1984; US GAO, 1987; Jones-Pendlebury, 1992, p. 155).

The fourth category of problems stems from the effort to make the performance of various entities comparable, also through the pre-definition of frameworks of compulsory accounts and the establishment of uniform accounting standards, which should moreover further behavioural homogeneity. This systems standardization, especially if it is enforced from the top without previously gathering the suggestions of the entities involved and without evaluating their implementation capacity, might damage the achievement of a *true and fair view*. For instance, the impossibility to define specific depreciation rates for various goods, or the limitations to the recognition of risk funds, diminish the quality of the information that can be drawn from financial statements. So the possibility of comparing data is only formally ensured, but loses relevance if only little relevant data are compared.[1]

B. We now move on to the second homogeneity feature, that consists in the modification of the policies and tools to disclose economic and financial performance. The following can be noted:

- it is evident that the mere production of traditional balance documents is not sufficient by itself to guarantee that these are read, understandable and useful. On the one hand, reports must be made clear and intelligible and they must satisfy the information needs of potential users; on the other hand, suitable disclosure tools must be employed in order to actually reach the users of reference;
- there are many scientific contributions in this sense, both from scholars and from official organisations, that illustrate the key characteristics of quality reporting. For instance, the CIPFA, Chartered Institute of Public Finance and Accounting, that awards a prize to the best financial statement of British public entities every year, puts forward a series of suggestions about good presentation, with regard to the usefulness of reports, their readability and some other essential issues – the results should not be construed to defend anybody's work, they should address real information needs and be timely, their cost should be related to the type of use (Likiermann, 1989, p. 27; Carpenter and Sharp, 1993);

  in order to ensure high quality reporting, a useful investment can lie in having financial reports audited, and devoting energies and resources to the preparation of accompanying notes that give actual explanations, as in the *Financial Statement of the Government of New Zealand*.

As far as disclosure policies are concerned, it should be emphasised that the financial statements of public entities tend to be read by experts only, that is professionals who have to deal with governmental accounting, and communication experts. The idea that citizens read the financial statement of their (local or higher-level) entity is not supported by empirical findings. They found their judgement on more directly visible phenomena (the good or bad quality of services, their accessibility, taxation levels). Whenever they actually need to know economic data, they look for ways to obtain concise information (Patton, 1992, p. 174; Högheim and Monsen, 1994, p. 15; Brusca Alijarde, 1997).

C. As regards the third item on the list (measurement of output and outcome), it should be noted that:

- the experiences of data collection, elaboration and dissemination on the overall performance of public entities are on the steady increase. When accounting adds a new function to its traditional function of authorisation and measurement of income and expenditure, i.e. it also acts as a support tool to the formulation of assessments on the quality of administrative actions, it is advisable to appreciate the impact of services delivered on consumer needs, that is actual performance;
- the growing awareness of this need leads to a situation in which the production of information on *performance* cannot be considered "optional" any longer. The GASB, for instance, by applying the concept of *accountability*, deems the co-existence of output measures and outcome measures to be indispensable – SEA, *Service Efforts and Accomplishments* – for the *General purpose external financial reporting* (GASB, 1994; see also GAO, 1998);
- nonetheless, the emphasis on the importance of this approach does not enjoy unanimous consent. In particular, the weakness of the theory of reference is pointed out and, in the end, the relevance and usefulness of the performance measures thus gathered are deemed quite modest (Jones, 1994).

D. As far as the fourth item on the list is concerned, it should be noted that the need for a corpus of accounting standards in support of book-keeping and reporting has already emerged several times in the various countries, in order to reduce to the utmost the subjectivity and discretionary power of preparers of financial statements and to limit the possibility of adopting window dressing policies. The existence and use of standards also favours the time and cross comparisons of summary reports.

As a rule, these standards include:

- a *conceptual framework*, that illustrates the purposes of the accounting system and sets out some underlying assumptions and general concepts (Montesinos-Vela, 1994, p. 398);
- book-keeping and measurement standards specific to the various classes of transactions (Pina, 1994).

As for the contents, they are largely drawn from business accounting, although there still remain some specific cases in which the transposition of concepts or rules is not feasible. The different institutional nature between public entities and business enterprises determines some considerable differences, especially with regard to how transactions are recorded, rather than to the conceptual framework.

An example of this can be made with regard to the concept of prudence, that has already been widely discussed as far as the financial statements of business enterprises are concerned, but that heralds possible inconsistency if dogmatically applied to local entities. Just think of an administration board that – in compliance with the prudence principle as elaborated by the Italian book-keeping doctrine – does not report part or all of the assessed but uncollected taxes in the financial statements of the periods to which they relate on an accrual basis. Such behaviour could make it difficult to perceive the fiscal pressure actually exerted upon taxpayers, which would reduce the overall informative value of financial statements.

Variance areas between business enterprises and local entities are even more evident if attention is focussed on the transaction classes typical of public entities, for which it is obviously impossible to use business accounting standards. This occurs both when expenses and revenues are recorded (for instance, grants received, aids and subsidies granted, tax assessment and collection, infliction of penalties, fines and other money duties) and when certain goods to be entered in the balance sheet must be assessed (military equipment, natural resources such as forests, lakes and natural goods, art collections, national heritage, diplomatic residences, roads and bridges, and many more) (see Mussari hereunder).

Another important element in the study of accounting standards is the process by which they are set out. In particular, the following distinctions are interesting:

- publication (i) edited by bodies of the Central Government or by institutions that however derive their authority from the central government, or (ii) devolved to the associations of professional accountants or of local entities, that is those who have to apply the accounting standards;
- top-down intervention by a decision-making élite, or (ii) preliminary implementation of a formal, wide-ranging consultancy process (the typical role of *Exposure drafts*).

From the point of view of legal validity, the standards (i) can be made compulsory or, more simply, (ii) their adoption can be suggested and advised.

The choice between the different alternatives formulated so far, is obviously influenced in a significant manner by the national legal system of each country. In particular, type (i) situations prevail in the countries where the legal system is derived from Roman law, whereas type (ii) situations are typical of the countries where the legal system is based on common law.

CONCLUSIONS

The study of recent innovations, their underlying motivations and uniform elements, that has been carried out in the central part of this paper, allows us to draw some conclusions, in the aim of both summarising some of the considerations made so far, thereby also making some final appraisals, and of drawing attention to some open issues and ongoing trends.

The very first conclusion concerns accrual basis accounting. The analysis of the various experiences highlights a powerful thrust towards the adoption of this system, both at central government levels and at regional and local government levels.

Consequently, the governments of a large number of countries are already preparing – or about to do so – the same documents used in the financial statements of business enterprises. Some countries are also beginning to define "accrual-based budgets", in order to get round the problems outlined in the foregoing paragraphs.

A second issue of the utmost importance concerns the relationships with both citizens and other stakeholders. It is now believed indispensable to activate communication and disclosure policies, aimed at providing clear and simple information on the financial position, performance and changes in financial position of public entities. Within the scope of these initiatives, extra information on the degree of service and effort accomplishment is also frequently disclosed, so that appraisals of the end effects of administrative actions can be made (see for instance the town councils of New Zealand).

The third consideration is linked to the processes adopted to implement innovations. The following can be pinpointed:

- different paths in every country. In some countries in particular, central government played a key role in perceiving the new need for information, in identifying the most suited tools to meet this need, and in decreeing that it was an obligation of all public entities to comply with the procedures and tools thus defined. In other countries, the initiative was taken at a local level or, at least, local governments were allowed to experiment, to suggest feasible solutions, to decide some issues concerning the timing and modalities of adaptation to the new accounting system;
- different paths within each single country at various levels of government. In some countries, modernisation affected first the local level, whereas in other countries the time priority was that of central government. However, a highly important issue lies in the dissemination of innovations that, once successfully implemented in one sector, are usually replicated in other sectors, at times with just a few adaptations. Hence, one of the effects of the first reform is the disruption of equilibrium.

The observations made so far show that the majority of countries are moving in the direction of a growing homogeneity of business and governmental accounting systems (Monsen, 1994, p. 301; Gilling, 1994; Mariel, 1997). This is no negligible consequence of governmental accounting reforms. The progressive narrowing of differences between the accounting policies used by public entities and those typical of business enterprises will make it easier – judged in perspective – for employees to move from the private sector to the public sector and vice versa, thus changing the labour market of this profession. Training paths are also destined to change, as they should allow people to be able to work in both the public and private sectors.

This greater homogeneity is fostered, in some cases, by the progressive loss of formal significance attributed to governmental accounting, that is reduced back to its function as a support tool to decision-making.

We can now move on to pinpoint some areas of intervention and discussion, that have already been addressed by studies on international accounting, and that are currently in the forefront of comparative governmental accounting: (i) international accounting standards and (ii) the harmonisation of accounting systems.

As for the first issue, the promulgation of international accounting standards meets the same needs we have discussed in regard to national standards – obviously enough, at a higher level. In particular, the existence of standards that are uniformly applied in a number of countries, could reduce the existing obstacles to the cross comparability of the performance of different public entities.

Some first attempts to promulgate international accounting standards have already been made, and others are currently underway. A prime example is given by the action carried out by the IFAC - Public Sector Committee, that has issued a series of documents since 1991 that are a useful reference grid for further in-depth studies.

There still remains a great deal of uncertainty about the organisations that will be called upon to set out international standards, about the process that will be followed, and about the actual legal validity of standards. Moreover, it is highly likely that there will be many key players, as there are many interests at stake. In particular, it is legitimate to expect that both national & supranational government organisations (the Governments of the leading countries and/or the EU Commission) and private organisations (typically, the expression of professional accountancy boards) will be working on the attainment of this objective. No need to say that the debate that will be conducted in the near future on how to set out the standards, will only apparently be linked to technical issues. The establishment of regulations with international validity is a typical field in which linguistic, cultural and professional lobbies exert their influence in order to expand their spheres of action (Jones, 1998).

The issue of harmonisation (Nobes-Parker, 1991, p. 70) features some interesting points of contact with the issue of standards. A series of circumstances, which are briefly outlined below, modify the information needs of various interested parties. The best way to meet these needs lies in the harmonisation of accounting systems, that is the adoption of homogeneous systems in their underlying assumptions, type and format of compulsory documents, contents of the elements of financial statements, length and expiry of accounting periods, and measurement bases.

The following are some of the events and circumstances that have caused the need for harmonisation:

- the growth of international capital markets, on which today the public institutions of a large number of countries are listed or about to be listed. The existence of very dissimilar accounting systems makes the choices of investors and rating agencies difficult, as they must incur high expenses in order to evaluate the reliability of borrowers;
- the fact that international organisations, such as the World Bank, the International Monetary Fund, and the European Investment Bank, grant loans to national governments and public institutions. It is thus necessary that the risks attached to the loans portfolios can be evaluated with sufficient reliability and in a simple manner, also in order to justify any differences in the treatment of various cases (Lueder and Kampmann, 1993, p. 63).

Scholars do not share all the same views on these issues. In particular, Nobes (1988, p. 204) argues that "very few (people) lend internationally to governments" (see the objections raised by Lueder and Kampmann, 1993, p. 65).

In this state of uncertainty about the feasibility of achieving worldwide harmonisation, there are many contributions aimed at supporting the chance of regional harmonisation, to be carried out through Regional Accounting Standards (Monsen, 1994) in homogeneous clusters of countries, such as the Scandinavian countries, the German-speaking countries (Brede and Buschor, 1993), Spain and Latin American countries, Australia and New Zealand.

Undoubtedly, this sort of circumscribed harmonisation is quite interesting for the member countries of the European Union. Among the factors that are frequently mentioned to support this trend, Lueder and Kampmann (1993, p. 69-78) point out:

- the information needs of citizens, who should be put in a position to be able to evaluate the *performances* of public entities belonging to nations that are strongly linked with one another;
- the need to make the accounting systems of the European Commission and of member countries more compatible. In the current situation, it is at times extremely complicated to assess the extent to which individual countries have managed to implement community policies. Harmonisation, instead, would make it easier to assess *accountability* in the relationships between the European Union and its member countries;
- the need to guarantee the good functioning of the common market;
- the possibility that, following harmonisation, more relevant values are made available to be used with a view to assessing each country's compliance with the parameters established in the Treaty of Maastricht.

Moreover, the harmonisation among member countries entails some similar efforts to be made within each country in order to narrow the differences among the accounting systems of various government levels.

If the thrusts towards EU harmonisation become powerful, some alternative modalities to pursue harmonisation will have to be compared: promulgation of a new EU directive, harmonisation through multilateral talks among member countries, setting up of an *ad hoc* independent body.

At the end of this paper, we think it useful to provide readers with a few brief comments on the issue of the introduction of accrual accounting.

As already stated, the shift of accounting systems from a cash basis to an accrual basis is put forward by many as a source of innovation, or better, as innovation itself, and is thus deemed absolutely positive (Monsen and Nasi, 1998).

However, there are no indisputable elements nor objective findings to sustain that accrual accounting actually improves information that is useful in making economic decisions and, consequently, the performance of public entities. Very little empirical research has been carried out so far on the actual impact and role played by the change to the accounting system on the quality of information and of the decisions taken by public entities.

This may be due to various reasons (difficulty in measuring the change, too limited historical series, a bias towards the innovations introduced that makes such survey superfluous), but it certainly hinders the formulation of a detailed appraisal, so this is an open research field.

Broadly speaking, the decision to switch to accrual accounting is at times taken without much intensive debate, also because this issue might seem of little interest at first sight for those who don't have to deal with accountancy. On the contrary, the consequences of the reform are of the utmost importance, and the flaws of traditional governmental accounting systems are not enough to justify the behaviour of those who seek an answer to every need for information and fair management in accrual basis.

As many scholars emphasise, the accounting systems of both private businesses and governments cannot be planned without considering their specific institutional frameworks and purposes (Oettle, 1987, p. 282). No accounting system enjoys universal validity, as accountancy always holds an instrumental function, it is a means to an end. Therefore, whenever the critical success factors of an organisation change, different bases of accounting may become necessary (Mouritsen and Bekke, 1997).

Furthermore, as far as the introduction of accrual accounting systems is concerned, there are a few problems related to the usefulness of experimentation. The lack of trials is a potential factor of weakness, whilst a period of voluntary adoption of the new system favours its tuning, and a gradual shift makes the task easier for the public entities that have to conform.

Finally, the fact cannot be overlooked that the more contextual the modernisation of accountancy is to the overall modernisation of the entire public administration of a country, the more meaning and vigour it acquires. Whenever it is reduced to mere technicality, it hardly ever produces the expected results. The potential usefulness of new information cannot be taken for granted, nor can its actual implementation in evaluation and decision-making processes. On the contrary, the reform of the accounting system is a process of change that should be managed carefully for the reform to become a governance tool of local governments.

NOTES

[1] From this point of view, the French reform is certainly noteworthy. Depreciation rates (and thus the forecasted economic life of a good) are independently fixed by Town Councils, that can consult a reference table prepared by the Ministry. Different rates for single goods included in the same category can also be established. On this issue, see Ministère de l'Economie (1997), p. 31. However, at least one drawback to the correct recognition of values can be found in the French instance, too, as only renewable goods can be depreciated.

REFERENCES

Anthony, R.N. *Tell it like it was: a conceptual framework for financial accounting.* Irwin: Richard D., 1983.

Borgonovi, E. *Accounting, legitimisation, consensus.* Paper presented to the 17th congress of the European Accounting Association, Venice, Italy, 6-8 April 1994.

_______, "Il sistema contabile negli istituti pubblici: caratteristiche, valutazioni, prospettive". In *Studi e ricerche della Facoltà di Economia e Commercio dell'Università degli Studi di Parma*, n. 17, Bologna: Pàtron, 1984.
Brede, H., and Buschor E. eds., *Das neue oeffentliche Rechungswesen*, Schriften zur oeffentlichen Verwaltung und oeffentlichen Wirtschaft, Band 133, Baden-Baden: Nomos, 1993.
Brusca Alijarde, M.I. The usefulness of financial reporting in Spanish local government. Financial Accountability and Management 1997; 13, 1.
Caperchione, E. "La finalizzazione al controllo della spesa nei diversi sistemi di contabilità pubblica". In *Il controllo della spesa pubblica*, E. Borgonovi ed. Milano: EGEA, 1995.
Carpenter, F.H. and Sharp, C.F. *Popular reporting: local government financial reports to the citizenry*, Norwalk, 1993.
Chan, J.L. "Characterizing a Nation's Governmental Accounting System". In *Recent developments in CIGAR*, K. Lueder ed. Speyer: Forschungsinstitut, 1996.
Chan, J.L. and Jones, R.H. eds. *Governmental Accounting and Auditing: International Comparisons*. London: Routledge, 1988.
Ellwood, S. "Pricing healthcare under "managed competition": the role of cost accounting in the UK National Health Service". In *Perspectives on performance measurement and Public sector accounting*, E. Buschor and K. Schedler eds. Bern: Paul Haupt, 1994.
General Accounting Office, *Managing for Results: The Statutory Framework for Performance-Based Management and Accountability*, 1998.
Governmental Accounting Standard Board, *Objectives of Financial Reporting*, 1987.
_______, *Service Efforts and Accomplishments Reporting*, 1994.
_______, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments – Exposure draft*, 1997.
_______, *Measurement Focus and Basis of Accounting -Governmental Fund Operating Statements*, 1990.
Gilling, D.M. "The New Zealand public sector accounting revolution". In *Perspectives on performance measurement and Public sector accounting*, E. Buschor and K. Schedler eds. Bern: Paul Haupt, 1994.
Godfrey, A.D., Devlin P.J. and Merrouche C. "Governmental accounting in East Africa". In *Recent developments in CIGAR*, K. Lueder ed. Speyer: Forschungsinstitut, 1996.
Hogheim, S. and Monsen, N. *On the application of different methods in municipal accounting research*. Paper presented to the 17th congress of the European Accounting Association, Venice, Italy, 6-8 April 1994.
IFAC - Public Sector Committee, *Guideline for Governmental Financial Reporting. Exposure Draft*, New York: IFAC, 1998.
Jones, R.H. The development of conceptual frameworks of accounting for the Public sector. Financial Accountability and Management 1992; 8, 4.
_______, "An indictment of performance measurement in the public sector." In *Perspectives on performance measurement and Public sector accounting*, E. Buschor and K. Schedler eds. Bern: Paul Haupt, 1994.
_______, *Building another tower of Babel: the diffusion of GAAPs*. Paper presented at a Conference on "The evolution of accounting in the second half of the 20th century", Lodz, 1998.
Jones, R.H. and Pendlebury M. *Public sector accounting, 3rd ed.* London: Pitman, 1992.
Laurent, P., *La M14. Enjeux et mise en oeuvre*. Paris: Editions Sormans, 1995.
Likiermann, A. "Financial reporting in the public sector". In *Public sector accounting*, London: Int. Van Nostrand Reinhold, 1989.
Lueder, K. *Finanzieller Jahresbericht fuer das Land Nordrhein-Westfalen (Prototyp)*, Speyer, 1991.
_______, "A contingency model of governmental accounting innovations in the political-administrative environment". In *Research in Governmental and Nonprofit Accounting*, vol. 7, Greenwich, Co.: JAI Press, 1992.
_______, *Konzeptionelle Grundlagen des Neuen Kommunalen Recchnungswesens (Speyerer Verfahren)*, Stuttgart: Staatsanzeiger fuer Baden-Wuerttemberg, 1999.
Lueder, K., Hinzmann, C., Kampmann, B. and Otte, R. *Vergleichende Analyse oeffentlicher Rechnungssysteme. Konzeptionelle Grundlagen fur das staatliche Rechnungswesen mit besonderer Berucksichtigung der Bundesrepublik Deutschland*, Speyerer Forschungsberichte, n. 97, Speyer: Forschungsinstitut, 1991.

Lueder, K. and Kampmann B. *Harmonisierung des oeffentlichen Rechnungswesens in der Europaeischen Gemeinschaft*, Speyerer Forschungsberichte, nr. 125, Speyer: Forschungsinstitut, 1993.

Lueder, K., Behm C. and Cordes U. *Praxiseinfuehrung des Neuen Kommunalen Rechnungswesens (Speyerer-Verfahren)*, Stuttgart: Staatsanzeiger fuer Baden-Wuerttemberg, 1998.

Mariel, P. *Modernization of the budgetary and accounting system of French communes*. Paper presented to the 6th CIGAR Conference, Milan, Italy, 1997.

Metcalfe, L. Un management pubblico responsabile: un punto di vista dalla Gran Bretagna. Azienda Pubblica 1988; 1.

Metcalfe, L. and Richards S. *Improving public management*, London: Sage, 1990.

Ministère de l'Economie et des Finances, *Instruction budgétaire et comptable M. 14*, Paris: J.O. de la République Française, 1997.

Monsen, N. "Regional accounting harmonization. A case for regional accounting standards". In *Perspectives on performance measurement and Public sector accounting*, E. Buschor and K. Schedler eds. Bern: Paul Haupt, 1994.

Monsen, N. and Näsi S. The contingency model of Governmental Accounting Innovations, a discussion. European Accounting Review 1988.

Montesinos, V. and Vela Bargues J.M. "Performance measurement in the public sector: some implications of spanish accounting regulation". In *Perspectives on performance measurement and Public sector accounting*, E. Buschor and K. Schedler eds. Bern: Paul Haupt, 1994.

Mouritsen, J. and Bekke A. Continuity and Discontinuity in Accounting Technology in Danish State Institutions. Financial Accountability and Management 1997.

Mussari, R. *Italian local government accounting reform: an application of professor Lueder's contingency model.* Paper presented to the 5th CIGAR Conference, Paris, France, 1995.

Nobes, C. "An historical-comparative perspective of governmental accounting". In *Governmental Accounting and Auditing: International Comparisons*, J.L. Chan and R. Jones eds., London: Routledge, 1988.

Nobes, C. and Parker R. eds. *Comparative international accounting. Third edition*, London: Prentice Hall, 1991.

Oettle, K. "Moeglichkeiten und Grenzen der Uebertragung des kaufmaennisches Rechnungswesens auf oeffentliche Verwaltungen". In *Doppik und Kameralistik*, P. Eichhorn ed., Baden-Baden: Nomos, 1987.

Osborne, D. and Gaebler T. *Reinventing Government: how the enterpreneurial spirit is transforming the public sector*, Reading, 1992.

Pallot, J. *"Newer than new" Public Management: financial management and collective strategizing in New Zealand*, 1997.

Patton, J.M. Accountability and Governmental financial reporting. Financial Accountability and Management 1992; 8, 3.

Pina, V. "Recent developments and usefulness of the Spanish Public Sector accounting system". In *Perspectives on performance measurement and Public sector accounting*, E. Buschor and K. Schedler eds. Bern: Paul Haupt, 1994.

Schedler, K. "Governmental accounting innovations at the Cantonal level in Switzerland: experimenting with the New Public Management". In *Recent developments in CIGAR*, K. Lueder ed. Speyer: Forschungsinstitut, 1996.

US G.A.O. *Current status and recent trends of State biennial and annual budgeting*, Washington D.C.: 1987.

Wildavsky, A. *The politics of the budgetary process, 4. ed.*, Boston: Little, Brown & Co., 1984.

Yoshida, H. "An overview of Japanese Governmental accounting". In *Perspectives on performance measurement and Public sector accounting*, E. Buschor and K. Schedler eds. Bern: Paul Haupt, 1994.

6

LOCAL GOVERNMENT ACCOUNTING IN EUROPE: A COMPARATIVE APPROACH

José Manuel Vela and Iluminada Fuertes

INTRODUCTION

During the nineties, many European countries introduced significant reforms in their governmental accounting systems that from an overall perspective follow a clear orientation: the introduction of more informative and business-oriented accounting systems. These reforms, that in most cases are still in progress, follow very different patterns and purposes in administrative environments characterised by heterogeneity.

Heterogeneity is perhaps one of the main features that also defines the present situation of Local Government Accounting Systems in Europe. These systems are indeed diverse and, in spite of the reforms introduced, the idea of a possible convergence in their final configuration and informative dimension seems to be a utopia. This diversity reinforces the need for comparative analysis of local governmental accounting systems in order to identify the differences and similarities that these systems present and also the environmental variables that can explain or justify them. Such an analysis is certainly difficult because it requires, from a contingency perspective, deep knowledge of the politico-administrative environments of the different countries. Knowledge is obviously influenced by subjective considerations and cultural conditions that are always present in any potential researcher interested in this field. But the comparative analysis of local governmental accounting systems is also difficult because the analysis of their informative dimensions requires a descriptive approach that evidences the need to define those elements in the structure of each system that are relevant for comparative purposes. A definition or even a consensus on the definition of these elements is thus needed.

The purpose of this paper, divided into two parts, is to bring forth some methodological considerations about comparative analysis of local governmental accounting systems in Europe. The first part of the paper presents, from an analytical point of view, a contingency analysis of the main elements that can be used to establish comparisons between countries, obviously based on politico-administrative environmental conditions that favour the introduction of accounting reforms at a local level. The second part of the paper, mainly descriptive, tries to identify the features of the European local government accounting systems that can better sustain, according to the authors, the implementation of comparative studies. Special attention is given to the relationship between budgetary and financial accounting systems.

COMPARATIVE ANALYSIS OF THE POLITICO-ADMINISTRATIVE ENVIRONMENT OF LOCAL GOVERNMENTAL ACCOUNTING SYSTEMS IN EUROPE: THE CONTINGENCY PERSPECTIVE

The use of professor Lüder's Contingency Model in comparative governmental accounting research can be considered, in the field of international governmental accounting, as a paradigm. If we review governmental accounting literature from the early nineties we find, from a methodological point of view, that the use of the contingency model has inspired a significant research effort oriented in two main directions:

a) The analysis of existing governmental accounting systems in some countries or sectors as in (Chan, 1994), (Mäder & Schedler, 1994), (Pallot 1995), (Godfrey et al. 1995) (Mussari, 1995) and (Bergamaschi, 1995).
b) The critical analysis of the model itself (Chan 1992), (Lüder 1994a) or (Jaruga, Nowak and Dixon, 1995).

In its early steps, CIGAR started with the publication of several studies referred to different countries (Chan & Jones, 1988), with a clear descriptive orientation (Bowsher, 1987), (Lüder, 1988), (Jaruga, 1988), (Jones & Pendlebury 1988). This orientation was very useful to know how governmental accounting systems were diverging at that time, and also to appreciate how different or similar they were. These studies evidenced the convenience and interest to develop further research in International Governmental accounting. But a comparative analysis was still difficult to carry out, considering above all that these studies still lacked a uniform framework and structure useful for the establishment of comparisons.

This uniform framework useful for comparative studies was built later by professor Lüder, as a consequence of several country studies (Lüder et al. 1989) that allowed the design of the contingency model (Lüder, 1992) and its further revision (Lüder, 1994a). Its usefulness for comparative studies is evident if we consider two main facts:

a) The model allows the establishment of an analytical and consistent framework for country studies. It builds up causal relationships that, in spite of their probabilistic nature, presumably explain and even predict the introduction of accounting reforms.
b) This analytical framework is useful for comparative studies because it allows the introduction of other variables not specifically defined that can be relevant according to their explanatory dimension.

The model, in its early and revised versions, was designed to be applied to different countries without distinguishing the administrative level to be considered. This is why it can be used at Central, Local or Regional levels. From our point of view, the application of the contingency model for comparative studies in the field of local governmental accounting systems in Europe, requires the introduction of several assumptions that we think are worth considering and that are mainly related to:

a) The consideration of the influence of business accounting as a stimulus.
b) The influence of social variables in the innovation process.
c) The influence of administrative variables in the innovation process.

The influence of business accounting as a stimulus

The influence of business accounting has acted as an important stimulus in many of the innovation processes that have been developed in the field of local governmental accounting in many European countries. Spain (Montesinos & Vela, 1996, p. 233) is perhaps one of the best examples if we consider the accounting principles applied, and also the fact that the Chart of Accounts that municipalities use is based on the 1973 Chart for business entities (Vela, 1996a, p. 211). This business influence is also clear at a local level in other countries such as Switzerland (Mäder & Schedler, 1994, p. 347), France (Mariel & Moraud, 1994, p. 14), Sweden (Alserud, 1992, p. 14.) and Belgium (Bouckaert, 1991).

The assumption that business accounting influences local government accounting as a stimulus on innovation processes at a local level in a considerable number of European countries is clear, even if the way in which this influence occurs is perhaps different. In Britain, for example, a country where professional standards coexist at a local level with legal accounting regulations, the importance of the accounting profession (Lapsley 1994, p.99) has certainly helped to diffuse business accounting influence. However, in other countries like France and above all Spain, this business influence arrived through a chart of accounts inspired by previous experiences developed for business entities. From our point of view, in both countries, recent reforms evidence that new accounting regulations have been issued with a clear orientation: emphasis on the similarities between governmental and business accounting rather than on the differences between them. The influence of this stimulus made it possible to avoid any negative impact of an implementation barrier that was formerly present in both countries: a legal system that traditionally gave major importance to budget and legal control in the accounting information systems of municipalities.

This business accounting influence should perhaps be considered as an important stimulus in many European local governments, even stronger than financial scandals. And the question whether or not this business influence actually exists as well as how it is transmitted can offer interesting comparative opportunities.

But there is also another important point to discuss: this business accounting influence seems clearer in most countries at a local level rather than at a central level. This is certainly for example the case of Britain, France and even Germany. And again, the reasons seem very different. In the British case, this fact can be explained because professional influence at a central government level is not so important as at a local level. In the French case, the important decentralization process that we will analyse later is perhaps the reason. And in Germany, business accounting influence seems to be the result of the differences between the accounting systems of the municipal core sectors (cash based) of a great number of municipalities and a municipal peripheral sector of satellite organisations - that has been growing in recent years - using a business accounting system (Lüder 1995, p. 13). These differences, as well as the growing importance of peripheral organisations, have stressed the need to shift the accounting systems of the core sector towards the business orientation of the peripheral one.

The influence of social variables

Our main assumption here is that in most European countries, and especially at a local level, the influence of social variables in accounting innovation processes is not very important, and that, perhaps, its role in the contingency model should be reconsidered.

This assumption needs an important clarification. The weak influence of social variables is explained by the environmental characteristics present in most European countries rather than by the particular configuration of European Local Governments.

If we consider previous studies where the contingency model has been applied, social structural variables seem to have a rather weak influence on European countries, with the exception of Poland, Switzerland and Germany (as shown on table 1). These studies are the following:

Germany (D)	(Lüder, 1995)
Canada (CAN)	(Lüder et al. 1989)
Denmark (DK)	(Lüder et al. 1989)
Unites States (USA)	(Chan, 1994)
United States (USA)	(Lüder et al. 1989)
France (F)	(Lüder et al. 1989)
Italy (IT)	(Mussari, 1995) and (Lüder & Kampmann, 1992)
Japan (JPN)	(Yoshida, 1992) and (Lüder & Kampmann, 1992)
Kenya (KEN)	(Godfrey et al., 1995)
New Zealand (NZL)	(Pallot, 1995 a)
Poland (POL)	(Jaruga, Nowak & Dixon 1995)
United Kingdom (UK)	(Lüder et al., 1989)
Sweden (SWE)	(Lüder et al., 1989)
Switzerland (CH)	(Mäder & Schedler, 1994)
Tanzania (TAN	(Godfrey et al. 1995)
Uganda (UGA)	(Godfrey et al. 1995)

Obviously, these studies were developed by different researchers and refer to different years. Anyway, the weak influence of social variables can be explained if we consider two main facts:

a) In most European countries, the influence of capital markets at a local level is very weak, or even absent as in Spain. Moreover, Spanish municipalities are mainly financed by taxes and grants and do not usually issue bonds.
b) Pressure Groups, organised as in Anglo-Saxon countries - for example the Citizens Budget Commission (Green, 1987, p. 191) in New York- are not important.

As we have already stated, some exceptions can be pinpointed. Germany is a country were social structural variables seem to have at present a positive impact at a local level, especially in the cases of commercial interests and of organised pressure groups (Lüder, 1995, p. 15). This is also true of Poland (Jaruga, Nowak & Dixon, 1995) and Switzerland (Mäder & Schedler, p. 351). On the contrary, these variables have a significant influence in the USA (Lüder, 1994a, p. 4) and in other Anglo-Saxon countries like, for instance, New Zealand (Pallot, 1995). Furthermore, in the less developed countries where the model has been applied (Godfrey et al, 1995), their influence also seems to be important.

The weak influence of social variables in most European countries offers, once again, valuable comparative research opportunities, especially in the field of empirical studies that have not yet been developed. These studies are of course

***Table 1.** Contingency Model - Influence of environmental conditions on governmental accounting innovations.*

Country	Stimuli	Social Vbles.	Political Vbles.	Admin. Vbles.	Implem. Barriers	Overall Assessment
Germany	+	+	-	-	-	UNFAVORABLE
Canada	+	--	+	+	+	FAVORABLE
Switzerland	+	+	+	-	-	FAVORABLE
Denmark	+	--	+	+	+	FAVORABLE
USA(Fed.)	+	+	+	+	-	FAVORABLE
USA (Sts.)	+	+	+	+	+	FAVORABLE
France	-	--	-	-	-	UNFAVORABLE
Italy	+	--	-	-	-	UNFAVORABLE
Japan	-	--	-	-	-	UNFAVORABLE
Kenya	-	+	-	-	-	UNFAVORABLE
New Zealand	+	+	+	+	+	FAVORABLE
Poland	+	+	+	+	-	FAVORABLE
UK	+	--	-	-	+	UNFAVORABLE
Sweden	+	--	+	+	+	FAVORABLE
Tanzania	+	+	+	-	-	FAVORABLE
Uganda	-	+	-	-	-	UNFAVORABLE
Spain	+	--	+	+	+	FAVORABLE

important if we consider that the influence of social variables is difficult to typify and that its effect on innovations needs to be tested empirically.

However, the application of Lüder's Contingency Model at the level of local authorities in Europe would certainly allow, according to table 1, the classification of favourable politico-administrative environments based on the positive influence of social variables (Switzerland and Poland) or with a clear politico-administrative orientation (Denmark, Spain and Sweden). Unfavourable environments should also be classified in the same way, according to the positive or negative influence of stimuli and the configuration of implementation barriers.

The influence of administrative variables

As we have already said, our assumption in the case of social variables was due to the environment of most European countries and not to the nature of individual local governments. In the case of administrative variables, the situation is different.

The influence of administrative variables offers, at a local level, excellent comparative opportunities. From our point of view, all the variables considered in the model are relevant at a local level, especially the **organizational characteristics** and the **standards setting organization.** But we also consider another variable in this category, not specifically typified for an application of the model exclusively at a local level, that also has a significant impact: the existence of an administrative decentralization process that affects financial relationships between Central and Local Government levels.

Organizational characteristics at a local level are important and can explain why accounting innovations have been introduced. Many countries, like Spain, France (Adans & Moraud, 1994, p. 41), Belgium (Bouckaert,1991, pp. 10-12) and Germany (Lüder 1994b, pp. 69-70), have decentralised their local organisation through the creation of satellite organisations such as autonomous bodies or local enterprises. This has stressed the need to unify accounting systems adopting business-oriented solutions. This unification, or harmonization, is certainly the first step towards the consolidation of the financial statements of all municipal organizations. The setting of accounting standards regarding the consolidation of municipal reports appears today as a significant element of what we should consider as an "informative accounting system". This municipal consolidation, with some exceptions as perhaps in Sweden (Mellemvik & Monsen, 1995, pp. 193-198), lacks today in the vast majority of European Countries adequate standards to be generally practised. This is the case of Norway, where no consolidation standards exist, or even Denmark where, in spite of some guidelines that were issued by the Kommunernes Revisionsafdeling in 1992, consolidation is not widely practised yet.

In Spain, no such standards have been issued yet and municipal consolidation is seldom practised (only at budget level and not in all municipalities). In France, as a consequence of the financial stress of some cities with a growing peripheral sector, and following the enforcement of the law of 6th February 1992 (Administration Territoriale de la République -ATR-), the situation seems rather favourable. In fact, some cities, like Orléans, have made considerable improvements (Adans & Moraud, 1994, p.45), even if this consolidation is once again not compulsory as in Spain. A similar case was identified in the Netherlands, where the new rules issued in 1995 offer the possibility of voluntary consolidation by third-party entities (Bac, 1996, p. 249).

The standards setting organization is another administrative variable that can explain a lot of differences. Britain is the only country where professional influence seems to be important or at least stronger than in other European countries. In these countries, accounting and budgeting regulations are set by law (Italy, Belgium, Spain, France and Germany). But in these countries the situation is not uniform. From our point of view, three models of accounting standards setting organization can be distinguished considering the administrative relationships between Central and Local Governments:

a) The TOP-DOWN model. Accounting standards and regulations are applied first at the Central Level and then extended to the local level. Under this model, Central Government has strong control over the accounting standards process and issues rules for both regional and local levels. This is clearly the case of Spain, where local authorities have followed the accounting solutions that were first introduced at central government level. The reform of the local government accounting system was inspired by and even a consequence of the reform of the central government accounting system. Belgium is perhaps a similar case, considering the creation of a Commission for Governmental Accounting in 1993 whose goals are to implement the use, at all administrative levels, of a uniform Chart of Accounts (Norverto et al., 1995, p. 383). Also in Portugal, the governmental accounting reforms affected first the Central Government level rather than the local one (Requena & Carrasco, 1995, p. 383).

The countries that follow this model usually develop global innovation processes at a local level. A global innovation process affects the local governmental sector as a whole, while the reforms introduced are applied or imposed to all local authorities by a change in legislation. A good example of such an innovation process is the Spanish one, clearly enforced by the top-down approach that has inspired all governmental accounting reforms in this country. This innovation process is usually developed by a change in the legislation and usually affects financial accounting without modifying or introducing management accounting systems. Also France has followed a similar direction with the M-14 Instruction and all previous decentralization laws, even though we prefer to include France in the third model due to the importance of these laws.

The consideration of global innovation processes leads also to distinguishing another category of processes: the selective one. The selective innovation process, which is not developed by a legislative change, is not directed to Local Government as a whole, and is inspired by managerial orientation implemented through the development of pilot projects. A clear example is Germany, where a number of pilot projects with different cities have been initiated (Lüder, 1994b, pp. 77-78) either by the cities themselves or by independent bodies such as the Bertelsmann Foundation. This innovation process does not require a deep change in accounting and budgetary legislation, even if it is possible to predict that the results of pilot projects can favour such a change. This is certainly the situation of the region of Baden-Württemberg that "has launched a pilot project with a middle-sized city on double entry, full accrual accounting and budgeting which is aimed at gaining experience with this kind of budgeting and accounting in local government" (Lüder, 1995, p. 14.).

Even if France has followed a global innovation process, a selective orientation has also been present in the reforms, especially considering that the M-14 Instruction - before being put into force in 1997 - was previously experimented in twenty cities from 1994 onwards (Laurent & Puyo, 1994, p. 25). However, this selective experimentation took place as a consequence of the change in the law, and not, as in Germany, with no significant changes to the law.

From our point of view, selective innovation processes, and especially the German one, are particularly interesting from a contingency perspective because they enforce a singular relationship between the dependent variable and the independent variables of the contingency model (Vela, 1996b). This relationship could be defined as a feedback effect from the accounting system on the politico-administrative environment (as considered for example in Jaruga, Nowak & Dixon, 1995, p. 3). The German local government accounting innovation process evidences a clear example of this kind of relationship, considering that the project developed in the region of Baden-Württemberg "ought to serve as a basis for pertinent adaptations of the Municipal Budgetary Acts". (Lüder, 1995, p. 14.)

b) The BOTTON-UP model. This is the model followed by the countries that introduce the reforms first at a local level, and maintain budget-oriented accounting systems at the Central Level. The question whether or not the reforms introduced at a local level are diffused to upper levels of Government is certainly difficult to predict. This is clearly the Swedish case, where reforms to the structure of final accounts were introduced at a local level and later became a model for Central Government too (Moreno, 1995, p. 361)

c) The TOP-DOWN decentralised model. This is the model in the countries where Central Government also controls the standards setting process for local authorities, but where important decentralization processes have facilitated the reform of local government accounting systems rather than that of Central Government. This is certainly the case of France (Mariel & Moraud, 1994, p. 15), the Netherlands (Fernández & Pablos, 1995, p. 285), and Italy where the decentralization process has also been important and where the reforms seem to have been introduced at a local level first (Mussari, 1995, p. 5).

The **decentralization process** appears as an important variable to explain how administrative environments affect accounting innovations in European local authorities. Comparative studies in this field should also consider the level of competencies that are transferred to local authorities, their financing systems and the way accounting systems adapt themselves to this decentralization atmosphere that over the last few years has dominated many countries. Spain has also developed an important decentralization process but its effects have not been so important at a local level, especially considering that Regional Governments created in the late seventies have received a significant amount of resources and competencies that in other countries have been shifted to local governments.

COMPARATIVE ANALYSIS OF LOCAL GOVERNMENTAL ACCOUNTING SYSTEMS IN EUROPE: A DESCRIPTIVE APPROACH

The contingency model explains and defines the relationship between independent variables (social, political and administrative) and a dependent variable, i.e. the introduction of more informative accounting systems. This issue certainly needs further clarification and the adoption of a descriptive approach in order to characterise and define more specifically the dependent variable, and to explain the elements or variables that define an "accounting system" and its "informative dimension". The model has not yet fully developed these variables nor has it defined what an informative system is.

Over the last few years, some comparative studies of local governmental accounting in selected European countries have been developed using a basically descriptive methodology for Denmark, Norway and Sweden (Mellemvik & Monsen, 1995), for France, Italy and Spain (Demeestère, 1995), and for Germany, United Kingdom, France and Spain (Vela, 1996b). Just like during the early steps of CIGAR, these descriptive studies too have no common structure that helps to establish comparisons, that from our point of view still have to be defined.

We can perhaps conclude that the uniform analytical framework that the contingency model defines should also be available for descriptive studies of governmental accounting systems.

These descriptive studies should be based on a list of items or categories relevant for the definition of any accounting system. A clear attempt in this direction has fortunately already been undertaken (Chan, Jones & Lüder, 1996, p. 18) with the identification of five main suggested items that should constitute and characterise a National Governmental Accounting System:

Objectives

Accounting Recognition and Measurement

Financial Reporting

Contents of Financial Reports

Information Dissemination.

From our point of view, there is one feature not explicitly included in the above list that should be stressed when defining the Accounting Recognition and Measurement item, i.e. the relationship between budgetary and financial accounting information. The definition of measurement focus and basis of accounting is of course important in characterising an accounting system. It defines "what" is recognised and "when" (Vela, 1996b). But from our point of view, and especially at a local level in countries like Spain, France, Sweden and Belgium, this analysis can be completed by answering another simple question related to the relationship between budgetary and financial accounting information in the system: "where are events or transactions recognised?".

This question may seem at first sight simple. But the analysis of the systems in several European countries at local government level evidences that four alternative solutions or models are possible:

a) The accounting system is limited to the recording of budgetary transactions.

In this sense, financial accounting is mainly budgetary, and presumably only the transactions that affect the budget are recorded. This is certainly the case of Germany and Portugal (Requena & Carrasco, 1995).

b) The budgetary system is linked to the accounting system and influenced by accounting rules.

