

# VI. Implications and Recommendations for DMCs

## 1. Introduction

The preceding parts reviewed the advantages and disadvantages of accrual accounting, country implementation experiences and the status of government accounting in selected ADB DMCs. A general trend towards adoption of accrual accounting in government was revealed.

However, the previous parts largely focused on implementation issues in developed country settings. The DMC environment is very different. For instance, there is often a chronic shortage of qualified accounting personnel in the private sector, let alone the public sector. Moreover, DMCs cannot all be grouped together: there are significant differences depending on stage-of-development, historical influences and fiscal pressures, among other things.

Most importantly, DMCs do not have the same latitude as developed countries to make mistakes in allocating scarce government resources. In a developed country, poor financial management may result in unnecessary higher taxes, higher debt or longer waiting times