This is the case of the M-14 reform in France, that has introduced accruals in the budget and even recognition, in the budget too, of a charge for depreciation of certain assets (Mariel & Moraud, 1994). This reform is oriented towards the creation of a unique budgetary and accounting framework (Demeestère, 1994, p. 11).

c) The budgetary system and the financial accounting system are linked but budgetary rules are different from accounting rules.

Spain presents a solution that links budgeting and accounting, however in a single system that allows the development of both processes even if they have different rules and bases of accounting (modified cash in the budget and accrual basis in financial accounting). Consequently, depreciation is only recognised in financial accounting, and not in the budget. Belgium also adopts dual orientation in its Chart of Accounts with a system of imputation of operations to the budget or the financial accounting system (Norverto et al, 1995, p. 87). The Swedish Chart also presents a dual solution with specific accounts that allow an accrual process to be carried out at the end of the year (Moreno, 1995, p. 342).

The Spanish case is certainly peculiar. Budgetary and financial accounting systems use different measurement focuses and bases of accounting because their reporting objectives are clearly different. While the first one is built for legal accountability purposes (to determine the budget execution figures for control purposes and to calculate the budgetary deficit/surplus of the year), the second one is concerned with the determination of financial and patrimonial positions according to the true and fair view philosophy and the determination of the economic result on an accrual basis.

In fact, the budgetary system measures revenues and expenditures recognising them when all the administrative acts legally prescribed have been carried out. This system uses a "flow of current financial resources focus" and accrues expenditures and revenues only if this condition is satisfied. This legal prescription mainly implies that receivables and payables are recorded, and that some expenditures and revenues are consequently accrued, but at budget level legal provisions prescribe whether a revenue or expenditure can be recognised, rather than General Accounting Principles. This recognition system can be defined as a modified cash basis.

On the contrary, an accrual basis is used to calculate the economic result of the year by comparing costs and revenues recorded through classes 6 and 7 in the Chart of Accounts. For this calculation, the focus is on costs and not on expenditure (Flow of economic resources). This means, for example, that the depreciation of fixed assets is recorded and incorporated in the calculation of the economic result (excluding depreciation on infrastructure assets that is not recorded because they are not reported on the balance sheet), even if it has no incidence in the budgetary deficit/surplus.

d) Budgeting and Financial Accounting are two different and independent processes.

This is the case of the United Kingdom, that over the last few years has developed a significant reform of its local patrimonial accounting system with new standards for depreciation and the adoption of current values for a great number of assets (except for infrastructures).

It is important to note that the items, described in Chan, Jones and Lüder's suggestions, can also be used to characterise local governmental accounting systems in Europe, and favour possible classification criteria among systems and even the use of morphologies, following a similar orientation as in other studies developed in the field of business accounting (Nobes & Parker, 1995, p. 65).

Morphological classifications in the field of governmental accounting have not yet been fully implemented due to perhaps the problems encountered in defining relevant factors to develop them and to the high level of heterogeneity among systems and even among local authorities in one single country (as for example in Britain). Anyway, a possible morphological classification could be based on factors such as:

1. Type of environment (based on the influence of social variables). Weak/Strong
2. Professional influence on governmental accounting regulations. Low/High
3. Basis of Accounting. Cash/Full Accrual
4. Reporting of fixed assets. Only Monetary/All Assets and Infrastructure assets
5. Accounting Entity. Single entity/Fund Accounting
6. Budget influence on the accounting system. Weak/Strong
7. Conceptual Framework. Not defined/Fully defined
8. Consolidation. Not Practised/Fully Practised
9. Uniformity of accounting rules and records. Chart of Accounts/Flexibility
10. Business influence. Low/High
11. Performance Indicators in Financial Reports. No/Yes

We have to insist that this type of morphological classification is subject to a lot of criticism and is always subjective and limited to the knowledge of each country's system. But this classification[1] can offer two main conclusions in the case of European local authorities that we think deserve discussion.

a) The British system is rather different to the systems adopted on the continent.
b) Some European countries present a rather advanced "informative system" at a local level. This is the case of Sweden, Switzerland, Spain and presumably France after the M-14 reform.

4. CONCLUSION

This paper has attempted to bring forth some methodological considerations on the comparative analysis of governmental accounting systems in European countries. Our main assumption is that this comparative analysis should adopt an analytical approach based on the contingency methodology that has inspired the contingency model, but should also include a descriptive orientation based on accounting systems and their informative dimension. The objectives of these systems, recognition and measurement (with an emphasis on the relationship between budgetary and accounting systems), financial reporting, contents of financial reports and information dissemination can of course be used as descriptive comparative bases to develop such an orientation.

The present situation of local government accounting in Europe evidences a high degree of heterogeneity. Differences among municipal organizations, in accounting standards setting organizations and even in accounting systems, evidence that any comparability or harmonization of local governmental accounting systems is difficult to achieve. Anyway, this should be a long term goal that the European Union should pursue and that perhaps ought to start with the implementation of a convergence process of central government accounting systems. This process has been developed at a business accounting level ever since the seventies and has offered at this level, to date, clear encouraging results. We don't find objective reasons to argue that a harmonization process of National Governments in Europe is not justifiable or convenient in the European Union.

But one fact is clear. CIGAR appears to date as a good initiative that can help to design harmonization strategies in the European Union at a governmental accounting level. Differences and similarities among accounting systems are more and more studied and consequently better known. Moreover, a contingency perspective of the stimuli, variables and implementation barriers that a hypothetical harmonization process can present offers a clear opportunity for further research efforts. This is why the comparative analysis of local, central and even regional accounting systems will continue in the future attracting debates and a great deal of attention in an environment where diversity justifies comparative studies.

NOTES

[1] This classification has been developed in the context of a research project that is still in an intermediate phase, and whose interim results are only available in Spanish and not yet published.

REFERENCES

Adans, B. and & Moraud, J.C. Les enjeux de la consolidation des comptes locaux. Revue Française de Finances Publiques 1994; 47: 39-47.

Alserud, I. Municipal Accounting in Sweden. Public Finance and Accountancy 1992; 8 May: 14-15.

Bac, A. "Local Government Accounting Reforms in the Netherlands". In *Research in Governmental and Non-profit Accounting,* Chan, J. and & Lüder, K. eds. Greenwhich Connecticut: JAI Press, Vol. 9, 1996, pp. 239-257.

Bergamaschi, M. *Evolution of Accounting systems in the European public healthcare sector: can we adopt a Contingency Model.* Paper presented to the 5th Biennial CIGAR Conference. Cour de Comptes, INTEC. Paris.

Bouckaert, G. Municipal Accounting in Belgium. Public Finance and Accountancy 1991; 12 April: 10-12.

Bowsher, Ch.A. Federal Financial Management: evolution, challenges and the role of Accounting Profession. Journal of Accountancy 1987; May: 280-294.

Buschor, E. & Schedler, K. eds. *Perspectives on Performance Measurement and Public Sector Accounting.* Bern: Haupt, 1994.

Chan, J.L. Methodological Individualism and comparative international governmental accounting research. CIGAR Workshop. Norwegian School of Economics and Business Administration. Bergen, May 1992.

_______ "Accounting and Financial Management Reform in the United states Government: an application of professor Lüder's Contingency model". In *Perspectives on Performance Measurement and Public Sector Accounting,* E. Buschor. & K. Schedler eds. Bern: Haupt, pp. 17-42. 1994.

Chan, J.L. & Jones, R. eds. *Governmental Accounting and Auditing. International Comparisons.* London and New York: Routledge, 1988.

Chan, J.L. & Patton, J.M. eds. *Research in Governmental and Nonprofit Accounting.* Greenwich, Connecticut: Jai Press, Vol 7, 1992.

Chan, J.L. Jones, R. & Lüder, K. eds. *Research in Governmental and Nonprofit Accounting.* Greenwhich Connecticut: Jai Press, Vol. 9, 1996.

Demeestère, R. La Comptabilité Communale: évolutions et perspectives. Revue Française de Finances Publiques 1994; 47: 7-12.

_______, *L'organisation des systèmes comptables, budgétaires et de controle financier des villes. Une comparaison internationale. Ministère de l'Equipement. Plan Urbain.* Paris: ESSEC, Décembre, 1995.

Fernández, J.M. & Pablos, J.L. "La Contabilidad Pública en Holanda". In *La Contabilidad Pública en algunos paises de la OCDE.* Madrid: IGAE, Ministerio de Economía y Hacienda, 1995

Green, C.B. "The use and usefulness of Governmental Financial Reports: the perspective of citizen-taxpayer organizations". In *Research in Governmental and Nonprofit Accounting,* J.L. Chan, ed. Greenwich, Connectitud: Jai Press, Vol. 3, part B, 1987, pp. 189-213.

Godfrey, A.D. Devlin, P.J. & Merrouche, Ch. *The contingency model and east Africa. Towards a critique.* Paper presented to the 5th Biennial CIGAR Conference. Cour de Comptes, Paris: INTEC, 1995.

Jaruga, A. "Governmental Accounting, Auditing and Financial Reporting in East European Nations". In *Governmental Accounting and Auditing. International Comparisons.* J.L. Chan & R. Jones, eds. London and New York: Routledge, 1988, pp. 105-121.

Jaruga, A. Nowak, W. & Dixon, R. *Lüder's Contingency Theory Complex adaptative systems and the reshaping of governmental accounting: towards an integrated model.* Paper presented to the 5th Biennial CIGAR Conference. Cour de Comptes, Paris: INTEC. 1995.

Jones, R. & Pendlebury, M. "Governmental Accounting, Auditing and Financial Reporting in the United Kingdom". In *Governmental Accounting and Auditing: International Comparisons.* J.L. Chan & R. Jones, eds. London & New York: Routledge, 1988, pp. 105-121.

Lapsley, I. La Comptabilité Publique Locale en Grande Bretagne. Revue Française de Finances Publiques 1994; 47: 81-104.

Lüder, K. "Governmental Accounting in West European Countries: with a special reference to the Federal Republic of Germany". In *Governmental Accounting and Auditing. International Comparisons.* J.L. Chan & R. Jones, eds. London and New York: Routledge, 1988, pp. 82-104.

_______, "A contingency model of Governmental accounting innovations in the political-administrative environment". In *Research in Governmental and Nonprofit Accounting.* J.L Chan. & J. M Patton, eds. Greenwhich, Connecticut: Jai Press, Vol 7, 1992.

_______, "The Contingency Model reconsidered. Experiences from Italy, Japan and Spain". In *Perspectives on Performance Measurement and Public Sector Accounting.* E. Buschor & K. Schedler, eds. Bern: Haupt, 1994a, pp. 1-16.

_______, La comptabilité Publique Locale en Allemagne. Revue Française de Finances Publiques 1994b; 47:69-79.

_______, *Comparative Governmental Accounting in an International Context with special reference to the Federal Republic of Germany.* Paper presented to the seminar "El control de los recursos públicos en una sociedad democrática". Universidad Internacional Menéndez Pelayo. Valencia, October, 1995.

Lüder, K. et al. *Comparative Government Accounting Study- Interim Summary Report, Revised Edition.* Speyer: Speyerer Forschungsberichte N° 76, 1989.

Lüder, K. & Kampmann, B. Vergleichende Analyse offentlicher Rechnungssysteme-Länderberichte, Bd. 7: Italien, Speyer: Speyerer Forschungsberichte, n° 73, 1992.

Mäder, H. & Schedler, K. "Performance Measurement in the Swiss Public Sector-ready for take-off!". In *Perspectives on Performance Measurement and Public Sector Accounting,* E. Buschor & K. Schedler, eds. Bern: Haupt, 1994, pp. 345-364.

Mariel, P.L. & Moraud, J.C. La modernisation de la Comptabilité Communale. Revue Française de Finances Publiques 1994; 47: 13-24.

Mellemvik, F. & Monsen, N. "Local Governmental Accounting in Denmark, Norway and Sweden: a comparative study of consolidation issues". In *International Research in Public Sector Accounting, Reporting and Auditing,* V. Montesinos & J.M. Vela, eds. Valencia: Instituto Valenciano de Investigaciones Económicas, 1995, pp.185-206.

Montesinos, V. & Vela, J.M. "Governmental Accounting in Spain: evolution and reforms". In *Research in Governmental and Nonprofit Accounting,* J.L Chan, R. Jones & K. Lüder, eds. Greenwhich Connecticut: Jai Press, Vol. 9, 1996, pp. 219-238.

_______, eds. *International Research in Public Sector Accounting, Reporting and Auditing.* Valencia: Instituto Valenciano de Investigaciones Económicas, 1995.

Moreno, J.M. La Contabilidad Pública en Suecia. In *La Contabilidad Pública en algunos países de la OCDE.* Intervención General de la Administración del Estado, Madrid,1995.

Mussari, R. *Italian Local Government Accounting Reform: an application of professor Lüder's contingency model.* Paper presented to the 5th Biennial CIGAR Conference. Cour de Comptes, Paris: INTEC. 1995.

Nobes, C. "International Classification of Financial Reporting". In *Comparative International Accounting.* C. Nobes & R. Parker, 4th edition. Englewood Cliffs: Prentice Hall International, 1995 pp. 60-74.

Nobes, C. & Parker, R. *Comparative International Accounting, 4th edition.* Englewood Cliffs: Prentice Hall International, 1995.

Norverto, C, Muñoz, C., Veuthey, E. & Zornoza, J. "La Contabilidad Pública en Bélgica". In *La Contabilidad Pública en algunos países de la OCDE.* Intervención General de la Administración del Estado, Madrid: 1995.

Pallot, J. *Contextual variables underlying innovation in National Budgeting, Accounting and Auditing: the case of New Zealand.* Paper presented to the 5th Biennial CIGAR Conference. Cour de Comptes Paris: INTEC, 1995.

Requena, J.M. & Carrasco, D. "La Contabilidad Pública en Portugal". In *La Contabilidad Pública en algunos países de la OCDE.* Intervención General de la Administración del Estado, Madrid: 1995.

Vela, J.M. Latest developments in Local Governmental Accounting in Spain. Financial Accountability and Management 1996a; August: 205-224.

_______, *A cross country study on local governmental accounting systems*. Paper presented to the 3rd. Cigar Workshop. Speyer. April, 1996b

Yoshida, H. Problematic dimensions, conventions and characteristics of governmental accounting in Japan. CIGAR Workshop. Norwegian School of Economics and Business Administration. Bergen: May, 1992

7

MUNICIPAL ACCOUNTING REFORM IN FLANDERS: AN EMPIRICAL STUDY OF THE OUTCOMES

Johan R. Christiaens

INTRODUCTION

The Belgian Non-Profit and Public Sectors have encountered a number of financial accounting changes and met with an increase in responsibility over the last ten years. There has always been a general tendency of reforming traditional cash accounting towards business-like accrual accounting. The most important examples are: Hospitals (1987), Municipalities (1990), Health Service Insurances (1990), Pension Funds (1991), Flemish Universities (1995), Flemish High Schools (1995), and Official Centres for Mutual Welfare (1997).

For Belgian government entities (i.e. municipalities) this was the first time that an accrual accounting change took place. The former accounting regulations, dating back to 1945, were based on a budgetary cash accounting system and had a primarily cameralistic approach. Currently, the legislator is also evaluating a reform for other government entities such as Secondary Schools, Provinces, Flemish Government Enterprises, the Ministry of the Flemish Community and even the Central Belgian Government.

This paper aims at presenting a general view of the empirical outcomes of the accounting reform and its merits, focusing on the Flemish municipalities and their annual accounts[1]. The subject is mainly studied from a technical-accounting point of view, although the usefulness of the new accounting output towards users is also given due importance.

After outlining the background, the objectives and the general contents of the reform, part 3 focuses on the lack of empirical research in this context of the public sector. Part 4 reveals some typical characteristics of the reform. The remainder of this paper is devoted to an empirical research on a random sample of 100 Flemish municipalities, based on their annual accounts as well as the returned questionnaires.

BACKGROUND, OBJECTIVES AND IMPORTANCE OF THE REFORM

Background

The legislator explains the reform principally as a necessary answer to the shortcomings of the traditional budgetary accounting system[2]. *Firstly*, the traditional cameralistic/cash accounting system is nowadays perceived as no longer satisfactory for several reasons, such as: the lack of a global picture, the budgetary accounting system does not provide management information, assets and liabilities are not disclosed, etc.

Secondly, the reform aims at transferring accounting and management principles and techniques as used in the profit sector. The Belgian legislator seems to be convinced that business-like accounting methods will undoubtedly lead to better management and to solving reoccurring financial difficulties. Apparently, business administration tools and techniques are assumed to be useful and transferable without any further proof.

Thirdly, the current budgetary accounting system will not be abandoned since it entails a number of advantages that cannot be denied. For example, budgetary accounting remains a means of controlling financial flows.

Objectives of the reform

The main objective of the reform was to provide information for users and interested parties in a more complete, objective and transparent way by providing financial information on assets and liabilities and by uniting the former cash accounting with accrual accounting. This was all meant to improve internal budget control/auditing, external control/auditing with specific regard to oversight bodies and citizens, and financial-economic management.

The changing role of accounting in the public sector is thus obvious: instead of being an ex-post recording of financial data and budget to date, the new financial accounting, which has been transferred from business accounting systems, aims at measuring municipal "wealth" and at improving financial management.

Description of the reform

Link Budgetary - Financial Accounting

The financial accounting system is strongly linked to the budgetary accounting system. An entry in the budgetary accounting system creates on-line a journal entry in the financial accounting system.

Apart from the automatic link between them, there is a limited number of possible entries in the financial accounting system which are not recorded in the budgetary accounting system. These unlinked accounts mainly represent non-cash items like depreciations, writing-offs, revaluations and stock mutations.

Importance

Apart from the budgetary accounting method, which is traditionally the cornerstone of a municipality, the financial accounting system has been added as a secondary, more or less "stand-alone" information system. Apparently, the financial accounting system is not a *condicio sine qua non* to manage the municipality from the point of view of the Municipal Executives. The role of the new financial accounting system does not seem to be made essential.

Increasing the extent of accounting

The new financial accounting system came into effect on 1st January 1995, whereas the budgetary accounting system has basically remained unchanged as shown in Figure 1.

PREVIOUSLY	CURRENTLY
BUDGETARY ACCOUNTING	**BUDGETARY ACCOUNTING + FINANCIAL ACCOUNTING**
Output: * BUDGET * BUDGETARY ACCOUNT	* IDEM * IDEM + * ANNUAL ACCOUNTS - Balance Sheet - Profit/Loss Account - Notes
Bases of accounting: * CAMERALISTIC/CASH (single entry)	* IDEM + * ACCRUAL (double entry)
Target: * CONTROL TOOL	* IDEM + * PATRIMONIAL VIEW; * MANAGEMENT TOOL; * USER NEEDS

Figure 1 Budgetary versus Budgetary + Financial Accounting

RESEARCH OBJECTIVES

Objectives

Inevitably, the current accounting reform that seems to have met with apparently poor and inhomogeneous adoption, raises the following important field research questions:

RQ1 ***Have municipalities complied with the reformed accounting regulations on financial reporting?***[3]

RQ2 ***What are the major areas (problems and differences) of non-compliance (if any) in municipality accounting practices?***

RQ3 ***To what extent are the reformed municipal annual accounts comparable?***

This paper attempts to examine how the changed regulations are adopted in practice, whether this implementation leads to conformity and compliance with the requirements, whether any disparities between municipalities occur, and finally whether the outcomes are comparable. This paper tries to present a preliminary appraisal of the effectiveness and the merits of the accounting reform in Flemish municipalities. It focuses on the compliance with this reform since all the merits depend upon the exact implementation.

Previous empirical research

In the *accounting practice research* empirical governmental accounting studies mainly reveal:
- the reforms are often an accounting change from cameralistic / cash accounting systems to accrual accounting inspired by business accounting practices;
- the existence of differing accounting techniques (*"cash"*, *"modified accrual"*, *"full accrual"*, *"encumbrance accounting"*;
- strong heterogeneity and topical differences in accounting practices and disclosure;

(GASB: Jones et al. 1985, CICA 1980 and CICA 1985 for American and Canadian States and local governments; Faber & de Jong 1988 for The Netherlands).

Studies concentrating on the compliance of governmental accounting practices with accounting regulations revealed a rather poor conformity of accounting practices to the extant professional and statutory requirements for local authorities in England and Wales. Local authorities appear to follow the letter, but published information is of limited value to citizens. (Jones & Pendlebury ABR 1982, Chandler & Cook FAM 1986; Jones & Pendlebury FAM 1991). The comparability of the annual accounts is weak due to gaps in the regulations or to non-compliance (Jones & Pendlebury ABR 1982; Faber & de Jong 1988; Jones & Pendlebury FAM 1991).

Attempting to explain the varying compliance rates across entities is the subject of a number of explanatory, causal studies. Most important examples primarily concern US governments: Zimmerman (JAR 1977); Ingram attempted to explain cross-sectional differences in disclosure of US States by economic/political incentives (JAR 1984) by means of a *"disclosure index"* which measured the technical extent of disclosure of accounting practices. This approach has been replicated in other studies: for US municipalities (Robbins & Austin JAR 1986; Giroux JAPP 1989; Cheng JAPP 1992; Allen & Sanders FAM 1994); using a *"compound index"* (Ingram & DeJong JAPP 1987).

User need research is a second important research area looking at the use and usefulness of the accounting output. For Scottish local authorities Collins, Keenan & Lapsley (1992) found that there was only a limited to moderate understanding of the accounting information and a weak perceived importance of annual accounts. Internal users prefer managerial budgetary information. In The Netherlands Faber & de Jong (1988) were interested in the usefulness of the changes to regulations within the scope of the size of the municipalities. Their research revealed a lack of disclosure of performance indicators.

TECHNICAL, CONCEPTUAL CHARACTERISTICS

The new accounting system is strongly inspired by business accounting. The applied conceptual framework is intended as almost a copy of business accounting without actually having examined the appropriateness. However, the traditional budgetary system has not been abandoned. On the contrary: in several ways budgetary accounting is dominating the new financial accounting system although the two systems have different targets.

Supremacy of traditional budgetary accounting

Recognition of costs

Due to the technical link between the two accounting systems incurred costs are posted in the general ledger in financial accounting only if they are being charged to budgetary accounting.

Written off amounts

Regarding debtors, stocks, accounts payable and other current assets, written off amounts are never charged to the P/L account before their final run-off. For example, doubtful accounts receivable can indeed be recorded as a separate asset, but without any estimated charge to P/L before the run-off is legitimated by the according piece of evidence. This piece of evidence has an external origin or is due to an internal decision to give up the account.

Double counting loan redemption

The payment of loan redemption is recorded in budgetary accounting as expenditure. At the same time this redemption is also charged to the P/L account due to the automatic link with the financial accounting system. Since the payment of the redemption is never a cost, an adjusting journal entry has to be made using a revenue account of the kind of non-cash revenue for the same amount. This unusual method is similar for loans receivable. It is a technical inadequacy that affects financial ratios.

Recognition of bank loans

Instead of being entered as contingencies (rights) in the Notes, loan facilities or credit lines are recorded as a current asset with respect to the account creditors: falling due after more than one year.

Disclosure cash at bank and in hand

Due to certain traditions and to the imposed balance sheet model, balances of cash at hand and in bank should always be disclosed on the asset-side of the balance sheet, even if credit balances occur.

Provisions for risks and charges

The accounting legislation defines this item as budgets set aside for risks and charges which might influence the capital and reserves in forthcoming years. Their funding depends on the availability of financial means. This definition is driven by budgetary accounting decisions and not by financial accounting reality.

Accruals/deferrals: conflict

The accrual/deferral accounts defined as accrued charges, accrued income, deferred charges and deferred income are very important in a patrimonial accounting system in order to cut off more correctly the earned vs. the non-earned P/L. However, these accounts are not promoted and used by the municipal accounting staff, and their implementation is even discouraged by some Belgian standard setters. The reason is that these accruals/deferrals are perceived as creating conflicts with the traditional budgetary accounting system.

Value corrections on immovable patrimony

Apart from a business-like depreciation system, municipalities have to revaluate (+ or -) on a yearly basis their immovable assets based on a specific real estate tax rate for land and on a certain construction price index for buildings. Such an adjustment does not cause a budgetary problem since these non-cash effects are distinctly disclosed in the P/L account from cash effects that have to correspond to the budgetary accounting. Therefore these revaluations are not relevant to the budget, but have a serious impact on the annual accounts.

It is rather remarkable that the effects of adjustment of this kind of "current cost accounting" are taken unquestioningly and directly to the P/L account, regardless of the real and permanent value, regardless of the actual earning power of the asset and even regardless of the prudence principle!

METHODOLOGY AND DATA COLLECTION

A sample of 100 randomly selected municipalities (addressed to the Municipal Treasurers) were asked to fill in and return a questionnaire as well as a copy of their financial statements as of 31st December 1995, including their initial balance sheet as of 1st January 1995 or earlier for the municipalities which had implemented accounting changes before 1995 (pilot municipalities)[4].

EMPIRICAL FINDINGS AND RESULTS

Overview accounting output 1995

In general, the output containing both the budgetary accounts and the annual accounts, is extensive (the median length is about 315 pages and 25% are longer than about 385 pages). Every Flemish municipality drew up the 1995 balance sheet and P/L account, except for 5 municipalities which had not been able to finish the statements by 30th April 1997.

The number of municipalities having disclosed a fixed assets movement schedule seems satisfactory (i.e. 84.9%). However, 9 of them merely disclosed a summary. Furthermore, the concept and the layout of all the schedules varies greatly across the municipalities, which hinders cross-sectional comparability.

The disclosure of the contingencies is very poor looking at the compliance of 37.2%. Focusing on the contents it is even worse since claims and litigations are never disclosed.

A rather important document is the trial balance, although frequently missing (the compliance is only 72.6%). In general the concept and function of the trial balance is not always well understood. The comments in the Notes on accruals/deferrals are very weak (i.e. 26.1%).

Many municipalities included comments on how to read and interpret the annual accounts (i.e. 78.7%) but the comments are very stereotypical and mostly gathered from business handbooks and courses. 18 municipalities disclosed at the most 2 pages, 10 disclosed at least 20 pages with a maximum of 41.75 pages.

In 76.6% of the municipalities the Notes contain a financial analysis, ratios and graphs almost completely in the style of business finance and sometimes greatly exaggerated. One might argue that the ratios and graphs are an attempt to justify the new accounting system and to serve user needs. Analyses of the budgetary accounts focusing more on revenue and expenditure flows are unfortunately put forward less (i.e. 38.9%).

Problem areas of adoption and areas of non-compliance

First drawing up

As mentioned above a considerable problem is the initial drawing up of assets and liabilities. Initial means that municipalities (except maybe the pilot municipalities) had no experience in accrual accounting. The term initial also means that municipalities have existed for years without keeping a record of assets and liabilities. They now have to set up a new system in an existing entity without having any prior accounting data at their disposal. This lack of adequate points of departure causes difficulties in identification, in making inventories and in valuation.

Investments

Investments such as shares in governmental and private enterprises have to be valued at their acquisition cost. Unfortunately, it is not quite clear what this rule exactly means. Is it the *historical acquisition value*, which normally must have been the share in the initially called up capital? Or does it mean the *share in the current called up capital*? Or does it imply that one should take the *share in the value of the capital and reserves to date*?

Focusing on the valuation of the shares in Gemeentekrediet, which is the mutual bank of all Belgian municipalities, the following practices have been adopted.

Table 1 *Gemeentekrediet Valuation shares*

Valuation rule	Unit value (BEF)	Munici-palities	Pilot Munici-palities	%
Historical acquisition value	10,000	16	3	18.8%
Share in current called up capital	42,857	77	7	9.1%
Share in net worth	145,000	-	-	-
No value	0	1	-	-
Rule unclear	8,000	1	1	100%
" "	45,714	1	-	-
" "	52,824	1	-	-
Data not available	-	3	-	
Total		100	11	11%

Apparently, the only two methods applied are *historical acquisition cost without any revaluation whatsoever* (10,000 BEF per share) and the *share in the current called up capital* (42,857 BEF per share). No one applied a current revaluation to the intrinsic value, which would have led to a valuation of 3 to 4 times the share in the issued capital, i.e. ca. 145,000 BEF per share.

It could be argued that the weak and differing adoption of this valuation rule is due to the first drawing up and to the lack of knowledge on how to define the first value. However, even the experienced pilot municipalities are still dealing with weak and differing adoption while at least the adjustment of initial erroneous values (e.g. 10,000 BEF) could have been made.

Stocks

Except for just 1 municipality where a fixed stock is disclosed, stocks have not at all been accounted for in the other 94 municipalities. It is obvious that each municipality does have stocks, but there seem to be different opinions as to the necessity and desirability of disclosing them.

The importance of these stocks (e.g. construction and maintenance goods) should not be over-stressed, but it should be considered that stock accounting information could contribute to the pursued improvement of municipal management, which is one the aims of the accounting reform.

Classification and compensation

Classification

The findings reveal that in certain annual accounts some balance sheet items are disclosed with a wrong sign.

In order to examine the background and frequency of this accounting practice, three general sign-tests were conducted on the 95 municipalities as shown in Table 2.

***Table 2.** Sign-tests: Number of municipalities*

	Acceptable sign (A)	Negative sign (B)	Cases	Total (A)+(B)
Sign assets	87	8	9	95
Sign liabilities	77	18	20	95
Sign P/L account	95	0	0	95

Testing the correct sign of the assets revealed 9 irregularities, 2 of which in the same municipality. A similar pattern has occurred in the liabilities while in the P/L account negative signs did not occur. The reasons for these unexpected signs are in a number of times misclassification, the not transferring of negative assets to the liability-side and vice versa. A probable reason is also the habit of systematically treating certain creditors in a fixed way as part of the liabilities even if a debit balance occurs, and vice versa.

Compensation

Based on the annual accounts compensation occurred in a total of 24 cases representing 20 different municipalities. This somewhat relevant number could be explained by the prevalence of formalism - not looking at the economic reality. Another explanation could be the lack of knowledge of accrual accounting principles. Anyway these practices are not in compliance with the regulations and disturb the use and the interpretation of the annual accounts as well as comparisons between compensated and non-compensated items.

Provisions for risks and charges: pension provisions

By virtue of specific legislation, municipalities have to provide pension plans for their municipal personnel (appointed) and also for the Mayor and Aldermen (mandated). Municipalities may play the role of pension-insurer themselves or they may cede these pension risks to an independent life-insurance company or to an external pension fund.

Municipal personnel

For the majority (92.7%) of municipalities being insured externally, there is no need for recording pension provisions. However, a crucial finding is that the 7 (7.3%) out of the 96 observed municipalities combining internal and external pension financing have not at all disclosed any pension provisions in their balance sheet, whereas they are at least partly pension insurer themselves. Even in the Notes they do not disclose any information about the applied pension plan and about their pension insurance programme either. Furthermore, there is no information about the intergenerational equity (CICA 1985, GASB 1987); in other words which generation is paying for whose pensions is not clarified.

Due to the non-disclosure of information in the financial statements, the consequences of the lack of pension provisions are very difficult to assess in the municipalities having pension obligations.

Mayor and Aldermen

For the Mayor and Aldermen all municipalities act as a pension insurers themselves. This means that in fact the municipalities should have accounted for pension provisions as liabilities, which appears not to be the case. Even in the Notes there is no calculation whatsoever, nor is any comment included. The same can be said as in regard to the non-disclosure of pension provisions for municipal personnel even if these amounts are less spectacular.

Accruals and deferrals

Use of accruals and deferrals

Only 29 municipalities (i.e. 29/95 = 30.5%) disclosed at least one kind of accruals and deferrals. Since it can be reasonably assumed that every municipality actually encounters period costs and revenues which imply the measurement and recording of accruals and deferrals, the fact that these are generally not recorded leads to presenting a rather unfair view of the balance sheet. An explaining factor could be the conflicting situation between budgetary and financial accounting in which the traditional budgetary system prevails implying no use of accruals/deferrals.

On taking a closer look at the municipalities which have recorded accruals and deferrals one could ask whether the factors *experienced municipalities*, *municipalities having bookkeepers with business experience* at their disposal and *municipalities having called in a professional consultant* in a permanent way might give an explanation. These data are summarised in the accompanying table.

Table 3. *Accruals/deferrals: explaining factors*

Attributes	Recorded accruals deferrals	Not-recorded accruals deferrals	Total
Experienced municipalities	4	7	11
Bookkeepers with business experience	11	16	27
Professional consultants (Deloitte Touch or Ernst & Young)	10	26	36
Total number of municipalities	29	66	95

Since the null hypothesis at a significance level of alfa = 5% could not be rejected, the X^2 test (substituted by binomial tests for the case in which expected n <= 5) revealed that no significant difference appeared due to the recording or non recording of accruals/ deferrals between the three factors.

Comments in the Notes

Examination of the Notes reveals that the balance sheet item accruals/deferrals is merely commented in 23 municipalities (i.e. 23/94 = 24.5%). In 6 municipalities there were no accruals/deferrals to comment on. The other 59 (i.e. 59/94 = 62.8%) municipalities have not disclosed comments on the contents of the item.

Disclosure of valuation rules

On looking at the empirical findings, some remarks can be formulated: *Firstly*, the comparison of the annual accounts as of 31st December 1995 with the initial balance sheet reveals a strong decrease in the disclosure of valuation rules regarding accruals/deferrals (i.e. the non-disclosure tends to 77.4%). The results and the interpretation are similar as regarding the valuation rules of provisions.

Secondly, there appears to be a lack of understanding the need for accruals and deferrals as well as their concept. The casuistical approach (i.e. just naming the cases of accrual and deferral right away, without any motivation or framework) in describing the valuation rules seems to prove that the actual background and objective of accruals/deferrals is not well understood.

Table 4. *Number of municipalities disclosing accruals/deferrals valuation rules*

Municipalities showing the model:	Initial Balance Sheet 1st Jan, 1995		Annual Accounts 31st Dec. 1995	
Ernst & Young	**18**		**0**	
Mod. Ernst & Young[5]	**2**		**0**	
Deloitte & Touche	**17**		**13**	
Mod. Deloitte & Touche	**2**		**2**	
Ad hoc[6]	**7**		**6**	
No disclosure	**42**	**47.7%**	**72**	**77.4%**
	88	**100%**	**93**	**100%**
Data N/A	**12**		**7**	
Total	**100**		**100**	

Accruals and deferrals: cut-off problems

It has already been mentioned above that the recognition of costs in financial accounting depends on the decision to charge them to budgetary accounting. In turn, the decision to charge them depends on budgetary and financial management rather than on the "true and fair view" of the really incurred costs[7]. Table 5 reveals the appearing cut-off practices concentrating on the purchase cycle of various goods and services, overheads.

The legal cut-off is not clear in handbooks and literature where there is only reference to GAAP, and particularly to the principle of matching. If GAAP were the standard, the practice of referring to <u>c) delivery date</u> (see table 5) would be the most acceptable cut-off rule as it is in business accounting.

Assuming that the time sequence is firstly *delivery date*, then *invoice date* and afterwards *date of receiving the invoice*, most of the practices roughly tend to anticipate costs. On the contrary, practices b.5 and d.5 seriously delay the incurred costs to the next year. The P/L effect of the practices that literally depend upon budget availability cannot be assessed nor estimated.

Taking the experienced municipalities into consideration one could imagine that due to experience, mutual exchange of information and support, the practices of experienced municipalities would tend to go more in the same direction. Therefore a X^2 test (substituted by binomial tests for the case in which n <= 5) was worked out and revealed that there is no significant (alfa = 0.05; 0.10) relationship in the behaviour of experienced municipalities as well as in their different practices.

Valuation rules

<u>Qualitative characteristics</u>

The frequency of municipalities disclosing the main six groups of valuation rules is as follows (data N/A for 6 municipalities):

a) Valuation	62
b) Revaluation	69
c) Depreciation	67
d) Amortisation	56
e) Other	3
f) Detailed per item	16
No disclosure	21

The fact that 21 municipalities (i.e. 21/94 = 22.3%) do not at all provide information concerning the valuation rules is attracting attention; as a matter of fact the non-disclosure of valuation rules is not in compliance with accounting regulations and negatively affects readability.

***Table 5** Cut-off practices*

Criterion	Frequency	
a) Invoice date 1995		45
b) Invoice receiving date, charging invoices arrived 1st Jan.- 15th Feb. 1996		12
c) Delivery date 1995		11
d) Other:		27
b.1 Invoice receiving date if goods and services are delivered in 1995	2	
b.2 Invoice receiving date if order date is in 1995	3	
b.3 Invoice receiving date, charging invoices arrived 1st Jan.- 31st Jan. 1996 and if goods and services are delivered in 1995		
b.4 Invoice receiving date, charging invoices arrived 1st Jan.- 28th Feb. 1996	1	
b.5 Invoice receiving date determines charging date	1	
	2	
d.1 Order date determines charging date		
d.2 Order date determines charging date if budget available, otherwise 1996	4	
d.3 Date of appropriation of the budget (vastleggingsdatum) determines charging date	2	
d.4 Availability of budget determines cut-offs	2	
d.5 Invoices dated before last Meeting Mayor & Aldermen 1995 are charged to 1995; all the other invoices are charged to 1996	3	
d.6 An arbitrary combination of rules; no further information	4	
	3	
Data N/A		5
Total		100

Quantitative characteristics

The arithmetic mean of the number of pages is 4.8 for the 94 considered municipalities. This figure appears to be divided into 2 clusters: a group showing nothing or at the most only a few pages and another group showing a lot of pages.

Optional legal rules
Particularly in the valuation rules regarding the initial balance sheet, many municipalities describe the valuation rules in their legal form which often contains more than one option (e.g. the valuation of sewers: one could select the price of purchase or construction or a fixed price per meter multiplied by the total length of the sewers). Unfortunately, in many cases one fails to select explicitly one of the options and it does not become clear which of the options was applied. This shortcoming keeps the reader of the annual accounts guessing.

Motivated exceptions on rules
Normally, most valuation rules have to be applied straight away. However, by virtue of art. 2 of the legislation, an alternative valuation rule is accepted for a number of assets if motivated. Again, it is often unclear what alternative rule exactly has been chosen and the necessary motivation is seldom included.

Double-sided rules
Double-sided rules mean that a certain valuation rule consists of two or more different parts without knowing the different fields of application. For example, some municipalities state in the valuation rules of the art patrimony that the rule consists of "insurance value/estimated value", which is to be interpreted that some parts of the patrimony are valued in terms of insurance value and other parts in terms of the estimated value. However, it is not made clear which part exactly is attached to which part of the rule.

Ambiguous rules
A few municipalities are disclosing internal contradictions in the selected valuation rules. For example, firstly there is the statement that a certain asset is valued on the basis of its insurance value. However, a few pages later, we find another statement that says that the asset is valued according to its acquisition value. This problem of first one rule, then another is probably due to irregularities in the editing of the annual accounts and to the use of formalised standard software. Anyway, the confusing rule remains difficult to interpret.

Contingencies

Referring to the provisions for risks and charges that this item has already run into, municipalities have to disclose in their Notes all relevant rights and commitments which are not included in the balance sheet. Reviewing the Notes of the observed 94 municipalities, the disclosure of contingencies was very poor. Disclosure appears to be limited to mortgages, guarantees on assets and certain real guarantees in 35 municipalities (i.e. 35/94 = 37.2%).

Claims, significant litigations, crimes against the environment, guarantees promised for supporting related parties and other commitments, which are all likely to occur in a municipal context, were not well disclosed. None of the case could be called a full disclosure. Furthermore, 59 (i.e. 59/94 = 62.8%) municipalities disclosed nothing at all with regard to rights and commitments.

Heterogeneity and comparability

In an attempt to roughly measure the comparability of the annual accounts, the C-index (Tas, van der 1992) was calculated[8]. This approach does not offer a complete and perfect view of comparability, but only highlights some of the major issues:

* Valuation shares Gemeentekrediet
C-index: $(16^2 + 77^2 + 1^2 + 1^2 + 1^2 + 1^2 - 97) / (97^2 - 97) = 65.4\%$

* Stocks
C-index: $(94^2 + 1^2 - 95) / (95^2 - 95) = 97.9\%$

* Pension provisions
C-index: $(7^2 + 89^2 - 96) / (96^2 - 96) = 86.3\%$

* Accruals/deferrals: "pure"
C-index: $(29^2 + 66^2 - 95) / (95^2 - 95) = 57.1\%$

* Accruals/deferrals: comments in the Notes
C-index: $(23^2 + 6^2 + 59^2 - 94) / (94^2 - 94) = 45.2\%$

* Cut-off problems
C-index: $(45^2 + 12^2 + 11^2 + 2^2 + 3^2 + 1^2 + 1^2 + 2^2 + 4^2 + 2^2 + 2^2 + 3^2 + 4^2 + 3^2 - 95) / (95^2 - 95) = 25.4\%$

* Contingencies
C-index: $(59^2 + 35^2 - 94) / (94^2 - 94) = 52.8\%$

The results are quite poor in this area for accruals/deferrals, cut-offs and contingencies. Although legislation is relatively strict, municipalities seem to adopt the reform inconsistently in accounting objectives, principles, valuation and disclosure. It is noteworthy that these C-indices have to be interpreted with care in that they do not measure the level of compliance with regulations, nor the importance of incomparable differences.

The items with a lack of comparability must be treated with caution particularly towards users. Financial analysts and other users could act too hastily in already using municipal annual accounts aiming at performance appraisal and inter-municipal comparison without being sure about the degree of comparability.

CONCLUSIONS

Nowadays there is in Belgium a strong tendency to reform the non-profit and public sectors from cameralistic/cash accounting to business/accrual accounting. This paper deals with an important accounting reform in municipalities mainly from a technical accounting practice point of view.

The objectives of the reform are, on the one hand, to create internal management tools and, on the other, to improve transparency and accountability towards (external) users. However, a number of implementation problems occur and questions can be posed because of the prevailing budgetary accounting system, the lack of an adequate conceptual framework and ignorance on user needs. Moreover, the new financial accounting system does not seem to be made indispensable, which might weaken its application and continuity. In other words, the financial accounting system is not ensured to last since:

- up to now financial accounting was not deemed necessary in order to manage a municipality;
- there is a very limited use of the annual accounts by stakeholders and citizens;
- there is a lack of professional (governmental) audit following up implementation and outcomes;
- the financial accounting system is not given enough importance: the budgetary resources do not depend on the financial accounting system.

The empirical approach consisted of a field research using the annual accounts and the responses on a questionnaire of a random sample of 100 Flemish municipalities. Additionally, a number of interviews with Executives of municipalities and related parties were held. This examination revealed that the compliance with adapted accounting regulations is weak and somehow legalistic. These weaknesses are not a thing of the moment, but seem to continue. As a matter of fact they occur even in the surveyed pilot municipalities, which have at least two years of experience.

More in detail the findings reveal:

- problems with the boundaries of municipalities not knowing the actual owner of certain assets and liabilities;
- stressing the letter instead of the contents and thus leading to unrealistic figures;
- classification, recognition and cut-off problems due to a lack of adapted conceptual framework;
- inconsistencies in valuation;
- conceptual valuation problems concerning *"public goods"* and goods with a historic, cultural, social, military importance but missing an economic value;

- initial drawing up problems mainly due to fundamental requirements vs. non-availability of (historical) records;
- a mixed approach: sometimes full accrual (e.g. inventorying fixed assets), sometimes not at all accrual (e.g. lack of disclosing stock, provisions, off-balance-sheet items);
- lack of understanding accounting techniques like the processing of deferrals and accruals.

Although strictly regulated and formalised, the accounting methods appear to differ a lot and the degree of harmonisation and comparability seems to be poor. Since the empirical approach is limited to a few important but arbitrarily chosen topics, one has to be cautious in extending the results; there also remains a number of unanswered questions.

Interesting questions for further research could be how to know more about problems and differences and how they are caused *(is it the "drawing up", the prevalence of budgetary accounting, the degree of qualification of the accounting staff, the lack of external audit, ...?)*. It would also be interesting to continue examining comparability more extensively in further research. Hopefully, these preliminary results will be of use.

NOTES

[1] Mod. Euraccounts means that the municipality uses the same model as the Euraccounts-municipalities without being related to Euraccounts.

[2] Ad hoc means that the municipality has edited its own model.

[3] - It is well known that a number of municipalities tend to use up their remaining budgets at the end of the year by placing (unnecessary) orders. As such the costs and the amount of trade creditors are increased more or less artificially. Such municipalities are not easily comparable with others respecting the guidelines of not using up their budgets.

- The contrary situation is also likely to occur: if the budget is not sufficient anymore, purchases at the end of the year are tended to be delayed and recorded in the next year when a new budget becomes available. This practice does not provide a real comparable view either.
- Apart from the varying practices in charging year end activities having consequences to P/L, there are also different practices as to the payment policy. Several interviews revealed that at the year end some of the municipalities are doing their best to pay off their creditors as much as possible before 31st December 1995 in order to reduce accounting work.

[4]

$$\text{The C-index} = \frac{a^2_1 + a^2_2 + \ldots + a^2_i + \ldots + a^2_m - n}{n^2 - n}$$

a_i = the number of municipalities applying method i
m = the number of alternative methods
n = the number of municipalities

The index ranges from 0 (no harmony) to 1 (maximum harmony in which all pairs of annual accounts are comparable with respect to a certain part of the report because they all apply the same method).

REFERENCES

Allen, A. and Sanders, G.D. Financial disclosure in US municipalities: Has the governmental accounting standards board made a difference?, Financial Accountability & Management 1994; 10, 3, August: 174-193.

Allen, S. *Capital accounting for local government in the U.K.: an attempt to measure the effect of applying commercial accounting concepts to the local government environment*, working paper CIGAR 5 Conference, Paris, 4, 5 May 1995.

Ball, R. and Foster, G. Corporate financial reporting: a methodological review of empirical research. Journal of Accounting Research 1982; 20: 161-234.

Canadian Institute of Chartered Accountants (CICA). *Financial reporting by governments: a research study*, 1980, pp. 223.

_______. *Local government financial reporting: a research study*. 1985, pp. 116.

Carpenter, V.L. and Feroz, E.H. GAAP as a symbol of legitimacy: New York's decision to adopt Generally Accepted Accounting Principles. Accounting, Organizations and Society 1992; 17, 7: 613-643.

Chandler, R. and Cook P. Compliance with disclosure standards in published reports and accounts of local authorities. Financial Accountability & Management 1986; 2, 2: 75-88.

Cheng, R.H., An empirical analysis of theories on factors influencing state government accounting disclosure. Journal of Accountancy and Public Policy 1992; 11, 1: 1-42.

Christiaens, J. *Financial accounting reform in Belgian municipalities: a preliminary limited field research*, working paper EIASM Workshop on the Role of Accounting in the Public Sector, Stockholm, 7th-8th November 1996, paper submitted at the Seminar New Public Sector, Edinburgh, 16th-17th December 1996, pp. 43.

Collins, W., Keenan, D. and Lapsley, I. *Local authority financial reporting: communication, sophistry or obfuscation*, Edinburgh: ICAS and CIPFA, 1991, pp. 46.

Faber, A., Jong (de) E.J. *De Gemeenterekening: theorie en praktijk van de jaarrekening volgens de Gemeentelijke Comptabiliteitsvoorschriften*, Research Memorandum No. 1988-41, Vrije Universiteit Amsterdam, 1988, pp. 40.

Governmental Accounting Standards Board (GASB), *Objectives of financial reporting*, Concepts Statement No. 1, 1987.

Giroux, G. Political interests and governmental accounting disclosure. Journal of Accountancy and Public Policy 1989; 8, 3: 199-217.

Ingram, R.W. Economic incentives and the choice of state government accounting practices. Journal of Accounting Research 1984; 22, 1, spring: 126-144.

_______, and DeJong, D.V. The effect of regulation on local government disclosure practices. Journal of Accountancy and Public Policy 1987; 6, 4: 245-270.

Jones, D.B., Scott, R.B., Kimbro, L., Ingram, R.W. *The needs of users of governmental financial reports*. Stamford: GASB, 1985.

Jones, R. and Pendlebury, M. Uniformity v. flexibility in the published accounts of local authorities: the UK problem and some European solutions. Accounting and Business Research 1982; 46: 129-135.

_______. The published accounts of local authorities, revisited. Financial Accountability & Management 1991; 7, 1: 15-33.

Lapsley, I. Research in public sector accounting: an appraisal. Accounting, Auditing & Accountability Journal 1988; 1, 1: 21-33.

Lin, Z.J., Baxter, G.C. and Murphy G.J. Improving government financial reporting in Canada: an evaluation of compliance with the PSAAC's accounting and reporting standards for governments. Financial Accountability & Management 1993; 9, 4: 235-254.

Robbins, W.A. and Austin, K.R. Disclosure quality in governmental financial reports: An assessment of the appropriateness of a compound measure. Journal of Accounting Research 1986; 24, 2: 412-421.

Tas, L.G. van der. Evidence of EC financial reporting practice harmonization: the case of deferred taxation. The European Accounting Review 1992; 1, 1: 69-104.

Wallace, W.A. *Accounting research methods: Do the facts speak for themselves?* Irwin: Homewood, 1991, pp. 103.

Zimmerman, J.L. The municipal accounting maze: An analysis of political incentives. Journal of Accounting Research 1977; 15: 107-144.

8

A STRATEGY FOR IMPLEMENTING COST ALLOCATION IN A DUTCH MUNICIPALITY

G. Jan van Helden

INTRODUCTION

Many governmental organizations have recently introduced business-like tools, such as output budgeting and responsibility accounting. The introduction of these tools has also encouraged the application of product costing and cost allocation which are important for purposes of output pricing, benchmarking, and the strengthening of control over internal services. This paper addresses an implementation strategy for cost allocation in a Dutch municipality. Politicians and managers should know why cost allocation takes place and they should be able to use its results. An important question in connection with this is the degree to which users of internal services can control the provision (quantity and quality) of these services, including the costs involved. A phased approach --first informing, then testing opinions, and finally reaching a consensus-- seems to hold good prospects for the development of knowledge, understanding, and control of processes of cost allocation.

Before this strategy is discussed in the sections 3 up to and including 6, section 2 addresses the particular status of cost allocation in Dutch local government. A good understanding of cost allocation in Dutch local government makes it also necessary to give a brief description of municipal tasks in the Netherlands and their budgetary impact. Section 7 contains the paper's conclusions.

COST ALLOCATION IN DUTCH LOCAL GOVERNMENT

Management accounting literature shows that the relevance of cost allocation is a controversial topic. On the one hand, cost allocation is expected to contribute to the efficient use of internal services, but on the other hand, allocation of indirect costs is adversely affected by arbitrary elements (Thomas, 1971; Zimmerman, 1979; see also Ahmed and Scapens, 1991).

Cost allocation is a topic of growing importance to governmental organizations in general and municipalities in particular. Since 1995, Dutch central government has required all municipalities to allocate indirect costs to functional categories within their yearly budget, i.e. to policy areas. This requirement is supposed to enable politicians to make choices on the basis of the full costs of each policy area (Ministerie van Binnenlandse Zaken, 1993). Another incentive to introduce cost allocation in local government in the Netherlands is the transition from input to output budgeting (Houwaart, et al., 1995; Van Helden, 1998). This development is connected with a broader international trend towards managerialism and application of business-like tools in government (Broadbent and Guthrie, 1992; Hood, 1995; Olson, et al., 1998; see for a comparison with Dutch developments: Van Leerdam, 1995; Van Helden, 1998). The necessity for budget cuts is considered to be the main cause for the introduction of output budgeting. However, outputs are, generally speaking, defined at a more disaggregated level than budget functions. Therefore, because of the introduction of output budgeting, many local government organizations make a more detailed analysis of their budgets and, although they are not required to, they allocate costs to outputs.

Some background information about the legal position of Dutch municipalities and their functions may contribute to a good understanding of cost allocation in local government. The legal position of municipalities within the decentralised unitary state of the Netherlands is characterised by autonomy and co-government. Although formally the Dutch governmental system is hierarchical, municipal autonomy indicates that local governmental organizations have discretion to initiate and conduct tasks within the constraints imposed by national (and provincial) regulation. Co-government, referred to as "medebewind", means that municipalities take part in the implementation of national (and provincial) laws. This implementation is not to be interpreted as mechanistic. Instead, it is value-laden and thus a source of municipal power (Toonen, 1987, pp. 110-111).

In the Netherlands local authorities are an important governmental layer: they spend up to about 30 per cent of the government budget (Cabinet of the Dutch government, 1997, p. 260). Municipalities perform activities varying from welfare and education to town planning and economic affairs, as well as from social services and employment programming to environmental affairs. In many instances, police, fire brigade, public transport and public utilities are transferred to corporations larger in scale which operate outside of the municipal organization (Van Helden, 1997, pp. 133-134). So, a municipality in the Netherlands can apply cost allocation and product costing to compare the product costs of a great variety of important products with those of other municipalities (benchmarking), or --if applicable-- to calculate the full product costs for pricing purposes.

A STRATEGY FOR IMPLEMENTATION

Cost allocation used to be approached mainly from a technical point of view. People in government were interested in finding the most appropriate technique of cost allocation whereby accuracy and simplicity would be balanced. A recent survey about the application of cost allocation techniques in Dutch municipalities shows that a majority of the municipalities use simple costs centre allocation techniques, sometimes in combination with mark-up methods, whereas Activity-Based Costing is hardly used (Groot and Budding, 1998, p. 62). Some results of this survey are shown in Table 1 (see also Van der Dussen, 1993; Van Helden, 1997; for applications of ABC in government and other non-profit organizations, see Antos, 1992; Verbeeten, 1994; Acton and Cotton, 1997; Pendlebury and Algaber, 1997).

Table 1. *Application of cost allocation techniques in Dutch municipalities*

application rate allocation technique	nearly always	frequently	occasionally	never
mark-up technique	21%	6%	18%	55%
cost centre technique	70%	9%	6%	15%
Activity-Based Costing	1%	1%	2%	97%

Source: adapted from: Groot and Budding, 1998, p. 62.

The relevance of technical aspects cannot be denied, but an equally or even more important question concerns the way in which cost allocation should be implemented in municipalities. Both managers and politicians are accountable for outputs and the costs involved and therefore will want to know why and in what way indirect costs are attributed to outputs. They will have to understand the results of the application of cost allocation techniques in order to use these results in decision-making. Therefore, their focus will have to shift from the technical towards the organizational and behavioural aspects of cost allocation (Shields and Young, 1989).

A research project examining the application of cost allocation was carried out in the municipality of Stadskanaal from May 1995 until July 1996. The most important questions politicians and managers of the municipality of Stadskanaal asked about their existing cost allocation system were: "I do not understand the system; how does it work?" and "What can be done to influence the allocated costs to my organizational unit or budget function?" The research project addressed these issues and aimed at promoting the acceptance and appreciation of the results of cost allocation techniques among politicians and managers of the municipality.

The research project utilized a strategy consisting of three stages. During the first stage accessible information on cost allocation was given to (potential) users, politicians and managers. The objectives to be achieved by cost allocation were illuminated; such as output pricing and the control of internal services. Also, various allocation principles were explained, for example the cause-and-effect principle versus the ability-to-bear principle. During the second stage politicians and managers were interviewed about possibly controversial aspects of cost allocation, for example regarding the circumstances in which the external provision of internal services might be possible. During the final stage all the politicians and managers within the organization took part in a plenary discussion during which they tried to reach a consensus about controversial themes from the second stage.

There were two reasons for adopting this strategy of informing, then testing opinions and finally trying to reach consensus. Firstly, the question "I do not understand the system; how does it work?" requires information to be made accessible to politicians and managers lacking financial training. Secondly, politicians and more particularly managers wanted to know how they could possibly influence allocated overhead costs. More specifically, there were disputes about privatising certain municipal tasks (for example waste collection) in which questions were raised about the amount of indirect costs to be attributed to these tasks. Moreover, abandoning obligatory internal transactions was an important topic of discussion in the municipality. Hence, it was assumed that not all of the people involved with cost allocation would share the same opinions, but a common understanding of their nature and impact is desirable.

Each of the stages distinguished above will be described in more detail in this paper. First of all, the reasons for choosing the municipality of Stadskanaal as the research object of the case study will be clarified. A nation-wide project was carried out in the Netherlands during the years between 1989 and 1995 to familiarize municipalities with the application of business-like tools, such as output budgeting and responsibility accounting (Houw aart, et al., 1995; Van Helden, 1998). Twelve municipalities acted as pioneers in applying and spreading these newly developed tools. These municipalities, in particular, were expected to be interested in the further development of these tools, and therefore also in implementing (and improving) techniques of cost allocation. Hence, one of the pioneer municipalities was chosen as the object of the case study. A more practical reason for the choice of Stadskanaal -- being a pioneer municipality in the nation-wide project-- was its proximity to the researcher's location. Stadskanaal is a medium-sized municipality that has about 33,000 inhabitants and an organization consisting of 235 full-time equivalent jobs. The scale of municipalities in the Netherlands varies greatly. Stadskanaal belongs to the category of municipalities with 20,000 to 50,000 inhabitants, which includes 30% of the total number of municipalities.

COST ALLOCATION AND PRODUCT COSTING: OBJECTIVES, CONCEPTS AND METHODS

This section deals with the first stage of the research project, i.e. the way in which information on cost allocation was provided to its users within the municipality; politicians and managers. The information was presented by means of a statement of about 8 pages (Van Helden and Bessembinders, 1996). A shortened form of this statement will be embodied in this section. First, the objectives to be achieved by cost allocation and product costing will be presented. Next, some allocation principles will be explained. Thereafter, the controllability of indirect costs by the users of internal services will be discussed. Finally, allocation principles and controllability will be dealt with simultaneously by means of a chart for taking decisions about cost allocation.

Objectives

Generally speaking, a distinction can be made between external and internal services. The former are related to the organization's customers, or its environment, whereas the latter fulfil a supporting or coordinating function with respect to the external services. Cost allocation has important implications for economic decisions on the amount, quality and price of internal services within an organization. Relevant questions are: what volumes of the internal services are needed, what quality standards are acceptable, what price (per unit of service) should be paid, should the external instead of the internal production of these services be preferred? These questions have in common that they refer to economizing on the usage of internal services. Consequently, in this respect the goal of cost allocation is to improve cost-conscious behaviour in consuming internal services (see for example Kaplan and Atkinson, 1998, pp. 61-63).

Table 2 includes the various goals to be achieved by cost allocation in local government. This table shows that some objectives -- such as policy-making based on full costs and control of internal services -- are generally applicable. Other objectives, however, are only relevant in a restricted number of cases. As, for example, many

Table 2. *Objectives to be achieved by cost allocation in local government*

OBJECTIVE	COMMENTS
Pricing of external services	is only applicable in circumstances where external services have to be priced on the basis of full costs, or where prices have to cover a (substantial) part of the full costs of those services
Policy-making based on full costs (and revenues) of external services	can be appropriate for all external services; enables to compare the costs of services within a municipality in different periods or compare the costs of services of different municipalities (bench marking)
Control of internal services	may induce cost-conscious behaviour in the consumption of internal services or stimulate considering external or internal provision of these services
Meeting accounting standards	is only relevant at budget levels; at the more detailed service level municipalities are not required to use cost allocation
Measuring assets for reporting to external parties	As most products are services, the importance of this objective is limited in local government

governmental activities lead to the production of services instead of (tangible) products, cost allocation for inventory valuation is of minor importance in local government. Moreover, product costing for pricing purposes is only appropriate for a restricted number of services, at least in the Netherlands (Van Helden, 1994, pp. 139-140). The relatively modest role which product revenues play in Dutch local government is illustrated by the fact that these revenues account for less than 10 per cent of their total income (Van der Dussen, 1992, p. 96).

Concepts

The distinction between *direct and indirect costs* is important in connection with the problem of cost allocation. Costs which are caused directly by the production of external products/services are called direct costs. Indirect costs refer to services which are carried out for several products/services. The allocation of indirect costs to external services is called *cost allocation* (Horngren, et al., 1997, chapters 13, 14 and 15).

Two types of internal services are distinguished in the case of the municipality of Stadskanaal:

1. *specific internal services*: organization units of the municipality perform particular services which have been ordered by other organization units of the municipality;
2. *general internal services*: organization units provide general support services for other organization units.

The costs of both the specific and the general internal services are to be allocated to the external products.

If specific internal services are provided, it is usually clear who is supplied with what. In the case of the municipality of Stadskanaal, the customer is the budget manager. The latter determines the number and quality of the services to be provided and agrees upon the price of those services in consultation with the (internal) supplier. The municipality of Stadskanaal makes use of contracts between internal suppliers and internal consumers that state the number of services which are to be provided on an annual basis, the agreed financial conditions, and the ways in which the execution of the contracts will be reported. Specific internal services provided by the municipality of Stadskanaal include, for example, the maintenance of sports fields and cemeteries, and the maintenance of buildings, such as sports centres and schools[1].

It is much more difficult, however, to use contracts for general internal services. This is because the relationship between internal suppliers and consumers is less well-defined, for the following reasons. General support services in an organization are central services which are of benefit to several products or, at times, all products. It is relatively difficult to predict to what extent the services in question will be used for particular products. Moreover, the services cannot be easily defined by means of a volume-indicator. General internal services of the municipality of Stadskanaal include, for example, reception, accounting, documentary information supply, accommodation, human resources management, job evaluation, and information technology services.

To sum up: the most important factor in distinguishing specific and general internal services is the degree to which users consider the internal service to be supplied as a bundle of homogeneous units so that pricing per unit of service is possible.

Allocation principles

As argued above, economizing on the usage of internal services is a main goal of cost allocation. This goal implies that indirect costs should be allocated to external products/services according to the degree to which these services cause indirect costs. The allocation principle in question is called cause-and-effect allocation. However, as will be explained later on, circumstances may exist in which this allocation principle is not appropriate, and another allocation principle, ability-to-bear allocation can be considered.

Economic reasoning may induce an organization to use the same "internal services" for its different external services/products. Technically speaking, it would be possible to produce the products separately, each with the help of its "own internal services". However, this is often not a sensible economic policy. In practice, an accounting department, for example, prepares the accounts for many different products. In such a case, application of the *cause-and-effect allocation principle* induces (indirect) costs of an accounting department to be allocated in proportion to the use made by the parties concerned of the internal services causing these costs (Horngren, et al., 1997, p. 475). This would entail the determination of the degree to which each of the various products causes costs to be incurred by the accounting department.

However, sometimes, cause-and-effect cost allocation is not possible, because the usage of internal services cannot be clearly connected to each of the external services. Application of this allocation principle may even be regarded as undesirable in circumstances when the top management of the organization wants to have full control over the internal services in question. Even when cause-and-effect allocation is impossible or undesirable, the organization may still want to calculate the full costs of its external services. This can be appropriate for such reasons as pricing, benchmarking, stock valuation, or if it is required by law (see also Table 2). However, cost allocation is not needed in order to improve the efficiency of internal services. In these circumstances application of the so-called *ability-to-bear principle* might be considered (Horngren, et al., 1997, p. 475). This principle implies that the "strongest" product will have to bear the heaviest burden. Private business organizations usually allocate such indirect costs on the basis of turnover or gross profit. However, this allocation base is not of much use to government organizations, such as municipalities, as they tend to have little or no revenues (turnover) and therefore no profits. Some government organizations have decided to allocate these indirect costs in proportion to the sum of the direct costs and those indirect costs which are allocated on the basis of the cause-and-effect principle. This is often done by adding a fixed mark-up (a percentage) to the direct and these allocated indirect costs per product.

Controllability of internal services

If an organization wants to improve cost-conscious behaviour regarding internal services, the effectiveness of cost allocation will greatly depend on the controllability of these services by their internal users. In this respect, it seems useful to distinguish between internal services which can be controlled within an internal market and those which have to be centrally controlled. As has been argued above, this distinction matches with the application of allocation principles. In the case of internal market control, the cause-and-effect allocation principle should be used, whereas in the case of central control the application of the ability-to-bear principle is more convenient.

Examples of internal services which *can* be controlled within an internal market are services connected with accommodation, cafeterias, and security. Obvious cost drivers for accommodation costs are the numbers of employees using these services or the numbers of square metres in use. Every organization unit can "pay" for the number of square metres it uses. An example of internal services which *cannot* easily be controlled within an internal market are activities connected with the external representation of local government. Politicians and senior managers decide how much they want to spend on these types of activities and how these activities will be carried out. Organization units have little control over such activities (Van der Dussen, 1993; Van Helden et al., 1994). Another example refers to safety requirements imposed by statute that have to be met by law and the underlying services cannot be controlled by the organizational units.

Allocation of indirect costs which can be controlled within an internal market may take place in different ways. One extreme refers to a situation where organization units are free to buy the services in question internally or from outside. The internal services would be priced on a per-unit-basis. This would imply the existence of a "real" market with relatively independent parties. In these circumstances the consideration of internal versus external provision of services is optional. This alternative is similar to the specific internal services distinguished in the municipality of Stadskanaal. The other extreme concerns a situation where discussions take place periodically (for example, once a year) as part of the budgeting system, between the suppliers and users of internal services about the quantity/quality aspects of the internal services, and the outcomes of cost allocation. The aim of these discussions would be to get a "fair" allocation of the indirect costs, which would have to be fully covered by the internal users. Additionally, some incentives might be given to suppliers of internal services in order to have them provide more "value for money". This alternative seems to fit with the general internal services distinguished in the municipality of Stadskanaal. There may also be an in-between alternative which consists of a fixed charge (which depends on the availability of capacity, to be determined in budget consultations) and a variable rate (which depends on the degree of consumption, resulting in a rate per unit). An example of the combined rate may concern computer services: a fixed charge is paid for the central data-processing function (for, among other things, software and hardware maintenance), whereas a variable rate is charged for the use of the central computer capacity (for instance, per standardized computer second).

The absence of controllability of indirect services within an internal market does not imply that activities and costs should not be controlled. As argued above, it is conceivable that services which are provided to assist the politicians are included in this category. In that case, they will have to be controlled at a central level, for instance by the chief executive, for there is no internal market which exerts control through the prices of services or budget consultations.

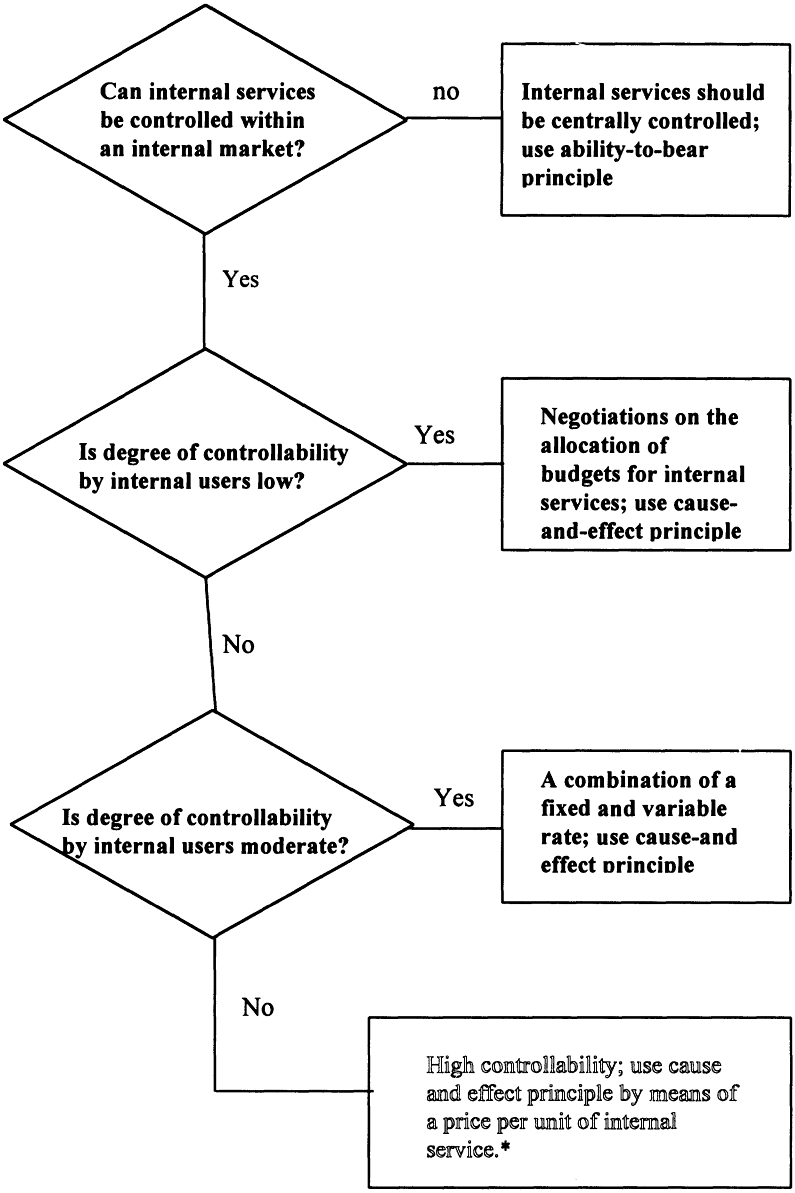


Figure 1. *Decision making about the allocation principle and the controllability of indirect costs (*external provision of services is optional)*

Taking decisions about cost allocation

Figure 1 contains a summary of the considerations which should play a part in the process of choosing an appropriate method of allocating indirect costs. The considerations presented in this figure involve weighing up the cause-and-effect principle and the ability-to-bear principle on the one hand, and the way indirect costs can be controlled on the other.

These considerations are based in particular on the argument that the efficiency of internal services should be improved. Obviously, if rates are to cover the costs of products, the full costs per product will have to be calculated as accurately as possible, even though objective data about the relationship between indirect costs and products are not available. It should be noted that allocation of overhead costs often follows a step-wise approach. In the first step costs of organization units which supply internal services are allocated to organization units which produce external services. In the second step the costs of the last organization units (both direct and allocated indirect costs) are attributed to the services of those units (Van Helden, 1997, pp. 140-141).

OPINIONS ON COST ALLOCATION

During the second stage of the project, four managers and one member of the executive committee were interviewed. The interviewees were chosen on the basis of their different positions within the organisation. Providers as well as users of internal services were interviewed. The aim was to obtain an insight into possibly diverging opinions on cost allocation issues, rather than to register dominant opinions within the organization. It should be emphasized that during the third stage nearly all members of the executive committee and all managers took part in the discussion on cost allocation topics.

The information on cost allocation embodied in the statement from the first stage was generally well received by the interviewees, who recognized the importance of cost allocation. Obviously, the politicians and managers of the municipality were interested in the subject.

The interviewees were presented with nine statements on cost allocation. The following six statements met with *approval*:

- the use of cost allocation can result in internal services being used more efficiently;
- from the point of view of policy-making, it is useful to know the full costs of external products, i.e. both direct and allocated indirect costs;
- internal consumers and suppliers should conclude contracts concerning the quantity, quality, and price of internal services, if possible;
- indirect costs should be allocated as much as possible on the basis of the cause-and-effect principle;
- users of internal services should be able to have a say in the quantity, quality, and cost allocation concerning internal services;

- the abolition of the principle of compulsory internal transactions has a positive effect on cost-conscious behaviour.

The following three statements, however, gave rise to *divided opinions*:

- comparison of the full costs of external services with the costs of the same services produced by other municipalities --benchmarking-- is useful (note: some respondents doubted whether the services of different municipalities were sufficiently comparable and also wondered whether data on costs could be compared if accounting systems differed);
- assuming that the costs of indirect activities cannot be controlled by internal users, these costs must be allocated to products on the basis of the ability-to-bear principle (note: one of the respondents held the point of view, although debatable, that indirect costs should always be allocated on the basis of the cause-and-effect principle);
- the abolition of the principle of compulsory internal transactions is only permissible for internal services which are not of strategic importance (note: some respondents do not make any exception for internal services of strategic importance and think that all internal services could be contracted out).

Next, the interviewees were given information about twelve internal services provided by the municipality. They had to choose between internal market control with cause-and-effect allocation and central control with ability-to-bear allocation. If they choose the former, they had to then define the type of cost allocation in

Table 3. *Users' opinions on the internal market controllability of internal services*

CONTROLLABILITY POSSIBLE*	DIVIDED OPINIONS ON CONTROLLABILITY*	NO CONTROLLABILITY
central data-processing facilities	financial accounting	Central financial policy
legal assistance and advice	accommodation	Representation
maintenance of buildings	human resources management	assistance for politicians
	assistance in personnel and organization policy	
maintenance of public parks and gardens	documentary information supply	

* In these cases, too, suggestions were made about possible allocation methods.

accordance with figure 1. The basic question was if or how costs should be allocated to the external services of the municipality. Table 3 shows some results. If internal market controllability is possible, various suggestions for cost drivers were provided (not shown in Table 3); in these cases a price per unit or a mixed fixed-variable rate could be used. On the contrary, if internal market controllability is impossible, central control and ability-to-bear allocation is convenient. In the case of divided opinions about internal market controllability (see the centre column of Table 3) further discussions had to take place in order to draw conclusions about the way to control and the allocation principle; the next section deals with these discussions. Evidently, opinions may have been influenced by information given during the first stage in which controllability of internal services was emphasized.

REACHING CONSENSUS

Approach

A plenary meeting of politicians and managers was held during the third stage of the implementation of cost allocation in the municipal organization of Stadskanaal. Well over 80% of the politicians (the mayor and members of the executive committee) and managers -- division managers as well as department managers -- took part in this meeting. Firstly, four groups of 5 to 7 participants discussed statements from the second stage which had not reached consensus during that stage (see also the previous section). Then, the participants tried to reach consensus about these statements. During these discussions participants were encouraged to develop their own understanding and opinions about the relevant cost allocation issues.

Controllability of internal services

In the second stage of the research project opinions were divided on the controllability of the following internal services (see Table 3): financial accounting; accommodation; human resources management; assistance in personnel and organization policy; documentary information supply. Two of these internal services were discussed in more detail during the third stage; namely, human resources management and documentary information supply. All four of the discussion groups concluded that the costs of these two internal services can be allocated on the basis of the cause-and-effect principle. But opinions were still divided on the controllability of these services, just as they were during the interviews of the second stage. However, a consensus started to take shape during the plenary discussion.

The following conclusion was drawn with regard to the costs of human resources management. These indirect costs could be allocated on the basis of the number of employees (either full-time posts or employees). However, the costs will only be controllable if managers are allowed to bear more responsibility for budgets than they are at the moment. If the managers are given scope to take decisions about the various budget categories, for example budgets for the number of regular and temporary employees, or for data-processing facilities, and about the possibility of substitution for these budget categories, they may be able to control the costs of human resources management allocated to their departments as well.

Similar conclusions were drawn from the discussion about documentary information supply. In this case, a distinction was made between obligations resulting from legislation concerning archives on the one hand, and nonobligatory filing on the other. If these statutory obligations have to be fulfilled, there is no scope for control. However, in the case of nonobligatory filing activities, managers can control the amount of work in the records department, for instance by selecting and reorganizing records before they are filed away.

The participants also discussed the interdependence of consumers and suppliers of relatively controllable internal services. The maintenance of public parks and gardens served as an example (see also Table 3). Internal consumers have to be confident that they will receive services at an acceptable quality and price. They must know enough about the services offered. If they are not knowledgeable enough, steps should be taken to increase their confidence. It was pointed out that external prices can be compared and regular counterchecks can be carried out on the price and quality of this type of internal services.

Ability-to-bear allocation

Some internal services cannot be contracted out but must be allocated according to the ability-to-bear principle. Generally speaking, the services in question are internal services which are thought to be of strategic importance, such as policy coordination, central financial and personnel policy. Intensive political control is exerted on this type of internal services and dependence on external suppliers is considered to be undesirable. However, during the discussion it was observed that less important parts of this type of internal services could be contracted out, for instance human resources management or administrative services in connection with the municipality's accounts. These services should also be controlled and managed at a central level, so that local managers do not get the impression that the municipality is "overspending", as they cannot control such behaviour, but must suffer its consequences.

Abolition of the principle of compulsory internal transactions

The supposition that the abolition of the principle of compulsory internal transactions has a positive effect on cost-conscious behaviour was generally accepted. Obviously, if certain internal services are too expensive or of insufficient quality, the threat of external purchases will result in better internal performance. The participants stressed that an internal service will have to be abandoned if it cannot be provided internally on the same conditions as it can be supplied externally. Lack of time was the reason why during the third stage no attention was paid to the intermunicipal comparison of the total costs of external products, on which opinions were also divided during the second stage.

FINAL OBSERVATIONS

This paper shows the importance of organizational and behavioural aspects of cost allocation in government. A phased approach -- first informing, then testing opinions, and finally reaching a consensus -- seems to hold good prospects for the development of knowledge, understanding, and control of processes of cost allocation. Hence, this approach focuses on the process of the introduction and appreciation of management accounting techniques (see also Lapsley and Pettigrew, 1994, p. 87; Lawton and McKevitt, 1995, pp. 47-48). Behavioural consequences of a new cost allocation scheme have not been measured. The approach primarily concerns an educational process through which politicians and managers can come to knowledge and consensus about cost allocation issues. Consequently, intended behaviour rather than actual behaviour is dealt with.

It is important to address the question of whether the approach outlined in this paper can be transferred to other municipalities or even to other governmental organizations. After all, this approach is based on a case study at one municipality, Stadskanaal. The approach can be characterised as process-oriented. It only raises questions about certain cost allocation issues, whereas the answers to these questions have to be given by the participants of each individual organization. Questions concern, for example, central or internal market control of internal services and cause-and-effect versus ability-to-bear allocation. Every government organization will have to find its own answers to these questions. This study shows how information about these issues can be obtained and discussed[2]. Consequently, transferability primarily concerns the process of providing information and obtaining common understanding on cost allocation topics. Hence, the approach may be applicable in many governmental organizations[3].

It is unlikely, however, that the approach is beneficial to all governmental organizations. First of all, the target group will be limited to those organizations which have already made some progress in developing and applying business-like tools, such as output budgeting and responsibility accounting[4]. Such developments provide fertile soil for the introduction of cost allocation and product costing. This condition probably excludes small-scale government organizations in which the lack of professional management and staff inhibits the use of advanced planning and control systems (Van Helden, 1998). Secondly, due to the broad scope of their tasks, large-scale municipalities in the Netherlands need to consider additional aspects if they want to apply this approach. If, for example, such a municipal organization also encompasses electricity and gas distribution, water supply and public transport, cause-and-effect allocation of municipal overhead costs will be relatively small because these tasks are organized in independent units, although there may be a need for cause-and-effect allocations of overheads within those independent units. Moreover, generally speaking these tasks have to cover their own costs, and consequently the ability-to-bear principle --if applicable at all-- will be based on business-like criteria, such as turnover and contribution margin.

ACKNOWLEDGEMENT

The author is indebted to Jan Bessembinders (division manager of the municipality of Stadskanaal) for his contributions to the research project, to participants of the sixth GIGAR conference in Milan (June 1997) for their suggestions, as well as to professor Robert Scapens (University of Manchester and University of Groningen) and professor David Heald (University of Aberdeen) for their helpful comments.

NOTES

[1] The contracting of this type of services is similar to the so-called Service Level Agreements (SLA's) which are used in UK government and other non-profit organizations (Pendlebury and Algaber, 1997, pp. 284-287).

[2] Player and Keys (1995) gave more general information about the introduction of new cost information systems, particularly activity-based costing systems. The following are a few of their recommendations, which are also interesting in the context of this paper: support from senior management, clarity about objectives to be realized, direct involvement of functional managers (instead of financial specialists), sufficient resources to realize innovations, the organization has to do it on its own (although often with external assistance), and see the connection with other management tools.

[3] It should be stressed that the author actively participated in designing a new cost allocation system. Consequently, the project was a mix of research and consultancy. During the first stage of the research project the author wrote and rewrote a statement about cost allocation issues in collaboration with one of Stadskanaal's division managers. During the third stage the author acted as a chairman of the plenary discussion between Stadskanaal's politicians and managers. The author's interventions were primarily based on mainstream accounting theory emphasizing rational decision making, controllability and accountability. However, the process and content of the project were also influenced by actions and reactions of participants from the local authority of Stadskanaal. For instance, the desirability of fairness in allocating indirect costs was stressed by some of the participants. The project can be regarded as an example of action research in management accounting. As Høgheim, et al. (1992, p. 22) observe: "Our experience then says that action research is search for natural reactions on action justified with rational ideas."

[4] This condition has been met in the case of the municipality of Stadskanaal, which has been a pilot municipality in a nation-wide project that made municipalities familiar with all kinds of managerial methods (Van Helden, 1998).

REFERENCES

Acton, D.D. and Cotton, W.D.J. Activity-Based Costing in a University Setting. Journal of Cost Management 1997; 11, Spring: 32-38.

Ahmed, M.N. and Scapens, R.W. "Cost Allocation Theory and Practice; the Continuing Debate." In *Issues in Management Accounting,* D Ashton, T Hopper, RW Scapens, eds. Englewood Cliffs: Prenctice Hall, chapter 3, 1991.

Antos, J. Activity-Based Management for Service, Not-For-Profit, and Governmental Organizations. Journal of Cost Management 1992; 6, Summer: 13-23.

Broadbent, J. and Guthrie, J. Changes in the Public Sector; a Review of Recent "Alternative" Accounting Research. Accounting, Auditing and Accountability Journal 1992; 5, No. 2: 3-31.

Cabinet of the Dutch Central government. *Miljoenennota 1998.* Den Haag: SDU, 1997.

Cooper, R. and Kaplan, R.S. *The Design of Cost Management Systems.* London: Prentice Hall, 1991.

Dussen, JW. van der. Financial Relationships between Central and Local Government in the Netherlands: Why are they different? Local Government Studies 1992; 18, No 4: 94-105.

Dussen, J.W. van der. Toerekening en beheersing van kosten kan effectiever. Bank en Gemeente 1993; 26, No. 9: 10-13.

Groot, TLCM. and Budding G-Tj. *Prestaties geprezen; cost accounting door Nederlandse gemeenten.* Den Haag: VNG Uitgeverij, 1998.

Helden, G.J van. Cost Allocation and Product Costing in Dutch Local Government. The European Accounting Review 1997; 6, No. 1: 131-145.

Helden, G.J van. A Review of the Policy and Management Instruments Project for Municipalities in the Netherlands. Financial Accountability and Management 1998; 14, No. 2: 85-104.

Helden, G.J van, Bessembinders J. Kostenverbijzondering bij een gemeemte; een strategie voor de implementatie. Overheidsmanagement 1996; 9, No. 11: 286-293.

Høgheim, S., Monsen, N., Olson, RH. Olson, O. *Action Research in Accounting; Experience in the Process of Redesigning an Annual Report.* working paper, Oslo, 1992.

Hood, C. The «New Public Management» in the 1980s: Variations on a Theme. Accounting, Organizations and Society 1995; 20, No. 2/3: 93-109.

Horngren, C.T., Foster, G., Datar. S.M. *Cost Accounting: a Managerial Emphasis.* Upper Saddle River: Prentice Hall, 1997.

Houwaart, D., Linde, R., van der, Pos J, Verduijn K. *Bestuurlijke vernieuwing, bedrijfsvoering en in formatie; slotpublikatie Stichting BBI.* Leusden, 1995.

Kaplan, R.S. and Atkinson, A.A. *Advanced Management Accounting.* Upper Saddle River: Prentice Hall, 1998.

Lapsley, I. and Pettigrew, A. Meeting the Challenge: Accounting for Change. Financial Accountability and Management 1994; 10, No. 2: 79-92.

Lawton, A. and McKevitt D. Strategic Change in Local Government Management: Comparative Case Studies. Local Government Studies 1995; 21, No 1: 46-64.

Leerdam, J. van. Changes in Dutch Government Organizations. Local Government Studies 1995; 21, No 3: 353-359.

Ministerie van Binnenlandse Zaken. *Voorstellen tot herziening van de provinciale en gemeentelijke comptabiliteitsvoorschriften.* Den Haag, 1993.

Olson, O., Guthrie, J., Humphrey G. *Global Warning!; Debating International Developments in New Public Financial Management.* Oslo: Cappelen Akademisk Forlag, 1998.

Pendlebury, M. and Algaber, N. Accounting for the Cost of Central Support Services in UK Universities; a Note. Financial Accountability and Management 1997; 13, No. 3: 281-288.

Player, S. and Keys, D.E. Lessons from the ABM Battlefield, Part I (Getting Off to the Right Start), Part II (Developing the Pilot) and Part III (Moving from Pilot to Mainstream). Journal of Cost Management 1995; 11, Spring: 26-38, Summer: 20-35, Fall: 31-41.

Shields, M.D. and Young, S.M. A Behavioral Model for Implementing Cost Management Systems. Journal of Cost Management 1989; 5, No. 3: 102-112.

Thomas, A.L. Useful Arbitrary Allocations (With a Comment on the Neutrality of Financial Accounting Reports). The Accounting Review 1971; 46, No. 3: 472-479.

Toonen, TAJ. "The Netherlands: a Decentralised Unitary State in a Welfare Society." In *Tensions in the Territorial Politics of Western Europe,* RAW Rhodes, V Wright, eds. London, 1987, pp. 108-129.

Verbeeten, FMH. Activity Based Costing binnen de gemeentelijke organisatie. Bank en Gemeente 1994; 27, No. 9: 23-27.

Zimmerman, J.L. The Costs and Benefits of Cost Allocations, The Accounting Review 1979; 54, No. 3: 504-521.

9

ACCOUNTING SYSTEM REFORM AND MANAGEMENT IN THE JAPANESE LOCAL GOVERNMENT

Kiyoshi Yamamoto

INTRODUCTION

All industrialized countries have implemented the public sector reforms since the 1980s, though there exist several variations. The new public management (NPM), which is rooted in management theory and new institutional economics, has been *in fashion* in many countries (Hood, 1991; OECD, 1995). NPM's philosophy is the belief that private sector management and commercial business practices are superior to public management and practices.

Accounting is an integral measure for NPM, as Power and Laughlin (1992) called NPM as a shift towards accountingization. The change from cash based accounting or budgetary accounting to accrual accounting is part of a broader public sector reform process in the Anglo-Saxon democracies, especially New

Zealand and the United Kingdom. The full accrual accounting system is able to provide more information than a cash based accounting system in terms of quantity and quality; the latter is considered a subset of the former. The aims of the introduction of accrual accounting are to facilitate more transparency in agency activities and to improve efficiency and effectiveness in the public sector. The introduction is however not an end in itself: its value depends on the level of the user's understanding and contribution to decision making. Accordingly, whether or not the accounting system change itself has occurred is an important theme for investigation, but it is not enough.

In this regard, a contingency model on the accounting innovations, which Lüder (1992, 1994) developed, has the following limitations, though the model is robust in explaining and predicting the accounting innovation process.

First, his model aims at explaining how the accounting system change, not the management system reform, has been accomplished. Transition to accrual accounting is, as indicated above, not a fundamental objective but a process element toward public sector reforms. Indeed, some commentators have shown that information on accrual basis was just a little useful for citizens (Alijarde, 1997; Yamamoto, 1997).

Second, Lüder has examined accounting reform at a national level. In addition to the difference in population between central government and local governments, local government has a distinct feature of local autonomy. Self-government and residents' autonomy are a major rule. The former means that local government is able to determine its own affairs, while the latter indicates that citizens shall participate in political decisions. We have to therefore consider the character of direct democracy in local government reforms.

Third, the model assumes that full accrual accounting is more capable than cash accounting and modified cash or accrual accounting. He also implicitly supposes that the change to accrual accounting will surely contribute to improve transparency and to promote efficient use in the public sector. The New Zealand governments and the executive agencies in the UK have shown the successful results on improving accountability and management through the introduction of a full accrual accounting system (GAO, 1995; Scott, 1996). In contrast, fiscal policy (financial management) based on the cash basis has been taken in Europe and the U.S. The member countries of EU must meet the convergence criteria set by the Maastricht Treaty for the entry into the Union in 1999. One of these criteria is that the budget deficit should be no more than three percent of the GDP and its debt should not exceed sixty percent of the GDP. In the U.S., the Budget Enforcement Act of 1990 provided a deficit control mechanism. The act imposed a requirement that a policy change for a particular year does not increase the estimated current and near term deficits relative to the levels forecast at the beginning of the current fiscal year. The policy of fiscal target or control by caps, so far, appears to successfully reduce budget deficit in each country, despite expenditure control on a cash basis. Thus, the assumption may need to be reconsidered.

The above successful results, through different approaches, may be supported by an emerging economic theory, the comparative institutional analysis (CIA). CIA indicates that a diversity of institutional arrangements is possible and the relative efficiency of various institutions depends on the value of exogenous parameters (Aoki, 1996; Nelson, 1995). Consequently, accounting as an institution has to be matched with exogenous factors such as political and social systems. In fact, IFAC (1998) describes:

> *"The most appropriate basis will depends on the characteristics and nature of the entity, the type and purpose of the report and the value of the information to users".*

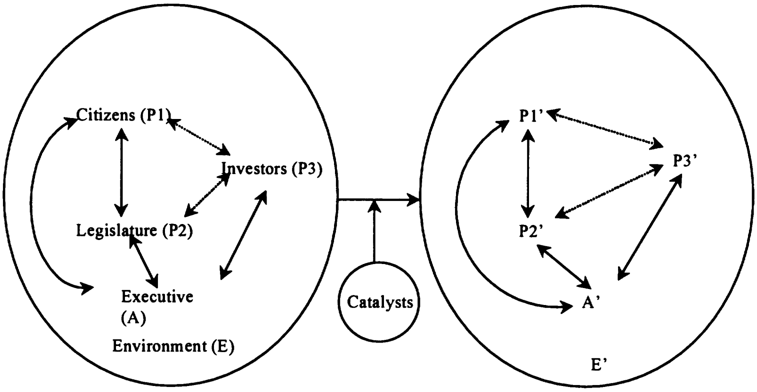
Also, empirical studies of the relationships between accounting system and financial performance (Daniels and Daniels 1991; Yamamoto, 1992) have shown that in a certain context accrual accounting was hardly effective to improving performance in the public sector compared to cash based accounting. Besides, Mussari (1995) indicated that accrual accounting did not directly lead to improve public accountability in Italian local governments.

In this vein, we will expand the contingency model into the whole process in terms of institutional complementarity. In the next section, an accounting system is considered a subset of the management system based on a multi-principal and agent model. Section 3 describes the financial management system in Japanese local governments and the background of public sector reforms. In Section 4, the possible scenarios are indicated in the Japanese local governments by using the expanded model. Lastly, in Section 5, some conclusions are shown.

MODEL

Lüder (1994) indicated three major players in the accounting reform process, the public, politicians and bureaucrats. It is useful that the players are separated into information provider and information user in terms of local autonomy, since citizens or the public as users have the mandate of direct participation. We further divide the players into principal and agent from a democratic point of view. In this principal-agent relationship, principals are no doubt citizens (P_1) and, legislature (P_2), though legislature is also the agent of citizens. Investors (P_3) as GASB (1985) described, are also principal because they provide the fund to local governments; modern governments generally finance the necessary fund for infrastructure from the market. On the other hand, the agents are the heads of executive branch (A) and public employees.

Under the framework (see Figure 1-a), the structural and obstacle variables in Lüder's model could be considered environmental factors (E). The stimulating elements are similarly regarded as thrusts (direct driving forces) for players: disturbance in balance of power for each player, fiscal scandals for P_1 and P_2, deregulation in capital market for P_3, and fiscal stress or deficit for A. The power



$\Delta E = E' - E$ = Change of environment

$\Delta Pi = Pi' - Pi$ ($i=1, 2, 3$) = Change of principal's preference

$\Delta A = A' - A$ = Change of agent's preference

Figure 1-a. *Multi-Principal and Agent Model*

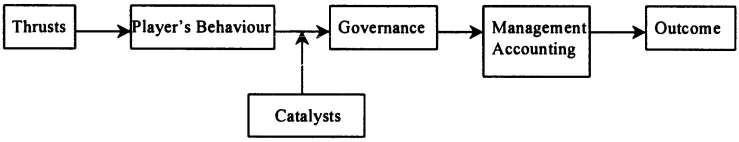


Figure 1-b. *Relationship with Governance and Reform's Outcome*

shift would produce a change of the control system, and fiscal scandals will strengthen the public interest in the public services.

As a result, people will demand more financial information in terms of quantity and quality. Also deregulation of capital market might promote investors to require the government to provide comparative financial information for their decision making. On the other hand, fiscal stress could put pressure on the government (executive branch) to improve efficiency or cut expenses. It would require the cost data on public services.

In addition, if we examine an accounting reform process as a whole, another element should be considered. Because the reform's outcome is determined by not only the player's behavior under the given environment but also the catalysts which are indirect driving forces for reforms (see Figure 1-b). In other words, catalysts function as a promoter or demoter for the transition, and the management system shall be set for the intended governance. Thus, this framing is a modified Lüder's model, but we further have to define the objective of the management system at the same time which reflects the vision of governance.

While the visions of governance are able to be classified by dimension in many ways[1] (for example see Jessop, 1993), in this paper we select two dimensions. The first is the dimension in regard to whether social problems are basically solved by market mechanism (competition) or social regulation (cooperation). The second is the dimension as to whether or not residents are direct participants in policy decisions. Using two dimensions, four government types are determined (see Figure 2).

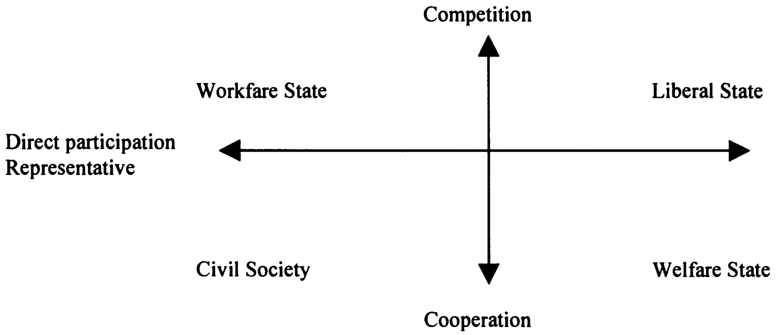


***Figure 2**. Government Model*

The first type is Liberal State whose governance is determined by competition and representativeness. New Right policy by Thatcher and Reagan is able to be considered a neoliberal strategy as market libertarians. Welfare State is the second type, and it is governed by the principles of cooperation and representativeness. It emerged during the long postwar boom and is called the Administrative State by public administration scholars. The third type is Civil Society which is characterized by direct participation and cooperation; therefore, it is considered the participative democracy proposed by Tocqueville. The fourth type is Workfare State whose governance is determined by competition and direct participation. The "welfare to work" agenda of New Labour in the UK and the Clinton Administration in the U.S. is a strategy for enterprise economics which are designed to protect the economy from the demand of democratic society (Cohn, 1997). In the workfare state, "a concern to promote flexibility and competitiveness in the field of social policy. . . demotes this goal (full employment) in favour of promoting structural competitiveness" (Jessop, 1993). Adopting the governance model, we can identify the management and accounting technologies suited to carrying out the policies corresponding to the above governance types.

First, in the case of Liberal State, the legislative branch has to control the executive branch. Especially in a neoliberal state, the benefits of the free market and the evils of state provision (by politicians and bureaucrats) are stressed. Hence, accountable management is suited for this type of governance. Also in order to prevent the discretionary behavior of bureaucrats, accrual accounting has an advantage in providing users with less biased/creative financial information than cash based accounting.

Second, in Welfare State, greater and sometimes conflicting demands from the public have to be considered and reach a mutual consent. As a result, cooperative management, which is supplemented by parliamentary control of the executive branch, is appropriate. In order to provide the interested parties with useful information to coordinate, some segment reportings by district, class, and generation are the integral method. Most public policies in Welfare State produce losers and beneficiaries (winners); for example, a new public work will benefit the district A, while it would damage the district B. Thus, conflicting interests have to be resolved by a corporate institution, i.e., representative democracy. Cash accounting however remains the dominant accounting system for controlling the executive through budgeting. Here accrual accounting would be partly adopted.

Third, Civil Society requires every citizen to participate in decision making. The combination of participative management and cash accounting is appropriate; the average citizen has little knowledge of business (accrual) accounting. Social values, such as preserving the natural environment also need to be measured in social reporting other than financial statements.

Fourth, Workfare State relies on a market mechanism and empowered citizens, though it allows citizens to take individual behaviors as customers rather than collective behavior. In this regard, NPM is a management for reaching the state's vision, and accrual accounting is suited to NPM, because in order to establish a contestable market such as internal market, it requires the comparative data in a consistent way, i.e. cost on accrual basis.

Table 1 shows the interrelationships between the accounting system and other elements. We can understand from this Table why the introduction of an accrual accounting system has produced good results in New Zealand. The successful results were caused by the matching among interrelated elements in governance. NPM operates in a market mechanism, consequently, accrual accounting in the private sector should be transferred to the public sector. Simultaneously, citizens are expected to act as customers in the public services. For example, resident satisfaction survey is an integral important performance measure in the capital,

*Table 1. Governance and Management / Accounting**

Primary Players	*Thrust*	*Catalyst*	*Governance*	*Management*	*Accounting*
$P_2(A)$**, P_3	Fiscal Stress, Fiscal Scandal	External Monitoring	Liberal State	Accountable Management	Accrual Accounting
A, P_2	Fiscal Scandal Fiscal Stress	External Monitoring	Welfare State	Corporate Management	Cash Accounting + Segment Reporting or Partly Accrual Accounting
P_1, A	Fiscal Scandal	External Monitoring	Civil Society	Participative Management	Cash Accounting + Social Reporting
P_1, P_3	Market Force	Liberalizati on Of Market	Workfare State	NPM	Accrual Accounting

* Each cell in the table shows a typical item and does not thoroughly describe all items.

* In case of president system, the head of executive branch (A) partly may play a role of the legislature (P_2), because the head is directly elected by the people.

Wellington City Council. Thus the New Zealand public sector consistently adopts NPM and accrual accounting under the governance of Workfare State.

FINANCIAL MANAGEMENT SYSTEM IN JAPANESE LOCAL GOVERNMENTS

Political System

The Japanese local governments are organized into two tiers, prefectures and municipalities. Prefectures include forty-seven administrative divisions. Municipalities are basic local public entities and are classified into cities, towns, and villages by the criteria of population and urban activities. Each prefecture has a governor and a unicameral assembly; both elected by direct popular vote every four years. Like the prefectures, municipalities are self-governing units administered independently and each municipality has its own elected mayor and assembly. Thus local governments have two principal organizations: the assembly as the legislature and the chief executive officer as their executive. It is known as the *president system* or the *chief system*.

Though local assemblies have the right to decide, only the matters of special importance, such as local regulations and budget, are determined by the assembly and other decisions are within the power of the chief executive. Japan has a centralized rather than federal system of government, even though the Constitution provides the basic principle of local autonomy. Local governments largely depend on central government both administratively and financially. The national ministries have the authority to intervene significantly in local government. Especially in financial autonomy, the central government has a great central power through the financial distribution system (see Figure 3). While the ratio of national taxes to local taxes is approximately 2 to 1, the ratio of national expenditures to local expenditures is conversely about 1 to 2. This reverse figure is caused by two reasons. The first is that a fixed percentage of national taxes are provided as local allocation taxes to local governments for unrestricted use. The second is that the central government grants subsidies to local governments for specific purposes.

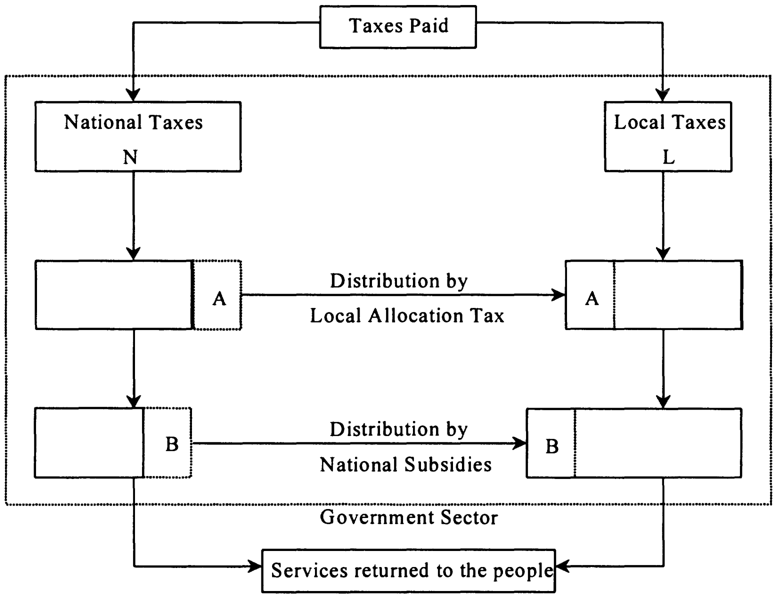


Figure 3. *Exchange of Funds Between the Central and Local Governments*

Notes

1: N : L = 2 : 1
2: N - A : L + A = 1 : 1
3: N - (A + B) : L + A + B = 1 : 2
4. The right sector indicates Local Finances, the left sector National Finances

Backgrounds

The centralized unitary system resulted in standardization among the different local governments and raised the people's lives to the standard of the developed countries. On the other hand, the unitary system by the central government gradually does not cope with the varied needs of citizens. Some innovative local governments have anticipated national policies, for example, making free of charge medical care for the elderly (now a small part of the care cost is burden to them) and regulations on pollution. In spite of these environmental changes, local governments are entrusted to implement central government functions under the control of competent ministers. It has eroded the autonomous behavior of local governments.

The accumulated will, which has called for replacing the present centralized system with the decentralized system since the Meiji Era (1887-1912), finally passed the Decentralization Promotion Law in 1995. Decentralization moved from the debating stage to the implementation stage by this legislation. Since the decentralization delegates central functions to local governments, local governments need to operate their functions more independently. In other words, self-determination and responsibility have to be enhanced. The former demands a high skill in policy making and financial management, while the latter requires an independent control or oversight body in place of the tight control by central government. These needs are the first thrust as a power shift between players: the change of intergovernmental relationships.

The next thrust is the financial stress in local governments. The share of local bonds of total revenues in local finance has increased every year since 1990; it accounted for 28.5 percent in 1997. The outstanding local debt at the end of 1997 is approximately $1,200 billion. The stress in local public finance demands efficient using of public money or cost savings to local governments.

The third thrust is the fiscal scandals. Public officials in local governments used the travelling and meeting expenses to other illegal objective such as private entertainment and fictional meeting with central bureaucrats at exclusive restaurants. The Hokkaido Prefecture is the worst in spending illegal objectives that came to the surface in 1995. Its expenses amounted to $34 million. The local regulations for disclosing government information that preceded the law by the central government, also assists citizens to check and detect the illegal matters. These scandals have not only made citizens more interested in activities of the local government, but required more transparency in the implementing process. In Hokkaido Prefecture, the number of audits which people demanded inspection commissioners increased at fifteen times in a few years.

Catalysts

Two major catalystic policies were developed by the Hashimoto Administration in 1997-98. The first catalystic policy was the introduction of mandatory external auditing to every prefecture and the large cities with a population of over three hundred thousand. The inspection commission system is established by the Local Autonomy Law. The commission consists of four persons appointed by the chief executive in the case of the prefecture; two from the assembly members, two from the informed persons. The office is independent from the chief executive while it belongs to the executive branch.

***Table 2.** Backgrounds of Inspection Commissioners*

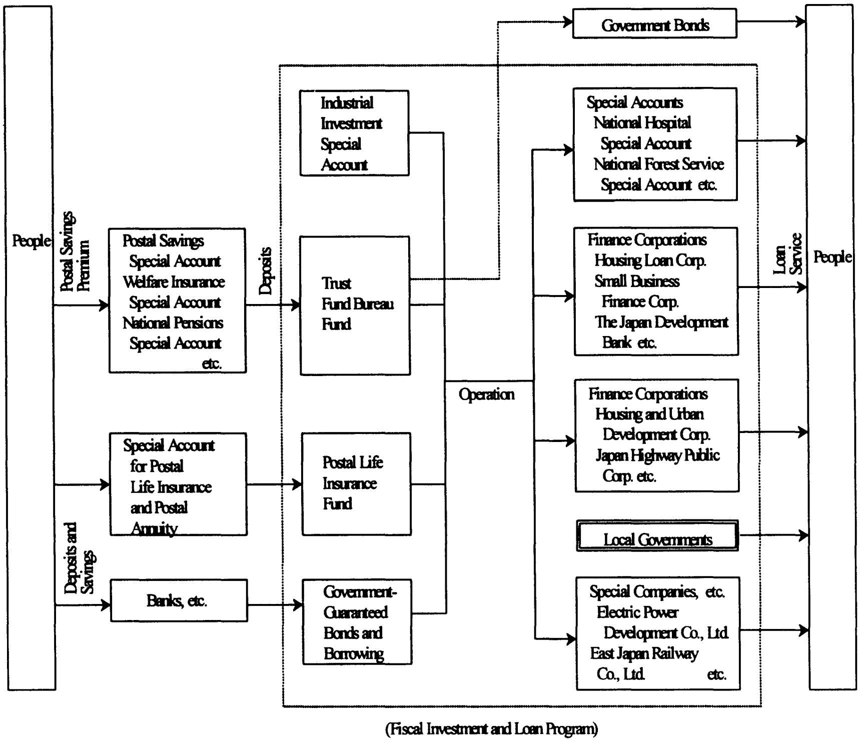
Background	November 1995 (A)	July 1996 (B)	(B) / (A)
	Persons (%)	*Persons (%)*	*Ratio*
Assembly Member	94 (50.0)	94 (50.0)	1.00
Retired Official	74 (39.3)	64 (34.0)	0.86
The Informed	20 (10.6)	30 (16.0)	1.50
Total	188 (100.0)	188 (100.0)	1.00

However, most of the informed persons have experienced in working at their own government. Table 2 shows the backgrounds of commissioners in all prefectures. The new auditing has started in 1999 through the annual contract with the chief executive, and implemented by a person having one of the following conditions:

- qualification of certified public accountant;
- qualification of lawyer;
- rich experience in central or local government auditing.

Since the new system strengthens independence and speciality in controlling the executive branch, it could not only contribute to improve transparency but also to check the illegal behavior in local government.

The second catalyst is the freeing policy of capital market in Japan. The policy intends to make the capital market global, fair and free by the 21st century. It is a comprehensive and drastic change in a short period; therefore, it is called "Japanese Big Bang." The Big Bang will inevitably affect public financial market which is now controlled under the Fiscal Investment and Loan Program (FILP). The FILP is greatly funded from the Postal Savings Fund and the Social Welfare Fund (see Figure 4). As a result, the Postal Savings and Postal Life Insurance Services, and the Welfare Insurance Services, as the main sources of FILP, are regarded as the candidates for privatization.



(Source: Ministry of Finance)

Figure 4. *Fiscal Investment and Loan – Flow Chart of Fund*

If these services are privatized by the freeing policy, the local bonds will lose the safe and reliable creditor. Under the present system, local governments are guaranteed for meeting their financial needs by issuing local bonds as a substitute for the approvals of the Minister of Home Affairs. Also, a significant part of local bonds are funded by FILP. The privatized Postal Saving and Welfare Insurance services will invest their funds in market mechanism. If the regulations on issuing local bonds are also removed, the same superior conditions in local bonds will disappear; regardless of financial state, any local government now can finance at the same lower rate than private finance. Local governments will be required to disclose their financial statements in the same business style as private companies, i.e. accrual accounting, because the market will demand comparative data.

DISCUSSIONS

We now come back to the multi-principal and agent model. According to the model, major players in public sector reforms are citizens, legislature, investors, and executive branch including bureaucrats. The Japanese citizens gradually have the power to check the local government, since the local regulations on information disclosure are strong tools to open the government. A voluntary non-profit oversight body, *Citizen's Ombudsman,* has achieved successful results on detecting many corrupt matters by using this regulation. Though the new external auditing would assist the body to check local government, the body still focuses on checking unfair or illegal behavior rather than participating in decision making or evaluating the policy. Also many people are little interested in participation or policy making. Even in Miyagi Prefecture whose governor was reelected by the citizen's active support, a survey of demand for public sector reforms shows that the citizens give the first rank to "recognition of residents' needs" (43.9%) while they rate citizen's participation low (12.2%).

On the other hand, assembly members who are agents as citizens, have a limited mandate because of the presidential system in local governments. This is different from the parliamentary system in the central government. Besides, the membership is biased in representativeness; minor groups in the population are in the majority of the assembly members and citizens little trust assembly members[2]. Therefore we are unable to consider citizens and legislature dominant players.

By contrast, investors who are another principal of the executive branch have the possibility to play a significant role, if the complete freeing of capital market would be implemented. Although it was discussed in 1997 whether or not the Postal Services including Postal Savings and Postal Insurance Services should be privatized, consequently, neither the Postal Services nor the Welfare Insurance Service was privatized. The Fundamental Law for Reorganizing of Ministries (FLRM) in 1998 has determined that the Postal Services shall be transferred to a state-owned corporation by 2003.

However, the law has given the Postal Savings, Postal Insurance and Welfare Insurance Services a mandate to autonomously invest their funds which are currently enforced to be deposited to FILP by the Fund Operation Law for the Deposit Account. As a result, the reform in public finance may lead to a competitive environment in capital market, while its competitiveness depends on the extent to which of these services underwrite the bonds that public corporations and local governments would issue.

Finally, the chief executive as an agent has the strong power, because the chief executive has the political leadership under the direct election system. In contrast to the central government, in which bureaucrats are most influential in policy making, the chief executive as an elected politician has more power than bureaucrats especially in strategic policy making[3]. It is never accidental that the innovative policies such as information disclosure and preserving the natural environment are implemented in advance of the central government. In this respect the chief executive plays an important role and can lead the reform.

The primary players in Japanese public sector reforms are therefore restricted to investors and chief executives. This restriction shows that necessary players are missing in the transition towards any governance (see Table 1). If the present governance is considered Welfare State, the change to Liberal State needs active investors and Workfare State demands citizens to act as customers. On the other hand, the transition to Civil Society hardly would occur because of insufficient citizen's involvement so far.

Accordingly, we can never identify the unique case for transition but predict three scenarios: transitions to Liberal State and Workfare State, and remaining of Welfare State. As a first scenario, Liberal State would be caused either by entering investors into reforming and implementing processes of the governance as another primary player, or through privatizing and contracting out. Investors would surely join the public services, if local bond market will be developed through reforming capital market. In this case, the local government would prepare and disclose its financial statements on an accrual basis, whether or not it prefers; investors would require the same disclosure rule as private companies. But the market reform is unable to be done by governors themselves, the decision depends on central government. On the other hand, privatization and contracting out can be implemented by the chief executive's leadership. Also they will cause competition among companies or between private companies and public sector departments.

The second scenario is that Workfare State would be accompanied by a market mechanism and consumerism. Though a market mechanism could be introduced through the same way in the Liberal State's case, Workfare State demands another element; citizens have to act as customers or consumers of public services in the internal market. In this case, the focused accountability is on the relationship between citizens and service providers, by contrast to the accountability between legislature and executive branches in Liberal State. As a result, a successful shift towards NPM depends on the political leadership and the extent to which citizens behave in accordance with consumerism. Unfortunately Japanese consumers are not accustomed to behave individually, so it is not easy to meet the second condition.

The third scenario is that Welfare State would remain if the executive branch keeps a strong power while citizens, legislature and investors are not influential in public policies. In this case, even if fiscal scandal or fiscal stress occurs, neither market force nor civil power changes the governance. The executive branch would basically keep the cash based accounting by adopting accrual accounting to several cases unless the chief executive has a leadership of reforms; even innovative chief executives just understand accrual accounting as a tool for improving transparency, *not* performance.

Consequently, we conclude that the third scenario of holding the present cash based accounting is most likely to occur in the near future. However, there is a significant possibility in reaching accrual accounting if capital market reform is implemented or internal market is accompanied with active consumers of citizens.

CONCLUSIONS

We have expanded Lüder's contingency model into a multi-principal and agent model in terms of governance. The model was useful for explaining plural reforms in the public sector. For example, Workfare State accommodates to NPM that is decentralized and market oriented management. In this case, accrual accounting is an integral tool for the management. However, its merits are limited unless interrelated management policies will be simultaneously introduced to the government because of the institutional complementary nature. The New Zealand government has adopted accrual accounting as a subset of NPM. Also, it allows the citizens to behave as customers. Therefore, it is proper that accrual based accounting is not always a uniquely determined system for public management. Actually the member countries of EU now have controlled public spending in cash based accounting.

Japanese local governments are also implementing public sector reforms under the same fiscal conditions. The most probable scenario is that the present Welfare State remains, though three scenarios are identified. In this case, accounting system is cash based accounting supplemented by accrual accounting, although accrual accounting will be fully adopted in a longer term. Accordingly, we further have to investigate the outcome of the accounting system reform in terms of financial performance and democracy other than its transition process. Any accounting system for local governments must promote democracy in addition to improve performance and strengthen accountability in democratic states. Also, since local governments in many countries are at the innovative process, the multi-principal and agent model needs to be examined in these innovative processes and their outcomes.

NOTES

[1] For example, Jessop (1993) indicated four models for the post-Keynesian welfare state: Schumpeterian workfare, neoliberalism, neocorporatism and neostatism states. Similarly, Peters (1996) showed four alternative models other than traditional government: market, participative, flexible and deregulated governments

[2] The share of members from the primary sector in towns and villages is about fifty percent despite only five percent in population.

[3] According to a public opinion poll, people placed the strongest power in policy making as follows: bureaucrats (37.0%), politicians (24.3%), industry (15.5%), public opinion (7.2%).

REFERENCES

Alijarde, M.IB. The Usefulness of Financial Reporting in Spanish Local Governments. Financial Accountability and Management 1997; 13, 1.

Aoki, M. Towards a Comparative Institutional Analysis: Motivations and Some Tentative Theorizing. The Japanese Economic Review 1996; 47, 1.

Cohn, D. Creating Crises and Avoiding Blame: The Politics of Public Service Reform and the New Public Management in Great Britain and the United States. Administration and Society 1997; 29: 584-616.

Damiels, J. and Daniels, C. Municipal Financial Reports: What Users Want". Journal of Accounting and Public Policy 1991; Spring.

GASB. *The Needs of Users of Governmental Financial Reports,* Stanford: 1985.

GAO. *Managing for Results: Experiences Abroad Suggest insight for Federal Management Reforms.* Washington DC: GAO, 1995.

Hood, C. A Public Management for All Seasons? Public Administration 1991; 69: 3-19.

IFAC - Public Sector Commitee, *Guideline for Governmental Financial Reporting. Exposure Draft,* New York: IFAC, 1998.

Jessop, B. Towards a Schumpeterian Workfare State? Preliminary Remarks on Post-Fordist Political Economy. Studies in Political Economy 1993; 40, Spring: 7-39.

Lüder, K. "A Contingency Model of Government Accounting Innovations in the Political-Administrative Environment". In *Research in Government and Nonprofit Accounting: A Research Annual,* J.L. Chan and J.M. Patton eds. Greenwich: JAI Press, Vol. 7, 1992.

_______. "The 'Contingency Model' Reconsidered: Experiences from Italy, Japan and Spain". In *Perspectives on Performance Measurement and Public Sector Accounting,* E. Buscher and K. Schedler eds. Haupt, 1994.

Mayston, D. Principals, Agents and the Economics of Accountability in the New Public Sector. Accounting, Auditing & Accountability Journal 1993; 3: 68-96.

Mussari, R. *Italian Local Government Accounting Reform: An Application of Professor Lüder's Contingency Model,* paper presented to the 5th CIGAR Conference, Paris, 1995.

Nelson, R. Recent Evolutionary Theorizing about Economic Change. Journal of Economic Literature 1995; 33, 1.

OECD, *Governance in Transition,* Paris, 1995.

Osborne, D. and Gaebler, T. *Reinventing Government: How the Entrepreneurial Spirits Transforming the Public Sector.* Addison-Wesley: MA, 1992.

Peter, B.G. *The Future of Governing: Four Emerging Models,* Lawrence KS: University Press of Kansas, 1996.

Power, M. and Laughlin, "Critical Theory and Accounting". In *Critical Management Studies,* Alverson, N. and Willmott, H. eds., London: Sage, 1992, pp. 113-135.

Scott, G.C. *Government Reform in New Zealand,* Washington D.C.: International Monetary Fund, 1996.

Yamamoto, K. Government Behavior and Accounting Information: An Empirical Study in Waster Water Treatment. Journal of Urban Management Research 1992; Vol. 7, No. 1, in Japanese.

_______. *Management and Accounting in Water Authorities,* paper presented at the 47 Conference of the Society of Public Utility Economics, Tokyo University, 1997, in Japanese.

10

RUSSIAN LOCAL GOVERNMENT ACCOUNTING: NEW NORMS AND NEW PROBLEMS

Anatoli Bourmistrov and Frode Mellemvik

INTRODUCTION

Since *perestroika* began in the mid 80s, the Russian society and economy entered a reform process. The idea was that the old system which was mainly built on ideological enthusiasm and strict bureaucratic control by the state, should be changed. Gorbachev was the first to take the responsibility of starting up the reform process by introducing his *perestroika.*

The primary idea of *perestroika* was far from destroying the existing economic and political system. However, the result of reformation was a complete change where the old planned economy was slowly eradicated, and Russia entered its new free market era. At the same time, during the transformation process, Russian society experienced changes geared towards a more democratic society. This was first reflected in Gorbachev's *glasnost* and *democratizatsia* period. However, as time passed, there were needs for changes also in the ways in which the Russian state was organized, and new norms of self-organization in local governments were introduced. Thus, *perestroika* led not only to changes in economy but also in governmental structure.

Accounting information (*ex-post* as well as *ex-ante*) influences the understanding of reality, e.g. the relationships between representative and administrative powers, in most organizations and especially in public organizations (Brunsson, 1989). Accounting principles and ways of preparing for instance financial statements reflect the context of accounting (Watts and Zimmerman, 1979; Garrod and McLeay, 1996). Therefore, it was to be expected that changes in economy and governmental structure would affect accounting in local governments in Russia. In this paper we are studying how events during the reform process influenced accounting in Russian local governments.

The purpose of this paper is to discuss changes in accounting in Russian local governments in the light of *perestroika* and consequent reforms. Firstly, we therefore briefly discuss the method of this study. Thereafter, we briefly describe the main ideas behind *perestroika*. The third part of the paper comprises descriptions of changes both in laws regulating local governments and in accounting regulations. In the fourth part we describe and discuss the consequences of these changes, focusing on the trends of expenditure in the Leningrad county government. The paper concludes with a discussion on changes in Russian local governmental accounting and whether central ideology has influenced local practice.

METHOD

We mainly studied the regulations governing Russian local governments and accounting. This means that we studied the Russian accounting norm system. Bergevärn *et al.* (1995) showed that an accounting system comprises two more or less integrated systems: the accounting norm system and the accounting action system. While the accounting norm system is characterized by rules and requirements to which organizations must conform in order to receive legitimacy from the environment (Scott & Meyer, 1983), the accounting action system comprises instrumental accounting activities.

Accounting influences and is influenced by its context (Grønhaug *et al.*, 1996). Garrod & McLeay (1996) showed that the political and economic transformation of a society influences what is regarded as accounting. The expectation was, therefore, that *perestroika* and consequent reforms would affect the accounting and budgeting norm system. A lot of changes in local governments were introduced by the central government, e.g. Federal Laws introduced new functions, rules and structures for local governments. Therefore, we had to study documents like the texts of the laws, juridical and political documents and recommendations, i.e.

documents regulating institutional changes. Furthermore, documents connected to accounting and budgeting regulations were collected. We interviewed and talked with officers at the Leningrad county government. The information gathering method may be described as a step-by-step procedure, e.g. when gathering some documents we were sent by one officer to another and so on.

It was relatively easy to find laws and other documents which were openly published. However, we found that it is still difficult to get information about actions, i.e. obtain accounting and even budget data from Russian government organizations. We had therefore to use personal contacts and more private networks to have access to the official budgets and accounts that we wanted to study.

MAIN IDEAS BEHIND *PERESTROIKA* AND CONSEQUENT REFORMS

Perestroika was necessary as a process of transformation and reconstruction. In the early 80s, a deceleration of the Soviet economy was observed. According to Lane (1992), this was due to several inconsistencies in the Soviet economy and political system. Firstly, inconsistency was observed between modern work methods and how work was organized and done in the Soviet Union. Secondly, between how control and management were implemented and the socialistic ideology of ownership. Finally, an inconsistency was observed between the centralization of economy and the need to give independence to economic and political agents. Central level politicians argued that the main goal of *perestroika* was to resolve these contradictions and achieve the acceleration of economic growth. To do this, four main elements of *perestroika* were introduced:

1. *Khozraschet* - the way economic responsibilities and independence were delegated to individuals and economic units. The objective was to shift organizational principles from highly hierarchical administrative models to a new system where local groups and individuals could have more influence.
2. *Glasnost* - means openness. The idea was to encourage the process of public debate and access to public information.
3. *Demokratia* - the intention was to create a democratic society where everybody could participate in decision-making processes. The way to democracy was seen through the process of *democratizatsia*, i.e. ordinary people should have the right to participate in political decision-making and, consequently, the power of central government, especially of the Communist Party, should be limited.
4. *Zakon i Kontroll* - the objective was to make people more law-oriented and, at the same time, to fight corruption and unofficial privileges of central government employees.

Thus, the goal of *perestroika* was to reduce the degree of centralization in economy and politics. However, the central planning system was still viewed as a major element of the economy. It has been argued that democratization processes in politics were not supported by democratization in economy. As a consequence, Russia experienced a tremendous economic crisis in the early 90s.

Consequently, the need for a more complete change of society and economy was recognized. At that time Yeltsin entered the public arena arguing that a complete change for the better implied the introduction of a market economy. As a consequence, decentralization in economy was introduced, for instance through deregulation and a privatization policy of state ownership.

It seemed easier to destroy old administrative planning routines, than to create a new market economy. The Federal government lost its old channels for controlling the economy, while no new ones were built (Bogachev *et al.*, 1995). However, after a while there was a reaction and new regulations and principles for organizing the public sector were introduced.

CHANGES IN LOCAL GOVERNMENT ORGANIZATIONS

Before the *perestroika*, in the Soviet period of Russian history, the governmental sector in the Soviet Union was represented by the so-called system of *Soviets* (translated as councils). There were *Soviets* at all levels of governmental hierarchy, i.e. national, republican, regional and local (territories, cities, towns, villages, etc.). Each council was comprised of elected representatives and an executive council committee (*ispolkom*). The *ispolkom* had the function of executing decisions made by the council through its functional departments, e.g. health, education, transportation.

However, in the Soviet Union's centralized political and economic systems, local governments were structurally parts of the central government. Real power was concentrated in the hands of the Communist Party. In fact, every local council was dependent on and tied to the Party's five-year plans of economic development. These plans were introduced by the Party through the executive committees of local governments, and councils only had to approve them (Ross, 1987; Jacobs, 1983; Cattell, 1965). The local representatives had no power to influence their budgets. The local budgets were just adaptations of the five-year plans under the system of central planning. The attempts to improve the relationship between the representative and executive bodies during the 1980s led to nothing.

The laws "On the general principles of local self-government and local economy in USSR" and "On self-government in the Russian Federation" were approved in 1990 and in 1991, respectively. These laws were the first steps toward a new governing system at a local level in Russia. However, the results were not as expected from the texts of these laws. Local self-governance was declared but the supporting financial and organizational rights were not provided.

The first sign of a more substantial change in the state's position towards local governments came in 1993 when the president of the Russian Federation issued a decree "On the basic principles of organization of state power in subjects of the

Russian Federation". That decree delegated the constitutional state authority to territories, regions, cities of federal importance, and autonomous formations of the Russian Federation, i.e. to the bodies of representative (legislative) and executive councils (administration) of the local governments (called in the law "subjects of the Russian Federation"). According to the decree, the representative council should reflect the population and be elected by the citizens. The representative body is responsible for decision-making and control, while the administrative body has to prepare the local budget, implement the budget decisions and execute all other decisions made by the representative council.

Thus, this decree made local governments relatively independent from the state. In 1995 a new Federal Law "On the general principles of the organization of local self-government in the Russian Federation" gave local governments more autonomy, and stated their responsibility to produce services within the limits of their budgets. The law defined that local governments had the responsibility of producing services for the citizens within their area. Furthermore, the law described the relations between the different types of local governments within the Russian Federation (Gorbunova, 1996; Kutaphin & Fadeev, 1997).

In conclusion, *perestroika* led to changes in the organizational principles of local governments. The historical development described above shows that local governments changed from being controlled by the Communist party to federally controlled organizations. However, this change was of a more rhetorical character. The centralized power remained too strong to change the substance. However, as time passed, the necessity for more autonomous and relatively decentralized local governments was revealed.

ACCOUNTING REGULATIONS FOR RUSSIAN LOCAL GOVERNMENTS

Accounting was important in the Soviet Union. However, there were considerable differences in how accounting was understood from the perspectives of Western countries and the Soviet Union (Liberman and Eidinov, 1995). Accounting, in accordance with the Soviet tradition, was very detailed, regulated and control-oriented (see e.g. Bailey, 1990). This is generally the case of all countries with centrally planned economies (see e.g. Chan (1996) in the case of China; Jaruga & Nowak (1995) in the case of Poland). The idea was that accounting should be applied for control purposes, and the main principle of accounting seemed to be uniformity. Enterprise accounting was much cash oriented and adjusted to the accounting system of the Soviet Union «nation». Accounting was meant to function as a tool for measuring the achievement of the national economic plans. This is why the accounting norm system was in the hands of the central government.

In Russia, as in most countries, the enterprise accounting law does not apply to local governments. Though there is no special accounting law for local governments, the regulations have changed, at least a little. In a centrally controlled norm system such regulations are often based on instructions from - for instance - the Federal Ministry of Finance. The most important Russian laws were approved in 1991[1]. These laws introduced the basic principles of the budget system of the Russian Federation, for instance principles about completeness, uniformity, independence and a one-year accounting and budgeting period. The uniformity principle declares that budgets for all local governments should use a common classification of revenues and expenditure. The independence principle states that each local government has the right to approve its own budgets. There are other principles that are not clearly stated in the laws but can be observed in budget statements (for example, the gross principle).

These laws also describe the structure of how expenditure has to be reported. It is stated that budgeted expenditure should be classified into two parts: the current (operational) budget and the development budget (capital investment). However, if there is a budget deficit, the priority should be placed on operational expenditure. According to these laws, accounting reports should be prepared in the same form as the budget, with additional registration of the percentage of implementation on each budget item.

The Ministry of Finance gave other instructions about budgets and accounts. According to the order issued on July 24 1994 all local governments of the Russian Federation should use a common classification of revenues and expenditure[2]. The purpose of this instruction seemed to be the ability to control and prepare consolidated budgets and accounts.

The latest Federal law on local self-government was approved in 1995. Neither former laws or instructions nor the new ones mention balance sheets. According to the normative documents, local governments should - for control purposes - prepare and report to the Ministry of Finance basically three statements: 1) A balance of budget implementation[3], 2) Specification of fixed assets and materials of the local government, and 3) A very detailed statement of revenues and expenditure. In the rest of this paper we will only focus on the statement of revenues and expenditure. When we refer to this statement as «the new report» we simply mean this statement presented according to the regulations and norms introduced since 1991.

Accounting in Russian Local Government: Changes

We have analyzed the statements of revenues and expenditure prepared according to the norms introduced since 1991, and compared them with statements in use before the *perestroika* reform was introduced. Firstly, we observed that there were no changes in accounting principles. The new report and the report that had to be prepared according to the regulations in force before these new laws were approved (the old report), treated revenues and expenditure in the same way. Though nothing was stated in these laws about when accounting transactions should be reported, both the new and the old reports allowed a mixture of accrual and cash-basis accounting systems.

Secondly, both the old statement and the new one had generally the same structure (see Tables 1 and 2). However, in the new statement revenues and expenditure are presented in more detail. At the same time, the expenditure classification is more activity-oriented and expenditure is mostly attributed to the various departments of local governments, e.g. department of education, department of transportation, etc.

Table 1. *Groups of revenues in new and old accounting and budget statements*

New	Old
1. Corporate income taxes	1. Payments from profit of local organizations
2. Personal tax	2. Profit tax from enterprises and organizations
3. VAT	3. Revenues from housing
4. Excise	4. Local taxes, licensing fees and duties
5. Property tax	5. Turnover tax
6. License payments	6. State tax from population
7. Other license and registration payments	7. Other taxes, payments and revenues
8. Payments for use of natural resources	8. Other non tax revenues
9. Payments for renewing of mineral base	9. Grants and transfers
10. Forest tax and payments	
11. Land use and rental payments for use of land	
12. Payments for use of animals	
13. Revenues from county's property	
14. Other non-tax revenues	

A more detailed analysis of these statements shows, however, that the notion of local government has changed. Firstly, the relationship between a local government and its companies has changed. In 1991, the Russian government introduced a new budgeting strategy which was mainly built on the collection of taxes from these companies. Before 1991 payments from profit earned by these companies was included in the local organization's accounts (Wallich, 1994; Dmitriev, 1996). However, in the new report local government revenues from companies are taxes, and reported as corporate income taxes.

Thus, from the perspective of the old report the collection of profit of companies was considered important. From such a perspective payments from profit from companies collected by a local government could be absorbed by this local organization and some of it could be transferred to the federal level.

In the new report the companies are regarded as separate accounting units, and they are therefore not included in the accounting reports of local government. Thus, according to the new law, the companies are regarded as more autonomous

Table 2. *Groups of expenditure in new and old accounting and budget*

New	Old
1. Expenditure on administration	1. Financing of national economy
2. Expenditure on police, fire department and state security	
3. Expenditure on notaries offices	2. Expenditure on education
4. Expenditure on industry	
5. Agriculture	3. Expenditure on health and physical culture
6. Protection of environment and natural resources	
7. Transportation, road maintenance and communication	4. Expenditure on social security
8. Development of market infrastructure	
9. House and communal expenditure	5. Scientific organizations
10. Disaster prevention and elimination	
11. Education	6. Other expenditure
12. Culture, arts and movie production	
13. Mass media	7. Transfers
14. National health and physical culture	
15. Social policy	
16. County's investment subsidies	
17. Maintenance of internal debt	
18. Other expenditure	

organizations. In this perspective the changes of Russian society towards a more market oriented economy are observable in local government accounting.

The second major change is observed in how revenues and expenditure are balanced (see Table 3). The old system implied some kind of revenue accounting. First of all, revenues had to be determined. After that, expenditure was adjusted to the revenues, and budget deficit or surplus was determined by subtracting expenditure from revenues. There were also detailed rules of how to cover a deficit, and for what purposes surplus could be used.

Table 3. *New and old principles of balancing revenues and expenditure*

Old Statement	**New Statement**
R - E = Deficit + Rules how to cover deficit	**E = R + Deficit**

According to the new system expenditure has to be determined firstly. After that, the local government must find ways to cover this expenditure. If there are not sufficient revenues to cover expenditure, a deficit situation will be reported. In such a situation the local government has to decide how to cover the deficit, for example, by applying for coverage to federal authorities, issuing municipal bonds, or/and by taking out a loan from Russian or even international banks.

Therefore, the accounting system reflects more freedom for local governments and more independence from the federal state, as well as more responsibilities for their own financial development. What this may mean is not easily answered. Could it be that the state is delegating inconvenient responsibility to local governments (for example, pushing down to local levels federal budget deficit)? Could this be a smart way of delegating problems and therefore a new way of centralization? Or could it really be one of the important political innovations in the transition of Russian society? Could this change vitalize the public sector, and reduce bureaucracy? It is impossible for us to answer these questions. The only thing we can do is to study the changes in action as they occur - if they do. However, we can already give a snapshot of what is happening in one local government – the Leningrad county government.

ACCOUNTING IN PRACTICE: ILLUSTRATIONS FROM THE LENINGRAD COUNTY GOVERNMENT

Leningrad county has to follow the accounting regulations of Federal Laws and the instructions of the Ministry of Finance. The 1995 law on self-government was effective from 1996 which meant that the county government had to make the first adaptations to the law already in preparing its 1996 budget. Figure 1 gives an illustration of how total expenditure of the county government developed during the period of 1995 - 1998 in nominal rubles. The figure also includes actual expenditure of 1994, 1995, 1996, 1997 and budgeted expenditure for 1995, 1996, 1997 and 1998.

The Russian economy has for many years been characterized by high inflation. Although the inflation rate has dramatically reduced over the last few years, there still was in this period a double-figure percentage in price increases per year. We have, therefore, presented the expenditure recalculated in fixed (1994) prices in Figure 1.

From Figure 1 we can see that actual expenditure in nominal terms for 1995 was higher than budgeted. The 1996 budget was much higher than the 1995 budget. However, in 1996, actual expenditure was lower than budgeted. The 1997 budget increased compared to 1996, but the 1998 budget was lower than the 1997 budget.

In fixed terms the 1998 budget was about the same as actual expenditure in 1995. From Figure 1 we conclude that the 1996 budget was too optimistic. While preparing the 1997 budget, politicians did not know that actual expenditure in

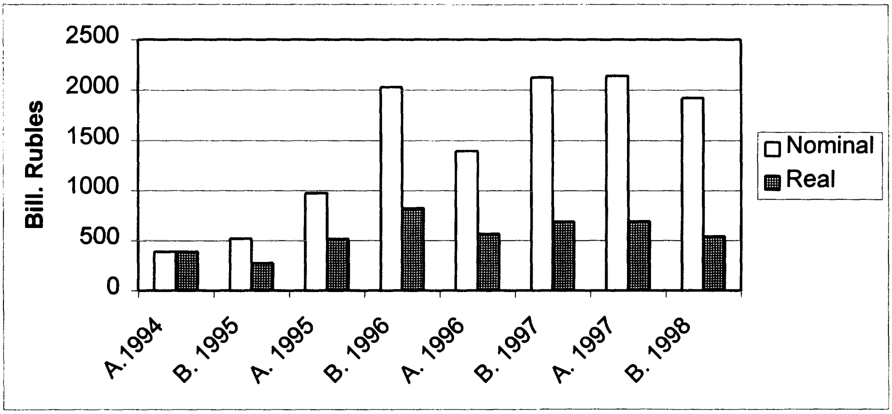


***Figure 1.** Expenditure in nominal and real terms for Leningrad county.*

1996 was much lower than budgeted. When preparing the 1998 budget they seemed to have learnt that optimism had to be replaced by realism.

This development signals that the links between accounting and budgeting were vague in the 1994-1996 period. Høgheim *et al.* (1989) showed that, in a Norwegian city budgets and accounts were so decoupled that there existed two worlds of management control - the world of actions and the world of decisions. In this Norwegian city the annual expenditure budgets were much lower than registered expenditure of the same year, and often even of the previous year. In the Leningrad county government the situation was rather the opposite in the 1994-1996 period. In 1996 the federal government reduced support to county and municipal governments, leaving the counties with more independence, but also with more expenditure to be covered by their own revenues. This resulted in the 1996 budget containing expenditure that exceeded available funds. This led to the co-existence of two worlds of management control in the county government. The world of decisions was much more optimistic than the world of actions. It is difficult to say what the reasons are for such optimistic budgeting. Perhaps, this is due to an optimism created by the laws on self-government and local autonomy, or perhaps this behaviour reflects the uncertainty of the county's government and politicians in handling these new laws. Wildavsky (1975) showed that administrative incompetence, due to - for instance - changes in the society influences budgeting. The administration had no experience in preparing budgets according to these new laws and the new situation, and politicians had not much experience in self-government.

Development in the 1996-1998 period shows that this county government is becoming more competent in handling the new situation. The autonomy of the county government and the reduction in federal financial support seem to have influenced the county government's budgeting behaviour. As the county government is responsible for its deficit, and as it has only limited opportunities of receiving extra financial support from the Russian Federation, its options are to increase regular revenues (taxes and fees) and/or reduce expenditure. From 1996 grants and transfers were reduced. The county government, thus, had to be financed through more local taxes. However, an increase in revenues is difficult to obtain due to the existing high rate of taxation in the Russian Federation and low percentage of tax collection (Kirkow, 1996).

When it is difficult to increase revenues, the only reasonable response is to reduce expenditure. This reduction is, however, not as dramatic as it may appear. In real terms the 1997 budget was higher than actual expenditure in 1995. It meant that 1997 service production could have included about the same amount of services as the previous two years. Post-1995 development reflecting the consequences of the 1995 law could be described as some kind of bridging the worlds of decisions and actions.

Though the links between budgeting and accounting have been much closer over the last few years, especially in 1997, changes have taken place. These changes are even clearer when we study the «consolidated» county government, i.e. the budgets and accounting reports of the county government including all entities (regions) for which the county government is responsible. Figure 2 reports the development in the main expenses of the consolidated county government. Investments in schools and hospitals were dramatically reduced in the 1997 budget compared with investments made in 1995. Even investments in the county-owned companies were decidedly reduced in 1997 compared with 1996. Expenditure for social-cultural activities (e.g. social security) have increased by about 100 % from 1995 to 1996.

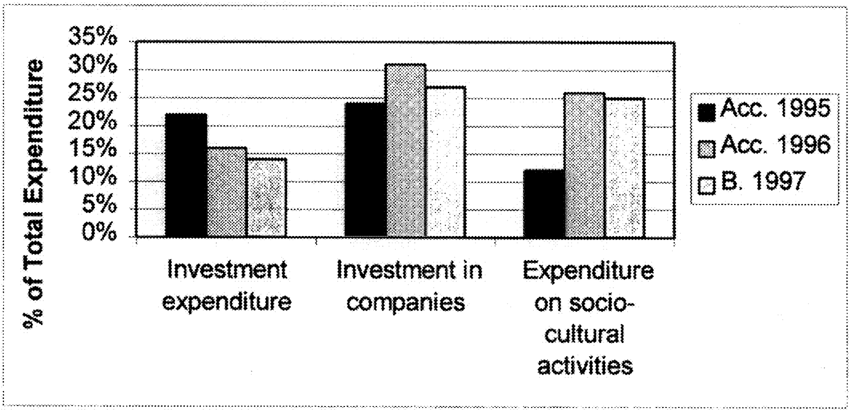


Figure 2. Structure of main expenditure in consolidated budgets and accounts.

Bridging the world of decisions and the world of actions seems therefore to have influenced the future horizon of the county government, making it more «today» oriented than towards building the society of «tomorrow». Most politicians are characterized by visions and ideas of improving society.

The change in the structure of key expenditure that is reported in Figure 2, illustrates more fire extinguishing activities than society building activities. Could it be that bridging the world of actions and decisions reduces the politicians' opportunities of creating visions, and changes them more into administrators of distress? Or could it be that such a crisis gives new knowledge to politicians, and perhaps helps them to understand better the complexity of the changing society? If this is true, such a crisis gives hope.

DISCUSSION AND CONCLUSIONS

Perestroika and consequent reforms have led to changes in Russian local governments and in their accounting. However, these changes only occurred about ten years after these reform processes started. In this way, it is easier to conclude that the accounting reality does not change as fast as the rhetoric of politicians. However, as this paper has shown, it is not even sure that what has been changed has truly reflected the ideas of *perestroika*.

Changes in Accounting and the Ideas of *Perestroika*

Local governments have been reformed several times since 1985, but it wasn't until 1991 that local governmental accounting regulations changed and began to reflect above all the new taxation policy of the central government. These accounting and budgeting changes were in no way radical, leaving local governments with about the same accounting and budgeting systems as they had before *perestroika*.

Through these reform processes, Russian governmental structure has changed. Local governments have become more autonomous and have been given more responsibility for their own economic and political decisions and actions. In this way *democratia* has increased. Furthermore, the ideas of *Khozraschet* and relatively economic autonomy and responsibility are also reflected in the accounting regulations. According to these regulations local governments are responsible for most of their expenditure and revenues. However, as the Leningrad county government description indicated, more focus is then placed on determining expenditure in the attempts to reduce part of it. Though the cutting of expenditure is delegated to local government politicians, it can be questioned whether such cuts give more influence to local groups and individuals. The groups or individuals that are experiencing these cuts, will hardly refer to this as a way of being more influential.

Glasnost' is also reflected in the changes of the accounting regulations. However, it is still difficult to access public information. As we experienced, only some reports were available for the public community. Others had to be obtained through networks which were not so easily built or entered. The reports themselves were also complicated, making them closed even when they were accessible.

It is difficult to argue that local governmental accounting regulations have been influenced by *zakon i kontroll*. In the laws of self-government and local autonomy there are no explicit arguments connected to the fight against corruption and privileges. However, because these laws give more responsibility to local politicians it could be argued that they will have incentives to be more honest and more reliable. On the other hand, these laws give more power to these politicians, and therefore also more opportunities for organizing privileges.

Our conclusion is therefore that *perestroika* has influenced governmental accounting, especially governmental accounting regulations, though the effects are still unclear. Could these accounting regulations be a way for the Russian federal state to avoid criticism, or could the small formal changes at the local level show that this is a good way of trying to introduce re-thinking into the Russian public sector? Given today's situation, how will accounting systems be developed in the future in Russian local governments? As this paper has illustrated it seems that the future development of Russian local government accounting will be influenced by two different and competing forces.

Two Forces Influencing the Development of Accounting Systems

Local governments today have greater autonomy than before and, thus, have the opportunity to develop more locally designed accounting systems. To improve the local economy and financial situation, local politicians and administrative staff may argue that it is necessary to develop an accounting system that would help them to improve financial control. This has already occurred in other local governments before (Mellemvik and Pettersen, 1998). However, the new principal (i.e. the electorate) in Russian local governments is not asking for improved accounts but for improved services. Many politicians and people in general will therefore argue for the need to use resources for other purposes than changing accounting systems. In this sense, two forces exist, i.e. the force of improving services where organizational action is more important than accounting information, and the force of improving financial information to be able in the next step to apply the information to improve service production. The domination of either of these forces will influence the process of changing accounting systems in local governments. If the force of improving services dominates, accounting systems in local governments will probably be left to the federal bureaucracy, e.g. new accounting norms for local government will now and then be issued from the federal level of government. If the force of improving financial information dominates, then probably it will launch the circle of innovations in local government accounting systems.

NOTES

[1] The full titles of these laws are "On the basic rights and rights of formation and usage of off-budget funds of representative and executive bodies of the state power in republics of the Russian Federation, autonomous formations, cities of federal importance as Moscow and St. Petersburg and bodies of local self-government" and "On the basic principles of budget system and budgeting process".
[2] The full title of the instruction is "On the introduction of changes and additions to the classification of revenues and expenditure in the budgets of the Russian Federation".
[3] Translation from Russian: "*Balans Ispolneniya Budjeta*".

REFERENCES

Bailey, D. Accounting in the shadow of Stalinism. Accounting, Organizations and Society 1990;15, 6: 513-525.
Bergevärn, L.E., Mellemvik, F. and Olson, O. Institutionalization of accounting - a comparative study between Sweden and Norway. Scandinavian Journal of Management 1995;11, 1: 25-41.
Bogachev, V.F., Cabakov, V.S. and Hodachek, A.M. *Strategiya Malogo Predprinimatelstva.* Sankt-Peterburg: Corvus, 1995.
Brunsson, N. *The Organization of Hypocrisy.* London: Wiley, 1989.
Cattell, D. *Leningrad: A Case Study of Soviet Urban Government.* New York: Frederick A. Praeger Publishers, 1965.
Chan, J.L. "Budget accounting in China: continuity and change". In *Research in Governmental and Nonprofit Accounting*, Vol. 9, J.L. Chan, ed. Greenwich: JAI Press, 1996.
Dmitriev, M. Russian reforms and state revenue policy. Problems of Economic Transition 1996; May: 56-68.
Garrod, N. and McLeay, S. *Accounting in Transition. The Implications of Political and Economic Reform in Central Europe*. London: Routledge, 1996.
Gorbunova, O.N. *Finansovoe Pravo.* Moskva: Urist, 1996.
Grønhaug, K., Mellemvik, F. and Olson, O. Accounting in a Scandinavian research context. Scandinavian Journal of Management 1996;12, 4.
Høgheim, S., Monsen, N., Olsen, R.H. and Olson, O. The two worlds of management control. Financial Accountability and Management 1989; 5, 3: 163-178.
Jaruga, A. and Nowak, W.A. Governmental accounting in transition: the Polish experience. Financial Accountability and Management 1995; 11, 1: 75-95.
Jacobs, E.M. ed. *Soviet Local Politics and Government.* London: Georg Allen & Unwin, 1983.
Kirkow, P. Distributional coalitions, budgetary problems and fiscal federalism in Russia. Communist Economies and Economic Transformation 1996; 8, 3: 277-298.
Kutaphin, O.E. and Fadeev, V.I. *Municipalnoe Pravo.* Moskva: Urist, 1997.
Lane, D. *Soviet Society Under Perestroyka.* London: Routledge, 1992.
Mellemvik, F. and Pettersen I.J. "Norway - A Hesitant Reformer?" In *Global Warning! Debating International Developments in New Public Financial Management.* O. Olsen, J. Guthrie and C. Humphrey, eds. Oslo: Cappelen Akademisk Forlag, 1997.
Ross, C. *Local Government in The Soviet Union: Problems of Implementation and Control.* London: Croom Helm, 1987.
Scott, W. R. and Meyer, J.W. "The organization of societal sectors". In *Organizational Environments: Ritual and Rationality*, J.W. Meyer, and W. R. Scott, eds. Beverly Hills: Sage Publication, 1983.
Wallich, C. *Russia and the Challenge of Fiscal Federalism.* Washington DC: The World Bank, 1994.

Watts, R.L. and Zimmerman J.L. The Demand for and Supply of Accounting Theories: the Market for Excuses. The Accounting Review 1979; 273-305.

Wildavsky, A. *Budgeting - a Comparative Theory of Budgetary Processes*. Boston: Little, Brown and Company, 1975.

11

SOME CONSIDERATIONS ON THE SIGNIFICANCE OF THE ASSETS AND LIABILITIES STATEMENT IN ITALIAN LOCAL GOVERNMENT ACCOUNTING REFORM

Riccardo Mussari

THE PROCESS OF REFORM AND THE «NEW» MODEL OF LOCAL GOVERNMENT

The Italian public sector, and Local Government in particular, is experiencing an era of considerable change arising from a process of reforms that the Parliament is still introducing[1].

These reforms influence many aspects of Local Government operations: organization, policy, management, finance, accounting and auditing, to quote the most important. The modification of this set of variables determines a frame of reference which differs considerably from just a few years ago and identifies a «new» model of Local Government.

In particular, with respect to the past, this new model is distinguished by two essential features:

a high degree of autonomy (financial, organizational and accounting) from the central government;

clearly defined responsibilities toward the administered community for the use of available resources.

As generally happens in periods of transition, this development is not completely harmonious. However, a new concept of accountability for Italian Local Government is undoubtedly taking shape.

In the «old model», limited accountability existed, primarily between the central government and tax-paying citizens, rather than between Local Government and its community. The decision-making capacity of these public organizations and their consequent duty to be accountable, apart from legal accountability, was minimal. Citizens did not receive much feedback about the results produced by Local Government.

The situation prior to the approval of reforms in the 90's may be summarised in the following points.

A) FINANCE

Public finance was high centralised. The central government raised money from taxation and distributed it directly, year by year, or through another public entity (the regional administration for example) to Local Governments to perform many public functions and services. In most cases the use of such funds was predetermined. Only a very small part of disposable resources was collected locally.

It is important to note that resources had previously been allocated on the basis of various criteria (in particular, past expenditure) but none of these reflected the capacity of Local Governments to economically satisfy the needs of local users. In other words, the quantity of resources allocated depended essentially on the negotiation capacity of the Local Government lobby in Parliament and, above all, on the fiscal and financial situation of the State rather than on previous economic performance. The capacity to «solve problems» seemed to depend more on the amount of money at disposal than on its use.

B) ORGANIZATION

The administration was regulated by several Consolidation Acts promulgated before or during the years of Fascism, that is, before the present Italian Constitution was approved in 1948. This means that organisation, establishing the services to be provision, their rendering, and the «working rules» were carried out centrally and practically the same for all Local Governments without any regard for their specific characteristics. The Local Government model was predetermined by the State and essentially universal.

C) BUDGETS AND ACCOUNTING

Budgets, accounting and financial reporting were modelled on those of the State. The system was very traditional, lacking accrual and management accounting. This was in absolute accordance with the centralised model of the State. Accounting language had to be uniform since the system was only aimed at allocating resources rather than observing the economic effects of decision-making[2]. Of course, there was no performance measurement system.

D) AUDITING

Auditing was internal and, in conformity with the law of 1934, the accounts of Local Governments were audited by three councilors chosen by the Municipal Council among those who were not members of the Town Executive Board.

The role of the Auditors consisted practically of verifying the formal correctness of the decisions made by the Town Executive Board and the correspondence of the data reported in the accounting books and the figures in the Statement of the accounts. It was a legitimacy check without any regard for the results of Local Government activity.

Moreover, even if in most cases this delicate function was assigned to honest people, this unfortunately did not necessarily imply their professional competence in performing this job.

E) POLITICIANS AND PUBLIC OFFICIALS

Since spending power was in the hands of the Town Executive Board and not of the top officials, politicians very often ended up managing without competence and in so doing neglected the role of managers. The consequent lack of co-ordination among the various functions of the organisation made it impossible to assign responsibility for the results of programs and services. In turn, the relationship between planning, execution and performance could not be clearly defined and this caused a lack of feedback information for managerial and political decision-making processes and, in many respects, for citizens too.

The process of reform, undertaken with the adoption of law n° 142 of 8 June 1990, contributed to modify the features described above.

A) FINANCE

Two fundamental principles have been stated since 1990:

1. the financial autonomy of Local Governments must be guaranteed and based on the certainty of their own and allocated resources;
2. Local Governments must have the power to levy new taxes.

As Local finances continue to be «mixed», the State is to continue to finance local institutions by means of allocations. To be more exact:

- the State is to continue to contribute to the financing of local services which are considered indispensable;
- the State assigns specific contributions in the case of exceptional situations;
- the State contributes to Local Government investment in the furnishing of public works of primary social and economic interest.

All other services that Local Governments wish to render to their communities must be financed by levying taxes or setting prices so as to recover all incurred costs.

New local taxes have been introduced (in particular ICI, a local property tax which should constitute the central pivot for fiscal autonomy).

Other taxes have been reformed and the Local Governments can now issue bonds[3].

B) ORGANIZATION

Since 1991 each Local Government has had its own Statute and regulations. The old laws have been abrogated. Now the State establishes only the main criteria and principles, while the Local Government establishes its own rules. The statute is a sort of «constitution» of Local Government in which each authority is free to determine the norms which had been previously imposed by law. It contains the fundamental norms for the body's organisation, for the tasks assigned to the body's single organs and their co-ordination. Municipalities and provinces are free to decide the number of staff needed to perform each function and service in accordance with principles of autonomy and economy, and according to criteria for professionalism and responsibility. The Italian Legislature has placed particular emphasis on public participation and encourages Local Governments to engage in dialogue with their communities and to take all public information into consideration in their decision making processes.

C) BUDGETS AND ACCOUNTING

Without going into details, we may try to summarise some of the most important innovations arising from the approval of accounting reform (Legislative Decree 25 February 1995, n. 77) which we will refer to as Lgs. D. 77/95[4].

- Guidance of programming activity has been greatly reinforced and an authorisation requirement has also been attributed to the pluriannual budget, increasing the reliability of this previously dubious document.
- The classification of expenditures in the budget is now less detailed than in the past and this should enhance the intelligibility of the document and reduce the need to repeatedly update the budget during the financial year.
- The cash budget has been abrogated.
- Operating budgets have been introduced to make officials responsible for the results of the organisational units they manage.
- A management control system is now mandatory.
- Accrual accounting will be gradually implemented by Local Governments.
- Financial reporting has been particularly revised, now requiring not only the compilation of a financial account but also a reliable balance sheet, a profit and loss account and performance indicators.

Notwithstanding the necessity to guarantee formal and substantial uniformity to public accounts in order to allow their consolidation, Lgs. D. 77/95 affords Local Governments a wide degree of autonomy in the accounting field. For instance, with regard to financial reporting, it is possible:

- to add indicators of efficiency and effectiveness;
- to draw up a consolidated balance sheet;
- to present a balance sheet at the beginning and at the end of the electoral mandate.

Such freedom of movement was further expanded with the approval of Law n° 127 of 15 May 1997. In fact, article 9, comma 4 of this law divides the provisions of Lgs. D. 77/95 into two categories:

a. compulsory norms,

and

b. flexible norms.

This allows each Local Government to formulate accounting provisions which are "made to measure" to suit subjective criteria including size, available resources and professional capacity. All this is obviously structured within a framework of mandatory principles which must be universally respected.

D) AUDITS

A new Audit System was introduced in 1990. The introduction of professional auditing is an attempt to satisfy the growing demand for transparency in the managing of public money and should act as a deterrent against impudent local administration.

However, in addition to traditional financial auditing, the Board of Auditors, made up of three professional Auditors, must evaluate results achieved in terms of performance (efficiency, productivity and overall performance) so that the Council may:

a) judge managerial performance;
b) make its political choices on the basis of economic information which was practically unavailable prior to the reform.

It should be pointed out that, in addition to its traditional role, the Board of Auditors acts as a kind of consultant directly connected to the supreme decision-makers of the organisation, the Council, in performing monitoring and policy functions[5].

Considerable importance is attributed to the auditors' duty to express substantiated judgement over the clarity, coherence and reliability of the budget and relative projects and programs. The auditors are bound to suggest to the Council all measures necessary to guarantee a credible framework. In turn, the Council is required to carry out all such measures or adequately substantiate any lack of compliance with the auditing body.

E) POLITICIANS AND PUBLIC OFFICIALS

A unique element in the Italian reforms is the new distinction between politicians and officials who are «responsible for services». The solution offered by the national Legislator is to clearly establish and separate the tasks and the responsibilities of «managers» and politicians.

Such a rigid definition of roles and duties can only work from a theoretical point of view since the suggested solution conceals the premonitory signs of another serious plague: forgetting that Local Government is, first and foremost, an organisation. This means its components need to communicate and cooperate in order to achieve the organisation's goals and objectives. It would be naive not to realize that such public organisations are hard-pressed to find practical solutions capable of ensuring a harmonious coordination between the two «hearts» of Local

Government: political and technical. Their coordination, essential to the overall performance of Local Government, should be facilitated by the appointment of a municipal/provincial director whose job it is to carry out the goals and attain the objectives established by the municipal/provincial executive body, achieving the greatest possible efficiency and effectiveness[6].

However, beyond these considerations, the law stipulates that «managers» must:

- manage offices and services according to the criteria and the norms established in the Statute and Regulations of the Local Government;
- perform all the tasks, including the adoption of acts to bind the administration to other entities, which the State law and the local Statute do not reserve specifically to other organs.

The approval of the accounting reform in 1995 has introduced important innovations.

Each year, following the approval of the municipal budget by the Council entrusted with deciding the amount of funds to be spent for each program, function and service, the executive board assigns an operating budget to each manager responsible for a service.

In this document, the short term objective to be fulfilled for each responsibility center is known in advance (this should be in agreement with those set in the documents in which the programs are drawn up) and the financial, human and technical resources available during the next year are presented.

Thus, an important step in the decentralisation process is taken, presumably resulting in:

a) the need for managers to have more specialised information and skills;
b) greater managerial autonomy from the Municipal or Provincial Executive Board in decision-making (it is important to note that spending power is in the hands of managers and not Municipal or Provincial Executive Board members);
c) greater authority and prestige for managers.

It seems evident that these norms entail a redistribution of decisionary power between politicians and «managers» of Local Governments. Clear objectives and performance targets for managers, along with the other variables mentioned in the previous paragraphs, will not only change the behaviour of administrators (managers) but, above all, will impose the widespread use of all those management techniques (including management accounting) which are indispensable for performing these new tasks and truly assigning responsibility for achieved results.

The renovated concept of assets and liabilities

The *Statement of assets and liabilities* is the balance sheet of the Local Government. Therefore, it is here that we find all the elements of assets and liabilities of Local Government, as well as the net worth which results from the difference between assets and liabilities.

As such, it should not be considered a breakthrough in Local Government because it was already specified in the laws written prior to the Lgs. D. 77/95.

Unfortunately, this duty was largely neglected. For example, we might recall that the Local Administration Division of the State Audit Court, in its «Special Report on auditing practices in municipalities with more than 8,000 inhabitants and in the Provinces (Report of 1991)», with respect to the obligation of drawing up the balance sheet and inventories, reported as follows: «It is the most frequently cited irregularity contained in the reports of the auditors' board: 57% of the organizations examined; 27% of these declared an absence of balance sheets and/or of inventories; the remaining 30% made use of inventories which had not been updated for decades».

Unfortunately, from the statements above, we deduce that it is extremely difficult not only to evaluate the elements that at present compose the wealth of the Local Government, but even to count them correctly.

It is necessary to observe that carelessness with assets is a very dangerous sign clearly indicating the lack of a managerial system. If we practically consider the legal requirement of a wealth appraisal report it is evident that an organ not interested in knowing of its own wealth and relative fluctuations caused by accounting transactions by definition is not of a well-managed organization.

It is not natural for an organization, regardless of its class and/or nature (public or private), not to take interest in its own wealth, since this means that it does not care about its own future. Every organization's ultimate goal is its survival, which clearly depends on the potential services it is able to offer and its potential energy, that is, on its wealth.

At this point we are bound to trace the cultural reasons for such a scarce interest in wealth variations.

This attitude does exist and is very much rooted in organizations with a presumption of immortality. Yet, the fallacy that the capacity to economically manage dwindling resources and the obligation to be accountable for results are not necessary for the survival of public organizations utilising public wealth is still widespread.

The idea that the future of these administrations, in their present economic dimension, may only be guaranteed by institutional conditions appears unfounded. Most probably, significant processes of reform that are of interest to Local Governments will contribute to drastically reduce the number of administrations with such cultural orientations. Otherwise, for many of them there will be a rapid and sudden «awakening».

However, if Local Governments have paid little attention to balance sheets, Legislators are also at fault since they have failed to offer timely principles and methods necessary to satisfy the urgency for such information. We feel that when the first important law for the reform of Local Government (L. 8 June 1990, n° 142) was approved, the evaluation criteria of the items in the balance sheets should have been clearly explained and every Local Government should have had sufficient time to update its inventories.

Once this operation was completed, they should have introduced, simultaneously for all Local Governments, a full accrual accounting system, imposing the use of double entry book-keeping.

In this way, not only timeliness, but also reliability of financial statements would be attained.

Unfortunately, it was necessary to await the approval of Lgs. D. 77/95 (five years later) in order to obtain the necessary indications delineating the drawing up of the balance sheet to make it finally clear that simple information based on cash transactions and distorted by the need to adapt it to accounting procedures was no longer sufficient for the ends of public accounting.

With regards to the widespread unreliability of assets and liabilities data, the legislator rightfully required all Local Governments to urgently update inventories prior to drawing up the initial balance sheet.

Article 72 of Lgs. D. 77/95 expanded the concept of Local Government assets and liabilities. In fact, the second clause of the previously mentioned article specifies as follows: «The wealth of local government is formed by the total of the assets, active and passive legal relations, rights and obligations belonging to each body and subject to evaluation, by accounting, with the relative final result representing net worth». The third clause declares that Local Government is to «include public domain assets in its balance sheet, making specific distinctions and retaining the specific characteristics stipulated by the provisions of the Civil Code».

In this paper, it is important to observe that, in compliance with the new law, local public wealth and the relative accounting document that certifies its qualitative and quantitative composition includes community assets as well, which obviously requires its «translation» into monetary units. In fact, «the measurement of assets and liabilities, like that of any limited greatness, has to be a number»[7].

The bearing of this innovation is substantial, leading us to formulate some general considerations.

First of all, it should be noted that prior to the reform of 1995, the Local Government estate was composed of the goods which belonged to Local Governments but which were not part of public domain. More clearly, all the property of Local Government was an element of its estate with the exclusion of some assets such as: roads, railways, immovables of historical interest, museum collections, cemeteries, municipal markets. All public domain assets which Italian law generally considers unsalable and indefeasible were excluded from the balance sheet and thus not evaluated but only described in particular inventories.

Two problems hinder a global evaluation of Local Government assets and liabilities, and therefore a fair evaluation of the year-end profit and loss result.

a) Identifying a concrete goal that should not be set out of simple corporate resemblance, but should be defined by considering the managerial purposes of Local Government;
b) The necessity to evaluate all aspects of Local Government wealth.

The first obstacle is difficult to overcome. It is the well-known problem called the *bottom line,* which international literature has addressed.

The concept of *interperiod equity* or even better, *intergenerational equity*, offers a good basis for discussion, with reference to the purposes of the year-end assessment of income and financial position[8].

In simple terms, these expressions mean that, in every fiscal year (or taxable period) or in every generation, contributors should not consume more resources than they produce in order to leave future generations with the public property, in its intact value, which was used to satisfy their needs and which will continue to be used in the future. The fact that not only the expenses relative to the consumption of current assets and services, that is of the resources needed to guarantee «the normal functioning» of the Local Government undertaking are declared, but also the potential services arising from durable goods or depreciable assets, which must be replenished, assumes particular importance. This means that covering expenses linked to the consumption of public resources used to satisfy collective needs must be guaranteed, yearly or generationally, by revenues and it should not depend on the payments of the future contributors. It should be emphasized that, in considering financial position and operative results, referring to a single fiscal year rather than to a multiannual time period equivalent to a generation, has a considerable impact. The advantages and disadvantages of each option are easily perceivable, so that it is probably indispensable to integrate short and medium-long term perspectives. On one hand, it is necessary to recognize the need «to draw up a financial statement» for a sufficiently short period of time in order to obtain accurate results to compare against the budget, facilitating decisions aimed at the effective and efficient use of available resources. At the same time, it is known that the effects of the public programs and projects often require long periods of time to reveal themselves completely.

From these perspectives, the definition of Local Government assets contained in the Lgs. D. 77/95, which includes public domain assets, seems fully acceptable. In spite of evaluation problems which will be discussed later, there is no reason why municipalities or provinces should not be required to publicly disclose the value of their assets. Anyone can perceive that the social and economic welfare of a community is largely dependent on the quality and quantity (that is the value) of those assets; therefore, ignoring the existence of community assets in financial reporting in fact means removing from the public those useful elements which allow judgements about the decisions made by political organs in control of a large portion of the collective wealth.

Moreover, in light of the public finance crisis, we retain that failing to produce information on the value of the community assets delays the investment expenditure in favor of incrementing the current expenditure as result of progressive depletion of public property.

Yet, when starting from the concept of *intergenerational equity* it does not seem possible, at least theoretically, to exclude community assets from balance sheets, except when more effective alternative sources of information may be found. Such assets certainly represent the most significant portion of collective wealth; Local Government therefore, is obliged to give accounts of their value not simply because they are instrumental to the development of the internal economic processes (of production and consumption) but, rather, because they are controlled by Local Government, their acquisitions being financed with public resources. Just as importantly, it is the duty of Local Government to make use of the resources available in order to guarantee the maintenance and possibly the increase over time of the economic potential that those assets incorporate so that future generations may make use of them at least to the same extent.

Italian accounting literature, however, presents different opinions concerning the appropriateness of including community assets in balance sheets. Generally, the justification for their exclusion lies in the absence of a market for these unsalable goods, and, therefore, of an exchange value to refer to.

In fact, «a good permanently removed from exchange becomes impossible to evaluate. The economic value of goods, in a free market economy like ours, is actually perceived and determined by exchange, through price formation. Public domain assets, removed as they are from the market, may no longer be assigned a price, so that the determination of their economic value is extremely difficult and arbitrary, without any real reference to market prices»[9].

Some authors suggest an interesting distinction between «social property» and «business wealth» and justify the exclusion of community assets from the balance sheet by pointing out that social property «does not play a specific business role, consisting of goods of unsalable nature and direct collective use for which their evaluation and inclusion in business wealth would have scarce importance»[10].

Other scholars seem to have the opposite view. With reference to the State budget it has been noted that: «If we assign business wealth the function of determining year-end profit and loss results, it is obvious that we must include all indistinct elements of investment expenditure, that is all those expenses that, in general, are judged as not pertaining to the accounting period in which they occur and which consequently, as a rule, do not participate in the determination of the same year-end profit and loss result»[11].

Others state that « the failure to evaluate community assets represents one of the less congruent aspects of public assets . ... Their lack of evaluation which, from the accounting perspective, excludes them from the assets, seems absolutely anachronistic; even more so if we consider the fact that their acquisition is measured in cash in the investment expenditure, their maintenance in the current expenditure, and their extraordinary maintenance and the eventual restructuring again in the investment expenditure. Therefore, ultimately, expenditures linked to community assets have a precise place in the financial statement, in book-keeping and in financial statements»[12].

The way to present the items in the balance sheet is similar, with some modifications, to the balance sheet layout made mandatory for companies some years ago as a consequence of the implementation of the European Community Company Law Directives dealing with annual and group accounts in our Civil Code [13].

One detail is however worth noting. In the layout of the statement of assets and liabilities, the public domain is included among fixed assets, while net worth is divided into two parts: I) net worth and II) worth from public domain. The worth from public domain is calculated by subtracting from the value assigned to the public domain those loans incurred during purchase which have not yet been paid off.

Without underestimating the importance attributed to the layout of items, that is, to the statement which guarantees a comparison of the various balance sheets of Local Government, there is no doubt that the most important means for achieving a fair and reliable accounting representation of assets and liabilities are the valuation criteria. These are imperative, not only for a fair presentation of the qualitative and quantitative situation of assets and liabilities, but also, for a reliable determination of the year-end profit and loss result.

Valuation criteria and depreciation

Article 72 of Lgs. D. 77/95 establishes the following valuation criteria.

1) Public domain assets:
   a) Those already acquired at the time that the Lgs. D. 77/95 came into force are appraised on the basis of the residual loan being extinguished.
   b) Those acquired afterwards are valued according to the cost criterion.
2) Land:
   a) Parcels already acquired at the time that the Lgs. D. 77/95 came into force are appraised according to their cadastral value, reappraised in light of fiscal norms;
   b) For parcels already acquired and for which the cadastral income is not estimable, the appraisal is made as with community assets already acquired;
   c) Parcels acquired afterwards are appraised according to the cost criterion.
3) Buildings:
   a) Those already acquired at the time that the Lgs. D. 77/95 came into force are appraised according to their cadastral value, reappraised in light of the fiscal norms;
   b) Those acquired afterwards are appraised on the basis of cost criterion.
4) Movables: cost.
5) Receivables: face value/nominal value.
6) Life annuities, perpetual leases: capitalization of the annuity at the rate of interest established by the Civil Code.
7) Inventories: norms of the Civil Code[14].
8) Accrued income and expenses: norms of the Civil Code.
9) Deferred charges and income: norms of the Civil Code.
10) Payables: residual value.

It is evident from the above list that «cost», as is also the case in the Civil Code, is the base criterion for the evaluation of the items representing Local Government assets; this choice is fully understandable and justifiable because it is a criterion of simple application and leaves only minimal margins of technical discretionary power.

However, some brief observations should be made.

The expression «cost» is never qualified, as are «purchase price» or «production cost». Consequently, the elements to include or exclude for a correct appraisal of the «cost» of the assets to include in the balance sheet are not identified. On the other hand, such specification, even if not directly expressed, is indirectly referred to in the stipulation that inventories must be appraised according to the norms of the Civil Code. In fact, article 2426 of the same code prescribes that «inventories, investment securities and shares not included in fixed assets are to be appraised at the purchase price or production cost».

No specific mention is made of the investment securities or shares which are, however, included in the balance sheets both as long and shortterm investments. Therefore, it seems necessary to refer to the criteria established in the Civil Code and to national and international accounting standards.

The decision to evaluate community assets already acquired in light of the loan payments to be made leads to the conclusion that the value of community assets when the Lgs. D. 77/95 came into force, still in possession of their service potential, is equal to the amount of money that has not yet been paid back. The value that will be depreciated in the years to come is equal, therefore, to the amount of money not yet paid back, while the value «already depreciated» is determined by the portion of the loans paid back. In other words, referring to the time expired between the contract of the loan and the accounting period in which the new norms came into effect, if the annual installment of the loan is considered equal to the depreciation allowance, this represents the cost of using the fixed asset (or durable good). Consequently, as we have already observed, if the loan was entirely paid back at the time that the new norms came to force, there would not be depreciation allowances in the future accounting periods even if a shorter period of time has passed from the purchase date of the good than the depreciation period indirectly stipulated in the Decree.

Moreover, if an amount of money superior to that which should have come from the «normal» process of depreciation was paid back during the past period between the contract of the loan and the enactment of the new accounting system, the value to be depreciated in the future and, therefore, the annually constant depreciation allowances, would be smaller. For this reason, future generations of consumers and tax payers would bear a reduced cost in nominal terms.

With particular consideration of assets of artistic value, it would probably be wise to indicate the criteria to follow in the case, if infrequent, of donation.

In any case, identifying the criteria for evaluating the "residual loan" for public domain belonging to the Local Government prior the Lgs. D. 77/95 by definition makes it impossible to appraise works of art and excludes them from the statement of assets and liabilities. In fact, such works are typically very old (buildings of historical importance, artworks, museum collections) and do not require any relative loan payments![15].

The decree does not propose a clear distinction between depreciable assets and non-depreciable assets. The decision to list the depreciation rates for the different categories of goods, inevitably leaving the list open for «other public domains assets» and for «other assets» is in contrast with the policy adopted by the Civil

Legislator who, in implementing the European Community Directive on annual accounts, decided to specify that the cost of fixed assets (tangible and intangible) which will only be used over a limited period of time must be systematically depreciated each financial year, in line with the reduced life expectancy of the asset. The absence of a general criterion to practically define the basic characteristic that an asset must possess in order to depreciate could cause some interpretative difficulties in applying the norms dealing with depreciation, given that this distinction has not traditionally regarded the accounting system of the Local Governments[16]. Moreover, such specification could be particularly useful, considering that the use of some community assets may not be limited in time.

The Decree establishes depreciation rates, following the logical approach of the fiscal legislator. The compiler of the income statement, in order to calculate depreciation, will not be asked to estimate the useful life of the assets, but will «automatically» apply the rates suggested. Once again, we may observe a difference from the approach in the norms of the Civil Code, which assign the directors the duty of finding the criteria and the depreciation rates to apply to the cost of fixed assets in line with their residual useful life expectation. In reference to public domains assets, the Decree, with particular reference to streets and bridges and other community properties, establishes the depreciation rate at 2%, and estimates that the depreciation period is fifty years, without distinguishing between the assets acquired after the effective date of the Decree and those already belonging to the Local Government, for which loan payments are still made. On the other hand, the constant depreciation allowance, in real terms, diminishes in value with the passing of the accounting periods, and consequently diminishes the burden borne by the passing generations of tax payers (apart from extraordinary expenses that are capitalized and then depreciated). This does not correspond to the fairness criteria. Moreover, the appraisal of the depreciation period might be questioned, above all for new public domains assets. In reality, considering «the useful life» of public domain assets to be unlimited by time, the choice to depreciate them is not the only or the best available way to make Local Government responsible for the use of such resources. If it is actually believed that Local Government is bound to guarantee the value of its wealth, and that the value also of community assets is unaltered in time if not increased, then it must be demonstrated with accounting tools that not only a service quota incorporated in those goods has been consumed, but also that all the necessary steps were taken to guarantee that the community assets will continue to generate services in the future as well, to the benefit of the administrated community. This objective is not directly achievable using depreciation. The identification of fixed and constant depreciation rates in the Decree makes it possible to divide a multiannual cost over several accounting periods, but does not guarantee that the depreciation allowance corresponds to the decline in value suffered by public domain assets nor allows the formation of reserves for their renewal[17]. On the other hand, since the depreciation allowance of the «new» public domain assets is determined with reference to historical cost, over an extended period of time that amount, will lose its relevance even as a point «of reference» for predicting the extent of the future cash flow necessary to maintain intact the service potential incorporated in such assets. As a consequence, even if an amount of money equal to the depreciation allowance were reinvested each year (this requires sufficient financial resources), with the passing of time, it is not guaranteed that the service potential of the public domain assets would remain unaltered. It is evident that the choice between depreciating public domains assets and finding accounting solutions to reveal if the Local Government is able or not to maintain the service potential incorporated in the public domain assets unaltered in time, depends to a large extent on the objectives of financial reporting[18].

CONCLUSION

The changes introduced by the Lgs. D. 77/95, not only those pertaining to the accounting of public assets, can be seen as the inevitable and natural consequence of undoubtedly vaster and more important changes. It is evident that accounting reform is nothing more than an indispensable complement of the full definitive affirmation of a «new» model of Local Government whose main characteristics are outlined at the beginning of the contribution.

These reforms direct and facilitate a sound change in the Italian Local Government accounting system. However, we firmly believe that the real obstacle to overcome is not simply the production of this or even more sophisticated data, but the understanding of their usefulness and, consequently, the will and capacity to communicate them. It is quite clear that the success of reform will depend not only on the production of new accounting information, but also on the understanding that this effort is useful only if it produces effects. Since in this field (communication) each Local Government is widely autonomous, these organisations should be concerned with exploiting this opportunity.

Beyond doubt, the «old» way of producing and communicating accounting data no longer works. The informative objectives, the quality and the quantity of public needs to be satisfied and the role of public organisations in the present scenario have definitively changed. But, above all, the interlocutors of Local Governments have changed: no longer only the Central Government but also the local communities with their changing demands, expectations and heterogeneous composition.

The old accounting system, which prevailed up until the eighties, reflected a model of Local Government which was guided from above and minimally autonomous.

In short, Local Governments have changed their accounting systems because they themselves have changed ever since the relationship between public organs and local communities has changed.

In this historical moment, it is necessary to undertake an in-depth discussion of the accounting autonomy that the new laws fully recognize.

The increasing level of self-management in the accounting field implies a considerable responsibility for Local Government, forcing it to avoid the error committed in the past. Autonomy is a «space» that, once conquered, must be occupied with intelligence and creativity without being hidden in banal operations of «recopying» what is prescribed by other subjects (associations, professionals and so on) instead of the Central Government. Certainly, a comparison of Local Governments and debates involving professionals and the scholars will be useful and important, but it would be a great error if, in the short term, «photocopy-regulations» predominated.

NOTES

[1] The term "Local Government" comprises different typologies: provincial, municipal, united municipalities and mountain communities. Italy is made up of 103 provinces and over 8,000 municipalities. Most of these latter count a somewhat limited number of inhabitants. Approximately 16% of Italian municipalities have over 8,000 inhabitants.
[2] On this topic, see (E. Caperchione and A. Garlatti, 1994), (L. Matteuzzi Mazzoni, 1982), (M. Mulazzani, 1992), (L. Puddu, 1984).
[3] In 1996, the current revenues of Italian municipalities were composed of 40% from local taxes (Source: Local Administration Division of the State Audit Court, 1998 Report).
[4] On this subject see (L. Anselmi, 1995), (G. Farneti, 1999), (R. Mussari, 1996).
[5] Concerning the auditing of Local Government bodies see (G. Farneti, 1998), (L. Marchi, 1997), (R. Mussari, 1995), (N. Persiani, 1996).
[6] The municipal/provincial director may be nominated by the mayor of a town with no less than 15,000 inhabitants or by the President of a Province. In towns with less than 15,000 inhabitants a municipal director may be collectively appointed by a group of collaborating municipalities whose combined population reaches 15,000.
[7] (F. Besta, 1922: p. 621).
[8] On the topic of using accounting to measure Local Government performance see (M. Ives, 1987), (R.K. Mautz, 1981) and (R. Anthony, 1985).
[9] (P.E. Cassandro, 1979: p. 270).
[10] (A. Buccellato, 1992: p. 74).
[11] (P. Capaldo, 1973: p. 305).
[12] (S. Arcidiacono and F. Bruno, 1988: p. 38).
[13] On this topic see (M. Elefanti, 1996) and (G. Farneti, 1999).
[14] "Article 2426 of the Civil Code refers to purchase price or production cost, each including other directly attributable costs. The production cost may also include an element of manufacturing overhead for the quota that is reasonably attributable to the product and for borrowing costs directly related to the product. ... The values determined in accordance with the above stated criterion must not be maintained if they exceed the realizable value deducible from the market trend. ... In order to calculate the cost of fungible goods, article 2426 of the Civil Code gives the option of applying one of the accounting formulas in use, e.g., weighted average cost, FIFO (first in, first out) or LIFO (last in , first out)" (A. Riccaboni – R. Ghirri, 1994: p. 136).
[15] Other nations have adopted a variety of solutions, including, for example, insured value. On this subject, in this volume, see J. Christiaens.
[16] For a historical perspective of depreciation in Italian Local Government accounting see (R. Mussari, 1994).
[17] We should stress that the obligation for Local Governments to account for a provision in their budget in order to finance the renewal of long-term assets was postponed to year 2000.
[18] An interesting accounting and reporting model for Infrastructure assets is proposed by Jesse W. Hughes. See (J.W. Hughes, 1994).

REFERENCES

Anselmi, L. ed. *L'azienda "Comune", seconda edizione riveduta e ampliata.* Rimini: Maggioli, 1995.

Anthony R.N. The flow of economic resources Focus. The Government Accountants Journal 1985; XXXIV, 3, Fall:51-52.

Arcidiacono, S. and Bruno, F. *I beni degli enti locali: caratteri, amministrazione, gestione, inventari.* Roma: NIS, 1988.

Besta, F. *La Ragioneria.* Milano: Vallardi, 1922.

Buccellato, A. *Il sistema informativo delle aziende pubbliche.* Padova: Cedam, 1992.

Capaldo, P. *Il bilancio dello Stato nel sistema della programmazione economica.* Milano: Giuffrè, 1973.

Caperchione, E. and Garlatti, A. "Trends in the evolution of accounting systems in Italian Local Governments." In *Perspectives on Performance measurement and public sector accounting,* E. Buschor and K. Schedler eds. Berne: HAUPT, 1994.

Cassandro, P.E. *Le gestioni erogatrici pubbliche, quarta edizione riveduta ed aggiornata.* Torino: UTET, 1979.

Elefanti, M. *Le rilevazioni patrimoniali e gli inventari negli enti locali.* Rimini: Maggioli, 1996.

Farneti, G. *Gestione e contabilità dell'ente locale, terza edizione.* Rimini: Maggioli, 1999.

Farneti, G. "La revisione." In *Enti Locali – La gestione economico finanziaria, seconda edizione.* AA. VV. IPSOA, 1998.

Hughes, J.W. "Accounting for Maintenance Costs On Governmental Infrastructures." In *Perspectives on Performance measurement and public sector accounting,* E. Buschor and K. Schedler eds. Berne: HAUPT, 1994.

Ives, M. Accountability and Governmental Financial reporting. Journal of Accountancy 1997; 4: 130-134.

Marchi, L. ed. *La revisione nelle aziende pubbliche.* Rimini: Maggioli, 1997.

Matteuzzi Mazzoni, L. *Il sistema dei bilanci delle aziende publiche territoriali.* Bologna: CLUEB, 1982.

Mautz, R.K. Financial Reporting: Should Government Emulate Business? Journal of Accountancy 1981;3: 53-60.

Mulazzani, M. *Ragioneria pubblica.* Padova: CEDAM, 1992.

Mussari, R. "Depreciation in Italian Local Government Budget: some critical considerations." In *Perspectives on Performance measurement and public sector accounting,* E. Buschor and K. Schedler eds. Berne: HAUPT, 1994

Mussari, R. Italian Municipal Audit: half a reform?. Financial Accountability and Management, Special Issue on Audit and Accountability in the Public Sector: Problems and perspectives 1995; 2:127-140.

Mussari, R. *L'azienda del Comune tra autonomia e responsabilità.* Padova: Cedam, 1996.

Persiani, N. *Revisione contabile e gestionale negli Enti Locali.* Padova: CEDAM, 1996.

Puddu, L. *Il bilancio degli Enti Locali.* Milano: Giuffrè, 1984.

Riccaboni, A. and Ghirri, R. *European financial reporting: Italy.* London: Routledge, 1994.

12

EXTERNAL REPORTING OF CAPITAL ASSETS: A SOURCES AND USES MODEL

Rita H. Cheng and Jean E. Harris

INTRODUCTION

Current financial reporting about infrastructure assets in the U.S. is inadequate. The debate about ways to address this inadequacy centers on the reporting of capital assets and charges and well as the construction of supplemental disclosures. Issues related to reporting capital assets values, charges and disclosures are enduring issues. They persist in debates about accounting because there is a lack of consensus about the purpose of depreciation and a lack of practical means for operationalizing depreciation in a reliable way.

In this paper, issues are examined that relate to reporting capital assets values and charges for non-business activities of governments. Beyond this brief introduction, Section II of the paper provides a background of the history of calls for reporting the cost and expense of capital assets for the non-business activities of governments. Then in Section III the envisioned advantages and practical limitations of depreciation are summarized. This is followed by a review of current reporting standards for capital assets and capital charges in Section IV. Finally in Section V a model is proposed for reporting capital assets and capital charges.

Issues related to capital assets reporting are some of the most serious issues in financial reporting because of the materiality of amounts reported, the cost of preparing reported information, and the way reported information may be used. The amounts reported for capital assets values and charges usually are substantial and tend to be material by any definition of materiality. For report preparers, the cost of recording and maintaining capital assets cost data can be significant. Finally and perhaps most importantly, capital assets reporting is an area that has the potential of informing as well as misinforming users. Each of these factors supports the careful consideration of any system for capital asset reporting.

HISTORY OF CALLS FOR REPORTING THE COST OF CAPITAL ASSETS FOR THE NON-BUSINESS ACTIVITIES OF GOVERNMENTS

The debate over accounting and reporting for capital assets of governmental entities dates back to the early 1900s. The 1913 Handbook of Municipal Accounting (Bureau of Municipal Research 1913, p. 48, 56-57) called for the creation of a capital account for the balance sheet reporting of a municipality's investment in capital assets, cash available for capital acquisitions, and outstanding indebtedness issued for capital purposes. The authors indicated that the main reason for this reporting was to "lay(s) the foundation for thinking about the need for funds for capital use...". The handbook also urged that "an annual charge to expenses should be made for depreciation, and provisions for this charge should be included in the budget of expenses" so there would be "a fund sufficient to replace the property at cost."

The Bureau of Municipal Research's position was not supported in textbooks of the 1920s and 1930s. Prominent authorities opposed reporting capital assets and depreciation charges. Oakey (1921) argued against the presentation of a capital balance sheet because debt could not be settled with capital assets, nor was debt secured by those assets. He also asserted that the dollar value of capital assets was not useful for decision making. Oakey contended that the primary information needed about a capital asset is its service capacity as well as estimates of acquisition and maintenance costs to support the needed service capacity (Oakey 1921).

Although capital assets are not security for the payment of debt obligations and are not a basis of credit, Morey (1936) argued that the accounts of a governmental entity should include capital assets. However, he opposed reporting depreciation expense. Morey recommended the reporting of capital assets because they are properties for which governments are responsible and accountable. Thus, he claimed, their inclusion served a different purpose from that served by similar items in the financial statements of a private business. Additionally, Morey contended capital assets are not available to meet the expenditure obligations of a government. Accordingly, Morey proposed separating the equity balance between that which is subject to expenditure, such as cash, and that which is not subject to expenditure, such as infrastructure.

Morey (1936) opposed reporting depreciation expense because he reasoned profit and loss information was not required. Morey (1936, p. 218) contended the chief question about capital assets was, "What did that property cost the government?" Further, Morey argued that a reserve for depreciation would be useful only if it were funded. This he thought was improbable for two reasons. First, governmental revenues are fiscal in character and often must be expended during the fiscal period. Secondly, to the extent public property is acquired through debt, it would be impossible to raise by taxation an amount to provide for depreciation in addition to the payment of bond principle.

Mikesell (1956) emphasized the need for adequate records all capital assets including infrastructure assets. He recognized the value of such information for internal management and capital budgeting. However, the 1974 AICPA Industry Audit Guide, *Audits of State and Local Governmental Units*, made the reporting of infrastructure assets "optional." The same Audit Guide also noted a renewed interest in the subject of depreciation for purposes of reimbursement, measuring the cost of services, and evaluating program efficiency. The Audit Guide therefore included an optional allowance for depreciation to be deducted from capital assets in the general fixed account group. This approach was brought forward into NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles* and included in the Governmental Accounting Standards Board's *Codification* (GASB 1996).

Contemporary debate on the reporting of capital assets escalated with the formation of the Governmental Accounting Standards Board (GASB). In Concepts Statement 1 (GASB 1996, Appendix B), the Board took the position that reporting only non-infrastructure assets and not depreciating those assets resulted from a narrow view which limited financial reporting to physical accountability. In contrast, GASB articulated a broad view of accountability that extended to concern about overall financial condition of the entity. Accordingly, GASB began to consider the need to change capital asset reporting. The Board identified the following information as being of interest: (1) service condition and potential for future service, (2) needs for replacement and maintenance, (3) costs relative to the value of services, and (4) ability of an entity to meet current and future service demands.

In 1985 GASB undertook a user needs study followed by extensive research and public forums on various aspects of the financial reporting model. With respect to capital assets, debate focused three issues.

1. Should capital assets be reported on the balance sheet, and if reported, should the display of accumulated depreciation be mandated, optional, or prohibited?
2. Should the costs of using capital assets be allocated over time, and if allocated should such cost information be recognized as a periodic charge in the

operating statement, disclosed in the footnotes, or provided as supplementary information?
3. Should the costs of deferred maintenance, particularly for infrastructure assets, be reported?

Until recently, it was the practice in federal, state and local government to report depreciation on property, plant and equipment only in business-like activities that recover costs from reimbursements or user charges. Thus depreciation was limited to business-type activities. Recent work of the Federal Accounting Standards Advisory Board (FASAB) resulted in a requirement to report and allocate costs for general use assets, such as office buildings, over their useful lives using a systematic and rational means of amortization. Many assets, such as monuments, parks and defense systems, are excluded from classification as general use assets. Ives (1995) observed that FASAB has distinguished those capital assets where depreciation serves a useful purpose, such as determining unit costs of agency activities and programs, from those items where depreciation serves no useful purpose. Accordingly, FASAB standards require disclosure of deferred maintenance and of physical condition for all capital assets, classified as stewardship assets, including those that are not reported or depreciated.

ENVISIONED ADVANTAGES AND PRACTICAL LIMITATIONS OF DEPRECIATION

Arguments for and against depreciation may be classified into four categories. These arguments are that depreciation: (1) conforms with private sector accounting, (2) enhances the measurement of interperiod equity, (3) serves as a surrogate for costs of service potential consumed, and (4) aids users in making decisions about the efficiency of management, allocating resources, and pricing products. In this section, we critique each of these arguments.

Conformance With Private Sector Accounting

Fremgen (1986) argued that widespread use of depreciation in business is a valid reason for considering its use in the public sector. However, he contended, such consideration should first identify uses for depreciation in government prior to its adoption as a practice. Chatfield (1977) pointed out the historical development of depreciation in the private sector arose due to an increased concern with income measurement. Capital assets were seen as a necessary component in the generation of revenues. Thus depreciation became the method used to allocate the costs of those assets among reporting periods. The practice was given legitimacy by the tax system, which focused on net income, and allowed a deduction for the depreciation of capital assets. But governmental entities, by their nature, are not profit oriented and are not subject to taxes.

The fundamental difference, as noted by Mautz (1989), is that capital assets for private sector entities help produce cash inflows whereas fixed assets for public sector entities allow governments to provide services. Therefore, the most important information for governments is the ability of the asset to allow the government to continue to provide the services. Another difference between the private sector and the public sector is the absence of the role of capital assets as collateral for debt. In the private sector, capital assets are frequently used as collateral for loans. However, public sector debt is secured by the tax levying authority of governmental entities.

Interperiod Equity

Concepts Statement 1 (GASB 1996, Appendix B) stated that financial reporting should provide information to determine whether current-year revenues were sufficient to pay for current-year services. An expense measures the cost of using an asset whereas, an expenditure measures the cost of acquiring an asset. Thus the intention is to match tax and other revenues earned in the current year with the expense of assets consumed in the current year. 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 ultimate objective is to match the contributions and consumption of current taxpayers to avoid shifting the economic burden of current asset use to future taxpayers. Fremgen (1986) questioned the validity of the concept of interperiod equity, and claimed that the concept was elusive and flawed. Further, he argued that historical cost depreciation does not contribute to the measure of interperiod equity.

Anthony and Herzlinger (1980) introduced the idea of accounting for depreciation in the context of the source of financing for assets as well as timing of asset funding. Source of financing is critical to evaluating interperiod equity because financing relates directly to the identification of parties who bear the economic costs of capital assets. Later Anthony (1994) argued that only for assets acquired from operating revenues or debt was a capital charge relevant for showing the maintenance of the entity's capital. If capital assets were financed from other sources of funds, depreciation is not useful because the entity did not provide the capital.

Surrogate for Cost of Consumption of Service Potential

Annual depreciation and accumulated depreciation are often viewed as indicators of the amount of service potential consumed or physical deterioration (Fremgen 1986). The central problem is that even if depreciation is conceptually relevant, the amount is unreliable (Thomas 1969). Conventional methods of calculating depreciation require the arbitrary allocation over time of the historical cost of a capital asset, and were developed to meet the objective of measuring income by matching revenues against expenses. Further, because of the arbitrary way conventional depreciation is estimated, it does not appear to be a reliable indicator of expense.

Arbitrary allocations of historical costs has been criticized as a surrogate for the opportunity cost of using assets, such as foregone rents. Bierman (1966) suggested that depreciation should be measured as the change in the value of an asset from the beginning of a period to the end of a period. Singer (1957) reported a variety of distinct ideas about depreciation. He concluded that there is little correspondence between the usage of depreciation and the common accounting definitions expressed by private sector accountants.

Decision Usefulness

Fremgen (1986) argued that depreciation is a "sunk cost" and thus is not relevant to planning and decision making. He claimed it is only the cash flow provided by the tax shield from depreciation that is relevant to decision making in the private sector. Accordingly, one would expect depreciation, as currently reported in the private sector, to be equally irrelevant to governmental decision-makers.

As Lev (1996) demonstrated, private sector accounting is an imperfect model that increasingly captures less of the relevant information content desired by users of financial statements. Anthony (1994) argued, even in the private sector, users of financial statements tend to disregard depreciation in making decisions because depreciation expense does not reflect the age of an asset, physical deterioration, current expenditures, the adequacy of maintenance, or the deduction for calculating taxable income. He concludes depreciation is unrelated to replacement needs or costs. Also, depreciation expense is not comparable across entities because of the many ways it can be calculated.

As discussed in the above sections, in reality, depreciation is an annualized, arbitrary, unreliable amount rather than a factual determination. Because it is an uncontrollable cost, it is not relevant to judging the efficiency of management performance. In the private sector, depreciation does not measure the cost of using existing assets, the cost of replacing assets, or the savings needed to replace assets. Thus, depreciation is irrelevant to resource allocation decisions. Relevant costs for resource allocation decisions are acquisition costs, disposal values, and opportunity costs. Including depreciation as a component in comparing costs in the public sector with costs in the private sector is fallacious should the governmental asset otherwise remain idle or if the depreciation charge exceeds the opportunity cost of foregone rent.

Depreciation is relevant to pricing decisions when price is intended to cover full costs of an activity. However, the highly aggregated reporting of entity-wide activities is not useful for cost analyses. Additionally, it may be argued that the inclusion of a capital charge should be at a level sufficient to cover the acquisition of future assets. Thus, capital charges for pricing decisions would be based on estimated future replacement costs rather than an allocation of historical costs.

Finally, the cost of producing information about capital assets values and charges must be considered. The production of capital asset information may be practical for newly acquired assets, but it can be expensive and impractical to obtain such information for old assets, particularly infrastructure assets. In fact, for many existing capital assets it will be necessary to estimate the capital charge. The decision usefulness of such estimate is highly questionable. Fremgen (1986) suggested, that beyond not being useful, the illusory quantification of depreciation may also mislead the users of financial statements. Since a capital charge is not relevant to evaluation of efficiency, to resource allocation or to make-buy decisions, the cost of preparing such information should be weighted against its potential benefits.

REPORTING STANDARDS FOR CAPITAL ASSETS AND CAPITAL CHARGES

In private sector reporting of capital assets, it is customary to report four items: original historical cost, accumulated depreciation, adjusted basis, and annual depreciation expense. In the U.S. public sector, three sets of accounting standards relate to reporting and depreciating capital assets. These standards are: (1) current standards for state and local governments as promulgated by the Governmental Accounting Standards Board (GASB), (2) proposed standards for state and local governments as circulated by the GASB, and (3) newly adopted standards for national government reporting as promulgated by the Federal Accounting Standards Advisory Board (FASAB). These three sets of standards and a fourth approach advanced in a working paper by Robert Anthony are reviewed in this section.

Current State and Local Governmental Standards

Basic aspects of current accounting standards for capital assets held by state and local governmental units in the U.S. have been applied widely for almost thirty years. With the exception of business type activities, also known as proprietary funds, and trusts funds with restricted or nonexpendable principal, no depreciation or equivalent charge is recorded. Current accounting standards state:

> *"Depreciation of general fixed assets should not be recorded in the accounts of governmental funds. Depreciation of general fixed assets may be recorded in cost accounting systems or calculated for cost finding analyses, and accumulated depreciation may be recorded in the General Fixed Asset Account Group" (GASB 1996, Sec. 1100.107).*

Under the modified accrual basis of accounting, the acquisition of a General Fund asset is recorded by showing the object of the expenditure, such as equipment, and the disbursement of cash. Thus the entire cost of an asset is reported and recognized when it is acquired; it is not allocated over the useful life of an asset through a depreciation charge. The recognition of the entire cost at the time of an asset's acquisition is consistent with a measurement focus on the availability of financial resources.

General Fund--Acquisition

Expenditure for equipment	$100,000	
Cash		$100,000

For purposes of having a record of an asset's acquisition, the cost of the asset is reported in the General Fixed Assets Account Group, and the source of funds for acquisition of the asset also is reported. Thus, in U.S. public sector reporting of capital assets, it is customary to report only an asset's original historical cost.

General Fixed Asset Account Group--Acquisition

Equipment	$100,000	
General Fixed Asset Acquired from Source X		$100,000

On disposal of an asset, revenue is reported in the General Fund and the asset is removed from the record of the General Fixed Assets Account Group.

General Fund--Disposal

Cash	$5,000	
Revenue from Asset Disposal		$5,000

General Fixed Asset Account Group--Disposal

General Fixed Asset Acquired from Source X	$100,000	
Equipment		$100,000

Although allocating an asset's cost over its useful life is prohibited, reporting accumulated depreciation is optional. Also the reporting of infrastructure is optional. Because infrastructure assets often represent a significant percentage of a governmental unit's assets, fixed asset reporting may be limited by the omission of infrastructure assets.

Proposed State and Local Governmental Standards

Since its creation in 1984, GASB has sought to design a comprehensive financial report for state and local governmental units to meet the needs of a variety of users. The currently proposed model is now circulating as an exposure draft (ED) entitled *Proposed Statement of the Governmental Accounting Standards Board, Basic Financial Statements--and Management's Discussion and Analysis--for State and Local Governments* (GASB, 1997). This proposed statement is a major initiative that covers many issues; with appendices, it is 324 pages long.

Consistent with the accrual basis of accounting and a total economic resource measurement focus, capital assets will be reported at their historical costs and will be depreciated in entity-wide reporting (GASB 1997, par. 35-37). As is the current practice, donated assets will be reported at their estimated fair market values at date of receipt less accumulated depreciation (GASB 1997, par. 35) and capital assets that do not deteriorate, such as land, will not be depreciated.

Use of the accrual basis of accounting for entity-wide financial reporting alters the timing of the recognition of transactions. As defined by GASB, accrual basis means that "most transaction are recorded when they occur, regardless of when cash is received or disbursed" (GASB 1996, Sec. 1600.102). Expenses, which measure expired costs including depreciation, are reported rather than expenditures. Although GASB views the accrual basis as a superior basis of accounting (GASB 1996, Sec. 1600.103), its use does not preclude manipulation. Under the accrual basis, manipulations often focus on assumptions that are critical to accruing revenues or expenses. For example, a change in the assumption about the percentage of revenues that will be collected can have a significant impact on the amount of revenue accrued.

The term, capital assets, will include infrastructure assets and these assets will be reported (GASB 1997, par. 33 and 278-280). An exception permits the exclusion of art collections and historical treasures from the definition of capital assets. Thus these assets may be excluded (GASB 1997, par. 33). For all assets on which a depreciation charge will be reported, the deprecation charge may be calculated by using any rational and systematic means of apportionment (GASB 1997, par. 37).

In the model proposed by GASB, it is not necessary to report depreciation directly on a basic, entity-wide financial statement. On the Statement of Net Assets, which resembles a balance sheet, assets may be reported for the entity net of depreciation (GASB 1997, p. E-13). The total amount of depreciation for the entire entity then is reported in a note about capital assets (GASB 1997, p. E-29). In the Statement of Activities, which reports revenues and expenses, it is not necessary to separately report depreciation expense. Rather this expense may be included as a component of functional/program expenses for the entity. (GASB 1997, p. E-14).

Information that will be disclosed for capital assets will include the following: (1) current and prior year balances for asset accounts and for accumulated depreciation, (2) capital acquisitions, (3) sales or other dispositions, and (4) current period depreciation expense (GASB 1997, par. 113). This information must be disclosed on an entity wide basis for major classes of assets such as land, buildings and improvements, vehicles, machinery and equipment, and infrastructure (GASB 1997, par. 36).

The mandatory reporting of infrastructure assets is one of the major changes required in the proposed statement. GASB's reasoning in support of this requirement draws on *Concepts Statement 1* (GASB 1996, Appendix B) and provides insight into its perceptions about the utility of depreciation (GASB 1997, par. 278). GASB's justification for depreciating infrastructure assets is that reporting an annual depreciation charge will aid in the following type of analyses:

1. determining if current-year revenues are sufficient to pay for current-year services (GASB 1996, Appendix B, par. 77a),
2. assessing the service efforts and costs of programs (GASB 1996, Appendix B, par. 77c),
3. determining whether an entity's financial position has improved or deteriorated as a result of the year's operations (GASB 1996, Appendix B, par. 78c), and
4. assessing the entity's financial position and condition (GASB 1996, Appendix B, par. 79a).

Respondents to an earlier and similar proposal, objected to the requirements of reporting infrastructure assets on the practical grounds that it would be too costly to develop the information (GASB 1997, par. 279). In this paper, it is argued that the justification for reporting infrastructure assets is fallacious on theoretical grounds given the arbitrary and unreliable nature of depreciation charges and the absence of management's ability to control depreciation charges. Curiously, GASB did not provide specific examples of decision models in which depreciation expense has proven to be useful information.

In Section II of this paper, the informational utility of depreciation charges was reviewed. The utility of depreciation is addressed below only as it is relevant to GASB's assertions. One problem with depreciation is that an annual depreciation charge does not show, with reliability, if current-year revenues are sufficient to pay for current-year services because depreciation is an unreliable approximation of physical deterioration of assets over an arbitrary period. Thus it is a poor indicator of service costs. It is rendered even less reliable when based on historical costs and when indirect costs are not allocated to functional categories.

Because depreciation is a poor indicator of cost, it is equally unreliable in assessing service efforts and costs for programs. Additionally, depreciation is fundamentally an uncontrollable cost. In the public domain it is important to judge costs in a comparative manner against accomplishments. But the only accomplishments entities report financially relate to the generation of financial resources. Finally and pragmatically, GASB's proposed statement does not require either the disclosure of program costs in the aggregate or depreciation as part of the detail of disclosed costs. Instead of disclosure of costs by programs, expenditures for the general fund and expenses for the entity may be disclosed by function. These functions are an aggregate of activities, such as health and sanitation, that cross program and administrative boundaries.

Depreciation is also an unreliable component in assessing whether an entity's financial position has improved or deteriorated. Financial position refers to the measure of an entity's economic resources and the economic claims on those resources. Historical cost is a poor measure of the value of an economic resource. The true value of an economic resource in the public domain is the service it can provide to the community. If valuation were not an issue, a major obstacle in assessing financial position would remain. Most non-financial resources of a government, such as infrastructure assets are not available to satisfy economic claims against the government. Depreciation does not address financial condition, a broad concept that extends beyond traditional financial measures to all the responsibilities for which a government should be held accountable. It is vital for a user of financial statements to understand that depreciation is always an arbitrary approximation rather than precise data.

Newly Adopted National Governmental Standards

The Federal Accounting Standards Board (FASAB) was established in 1990 to recommend accounting principles for the federal government. It has adopted two standards that relate directly to the reporting of capital assets: Statement No. 6, *Accounting for Property, Plant, and Equipment* and Statement No. 8, *Supplementary Stewardship Reporting*. In the FASAB model the reporting of depreciation charges is dependent on the use of an asset. Assets are viewed as being used for one of four purposes. These are (1) general use assets, (2) mission assets, (3) heritage assets, and (4) stewardship of lands for public use. Heritage assets are described as single use if they serve only as a national treasure or multi-use if they have an operational function as well. The operational components of multi-use assets are treated as general use assets. The basic aspects of the FASAB Model are described in Exhibit 1.

The FASAB model recognizes that many assets acquired by government are peculiarly governmental and have no private sector equivalent. Given the unique nature of these assets, often retirement is not anticipated or if retirement is anticipated it does not follow a rational and systematic pattern. Understanding the basic categories of asset use is critical to understanding capital assets reporting by the national government. With some exceptions, assets are classified as follows:

1. General use assets are assets that could be used for alternative purposes by other governments, the nonprofit sector or the private sector, but which are used by the federal government to provide goods and services. Thus these assets are reported and depreciated as they would be in the private sector (FASAB 1995, par. f-i).

2. Stewardship assets, including mission assets, heritage assets and stewardship lands. For all stewardship assets extensive supplemental disclosures are required (FASAB 1996).
   - Mission assets, such as weapons systems and space exploration systems, are unique to government. Due to rapid obsolescence, retirements do not follow a rational and systematic pattern. Thus these assets are not reported or depreciated as assets (FASAB 1995, par. l-q).
   - Heritage assets include monuments, cherished national sites, national museums, etc. The retirement of these assets is not anticipated. Thus these assets are not reported or depreciated as assets. When a monument is used in governmental operations, renovations and improvements that relate to day to day governmental operations are treated as general use assets (FASAB 1995, par. r-u).

***Exhibit 1**: Basic Aspects of national Reporting, The FASAB Model*

Use of Acquired Asset	*Treatment of Capital Assets*	*Supporting Argument*
general use assets	Assets are reported. Depreciation is charged except for land.	Assets are used in non-unique ways to produce goods or services.
Stewardship assets:		
a) mission assets	Assets are not reported. Depreciation is not charged. Acquisition and renewal costs are expensed as incurred	Assets as weapons systems and space exploration systems have no alternative use. Due to rapid obsolescence, use and retirement is not rational.
b) heritage assets	Assets are not reported. Depreciation is not charged. Acquisition and renewal costs are expensed as incurred.	For monuments, cherished historical sites, national museums, etc., retirement is not anticipated.
c) land in public domain	Assets are not reported. Depreciation is not charged. Acquisition costs are expensed as incurred. Supplemental disclosures are required.	Retirement of land is not anticipated for land that is unrelated to the provision of general goods and services and is accessible in the public domain.

Additional Required Disclosures: Financial and non-financial information relating to stewardship assets including intangible assets (FASAB 1996). Description of condition of assets and estimated cost to remedy deferred maintenance of assets (FASAB 1995. Total probable and measurable cleanup costs with allocation of periodic charge reported on statement of net costs (FASAB 1995).

> Stewardship lands include national parks and forests. These lands are not related to the production of general goods and services and are accessible in the public domain. These lands are not reported as assets because retirement is not anticipated (FASAB 1995, par. v-w).

Additionally stewardship assets include intangible assets such as nonfederal physical properties which were financed from federal resources but are owned by state and local entities, human capital, and research and development (FASAB 1996, par. i). For each type of asset, FASAB No. 8 sets forth a definition, means of measurement and minimum reporting requirements. Additionally, FASAB No. 8 provides for a current service assessment of the sustainability of programs. These assessments show receipts and outlays by program for a base year and six subsequent years (FASAB 1996, par. 101). The significant amount of required supplemental stewardship information (RSSI) that must be disclosed about stewardship assets including intangibles, emphasizes the management focus of the FASAB model.

Because it is unlikely that the credit or performance of the national government will be assessed based on its financial reporting, entity-wide reporting at the national level appears to be motivated more by internal considerations than by external considerations. Realistically, except for private agencies that rate the credit of state and local governments, most users of governmental financial information reside internally in the legislative or executive branches of state and local government rather than externally. Thus the FASAB Model offers insight into the kinds of information that can be reported externally that would be of benefit to users within government.

Approach Proposed By Robert Anthony

Anthony (1994) argues for an alternative model for reporting and depreciating capital assets. The Anthony Model is general in scope and could be applied in the private sector as well as in the public and non-profit sectors. In the Anthony Model, the reporting of depreciation charges is dependent on the source of funding for an asset. Assets are viewed as being acquired from one of four sources of funds: (1) contributions or grants, (2) borrowing, (3) operating revenues or (4) prior accumulation of funds. The basic aspects of the Anthony Model are described in Exhibit 2.

Anthony (1994) is concerned that financial reporting provide users of financial statements with useful information. The objective of his model is to charge current taxpayers a reasonable amount which when accumulated will provide for maintenance of the entity's capital; it is not to allocate historical costs to time periods. The major elements of the Anthony model are:

1. Assets acquired by grant or contribution will be reported but not depreciated. Costs are born by the donors and not by users.
2. Assets acquired by debt will be depreciated. The amount of reported depreciation will be the annual principal payment. Costs are born

primarily by future users. Two entries for the annual principal payment are related to reporting depreciation.

Payment of Principal

Bonds Payable	$ 10,000	
Cash		$ 10,000

Recognition of Depreciation Expense

Depreciation Expense	$ 10,000	
Accumulated Depreciation		$ 10,000

3. Non-major, routine acquisitions are expensed. Major asset acquisitions are depreciated. The amount of depreciation is based on an annual estimate of an annuity payment sufficient to provide for a stated amount of renewal in a fixed number of years. To the extent renewal cost is from accumulated resources, cost is born by prior taxpayers. If renewal cost is provided from current generated revenues, the cost is born by current taxpayers. Three entries are related to reporting depreciation.

Recognition of Renewal Expense

Renewal Expense	$ 20,000	
Liability for Renewal		$ 20,000

Funding of Renewal Expense

Cash, Renewal Reserve	$ 15,000	
Cash, General		$ 15,000

Payment of Renewal Costs

Liability for Renewal	$ 15,000	
Cash, Renewal Reserve		$ 15,000

If the provision in the second entry is less than annual expenditure in the first entry, the shortage represents the extent to which renewals are underfunded. If above entity just began reporting, its renewals are underfunded by $5,000.

Liability for Renewal

	20,000
15,000	
	5,000 *underfunding*

4. Assets acquired with accumulated resources are reported but not depreciated. In effect, these acquisitions are viewed as a contribution of prior taxpayers.

Anthony argues that application of his model would facilitate management by indicating the financial resources needed in a given period to provide for debt service, routine acquisitions, and major renewals. Anthony's model would also

Exhibit 2: *Basic Aspects of Anthony Model*

Source of Fund to Acquired Asset	*Treatment of Capital Assets*	*Supporting Argument*
Contributions or grants	Assets are reported. No depreciation is charged	Asset cost is zero. Depreciation is a means of recovering costs and thus is inappropriate.
borrowing	Assets are reported. Annual principal payment on debt is used to measure amount reported as depreciation in lieu of a conventional calculation of depreciation.	Annual principal payment is a conservative and acceptable surrogate for depreciation. As an obligation that must be met, it is more relevant than conventional depreciation.
Operating revenues	Non-major, routine acquisitions are expensed in lieu of depreciation and thus are not reported as assets.	Expense approximates depreciation. Budgeting expense is more relevant than budgeting depreciation.
	Major acquisitions are reported. A renewal charge is projected in lieu of depreciation, and equivalent financial resources may or may not be accumulated.	Present value of future renewals is reported and equivalent financial resources are accumulated.
Prior accumulation of funds	Assets are reported No depreciation	Present cost is zero. Prior taxpayers bore cost.

support decisions about the amounts to be budgeted for total spending, the sufficiency of charges for services, and the amount of services to be paid by current users to maintain financial capital or interperiod equity. Additionally, it should encourage the maintenance of capital assets by providing a measure of unfunded renewal costs.

PROPOSED MODEL FOR REPORTING CAPITAL ASSETS AND CAPITAL CHARGES

With respect to reporting charges for the cost of capital assets, both the FASAB and Anthony models appear to have merit. We believe these models can be combined in such a way as to produce a cost-effective framework for adequately expensing capital assets and for simultaneously providing information that is useful to users of financial statements. In this section we propose a model for the external reporting of capital assets that extends the work of the FASAB (1995,1996) and Anthony (1994).

Guiding Principles

In constructing our proposed model, we were guided by a belief that a framework for the reporting of the costs of capital assets should be simple enough for a person who has only an exposure to principles of accounting to grasp and be cost efficient to implement. In addition, we were concerned that expenses related to capital assets and the accumulation of related costs be reasonably constructed to allow users of financial statements to consider the information in making decisions. Third, we focused on the general oversight purpose of external financial reporting; not the development of measures for cost accounting systems. Fourth, in rethinking the reporting about capital assets, we were not constrained by conventional depreciation, an exercise in spreading the value of the historical cost of an asset of over an imprecisely estimated life using an imperfect means of allocation, in rethinking the reporting about capital assets. Finally, we believe that, users of financial statements should be afforded a substantial amount of non-financial information about capital assets, particularly infrastructure assets.

Proposed Framework

As depicted in Exhibit 3, our model can be described as a uses and sources model because reporting the costs of capital assets is partially dependent on an asset's use (FASAB 1995,1996) and partially dependent on the source of financing (Anthony 1994).

1. As in the FASAB Model, stewardship assets would not be reported or depreciated. Stewardship assets include mission assets, single purpose heritage assets, and stewardship lands. The reasons for excluding these assets are articulated in discussion of the FASAB model. Consistent with the FASAB model, required supplemental stewardship information is reported.
2. As in the Anthony Model, a capital charge would be reported and accumulated for general use assets based on the source of financing. No capital charge would be reported for general use assets obtained by gift, grant, or from the prior accumulation of resources as the donors, grantors or past taxpayers bear these costs. With one practical exception, capital assets charges would be reported for assets obtained by debt or from general revenues. The exception is that a generous threshold would be set to allow for the immediate expensing of routine acquisitions. For major, non-routine acquisitions acquired by issuing debt, the amount of the capital charge would be the same as the annual payment of principal. For major, non-routine assets acquired from general revenues, the capital charge would equal the current year savings required to provide for renewal at a future time. For major asset renewals, costs for components would be estimated separately.

3. For all stewardship assets including intangibles supplemental disclosures would parallel the FASAB requirements. Intangible assets include non-entity physical properties, human capital, and research and development. Non-entity physical properties are assets that were financed from resources of the reporting entity but are owned by another entity, such as a federally funded highway which is owned by a state. Basic disclosure requirements include a definition, means of measurement, and minimum reporting requirements as well as current service assessments to the sustainability of major programs. These assessments show receipts and outlays by program for a base year and subsequent years. Common reporting requirements would be a description of additions and withdrawals in physical units and assessments of the condition of assets. Drawing from FASAB, the assessment of condition would include (1) the averages of standardized condition rating codes, (2) percentage of asset above or below acceptable condition and (3) narrative information.
4. The proposed model provides for three disclosures in addition to those recommended by FASAB. (a) General assets would be classified as infrastructure and non-infrastructure assets. All reporting on financial statements would be detailed by these two categories. Disclosures for stewardship assets would extend to infrastructure assets, and include additions and withdrawals, as well as assessment of condition. (b) The amount of general use infrastructure acquisitions should be disclosed by

Exhibit 3: *Proposed Framework For Capital Assets Charges*

	Columns represent sources of financing per Anthony		
Rows represent use of assets per FASAB	*Internal Loans, External Debt*	*Accumulated Resources, Contributions, and Grants*	*Operating Revenues*
General, non-infrastructure	C/**P**	**C**/-	C/**R**
General, infrastructure	C/**P**	**C**/-	C/**R**
Heritage, Multiple Use	C/**P**	**C**/-	C/**R**
Heritage, Single Use	**E**/-	**E**/-	**E**/-
Mission	**E**/-	**E**/-	**E**/-
Stewardship Lands	**E**/-	**E**/-	**E**/-

Supplemental disclosure of non-financial information would be required for general use infrastructure assets, heritage assets, mission assets, and stewardship lands.

Each cell shows method of cost recovery method first by use of asset and then by source of financing. Methods are (P) debt principal charged in lieu of depreciation, (C) capitalization, (E) immediate expensing, and (R) renewal provisions. Bold letter indicates recommended method.

each major source of financing. Major sources of financing are debt, current revenue, grants and contributions, and accumulated resources. (c) A schedule should be prepared to disclose probable infrastructure acquisition costs over a prospective period of years together with the proposed sources of financing these projected acquisitions.

Strength and Weaknesses of Proposed Model

The strengths of the proposed model are its simplicity, utility, consistency with interperiod equity, and feasibility. The proposed model is reasonably simple to understand. Only two measures are used to compute a capital charge: principal payments on debt and projected savings to provide for renewals.

The measures presented in this model have practical meaning that relate to users' needs such as asset condition which relates to service potential and unfunded renewal which provides a measure of deferred maintenance costs. Thus the data generated in the proposed model should be useful for planning and control purposes. This model emphasizes meeting obligations and providing meaningful disclosure rather than allocating historical costs. Non-financial disclosures include a description of physical quantities of assets and of acquisitions and withdrawals as well as the condition of assets.

The proposed model is representationally faithful in its reporting of equity. It charges the cost of capital assets to past, current and future providers of resources in a manner consistent with their economic burdens.

Finally, the proposed model is feasible to implement. Reporting resources are not wasted on assets that will be rapidly consumed or never exhausted. Capital asset charges are only recorded for general use assets acquired by debt or from operating revenues. The most demanding part of the model to implement are the supplemental disclosures. However, disclosure requirements could be imposed over time. Additionally, once the information is compiled for the initial disclosure, updating the disclosure should require considerable less expense.

One weakness of our proposed model is that it does not provide disaggregated cost accounting data. Administrators need information about the costs of providing programs/activities including facilities costs for a variety of purposes including the pricing of some goods and services. Neither the proposed model nor any of the other models reviewed adequately address this need. This is primarily an internal demand for information that will probably require separate or integrated cost accounting systems. Another challenge is that not all assets fit into the defined use categories or are financed from a single source of financing. These challenges, we believe, can be addressed and resolved.

We offer this model as an extension to Anthony's guiding proposals and the progressive standards of FASAB. Although only a few lines on the financial statements, reporting a charge for capital assets involves a substantial investment of resources for a preparer. Changing the reporting of capital charges can involve extensive and expensive changes to accounting software. Only a model that is simple, useful, equitable, and feasible can justify the resources required for implementation.

REFERENCES

AICPA (American Institute of Certified Public Accountants), *Audit and Accounting Guide, Audits of State and Local Governments*. New York, NY: AICPA, 1974.

Anthony, R.N. Games Government Accountants Play. Harvard Business Review 1985; Sept.-Oct.:161-170.

Anthony, R.N., *In Lieu of Depreciation*. Working Paper 94-067, Graduate School of Business Administration, Harvard University, 1994.

Anthony, R. and Herzlinger, R. *Management Control in Nonprofit Organizations*. Irwin: Homewood, IL, 1980.

Bierman, H.Jr. Further Study of Depreciation. Accounting Review 1966; April, 41: 271-274.

Bureau of Municipal Research, *A Handbook of Municipal Accounting*. New York, NY: D. Appleton & Co., 1913, pp. 48, 56, 57..

Chatfield, M.A., *A History of Accounting Thought*. Huntington, NY: Robert Krieger Publishing Co., 1977.

Federal Accounting Standards Advisory Board (FASAB), *SFFAS No, 6, Accounting for Property, Plant, and Equipment*. Washington, D.C.: Government Printing Office, 1995.

Federal Accounting Standards Advisory Board, *SFFAS No. 8, Supplementary Stewardship Reporting*. Washington, D.C.: Government Printing Office, 1996.

Fremgen, J.M. On the Role of Depreciation in Governmental Accounting. the Government. Accountants Journal 1985/1986; Winter, 34, 4: 10-23.

Governmental Accounting Standards Board (GASB), *Codification of Governmental Accounting and Financial Reporting Standards*. Norwalk, CT: GASB, 1996.

Governmental Accounting Standards Board (GASB), *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments, Exposure Draft*, with *Appendix E, Illustrations to Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments, Exposure Draft*, and *Appendix F, Codification Instructions to Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments, Exposure Draft*. Norwalk, CT: GASB, 1997.

Ives, M.G. Manipulations, One-Shots - Where Are the Accountants?. Association of Government Accountants Journal 1996; Spring, 44, 1: 40-42.

Ives, M.T. A New Financial Reporting Model. Government Accountants Journal 1995; Winter, 43, 4: 6-10.

Lev, B. "The Boundaries of Financial Reporting and How To Extend Them." In United States Securities and Exchange Commission *Financial Accounting and Reporting of Intangible Assets*, Washington, D.C.: 1996.

Mautz, R.K. Moments Mistakes and Opportunities. Accounting Horizons 1988; June: 123-128.

Mikesell, R.M. *Government Accounting, Rev. ed.* Homewood, IL: Richard D. Irwin, 1956, pp. 375-385.

Morey, L. *Introduction to Governmental Accounting 2nd ed.* New York, NY: John Wiley, 1936.

NAA (National Association of Accountants), *Current Practice in Accounting for Depreciation*, Research Report No. 33, April 1958, pp. 10-13.

NCGA (National Council on Governmental Accounting), *NCGA Statement 1, Governmental Accounting and Financial Reporting Principles*. Chicago, IL: Government Finance Officers Association of the United States and Canada, 1979.

Oakey, F. *Principles of Government Accounting and Reporting*. New York, NY: D. Appleton & Co., 1921.

Singer, F.A. 'Depreciation' - Better Left Unsaid. Accounting Review 1957; July, Vol. 32: 406.

Thomas, A.L. The Allocation Problem in Financial Accounting Theory, Studies in Accounting Research No. 3, American Accounting Association 1969; Evanston, IL.

13

NEW PUBLIC MANAGEMENT AND ITS ACCOUNTING IMPLICATIONS: SOME REFERENCES TO RECENT DEVELOPMENTS IN SPANISH LOCAL AUTHORITIES

Amparo Gimeno Ruiz

INTRODUCTION

During the last decades, governments of most developed countries have implemented serious reforms in different levels of Public Administration in order to improve management efficiency and effectiveness.

This reform process, characterised by a customer and total quality orientation and by the adoption of business oriented management tools as decentralization, performance evaluation, competition, targets definition or lean management, shows the impact and results that the organization philosophy of New Public Management is introducing in the field of Public Administration.

The purpose of this paper is to present the main new public management initiatives adopted in Spanish local authorities and to evaluate how Spanish municipal accounting systems can support and satisfy the information needs that new public management techniques require, especially considering that recent reforms have mainly stressed changes in financial accounting rather than the introduction of cost accounting systems that only several government entities have developed to date.

The first part of the paper is concerned with the description of some relevant aspects of New public Management and the challenges entailed in accounting systems.

The second part analyses the Spanish situation in the new management context. We will try to explain the main developments carried out by the Spanish government, especially with regard to local authorities, and to assess their situation with reference to other countries.

NEW APPROACHES IN PUBLIC SECTOR MANAGEMENT

The economic pressures along with the growing demand for services, have impelled the governments, during the last 20 years, to undertake significant reforms in order to increase efficiency and effectiveness levels.

These changes have been influenced by modern economic theories such as Public Choice, the Principal-Agent and organisational private sector theories (Pollit, 1990, Hood, 1991, Hughes, 1995). There is an extended presumption that public sector bodies should not expand to provide services that can be supplied by the private sector. This has led to a new way of understanding the role of governments, which contrasts with the traditional theories of Public Administration.

This range of reforms has been given the name of New Public Management (hereafter NPM) which means, in short, focusing on performance in terms of efficiency and effectiveness, rather than on compliance with rules and regulations, and greater confidence in market mechanisms.

The main features of this philosophy (even regarded as an ideology (Pollit 1990, 6), have been the subject of a number of studies (see for example Hood, 1991, Osborne and Gaebler, 1992). According to these authors, these features can be summarised as follows:

- *«Hands on professional management»*. There has been greater emphasis on management and on letting managers be «free to manage». This does not mean looser control and entails a separation between the realm of politics and the realm of management. In doing so, there is the need to better define responsibilities.
- *Streamline the organization* through decentralisation, management delegation and privatizations.

- A *shift in management forms from processes to results and to focus on outputs instead of inputs.*
- *Emphasis on cost reduction and higher levels of performance.* To do more with less.
- The *use of business sector tools* such as management by objectives, and performance-related pay schemes.
- *Introduction of greater competition.* Due to the fact that public organizations developed their activities in a monopolistic context, they didn't have to be concerned about improving their performance. Management in the public sector has so far not been subject to market discipline and, therefore, it might be argued that it does not have as much incentive and motivation as counterparts in the private sector to maximise the efficiency with which services are delivered.
- *Citizen orientation.* Public services have to be more responsive to citizen preferences and needs.

These changes are not all present to the same degree. Each country has stressed different initiatives, according to its economic, political and social environment.

So there is an ongoing process of change in the public sector. This change is influenced by different theories such as the organizational theory, and Public Choice principles. In this context, accounting has an important role and the introduction of those initiatives is an important challenge to accounting information systems. These challenges should be studied taking into account the changing environment and the developments of other disciplines which have a significant influence on how the public sector is understood. As Pollit (1990, viii) states:

> *"Disciplinary boundaries are in any case usually the product of specific historical circumstances and aspirations, not all of which wear well through changes of time and social and academic purposes".*

ACCOUNTING IMPLICATIONS OF NEW PUBLIC MANAGEMENT

Accounting as an information system plays an important role in whatever reform processes that any organization would want to undertake.

For this reason, several statements on the objectives that have to be fulfilled by accounting information systems (GASB, 1987; FASB, 1978; in Spain AECA,1980, IGAE, 1991-1992) have been issued[1]. These objectives, as far as public sector accounting is concerned, can be classified in various ways, but we are going to summarise them in two interrelated categories as follows (see Figure 1).

1) Accounting information has to be useful for decision making. It mainly helps managers with resource allocation, allowing them to compare the results with other entities, or with other periods. It also has to allow the taxpayer/voter to assess the management of those they look up to.

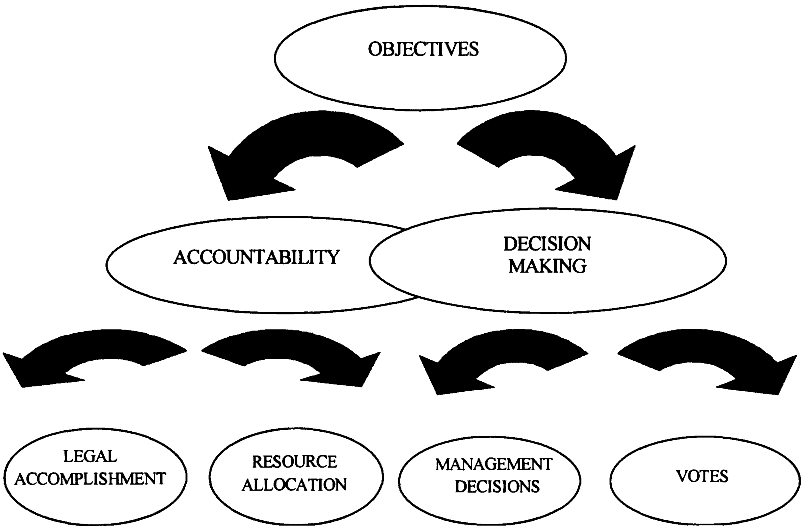


Figure 1. *Objectives of Public Sector Accounting*

2) Accounting data has to be able to assign accountability. This accountability should be understood not only in terms of accountability purposes but also as regards value-for-money accountability.

As we have already pointed out, the public sector has undergone significant structural reforms during the last 20 years. Its role and the way it is managed have changed. Market mechanisms have been introduced and it is not operating in a monopolistic context any more.

In this new context the lack of useful information is a major drawback for managers. This becomes even more salient if we take into account the differences between the public and the private sector. In the public sector context, for example, unlike in the private one, it is not so easy to make estimations upon past data, because it is not possible to be sure about the continuity of managers and politicians, as this depends on periodical elections. This is even more important at a local level where politicians are more involved in the management arena, and decisions are not only based on data but also on political preferences.

So, while the objectives of accounting information have not changed, the environment where this information is used has changed and, therefore, accounting systems need to evolve in order to attain these objectives.

Therefore, the features that characterise NPM raise a range of challenges to the accounting systems that we are trying to tackle. The accounting implications of NPM characteristics are summarised in Table 1.

The decentralization process through the establishment of agencies with specific allocation of resources along with the devolution of competencies, entails the disaggregation into sub-entities (in Spain, in accordance with IGAE statement n°7, this situation has led to the creation of accounting reporting sub-entities). This

Table 1. *Accounting implications of NPM characteristics*

NPM CHARACTERISTICS	ACCOUNTING IMPLICATIONS
Hands on management Focus on outputs Private sector based management Emphasis on economy and cost cutting	Cost accounting Performance Measures Budgeting
Decentralization	Comparative information Consolidated accounts Uniform information Performance audits
Competition	Comparative information Cost accounting Disclosure of information
Citizen orientation	Easy understandable information

disaggregation highlights the importance of the *uniformity* of information. This requisite is essential in order to enable both *comparability* among different entities, and *information consolidation* in order to provide an overall insight. In the Spanish case this disaggregation stresses, according to Vela (1996), the need to issue a set of rules, which make it easier to integrate the accounts of the distinct sub-entities.

Another issue related to this feature is the need to develop and improve performance audits. Greater decentralization requires greater and better control. In Spain, in contrast with other OECD countries, public sector audits are mainly devoted to check that legal rules have been complied with; however, this orientation is insufficient, and other issues related to performance and client satisfaction are also relevant.

The introduction of competition to encourage the pursuit of greater levels of efficiency and effectiveness, requires *comparative information* in order to compare data, so that the decisions about contracting out and privatization are based on appropriate information. It is necessary to elaborate the information under some standards if we wish to prompt competition in the public sector since efficiency can only be increased if the market is fed with appropriate signals. As Smith (1992) states, one method of stimulating competition is through the disclosure of comparative information about performance in public sector organizations. But this alternative raises another issue, as the provision of financial or management information is not harmless to public organizations, and even less so if they are playing in a competitive environment, but, as Hepworth (1993) pointed out, competition makes managers reluctant to release information «in order to prevent competitors from gaining a market advantage».

On the other hand, in a non-profit environment, the elaboration of comparative data is not easy, since there are qualitative factors which accounting has so far been unable to reflect satisfactorily. In this sense, the differences between the public and the private sector should not be overlooked.

The introduction of business management tools raises further issues related to cost accounting and performance measurement, which once again stress the importance of elaborating information in a uniform and comparative way.

The development of more accurate cost accounting information systems in the public sector environment is another key problem. In this field some problems arise, for example, the difficulty in allocating costs to products/services. In doing so, and in order to pinpoint the costs of services, it is important to include the cost of capital and the depreciation of assets (Pallot 1993). These are not easy subjects. Problems are incurred in allocating costs to the right outputs. Furthermore, it is no easy task to calculate the cost of the capital, because public funding and private funding come from different sources.

These drawbacks are important especially when decisions such as contracting out and competitive tendering have to be taken. In these kinds of situations, the lack of data gathered following the same criteria could lead to wrong decisions.

Moreover, it could be expensive to sort out the inconveniences explained above, and the trade off between the cost and the benefit of the effort should be duly assessed.

The application of business management principles to the management of public services makes the relationship between managerial autonomy and political control difficult. NPM principles, and especially the principle «let managers be free to manage», entail the separation between political and managerial realms. To set broad objectives is a political task and to make the objectives operational is a managerial one, but the boundaries between them are not clear-cut. This means to distinguish between political accountability and technical accountability (Pallot, 1993). While the former is related to the objectives chosen, the latter is related to the results achieved.

In this context, accounting information systems have to be able to provide appropriate data for decision making. On the one hand, accounting information has to be useful to politicians in order to help them to choose objectives and, on the other hand, it has to be useful to managers in order to design the strategy to achieve these objectives. As Stewart (1984, 31) pointed out:

> *"There is a challenge to public accountants to meet more fully the information requirements of performance and programme accountability and, above all, of policy accountability."*

These problems are concerned with the measurement of the achieved performance and the distinction between output and outcome. To assign accountability, both of these concepts have to be well defined and assessed. The lack of clear objectives, the problems in identifying outputs and outcomes, and the lack of accurate result indicators, are some of the problems that arise when we try to measure results. The importance of designing more accurate performance measures becomes greater if we take into account, for example, the fact that linking budgeting with performance is increasingly widespread.

There are a number of problems associated with designing performance indicators, and many studies have been devoted to these issues, but more development is necessary since performance measurement is the right way to assess the introduction of the NPM philosophy.

Another issue related to the results and to the decentralization process is concerned with the surplus generated by public entities (Pallot 1993, 235). If entities could retain surpluses, they could use them as an incentive to attain better results, but this could be contrary to general interest, even more so when the concept of results is not clear in the public sector context. Australia has adopted quite a good solution with the imposition of an «efficient dividend» which means that a department can retain the money it has saved after the dividend has been paid (Hicks, 1990).

It is important to note that stressing quantified measures can lead to neglecting qualitative ones and to forgetting the relevant issue which is whether or not public interest is improving.

The trend toward more responsive public services to citizens, which is present in the managerial reforms adopted in most countries (OECD, 1995), implies the necessity of providing clearer information that even citizens without accounting knowledge can easily understand. This trend also implies that information on citizen satisfaction must be gathered and - according to Schedler (1996) – that a new form of benefit accounting must be designed.

Significant advances have been made in accounting in most OECD countries. The changes introduced have sought to improve the existing accounting information systems by trying to overcome these challenges. One of the most important initiatives has been the introduction of accrual accounting, and even accrual basis budgeting is currently under study in some of these countries.

We can mention New Zealand as one of the trailblazing countries in introducing Resource Accounting for all levels of government and elaborating financial statements quite similar to private sector ones. Great Britain is moving in the same direction, as the introduction of Resource Accounting for agencies and departments is a reality for the entire Central government ever since it was first proposed in 1994. The first financial statements are expected by 1999.

In Spain, as opposed to private sector accounting, public sector accounting has not been able to cope with objectives in a satisfactory way. Until a short while ago, emphasis was placed on budgeting data with a limited degree of information. The budget is not able to reflect the financial situation of the reporting entity. It just reflects the increases on financial liabilities, which are devoted to financing deficits. So, hitherto, the budget has not been a managerial tool, but rather a tool to control the accomplishment of legal rules.

This type of orientation is insufficient to face the new necessities brought about by the new management forms. Although some steps have been taken to improve financial information, such as the adoption of accrual accounting in the elaboration of accounting information, more work needs to be done in fields like cost accounting and budgeting, and in the design of performance indicators which take into account the specific characteristics of public sector activities.

SOME NOTES ABOUT THE SPANISH CASE

Today Spain is undertaking a significant number of reforms with a wide scope in the public sector. This process seems to be under pressure as the effective European economic union is drawing nearer.

As we have already mentioned, the changes in management and accounting are not isolated processes and they have to be studied in accordance with their environment. Thus, the reforms in the Spanish public sector have to be understood as part of the political reforms.

While other countries were concerned about the growing deficits and fiscal pressures, which were the reasons why they started to develop significant reforms, Spain was more involved with the political situation. After forty years of dictatorial regime, the new born democracy was more concerned with getting consensus among the different parties. The left wing, in office after the first democratic elections, was at the time more interested in extending the welfare state than in managerial or accounting matters.

Only when the political situation was stable, in a context of growing deficit and increasing unemployment, in which Spain also found itself under pressure due to the approaching economic union, did the Spanish government turn more attention to managerial topics.

Hood (1995, 105-106) considered the introduction of public management reforms as being related to two factors or dimensions: motive and opportunity. Motive is linked to the hope of saving resources during acute fiscal stress or in a context of outsized government, while opportunity is related to the existence of a particular situation which allows politicians to influence the public sector as a whole.

As Van Helden (1996) underlines in talking about local authorities, this explanation is not enough and a further analysis is needed. As far as local authorities are concerned, we have to take into account the relationship between local and central levels, and, above all, the degree of dependence on central government funding.

According to Van Helden (1996, 11-12) we can consider the following situations:

- a.1 When a local government is highly dependent on central government funding, and the central government has motives (financial problems) to introduce NPM, then the local government will be affected by these motives.

a.2 If there is high dependence on central funding but central government has no motives to introduce NPM, then local authorities will also have no motives.

b If a local government is not significantly financially dependent on the central government, because it has enough financial autonomy, then the introduction of NPM reforms will depend on their own motives.

The Spanish situation is reflected in Van Helden's a.1 hypothesis. As it can be seen in the following tables (Table 2 and 3), Spanish Autonomous Communities and municipalities are substantially dependent on central government.

Table 2. *Autonomous Revenue Composition: Year 1994*

MAIN TYPES OF REVENUES	AUTONOMOUS COMMUNITIES (% OF TOTAL REVENUES).
TAXES	11.96%
CHARGES & OTHER RECEIPTS	5.73%
PATRIMONIAL REVENUES	0.63%
SALES OF REAL INVESTMENTS	0.45%
FINANCIAL REVENUES	0.60%
GRANTS	**80.63%**
TOTAL	100.0

Source: Direccion General de Coordinación con las Haciendas Teritorriales.

In regard to this strong dependence, it is important to note the following points:

- The taxes managed at local and autonomous levels are either of little importance or have significant limitations to their modification.
- The grants received have to be classified under conditional grants (funds have to be spent on specific activities) and non-conditional ones (the resources can be used to finance any expenditure). This means that an important part of the resources that the Autonomous Communities receive have to be devoted to specific issues. This situation makes dependence on the central government even stronger.
- Therefore, due to this significant dependence, the reforms at a local level in Spain have followed those introduced at a central level, the exact opposite to what has happened in other countries such as the UK or Germany. There are some initiatives taken at a central level which can be categorised under NPM philosophy. Briefly, we can point out the following:
    - Privatization: not just as a part of managerial reforms but as a means of financing the deficit.
    - Decentralization: with a limited scope. Only some services have been delegated. This decentralization has been flanked by the development of legal premises.

- Citizen orientation. Perhaps, most management initiatives can be categorised in this group.
- Performance measures.

Decentralization in Spain has mainly consisted in transferring powers from Central government to Autonomous Communities. The devolution of responsibilities to other levels of government is stated in the Constitution and, until now, there has been an ongoing process to develop this mandatory norm. In this context an agreement which significantly advanced decentralization by transferring responsibilities in 32 fields was signed in 1992. This process has been impelled by the interest of some Autonomous Communities more concerned with the decentralization of powers.

After the last elections held in 1996, the conservative party came into office, sustained by the main nationalist party. This party is one of the most interested in decentralising powers, and as a consequence of political agreements, fiscal responsibility has been increasingly devolved. A reduction of central government

Table 3. *Local Revenue Composition: Budget 1995*

MAIN TYPES OF REVENUES	MUNICIPALITIES % OF TOTAL REVENUES.
TAXES	29.30 %
CHARGES & OTHER RECEIPTS	16.09 %
PATRIMONIAL REVENUES	2.35 %
SALES OF REAL INVESTMENTS	2.54 %
FINANCIAL REVENUES	9.13 %
GRANTS	**40.59 %**
TOTAL	100.0

Source: Direccion General de Coordinación con las Haciendas Teritorriales.

grants has been attained through letting autonomous communities manage 30% of personal income taxes. This has led to greater accountability not only for the management of services, but also for the management of funds.

Ever since 1994, the management of 15% of personal income taxes has already been transferred to the Autonomous Communities. Moreover, there is a compensatory system of grants in order to balance the differences among the various communities.

The new system implies management devolution of 30% of personal income taxes to the Autonomous Communities in an ongoing process which will finish in the year 2001.

This financing model means that the Autonomous Communities will not only manage services (expenditure) but also funds, and therefore they will become more independent from the central level and, at the same time, more accountable to local taxpayers.

Although from a theoretical perspective this initiative seems to be a good advance in devolving responsibilities for the provision of services and for the management of funds, and although it could make the Autonomous Communities more accountable, some problems arise. Due to the fact that not all of the autonomous communities have the same degree of development, this model could create significant imbalances among communities. Furthermore, this reform alone cannot solve all the related problems, and the degree of dependence after the devolution will be still high.

Although these measures are significant, the decentralization from Autonomous Communities to Local Authorities has not been addressed. Law 7/1985 envisaged principles of financial autonomy and responsibility, and consequently the decentralization of competencies to local authorities. Today, more interest is devoted to this field, as reflected in a local document (the «local pact») currently under discussion.

As far as accounting is concerned, until 1985 when Law 7/1985 was passed, local authorities were excluded from the accounting reform process which, at a central level, had been introduced by The General Budgetary Law in 1977.

The General Budgetary Law introduced a programme budgeting system at a central level. However, essential aspects to support this initiative, such as cost accounting, were neglected, thus this initiative seems to be just a new way of classifying expenditure.

As we have already pointed out, Spain is still not competent enough to develop cost accounting in the public sector context. A cost model designed for autonomous entities, known as CANOA (Normalized Management Accounting System for Autonomous Organizations) today exists. This project, as Montesinos and Vela (1996) pointed out, is the first step towards devising a far-reaching reform of public management accounting systems in Spain. The objective of this model is to provide useful information in decision-making processes, to provide the cost of services and activities developed by these entities, and to allow the levels of efficiency and effectiveness achieved to be measured. Although this model is only designed for autonomous entities, it can be applied to other public entities in the future.

Law 7/1985 and Law 39/88 started, at a local level, the necessary reforms in the budgetary field which finished in 1990 with the 1990 Local Accounting Instruction. This meant a significant reform at a local level introducing mainly[2]:

- A double entry system of book-keeping for budgeting and financial reporting systems.
- Accrual basis at financial accounting level.
- A link between financial and budgetary accounting.

This reform does not develop a management information system, neither does it develop tools to provide information on efficiency and effectiveness.

Although this reform was significant, appraisal has not been unanimous. Assessment of the reform depends on the size of the municipalities in which it has been implemented, as shown in the surveys by Brusca (1996) and Dasi et al (1996).

Brusca (1996) developed a survey among provincial authorities and municipalities with more than 20,000 inhabitants. This study shows that the majority of them valued positively the reform, but the respondents also pointed out the lack of information on economy and efficiency provided by the new model.

On the other hand, a limited survey on the assessment of this reform carried out among accounting finance directors of municipalities in the area surrounding Valencia, which are smaller than the municipalities in the previous study, (Dasi et al, 1996) brought to light a lower degree of appraisal. The financial directors of these municipalities do not have, in general, a good view of the reform. In their opinion, this reform requires more means in order to be carried out successfully. They consider that it seems to be designed for bigger municipalities and doesn't take into account the limitations of smaller local authorities. In this sense, the main limitations they pointed out are related to the lack of qualified staff and the lack of appropriate software to develop the requirements entailed in the Instruction.

They also pointed out that in order to attain greater levels of efficiency and effectiveness, it is necessary to develop an accurate cost accounting system. On the other hand, they stressed the fact that users of accounting information have no skills or culture to use this kind of information, and that the only thing they are interested in is how much money is left to be spent. So, in their opinion, a change in user culture has to take place in order for managers to be given more freedom to manage.

The managerial initiatives at a local level are confined to reorganisation and, in general, there is a lack of substantial reforms. Reforms have been adopted on the initiative of isolated local authorities and a general framework is lacking. In our opinion, the pressure for change does not allow for time to be taken to analyse different alternatives. Moreover, the lack of a developed cost accounting system for local authorities creates a significant drawback in view of the implementation of more elaborate reforms.

Among the initiatives adopted by Spanish local authorities we can mention:

- Contracting out: some services are such as water supply or waste collection are provided by the private sector.
- One Stop-Shops: the implementation of citizen attention points, where related services are brought together.

The creation of agencies and the devolution of the management of some services, is not a common initiative. But there is a successful agency that has been created by the Diputacion of Alicante which we would like to talk about. Although it has a limited scope and it could seem representative in comparison with other countries, it marks an important step towards NPM initiatives at the Spanish local level.

SUMA: Managing Taxes

SUMA is an autonomous organization of the Diputacion of Alicante. It was launched in 1993 with the aim of becoming a useful tool in local financial management (Plaza, 1995)[3]. This initiative means the introduction of a new philosophy in managing local taxes. It is based upon the principles of efficiency, flexible organization, and responsiveness to double customers - local authorities and taxpayers.

The establishment of SUMA is the response to a situation that characterises most of the activities of the Spanish local sector: the lack of an appropriate organization and, in this particular case, the deficient management of local taxes. As the followings points show:

- There is no unified data source so the collection of taxes needs a variety of sources (census, lists..).
- There is a lack of income accountability; nobody is accountable for incomes.
- Work is not standardised. There is no routine practice to collect taxes.
- There is a politicization of systems, so it is necessary to define the boundaries of the political and management fields.
- There is a lack of management culture, so some business principles should be introduced.

Due to this situation, the Diputacion of Alicante started a reform process of tax collection in 1987 which was finalised in setting up an agency called Suma in 1993.

This agency manages tax collection devolved by some administrations such us: Councils, Generalitat Valenciana, Ministry of Economy and Finance, Diputacion of Alicante and National Health Service.

This agency also delivers some other services such as:

- Financial and economic advice to local authorities.
- Financial support by advancing money on the basis of uncollected self-assessed local taxes.
- Development of new software in order to help local authorities .
- Support to the elaboration and execution of local budgets.
- Studies on costs and financing of local services.

This initiative, as we have already pointed out, is based on the application of some business management tools, especially as far as organization, setting objectives, and human resources policy are concerned. This new approach in the field of financial management in Spain can be considered as a Spanish initiative in following NPM principles, inasmuch as the agency tries to further develop the following points:

- Responsiveness and quality service to two types of customers: taxpayers and administrators.
- Development of internal team work culture.
- Boosting intermediate levels and flattening the organization, thus reducing the number of hierarchical levels.
- An appropriate human resources policy. This encompasses performance-related pay schemes, promotion based on results, and staff training programmes.
- Study on the costs of different services.
- Internal control and organization audit.

- Management by objectives.

With regard to objectives, it is important to note that, besides the broad objectives such as improving the organization or the responsiveness to customers, SUMA tries to fix concrete and measurable objectives so as to make it easier to assess the results achieved.

CONCLUSIONS

Public sector management is evolving towards a more business-oriented management. In this context, accounting systems must be able to respond to the need for new types of information which are required by the new forms of public organizations. Therefore, improvement is an essential part of these reforms. In this paper we have tried to present the main challenges that the NPM philosophy entails in accounting information systems.

One of the main features of NPM is the greater emphasis on efficiency and effectiveness, but this emphasis in an environment where politicians are subject to periodical elections, can lead to a greater stress being placed upon easily measurable short-term objectives, rather than on ambitious long-term objectives. This risk is even more significant in local authorities where politician-citizen relationships are closer, especially in small municipalities which are predominant in Spain.

In this sense, according to the OECD report (1991, p.13):

> *"Within the constitutional framework, political authorities have the responsibility to decide the balance of economic efficiency and other values; but the extent of associated economic losses will depend on the cost-effectiveness of the public sector. However, the information available may be inadequate for such decisions to be made without risk".*

At an international level, there have been significant developments in accounting information systems in order to satisfy information needs, but more work in this field is necessary. The design of new kinds of indicators which allow non quantitative aspects to be taken into account is still a challenge. Another challenge is how to produce information that citizens can understand easily.

Spain is making its first steps to tackle all these issues, especially at a local level. The development of an adequate cost accounting system is one of the main tasks that have to be dealt with. International experiences are an important reference point, but it is important to remember that copying the reforms of other countries can be very dangerous.

NOTES

[1] IGAE stands for Intervención General de Estado. It is a governmental entity involved in governmental accounting issues.

[2] A deeper study of local accounting in Spain can be found in Vela (1996).

[3] SUMA is not an acronym and means adding efforts.

REFERENCES

Brusca Alijarde, I. The Usefulness of Financial reporting in Spanish Local Governments. Financial Accountability and Management 1997; 13, 1.

Dasi, R., Pelejero, L and Gimeno, A. *El Nuevo Sistema de Información Contable de la Administración Local. Reflexiones en torno a su Implantación en los municipios del Area Metropolitana de Valencia.* VII Encuentro de Profesores Universitarios de Contabilidad. Barcelona. 1996

Financial Accounting Standard Board. n°4. *Objectives of financial reporting for Business Enterprises.* Stamford: Connecticut, 1978.

Governmental Accounting Standard Board. *Objectives of Financial Reporting. Concepts Statement n°1.* Stamford, Connecticut: Gasb, 1987.

Hepworth, N. "Performance Measurement in Local Government in the United Kingdom." In *Perspectives on Performance Measurement Public Sector Accounting.* Buschor E. and Schedler K. eds. Bern: Paul Haupt, 1993.

Hicks, A. *Budgeting for Results: Recent Developments in Five Industrialized Countries.* Public Administration Review 1990; January/February.

Hood, C. *Public management for all seasons.* Public Administration 1991; 69, Spring.

Hood, C. *The New Public Management in the 1980s: Variations on a Theme.* Accounting Organizations and Society 1995; 20, 2/3.

Hughes, O. *Public management and Administration: An Introduction.* Macmillan Press Ltd, 1994.

Intervencion General De La Administración Del Estado. Documento sobre principios y normas contables núm 7 . «Información financiera pública», 1992.

Montesinos, V and Vela, J.M. *Governmental Accounting in Spain: Evolution and Reforms.* Research in Governmental and Nonprofit Accounting. Chan, Jones &Lüder eds. Vol 9, 1996.

Memoria de SUMA, 1993. Diputación de Alicante.

OECD. *Serving the Economy Better.* Occasional Papers on Public Management. Paris: OCDE, 1991.

OECD. *Public Management Development. Update 1995.* Paris: PUMA OECD, 1995.

Pallot, J. "Specifying and Monitoring Government Performance in New Zealand: An Evaluation of Progress to Date". In *Perspectives on Performance Measurement & Public Sector Accounting.* Buschor E. & Schedler K. eds. Bern: Paul Haupt, 1993.

Plaza Gonzalez, F. *La Modernización de la Gestión Tributaria y Financiera.* Workshop sobre problemas financieros de las Corporaciones Locales, 1995.

Pollit, C. *Managerialism and the Public Services. The Anglo-American Experience.* Basil Blackwell, 1990.

Schedler, K. *Governmental Accounting Innovations at the Cantonal Level in Switzerland: Experimenting with the New Public Management.* Recent Development in Comparative International Governmental Accounting Research. Speyerer, 1996.

Smith, P. Negative Political Feedback: An Examination of the Problem of Modelling Political Responses in Public Sector Auditing. Accounting Auditing and Accountability Journal 1992, 5.

Stewart, J.D. *The Role of information in public Accountability.* Issues in Public Sector Accounting. 1984, pag. 31.

Van Helden, G.J. *A Policy and Management Instruments Project for Municipalities in the Netherlands.* Paper presented to EIASM Workshop on the role of accounting in public sector transition. Score, Stockholm, 1996.

Vela Bargues, J.M. *Latest Developments in Local Government Accounting in Spain.* Financial Accountability and Management 1996; 12, 3, August.

Vela Bargues, J.M. *El Concepto de Imagen Fiel en el Nuevo Marco Normativo de la Contabilidad Pública Española.* Madrid: ICAC. Ministerio de Economía y Hacienda, 1996.

14

THE SCOPE OF ACCOUNTING CONSOLIDATION IN THE LOCAL PUBLIC SECTOR

Evelyne Lande

Over the last few years various case studies have been carried out on the subject of accounting consolidation in the public sector in France, led by consulting groups and auditing offices, as well as in OECD countries and more specifically in Anglo-Saxon countries.

Studies and research on consolidation deal with the problem of the definition of the scope of consolidated accounting, and with such questions as which elements or component units need to be included in Public Consolidated Financial Statements, and how these elements could affect the information provided in the financial statements.

This fundamental issue influences the relevance of consolidated information and its utility for user groups. However, the analysis of the experimentation, in particular as performed in France, shows that there is a consensus for adopting criteria used by the private sector for the identification of the scope of consolidation.

This adaptation can be justified based on studies devoted to corporate group financial statements. Nevertheless, this adaptation also implies identifying user needs in the private and public sectors. The objective of this paper is to analyse user needs in order to test the hypothesis of the applicability of private sector criteria to the public sector with a view to defining the scope of consolidation. We describe the solution adopted in the private and public sectors in France and in the USA, and we propose a definition of the scope of consolidation. Finally, we will test this proposal in towns with 10,000 inhabitants or more in France.

THE DEFINITION OF THE SCOPE OF CONSOLIDATION

User Needs and the Objectives of Financial Statements

Based on the analysis by Jones et al. (1985), it is possible to identify 3 categories of external users of municipal financial statements:

- Citizens
- Legislative and oversight groups
- Investors and creditors

Citizens can be divided into two groups: electors and taxpayers. These two groups have different objectives. Electors are mainly interested in the programme of the candidates, and in the proposed or actual uses of public finance, whereas taxpayers want to minimise taxation and to be sure that money is well used.

To evaluate elected officials' objectives, the elector will focus only on financial data without adopting a portfolio approach. When elected officials are involved in the management of various entities related to the city, it is more relevant to have an overall view of the activities for which they are responsible. Patton (1985) sustains this position:

> *"When officials are subject to common environmental variables or when they can influence the outcomes of others, it is optimal to base the performance assessment of each individual on the performance of all".*

Consequently, electors should be interested in consolidated financial statements including all of the activities managed or handled by elected officials.

For taxpayers, a similar point can be made although the objectives differ in that they focus on the efficiency of the use of taxes. The control of efficiency would imply that taxpayers are focussing only on the financial information of the entity (the city in this case) receiving the taxes. Nevertheless, if taxpayers choose a portfolio approach they will analyse all taxes paid to different entities and the public services offered by these public entities. Thus, taxpayers will wish to have consolidated financial statements including all activities realised or financed by taxes, and also entities with their own taxation (such as the city or some cross-city organisations) or entities such as not-for-profit organisations financed mainly by grants from the city (the grants are part of the collected taxes).

The second category of external users is made up of legislative and oversight groups, such as the audit commission, the *Cour des comptes* in France (equivalent to the GAO), and other higher level government control entities. According to Patton (1985, p.95), these organisations would prefer to focus on individual financial statements, since public grants and taxes are accorded to an entity and not to a group. Wilson (1990, p.72) stated:

> *"Further analysis revealed that of the three user groups, the legislative and oversight group was more strongly opposed to aggregated capital reporting than the citizens, and investors and creditors".*

In fact, this position is not really valid in France, because the audit commission focuses on individual financial statements, but also needs to analyse financial and operational links of the city with others entities. For example, when an audit commission analyses the financial statements of a city, it also analyses the financial statements of the main associations financed by the city to find out if taxes are properly used by associations, in accordance with laws and regulations. Then, the audit commission defines *de facto* a scope of consolidation by including some related entities to the primary government in its investigations. The objectives of the legislative and oversight groups are finally close to those of taxpayers but with additional control of regularity and conformity to laws.

The last group is composed of the creditors and investors. Logically they would focus only on city accounts to determine solvency. Nevertheless, the analysis of only individual financial statements does not always allow its objective to be reached because:

- Component units can increase the financial risk of the primary government or affect its solvency in the case of bankruptcy of a component unit,
- The solvency of a city is based on the capacity of taxpayers to pay taxes. We need to determine all the taxation services of the citizens in order to measure the actual fiscal burden.

Creditors also need to take into account consolidated financial statements that include the financial consequences of the links between the city and its component units.

Consequently, each group of users has its own objectives. These objectives can lead to different interpretations of the concept of "entity" and of consolidated financial statements. To satisfy all the needs of the different users, we have to set up consolidated financial statements with four objectives:

- Management accountability
- Financial accountability
- Public service accountability
- Legal accountability

The Concept of "Entity" in the Private and Public Sectors

The study of the various concepts of "entity" in France (in the private and public sectors) and in the USA (only in the public sector through the position of the GASB) identifies three relevant focal points:

- For investors: it is the position of the French Private Sector and of the French Institute of professional accountants (OEC) for the public sector.
- For the audit commission: it is the position chosen by the national audit commission in France.
- For investors, taxpayers and the audit commission: it is the position held by the GASB.

The scope of consolidation from the investors' viewpoint

In the French Private Sector, the scope of consolidation is defined by the decree dated 3 January, 1985 (transposition of the 7th EEC directive), based on a two-fold concept, management and financial control. According to this decree, the parent company must present consolidated financial statements when it exclusively or jointly controls one or more subsidiaries, or when it exercises an influence over the subsidiary. There are three levels of control:

1. Exclusive control which stems from either:
    - A direct or indirect majority of voting rights, or
    - The appointment for two successive financial periods of the majority of the board directors, management or oversight body. The parent company is presumed to have power to appoint, when it has, directly or indirectly 40% of voting rights and no other shareholder owns more than 40%, or
    - A right to exercise an influence through contract or charter clauses, when permitted by law, and when the parent company is a shareholder (regardless of its size) of the enterprise.
2. Joint (or shared) control, which occurs when the control is shared between a limited number of shareholders (joint venture).
3. Influence on the corporate management and the financial policies which is assumed when the parent company directly or indirectly has at least 20% of the voting rights of the enterprise.

This analysis makes reference to three different types of control:

- Financial control based on the notion of capital shareholder;
- Management control based on the notion of voting rights;
- Economic control based on contract or charter articles.

The objective of this analysis is to establish the degree of autonomy of the entity at the financial, management and economic levels. It appears that there are different measures of autonomy. This analysis could seem to focus on management control (the definition mainly refers to voting rights), and on the definition of an entity based on management accountability. However, in practice, the definition of a subsidiary relies mainly (and almost exclusively) on financial control through share capital control.

This does not imply that the other types of control are not taken into account, but these are dependent on share capital control. Moreover, shareholders are generally only interested in the financial consequences of management. Where there is no link of capital share between the parent company and the entity under management control of the parent company, there is no potential financial impact and no reason to include it in consolidated financial statements. This concept of the scope of consolidation refers to the investors' viewpoint.

Such a concept of the consolidated accounting entity does not seem to be relevant for the Public Sector, because there are few cases of financial control through share capital. Therefore, it is necessary to modify this position to include other forms of financial control and not only share capital control. It is the position chosen by the OEC (1992).

This position results from various case studies on consolidation carried out in France at the beginning of the 1990's by consulting groups (Bouinot, 1991). The analysis of these various studies on consolidation in the Public Sector shows that the level of control reflects the transposition of the decree dated 3 January 1985, with some modifications to take into account the particularities of the Public Sector and its financing sources. The OEC identifies three levels of control:

- Exclusive control;
- Joint control;
- Influence on policy.

Control is exerted on voting rights, financing (direct or indirect) and contractual relationships. However, in practice, control is, above all, based on financial aspects. The objective of the accounting entity concept is to present the financial impact of city management. It is financial accountability that is chosen and not management when focussing on investors' needs.

The Scope of Consolidation from the National Audit Commission's Viewpoint

In France, the CRC (French audit commission for cities and other local governments) looks at the degree of autonomy of entities with some links with the primary government. When the entity is qualified as having no autonomy, the CRC qualifies this relation as "*de facto* management", which implies that all or part of the activities of this entity is included in the financial data of the local government.

According to the CRC, there is no autonomy when the following three conditions arise:

- The local government plays an important role in the entity's management,
- The local government finances almost all of the entity's expenditure,
- The entity's activities are part of the mission of the local government.

This concept of autonomy is based on two types of control (financial and management control) and also on the notion of public service. The position of the CRC is noteworthy because it introduces another criterion: public service. Nevertheless, this position on the concept of autonomy often tends to include very few entities since all three criteria have to be met. This position is more relevant in introducing the criterion of public service to the three other criteria (financial, economic and management).

The Scope of Consolidation for the GASB: From Oversight to Financial Responsibility

In 1981, the NCGA published a statement for the first time defining the scope of consolidation (statement 3, 1981). In fact, before this statement, several definitions were proposed (Coopers & Lybrand, 1978, Holder, 1980).

The NCGA's position was the subject of much criticism, in particular from Freeman & Shoulders (1982) who maintained that it is not oversight responsibility which is important, but the capacity of the primary government to exercise control. In this sense, even if the primary government does not exercise effective control over its component units, the ability for control necessitates the inclusion of component units in the consolidated financial statements.

Shoulders (1987) used a survey to test an alternative concept of oversight responsibility: financial responsibility. In this questionnaire, respondents where required to rank several criteria based either on oversight responsibility or financial responsibility. The results shows that criteria based on financial responsibility appeared more relevant for respondents in defining the scope of consolidation than oversight responsibility.

The criticism following the NCGA's publication of Statement 3 was taken into account by the GASB, the successor of the NCGA, when it published Statement 14 in 1991. According to the GASB, this new definition of the accounting entity is also useful for making elected officials responsible in terms of a control objective. This new definition reinforces the accountability of the elected officials:

> *"(...) The elected officials are accountable to citizens for their public policy decisions, regardless of whether these decisions are carried out directly by the elected officials through the operations of the primary government, or by their designees through the operations of specially created organisations". (§8)*

This modification of the objectives assigned to consolidated financial statements needs to define new criteria that characterise the scope of consolidation:

1. The legal dependence or the degree of validity of the legal structure of the entity.

2. The entity's management dependence, when the primary government appoints the majority of members, or if it is able to impose its will on the component unit.
3. The entity's financial dependence in two cases, the fiscal dependence and the contractual dependence, when the city is given financial profit or the city is responsible for financial losses.
4. Finally, the entity's economic dependence when it provides almost all of its services to the primary government.

Moreover, the GASB, as in the French Private and Public sectors classifies the entity according to three levels of control:

1. the related organisations to be mentioned in the Notes to the Consolidated Financial Statement
2. the entity to be presented separately
3. the blending of component units to be merged in the primary government financial statements.

Proposed Definition

This proposition is based on five criteria that take into account the specificity of the French Public Sector.

The first criterion is based on the influence of the city on the management of the entity. This influence is assumed when the majority of the directors are appointed by the city, or when some of the elected officials of the city are lawfully appointed members of the entity's board, or when the members are almost the same in the entity as in the city council. However, this is just an assumption and it is necessary to determine actual influence, and whether the city can exercise a real influence over the management of the entity. For example, legally the mayor in France is the president of the board of the local hospital. However, he does not have any true responsibility in the management of the hospital. Consequently, even if the mayor is a member of the board, the city has no real power to make others on the hospital board vote as he sees fit.

The second criterion is based on the financial influence of the city on the financing of the entity's activities. To evaluate the financial influence, it is necessary to take into account all forms of financing: direct or indirect, financial participation, grants, benefits, etc. Nevertheless, financial participation needs to be divided into two parts: first, usual or current ordinary financing and second, occasional or exceptional financing. In the second case, the entity financed by the city is not an entity to be included within the scope of accounting consolidation, unless there are other criteria that influence the degree of dependence of the entity. However, some information on the relation between the city and the entity benefiting from this occasional financing must be shown in the Notes to the Consolidated Financial Statements.

The third criterion is based on the city's economic influence over the entity. This degree of economic dependence is caused by the extent of the entity's activities that are provided or made for the city. In fact, this criterion of control is dependent of the other criteria: the criterion of financing or when the entity's activities are part of the city's authority. This criterion is, above all, useful to determine the level of control of the entity by the city.

The fourth criterion is based on the legal validity of the entity's status. For example, when the entity is not legally distinct from the city it appears that this entity is included within the scope of consolidation. In France, this is commonly the case with water and sewer activities. The city has to separate these activities from its other activities. These activities have financial autonomy and their own financial statements, but they are not legally distinct from the city. Therefore, it is necessary to include them within the scope of consolidation.

The fifth criterion is based on the nature of the activity. In France, the city and other local governments must provide certain services to the population. However, these activities can be contracted out to other entities, and it is necessary to include these activities in the consolidated financial statements.

Figure 1 shows the different criteria and their links. This figure makes it possible to identify 4 scopes:

1. The scope of exclusion.
2. The scope of accounting, which can be divided into three levels of control:
   - Absolute control, when the entity does not have a legal status, or when the managers of the city and the entity are the same (the case of the municipal not-for-profit organisation);
   - Exclusive control, when there is economic control or management control;
   - Joint or shared control, when the entity's activities are shared among several users.
3. The scope of financial risk for the entity with financing agreements or guarantees for loans.
4. Political and institutional scope (for example, hospitals in France).

Entities that fall within the last two scopes must be mentioned in the Notes to the Consolidated Financial Statements, stating the nature of the relationship between the city and the entities.

This proposed definition of the scope of consolidated accounting was tested in a small city near Paris, and was also proposed to all mayors of cities with 10,000 inhabitants or more, in order to ascertain whether such a definition corresponds to the notion that mayors had of the activities for which they are responsible.

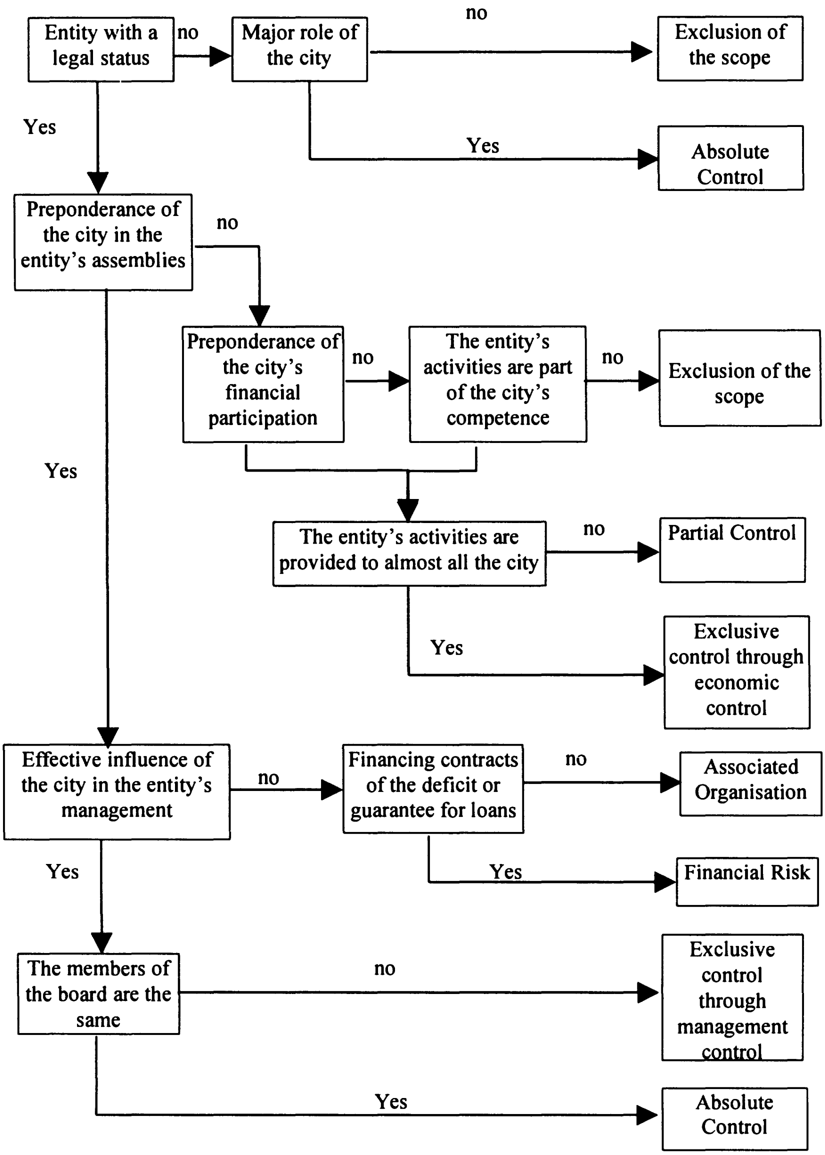


***Figure 1**: Definition of the scope of consolidation*

THE PERCEPTION OF THE ACCOUNTING ENTITY BY FRENCH CITIES

To test this proposal we chose to send a questionnaire to mayors. This questionnaire was sent to cities with 10,000 inhabitants or more during March 1995. We received 303 replies with a 36% response rate. This questionnaire was composed of several questions organised around two themes:

1. What is the notion of a component unit for the cities?
2. Why is it necessary to include an entity in city consolidated financial statements?

The replies to the questionnaire were analysed in two phases. First, the general trend was presented for each question, and then, the results were broken down to distinguish three types of respondents: mayors and deputy mayors, secretary-general and the Financial Service. The purpose of the second analysis was to test whether the replies showed any political bias.

The Definition of Component Units

To define the notion of component units, three criteria were tested corresponding to three definitions:

1. The first definition was based on the private sector concept of the subsidiary and was adopted by the OEC. This definition is essentially based on financial control.
2. The second definition is based on Statement 14 of the GASB. The city must include all entities for which it is financially responsible in its financial statements. The objective of this definition is based on the notion of financial accountability.
3. The third definition is based on the nature of the entity's activities and especially when these activities are part of the city's missions.

Among the three definitions, financial responsibility and financial control were chosen by 86% of respondents, a much higher percentage than that achieved by the type of activity criterion, with only 47% yes answers.

Here are the percentage answers to the question asking what a component unit is:

	Yes	No	NA
A controlled entity	86%	9%	5%
An entity for which the city is financially accountable	86%	10%	4%
An entity endowed with a transfer of public powers	47%	40%	13%

These answers show that the criteria of control and financial accountability are considered jointly. This opinion is reinforced by remarks on this question. It appears that respondents wish to have an overall vision of activities managed by the city with no consideration given to the legal structure of the city.

> *"It is an autonomous entity carrying out activities of general interest, that justifies financing from the city. Financing means that the component unit must be accountable for the utilisation of funds and must be controlled."*

> *"A component unit is an entity that has a general responsibility to the local government, not only at a financial level but also for all or part of its activities."*

The last criterion based on the transfer of public powers was rejected. Nevertheless, this notion was misleading and it would have been better to change it to the notion of contracted-out public-type activities, especially because respondents included this notion in their remarks:

> *"An entity carries out a mission of local public interest in co-ordination with city policy."*

> *"An external structure which carries out a public service mission on behalf of the local government and with its approval."*

When we analysed the responses after having distinguished the respondent types, we observed that the χ^2 test was not significant for the first proposal based on the control criteria and for the third proposal. For these two questions, the type of respondent does not make it possible to differentiate answers. Nevertheless, it appears that mayors are more attached to the control criterion, putting in evidence of their management compared to other criteria, whereas the internal financial services prefer the criterion of financial responsibility.

Consequently, it appears that the definition of the component unit is generally

***Table 1**: Comparative Analysis of the Component Unit Definition*

	Control	Financial responsibility	Public prerogative
Mayor	**92%**	88%	56%
Financial service	85%	**88%**	48%
Secretary general	82%	83%	49%
Others	89%	86%	37%
Mean	86%	86%	47%
χ^2 value = a	5.02	1.29	3.38
$p(\chi^2>a)$	0.541	0.972	0.760
Test value	- 0.02	- 0.83	- 0.51
Test interpretation	not significant	significant	not significant

agreed on and has many sides, as summarised in the following statements:

"A component unit is an entity which benefits from significant help (direct or indirect) from the local government, and which has a real autonomy for its decisions and which needs a special interest from the local government in order to:

"check the balance between the general purpose of policies of the local government and this entity's objectives,"

"prevent financial difficulties and control short, medium and long term agreements with the local government."

Therefore, in order to define component units, it is important to rely on different criteria based on control, financial risk and the notion of public service. This reinforces the options put forward in the first part of this paper for defining the scope of consolidated accounting.

The Reasons for Consolidating Component Units

Defining component units does not mean that respondents want to consolidate them within the city's financial statements. It is useful to know why respondents consider it necessary to consolidate component units. Thus, the following question was asked:

Do you think that accountability for city's activities implies giving further information on the component units when:

	Yes	No	NA
The city controls the component unit	90%	7%	3%
The city is financially responsable for the component unit	95%	2%	3%
The component unit has been given public powers belonging to the city	73%	16%	11%

In fact, and this may be surprising, the percentage of "yes" answers for the three proposals is higher than that of the preceding question. This may be explained by the fact that the definition of a component unit is very complex, and the definitions proposed corresponded only to some of the very complex links existing between the city and the component units.

However, according to the respondents, when a component unit is controlled or implies financial responsibility for the city or benefits from public transfer, the city must take into account the particular links between the component unit and the city if the local government wants to give a complete account of the city's activities.

We may note that the criterion of financial responsibility is the most important motivation with a 95% of 'yes' answers. Consequently, information on financial consequences is the most important reason to consolidate the component unit. There is a need to be accountable for controlled activities (90% of 'yes' answers) and for delegated activities (73% of 'yes' answers).

These answers show that respondents are very favourable to the publication of more information. It reinforces the concern for consolidation in the local public sector. Moreover, the criteria of management control and financial responsibility would make it possible to satisfy citizens' needs focussing on management, the level of public services provided, and financial choices, as opposed to the investors' needs focussing principally on financial responsibility.

CONCLUSION

The consolidated accounting entity proposed is based mainly on a concept of management control, which permits the first two levels of control to be defined (absolute control and exclusive control through management control) whereas the financial, economic and public service criteria are taken into account in defining the last two levels of control (exclusive control through economic control and joint control). As indicated, it is possible to define the accounting entity related to user needs, since the proposal is a compromise between management and financial responsibilities. Based on the two hypotheses we can conclude:

- The scope of accounting in the private sector is not relevant to the public sector because the objectives of financial statements in the private and public sectors are different in France, and these objectives influence the scope of consolidation;
- The proposal seems to have been well-received by cities with 10,000 inhabitants or more which are interested in providing financial statements from a financial and a management accountability viewpoint.

REFERENCES

Bouinot, J. and Yves, R. La consolidation des comptes locaux: la pratique d'une approche sur mesure. La lettre du financier territorial 1991; Octobre.

Coopers & Lybrand, *Financial disclosure practices of the American cities II: closing the communications gap*. 1978.

FASB, FAS No 140-B, *Preliminary views on major issues related to consolidation policy*. August 1994.

Freeman, R. and Craig, S. Defining the governmental reporting entity. Journal of accountancy 1982; October: 50-63.

GASB, Concept statement No 1, *Objectives of financial reporting*. Stamford, CT: 1987.

GASB, Statement 14, *The financial reporting entity*. Norwalk CT: 1991.

Holder, *A study of selected concepts for government financial accounting reporting*. NCGA research report, Chicago: 1980.

Jones D., Scott R., Kimbro L. and Ingram R., *The needs of users governmental financial reports*. Stamford, CT: GASB Research report, 1985.

NCGA, Statement 3, *Defining the governmental reporting entity*. 1981.

OEC, *La consolidation des comptes - Méthodologie d'approche à l'usage des collectivités locales*. Paris: Éditions Comptables Malesherbes, 1992.

Patton, J. "The governmental financial reporting entity: review and analysis." In *Research in governmental and non-profit accounting*, vol. 1. JAI Press Inc., 1985, pp. 85-116.

Shoulders, C. "Criteria for identifying the municipal organisational reporting entity." In *Research on governmental and non-profit accounting*, vol. 3, Part A, JAI Press Inc., 1987, pp. 181-206.

Wilson, E. *Financial reporting by State and local governments: a survey of preferences among alternative formats*. Norwalk, CT: GASB research report, 1990.

15

EXTERNAL AUDIT IN SPANISH LOCAL AUTHORITIES

Vicente Montesinos Julve

INTRODUCTION

Over the last ten years an important development in municipal accounting has taken place in Spanish local entities. Nevertheless, external local audits are hardly ever performed, even in big and medium-size municipalities.

The paper presents, on the one side, an empirical analysis of the current state of external audit and control in Spanish entities, by the study of the data resulting from the answers given in a personal questionnaire sent to regional external audit institutions. On the other side, the foreseeable evolution is analysed, applying Prof. Lüder's contingency model. Large-scale changes in the "state of the art" should however not be expected in the short term.

EXTERNAL AUDIT OF SPANISH LOCAL AUTHORITIES IN A EUROPEAN ENVIRONMENT

Public accounting and public finance audit environments can be labelled very differently, but never uniformly across Europe. The diversity of legal, cultural, social and economic traditions have conditioned the accounting systems and public accounts auditing systems, thus resulting in significant differences among European countries. These differences also appear frequently within a single country (see EURORAI).

With regard to external control of local public accounts, two main parameters can be applied in order to classify the prevailing systems: the public or private title of the auditor and the amount of emphasis placed upon either legality or management when carrying out the audit work (see Table 1).

In accordance with the first criterion just mentioned, the most traditional systems within the legal systems in the Roman and Germanic lines (on international accounting and legal systems comparative analysis, see Van Peursem and Pratt, 1992) have local accounts auditing models of a public nature (1 and 2), centralised (1) or decentralised (2), whereas private auditors have acquired greater importance in countries with an Anglo-Saxon influence (3).

In countries such as France and Spain the audit of local authorities has traditionally been carried out by single audit institutions (courts of auditors) for the whole State (type 1 models). Within the same group of legal systems there are countries with a tradition of political decentralisation, such as Germany and Austria, where regional courts of auditors, and even external audit bodies dependent on the same municipalities, play a significant role in the independent audit of local authorities (type 2 models).

On the other hand, over the last twenty years a tendency towards decentralisation can be observed in countries such as France and Spain, and in this sense, the *chambres régionales de comptes* and the *tribunales de cuentas regionales* (regional courts of auditors) have been established in France and in Spain, respectively, in line with the prevailing courts of auditors of the German *Länder*. Thus, a shift towards type 2 models can be observed. Countries such as Italy have also followed a process of decentralisation in the external control of local finances through regional control committees, even though at present the future of these committees is under discussion, and their definite function is still not clear.

Local auditing developed by professionals from the private sector has evolved greatly in Northern European countries, such as in Scandinavian countries and Holland (3). The privatisation process of public services has influenced this process, in such a way that audit municipal bodies have been the origin of private auditors' organisations in charge of local public accounts (see Intervención General de la Administración del Estado).

Thirdly, a mixed development in the case of the United Kingdom should be emphasised (type 3 model). This development has been effected through the Audit

Commission, which enables district auditors of this organisation to carry out directly the audit of municipalities and rely on the co-operation of private audit firms, whose performance is controlled in an indirect way by the Audit Commission itself.

The collection of audit fees for the auditing of municipal financial reports is a practice coherent with the subsistence of private auditors. However, this practice has also been adopted by public control bodies, such as the Audit Commission of England and Wales.

On the other hand, audit activities have traditionally focused upon legal compliance and accounting regularity (type A), even though this emphasis has been gradually shifting towards aspects related to value for money and management audits (type B), as new public management philosophy and techniques have evolved. Undoubtedly, these efficiency, effectiveness and economy audits (value for money audits) have become very important in the United Kingdom, Holland, and Scandinavian countries. Also in Germany a significant effort is being made on this matter.

However, value for money audits hardly ever exist within the public sector in Italy, and in France and Spain these audits are at an incipient stage. A third possibility is a mixed model of local audits (type C), which can be considered as

Table 1*. External control systems of local authorities*

SUBJECT AUDITOR/ EMPHASIS OF THE AUDIT	PUBLIC AND CENTRALISED (1)	PUBLIC AND DECENTRALISED (2)	PRIVATE (3)	MIXED (4)
LEGALITY (A)	A1	A2	A3	A4
MANAGEMENT (B)	B1	B2	B3	B4
MIXED (C)	C1	C2	C3	C4

the model towards which European countries tend. For practical reasons there is, however, a tendency to implement and present value for money audits as well as compliance audits.

Taking as a reference the control systems shown in Table 1, it can be established that the evolution of external control systems of public authorities is taking place in a downward direction (greater emphasis on management) and towards the sections on the right of the chart (greater importance to private auditors). Nevertheless, there is strong passivity which restrains this evolution due to factors such as the legal systems, and the political and administrative variables. This leads to foreseeing the subsistence of significant differences among European national control systems.

The incidence of this environment in the evolution of local auditing in Spain is considerable, but perhaps it does not affect it in a dynamic sense by encouraging the progress and development of the control, as we shall comment in section 6 of this paper.

CHARACTERISTICS OF THE SPANISH PUBLIC SECTOR

Significance of Public Entities and Local Authorities

Spanish public entities are organised into three territorial levels: Central Government, Local authorities (mainly municipalities and diputaciones[1]) and Autonomous Communities (established at regional level by the 1978 Spanish Constitution). Seventeen Autonomous Communities and fifty Provinces exist currently in Spain. The economic importance of the totality of public entities has increased enormously in Spain during the last twenty years. Thus, in 1975 the total expenditure of public entities accounted for 25 percent of GDP (gross domestic product). This figure duplicated in 1995 reaching almost 51 percent of GDP. The participation of local authorities in public expenditure has remained stable around 10 percent of GDP (9.9 percent in 1975 and 11.4 percent in 1995), whereas public expenditure in the autonomous communities, which did not exist as such in 1975, accounted for around 18 percent.

The increase in public expenditure has led to an increase in fiscal pressure, which has implied a rise of 20 percentage points above GDP, rising from 21.6 percent in 1975 to 41 percent in 1995. At the same time, in 1995 the public deficit accounted for 7 percent of GDP, the national debt for 66 percent and the interest tax burden for 6 percent. However, this trend has changed over the last few years, and convergence requirements were finally met in 1998.

Thus, the increase in public expenditure, deficit and borrowing, as well as the rise in fiscal pressure are some of the most significant circumstances which have encouraged a greater interest for accounting and auditing in Spanish public entities. Nevertheless, in the case of local authorities, there is a gap in the evolution of the information and finance control systems as far as central and regional administration is concerned, which contrasts with the claims for larger resources and powers made by the politicians of the Spanish local sector.

The Structure of Local Authorities on the basis of their Sizes and Resources Availability

In Spain the local sector is made up of about 8,000 municipalities, predominantly small ones. Thus, 86 percent of the municipalities have less than 5,000 inhabitants, which only means 16 percent of the population; these municipalities are allocated 15 percent of the local budgetary resources. 1.35 percent of the municipalities have more than 50,000 inhabitants, which means 51.38 percent of the population; these municipalities are allocated more than 53.64 percent of available resources. Finally, Madrid and Barcelona, the two municipalities with more than 1,000,000 inhabitants, account for 0.02 percent of all municipal governments, which means

Table 2. *The structure of local authorities per population sections*

POPULATION	LOCAL AUTHORITIES		INHABITANTS		EXPENDITURE	
	Number	%	Number (thousands of people)	%	Amount (millions of euros)	%
LESS THAN 5,000	6,978	86.22	6,248	16.07	2,907.01	14.98
FROM 5,000 TO 50,000	1,006	12.43	12,653	32.55	6,086.11	31.38
FROM 50,000 TO 1,000,000	108	1.33	15,318	39.41	7,552.35	38.92
MORE THAN 1,000,000	2	0.02	4,654	11.97	2,844.81	14.72
TOTAL	8,094	100	38,872	100	19,390.28	100

12 percent of the population, and they receive 14.72 percent of the total local sector budgetary resources (see Table 2).

The financial power of municipalities, and accordingly the complexity of their functioning, is clearly shown in Table 3, where a great dispersion can be observed in an interval which ranges between an average expenditure of 236,668 million pesetas (1,422.40 million euros) in municipalities with more than one million inhabitants to 69.31 million pesetas (0.42 million euros) in municipalities with less than 5,000 inhabitants (see L6pez, 1996: 16-33).

The eight autonomous communities which have a regional external control body account for 66 percent of the population and 50 percent of the number of municipalities in Spain (66 percent of the municipalities with more than 50,000 people). In these autonomous communities the GDP parameters per inhabitant and density of population are generally above the national average, as Table 4 indicates.

Table 3. *Average expenditure per local authority and inhabitant according to population sections*

POPULATION	EXPENDITURE PER LOCAL AUTHORITY		EXPENDITURE PER INHABITANT	
	Millions of pesetas	Millions of Euros	Pesetas	Euros
LESS THAN 5,000	69.31	0.42	77,975	468.64
FROM 5,000 TO 50,000	1,066.60	6.41	80,032	481
FROM 50,0000 TO 1,000,000	11,635	69.93	82,035	493.04
MORE THAN 1,000,000	236,668	1,422.40	101,705	611.26
TOTAL	399	2.40	82,997	498.82

Table 4. *The structure of local authorities per autonomous communities*

AUTONOMOUS COMMUNITY	GDP / INHABITANT (thousands of euros)	DENSITY OF POPULATION	NUMBER OF LOCAL UTHORITIES	LOCAL AUTHORITIES >50,000 PEOPLE.
Andalucía	8.03	80.9	769	19
Canarias	11.99	209.4	87	4
Castilla-La Mancha	9.58	21.1	915	6
Cataluña	13.75	191.2	944	18
Comunidad Valenciana	11.29	166.7	541	9
Galicia	9.48	92.3	313	7
Navarra	12.98	50.0	271	1
País Vasco	12.63	290.6	248	9
Spanish average	9.94	77.6	8,094	111

ECONOMIC AND FINANCIAL INFORMATION AND PRESENTATION OF LOCAL ACCOUNTS

The Local Accounting Standards Framework: a Model Close to the Central Government Accounting Information System

The accounting and budgetary standards of local authorities are the same for the whole Spanish territory, since they are issued by the Ministry of Economy and Finance. These standards have gradually been adapted to those of the Central Government, despite a time lag of more than five years. Thus, the first Chart of Accounts for local authorities was adopted in 1990, whereas the first version for the central government had already been adopted in 1983. Within the scope of the practical implementation of these accounting standards, the new double-entry accounting information system for central government was established in its initial version in 1986; whereas the new local accounting model started to be compulsory only after 1992. However, in a considerable number of local authorities, especially those of small size and with scarce resources, the implementation of these standards is still not fully effective.

Local Authorities Financial Reporting

As far as statements and annual reports are concerned, local authorities draw up the *General Account (Cuenta General),* which also includes the following statements: balance sheet, statement of financial performance, statements of financial and cash flows, statement of commitments, and budget settlement.

The elaboration of both the financial and budgetary statements is the responsibility of the internal comptroller office of these local authorities. This office also audits the autonomous entities and trading corporations dependent on these local authorities.

By October 15 of every year, local authorities, their autonomous entities and the trading corporations with a capital in which local authorities have either total or majority shareholding, have to present their accounts before the Central Court of Auditors and/or the regional external audit institutions. However, it is not the custom for citizens to demand for or read the financial information published in these documents.

The degree of reporting carried out by Spanish local authorities before the court of auditors is about 75 percent, a percentage which in those municipalities with more than 50,000 inhabitants amounts to 89 percent, in municipalities with a population between 5 and 50,000 this rate amounts to 75 percent, and in municipalities with less than 5,000 inhabitants it amounts to 59 percent. These results correspond to the greater or lesser possibilities of human and material resources of municipalities, depending on their size.

The legal measures for failing to complete the presentation of the accounts are not very effective. Other mechanisms are not effective either, such as those of a political, financial and commercial nature.

Internal Control

Internal control in local authorities includes three aspects: *Auditing* (direct review of the financial legality and the actual performance of specific administrative actions), *Compliance Audit* of accounting principles and legal regulation, and *Efficiency, Effectiveness and Economy Audit (Value for Money Audit).* Audit procedures must be used when carrying out the last two types of control.

In accordance with the appropriate legal regulations, government employees responsible for internal control carry out their tasks with complete independence; they may seek any information they consider necessary and carry out as many audits and tests they regard as essential.

A significant limitation the Spanish internal control system has is the confluence within a single body, the *Internal Comptroller Office* of the entity, of tasks linked to the elaboration of economic and financial information, on the one hand, and to the control on administrative actions and on the fairness of this same information, on the other. Finally, there is no appropriate separation of tasks among the officers responsible for accounting and those in charge of the internal audit and control of the entity.

EXTERNAL CONTROL OF LOCAL AUTHORITIES

General Aspects

After the abolition of the parliamentary external control established in the times of the second Spanish Republic (1934), during the years of General Franco's dictatorship there was no independent external control system, since the members of the Court of Auditors were directly appointed by the executive.

In 1982 the new Court of Auditors regulation was issued according to the new Constitution. The Court of Auditors was understood as a parliamentary body responsible for the external and independent control of public sector financial reporting and management. Afterwards, within the evolution of the new decentralised State made up of Autonomous Communities, regional external audit institutions (*Órganos de Control Externo*, OCEX, bodies dependent on the regional parliaments) were established in eight Autonomous Communities: Navarra, Cataluña, Valencia, Galicia, Andalucía, País Vasco, Canarias and Castilla-La Mancha (see Montesinos, 1994; Ordoqui, 1992).

The Central Court of Auditors (National Court of Auditors) and the regional external audit institutions (OCEX) are responsible for the *external control* of the financial reports and the economic management of local authorities and entities dependent on them (see Iglesias, 1994).

After receiving the audit report of the institution in charge of the external control, the local authority must take the necessary steps so as to correct any deficiency which has been detected and assume any relevant responsibilities. However, the content of the audit reports is not binding for local authorities, which are responsible for their own actions and omissions.

Audit Effectiveness and Scope of Regional Audit Institutions on Local Authorities

Regional external audit institutions implement two types of actions within the limits of local authorities: the audit of particular entities, and the formal and global analysis of the entirety of local authorities, starting from the reports these submit to audit institutions.

Specific audits generally do not include aspects related to economy, efficiency and effectiveness, and they confine themselves to aspects of financial nature and aspects regarding the compliance with legality. In the case of the National Court of Auditors, specific audits are mostly only partial financial audits, with an emphasis on areas such as budget settlement, loans, personnel, public tenders or urban development. Implementing complete legal and financial compliance audits is more common in regional external audit institutions, and in some of them value for money audits are carried out, in areas such as urban planning, environment or programme audits.

Taking the audits of local authorities carried out during the last accounting periods in the Autonomous Communities with external regional audit institutions as a point of reference, the following can be observed (see Table 5, 6 and 7):

Table 5. *Financial and compliance audits of regional external audit institutions, according to the type of local authority*

YEAR	LOCAL AUTHORITIES	SUPRAMUNICIPAL ENTITIES	AUTONOMOUS BODIES	PARTLY-OWNED SUBSIDIARIES IN MORE THAN 50%
1992	21	4	5	2
1993	17	5	2	1
1994	70	4	2	-
1995 *	38	2	-	1

* The data concerning Galicia are not available

- the number of audits carried out is very limited in relation to the total number of entities. This indicates an insufficient scope of external control at a local level.
- There is a stagnation in the number of implemented audits, as increases and decreases which do not follow a uniform tendency in their evolution can be observed.
- There is very little influence of external control on the audit of autonomous entities and local corporations.
- The audits of large municipalities do not correspond to the significance their expenditure represents in relation to total local public expenditure. On the contrary, the number of audits of small municipal governments is well above their relative financial burden at a national level.

***Table 6.** Financial and compliance audits. Number of audited local authorities per number of inhabitants*

YEAR	< 5,000	FROM 5,000 TO 20,000	FROM 20,000 TO 50,000	> 50,000	TOTAL
1992	7	9	3	2	21
1993	3	6	5	3	17
1994	33	20	4	13	70
1995 *	16	9	1	12	38

* The data concerning Galicia are not available

***Table 7.** Financial and compliance audits. Number of audited local authorities per budget size (in millions of pesetas)*

YEAR	< 60 MILL.	FROM 60 TO 1,000 MILLION.	FROM 1,000 TO 10,000 MILLION	> 10,000 MILL.	TOTAL
1992	-	14	6	1	21
1993	-	7	7	2	16
1994	8	34	23	5	70
1995 *	-	22	13	3	38

*The data concerning Galicia are not available

As far as the *formal and global analysis* of the reports presented by local authorities is concerned, the National Court of Auditors and the regional external audit institutions develop a general review of the aggregated accounting statements, they carry out a review and verification of the informative content of the annual accounts, and implement detailed analyses on certain administrative contracts.

FORESEEABLE EVOLUTION OF EXTERNAL CONTROL IN SPAIN: AN APPROACH THROUGH THE CONTINGENCY MODEL

After considering different methodological alternatives, we have thought that the modified contingency model applied by Prof. Lüder (1994) to Public Accounting innovations (see Figure 1) could be a useful tool to analyse the foreseeable evolution of external control in the Spanish local sector and the factors which could influence their development. We consider that this model may be applied to large and medium entities, since in the case of the smallest entities (less than 5,000 people) the implementation barriers, such as the small size of these entities and the scarcity of human and material resources, make it extraordinarily difficult nowadays to develop external audits and, therefore, it seems advisable to leave them out of our analysis.

The application of the contingency model methodology has been implemented as a first approach to the problem. Next we are going to make a brief presentation of the main variables we have considered within the mentioned model (see Montesinos and Vela, 1996: 233-6). Depending on the degree of incidence, we shall include the different influence factors followed by the signs: + (if there is a positive incidence); - (if there is a negative incidence); = + (if a positive influence is foreseen in the future although there is none at the moment) and = - (when a negative influence is foreseen in the future, although there is none at the moment).

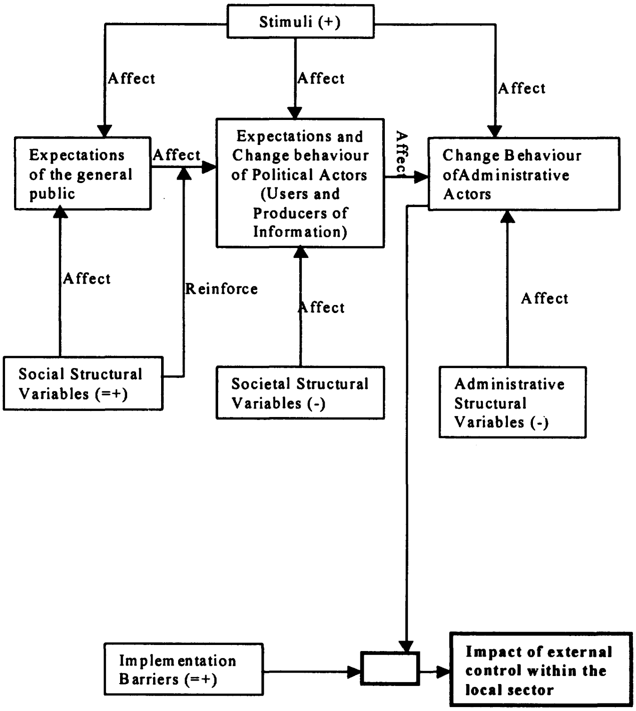


***Figure 1.** Prof. Lüder's Modified Contingency Model (Applied to external control impact and development in large and medium Spanish local entities)*

Stimuli

Stimuli are temporarily present, linked however to unstable environmental characteristics that indirectly affect the process of introducing external control in local authorities through behaviour variables. The most important variables are:

- Fiscal stress (+). Financial difficulties of local authorities have increased throughout recent years, and this has encouraged their interest in achieving a good rating which places them in a condition to obtain additional financing.
- The search for a public sector management reform (+). Local administration reform plans are also considered important: information and

planning systems of a strategic nature (see Vela, 1994), especially in larger municipalities, are being introduced.

- Business practice in the matter of financial auditing (= +). The obligatory nature of the auditing of accounts in trading corporations, legally introduced in Spain in 1988, obliterates arguments for municipal governments not to submit their accounts and management to the audit of independent experts every year. However, at present this circumstance has not been an effective stimulus to introduce the obligation to audit local authorities. In spite of this, it is foreseeable that within the current logic of a market approach applied to the public sector and of market requirements, this variable will have a positive effect in the near future.
- International influence (= +). European practices in the matter of the audit of local authorities are very different - as briefly indicated in section 1 of this paper - and an annual external audit has not yet been brought into general use. The pressure in this sense cannot be perceived on Spanish local authorities, even though a positive incidence of the influence of Anglo-Saxon practices could be expected in the future. In the same way, the austerity required by the compliance with the Treaty of Maastricht conditions will gradually result in the greater control of the totality of local authorities and, accordingly, they will become a positive incentive over the next few years.

Political Structural Variables

Structural variables are relatively stable environmental characteristics that again affect indirectly the process of introducing external control in local authorities, via behavioural variables (structural variables). In my opinion, the incidence of the political structural variables indicated by Professor Lüder can be described as follows:

- Political culture (-). Political culture should lead to the search for local accountability. However, in practice, political groups are usually interested in the practice of audits "to the others"; in other words, the practice leads to implementing audits whenever a change in the political sign of the municipal government takes place. Obviously, this circumstance does not help to develop the audit as something normal and usual in local authorities.
- Political competition (+). Political competition makes political groups interested in trying to show a transparent image before the citizens. In certain circumstances this encourages the development of the auditing of local accounts.
- Political system (-). The political system has not taken on the importance of carrying out external audits in local authorities effectively and regularly. Thus, even though the Court of Auditors has legal powers to audit the

entirety of municipalities when considered necessary, this Institution does not have the necessary resources. For this reason, democratic sensitivity should develop the necessary mechanisms so that external control becomes effective. As long as this necessity is not introduced within the political system, and as long as auditing is considered as an obstacle for management or a weapon to be used against the political enemy, this variable will work negatively.

Societal Structural Variables

The behaviour of this type of variables can be described as follows:

- Societal culture (-). In similar terms to what has been indicated for the political system, as long as the citizen and society in general do not assess the added value that audits have within the local sector, but rather the former receive a far too political and sometimes hardly reliable reading of these audits, this will be a negative factor for the development of external control at a local level.
- Audit expectations gap (-). At the present time, there is a significant expectations gap in the matter of auditing in general in Spain, as well as a sometimes negative idea of the auditor's independence. This circumstance also plays negatively against the greater introduction of independent auditing within local public entities.
- Approach to credit (+). In this case, as already mentioned when talking about stimuli, the wish to approach credit plays a positive role.
- Pressure groups (+). The influence of pressure groups also plays a significant role in a positive sense, especially auditing and consultancy professionals, who in recent years have been acting as a "lobby", even at an international level.

Administrative Structural Variables

In the matter of structural variables of an administrative nature, their influence on external control at a local level comes down specifically to:

- Administrative culture (-). Administrative culture within the Spanish public sector does not favour, for the time being, the development of external auditing, and there are no circumstances which anticipate a change in tendency. Traditional culture still prevails, with a much greater emphasis on internal control than on an independent external audit.
- Organisational Model & Internal Control (-). The Organisational Model does not make it easy to develop internal audits, since the different sections usually act as watertight compartments, hardly ever open to internal reviews. Internal control is essentially oriented towards the control of legality, rather than towards guaranteeing mechanisms of organisational

nature which ensure an appropriate distribution of functions and the actual protection of the entity's resources.

- Innovation and Reform Process (+). The administration reform process and the introduction of innovations is a structural variable with a positive incidence, since it is very difficult to develop modern administration and to introduce business practices without effective and independent external control. The introduction of information systems basically developed and founded on the application of generally accepted accounting principles has been especially considered.
- Financial resources for external audits (-). The financing system of external audits of local authorities does not include the payment of fees to the Courts of Auditors, as in the case of England and Wales. On the other hand, the resources which are allocated to these Courts of Auditors are limited. For this reason, it would be necessary to rely on private audit professionals. In any case, it becomes necessary either to increase public resources for the Courts of Auditors or to introduce the duty to assign sufficient financial endowments to local authorities so as to finance the performance of independent audits.

Implementation Barriers

Implementation barriers are relatively stable characteristics that directly influence the process. By eliminating small entities from the population under analysis, the effect of these barriers thus becomes negative only where the legal system is concerned. Consequently, the following situation arises:

- Size of entities (+). Apart from small local authorities, the negative effect concerning the size disappears in all other entities.
- Staff Qualifications (= +). The technical qualification of civil servants in local authorities has improved considerably in recent years, due to the incorporation of new generations of experts. This will hopefully lead to a better attitude towards the external control of management performances and entities' accounts.
- Legal system (-). The legal system does not include the mandatory annual audit, and the only external control which is considered as legal is the external control of the Courts of Auditors. Undoubtedly, this makes it difficult to introduce independent audits, especially considering that external control in firms was not effective until legally enforced in 1988.

Foreseeable Evolution

From the previous analysis, a slow but positive evolution of external control at a local level in Spain may be expected - an evolution which is a consequence of the following circumstances:

- Variables such as local fiscal stress and the search for a public management reform that makes it possible to trigger off more competitive and efficient local performance, are positive stimuli for the introduction of external control in Spanish local authorities. Other environmental variables, such as financial audit business traditions and current practices, and the international framework, especially the European convergence requirements, have a rather balanced influence, although in the medium term the evolution can be expected to become positive for the development of financial and performance audits in municipalities.
- The public in general may influence favourably the extent of external audit. However, the negative incidence of two variables that can only change in the medium to long term, must be taken into consideration: the societal culture and the negative impact of the expectations' gap concerning auditing in general.
- Political actors (users, information producers and managers) have predominantly negative influences through structural political variables, hardly ever balanced by social variables and the perceptions of the public in general.
- Nevertheless, political competition frequently discloses financial and administrative malpractice in the public sector, that turns into public scandals through the media; thus, these circumstances may become powerful tools to promote the audits of local authorities' reports and management, but this effect is hardly predictable at the present time.
- In any case, if favourable political and social circumstances appear simultaneously, they have a joint, synergetic impact on the implementation of new rules and practices for financial control; the problem is the rather short-term social and political memory of our societies, that can easily result in the dilution of this driver in just a few months or even weeks.
- As far as administrative actors are concerned (managers, audit institutions, elected representatives and information producers), who will finally have a greater influence on what regards the larger or lesser effectiveness of external control at a local level, predominantly negative administrative structural variables are observed, although the renewal of the staff and the introduction of competitive stimuli may balance or even change this influence in the medium term.

Independently of the fact that other circumstances may arise and that the intensity of some of the variables may be different from those foreseen at present, my general conclusion, as a result of the analysis of the actual data on trends and agents' behaviour, is that the evolution of the external audit of the financial and economic reporting and performance of local authorities, despite the innovations in the matter of accounting, will probably be rather slow and, therefore, far from generating a generalised obligatory audit of these entities in Spain.

NOTES

[1] The *diputaciones* are the provincial entities. One or more provinces make up an autonomous community.

REFERENCES

Buschor, E. and Schedler, K. eds. *Perspectives on Performance Measurement and Public Sector Accounting*. Bern, Stuttgart, Vienna: Haupt, 1994.

Cámara de Cuentas de Andalucía ed. *Los órganos de control externo y el sector público*. Sevilla: Cámara de Cuentas de Andalucía, 1992.

Cámara de Cuentas de Andalucía ed. *Encuentro sobre la problemática actual de las Corporaciones Locales*. Sevilla: Cámara de Cuentas de Andalucía, 1994.

Carrasco, D. ed. *La nueva Contabilidad Pública*. Barcelona: Ariel, 1994.

Chan, J. L., Jones, R.H. and Lüder, K.G. eds. *Research in Governmental and Nonprofit Accounting, Vol. 9*. Greenwich, Connecticut: JAI Press.

Eurorai, *Public Finance Control at Regional Level*. Valencia: Eurorai, 1996.

Iglesias García de Vicuña, C. *El control externo de las Entidades Locales*. Cámara de Cuentas de Andalucía, 1994, pp. 149-163.

Intervención General de la Administración del Estado. *La Contabilidad Pública en algunos países de la O.C.D.E.* Madrid: IGAE, 1995.

López Hernández, A.M. *La Contabilidad Pública en el Subsector de la Administración Local*. Madrid: Instituto de Contabilidad y Auditoría de Cuentas, 1996.

Lüder, K. Contingency Model" Reconsidered: Experiences from Italy, Japan and Spain. In Buschor, E. Schedler, K. eds., 1994, pp. 1-15.

Montesinos Julve, V. "Nuevas perspectivas para el control económico-financiero ante la reforma del Plan General de Contabilidad Pública." In Carrasco, D. ed., 1994, pp. 289-318.

Montesinos Julve, V. and Vela Bargues, J.M. "Governmental accounting in Spain: evolution and reforms." In Chan, J.L., Jones, R.H. and Lüder, K.G. eds., 1996, pp. 219-238.

Most, K.S. ed. *Advances in International Accounting*. Greenwich, Connecticut: Jai Press Inc, 1992.

Ordoqui Urdaci, L. "Importancia de los órganos autonómicos de control externo y claves para su buen funcionamiento. Especificidades de la Cámara de Comptos de Navarra." In Cámara de cuentas de Andalucía ed., 1992, pp. 47-89

Van Peursem, K.A. and Pratt, M.J. "The 'user' orientation of public sector accounting standards: an international comparison." In Most, K.S., 1992, pp. 289-312.

Vela Bargues, J.M. La comptabilité locale en Espagne. Revue Française de Finances Publiques 1994: 105-14

INDEX

D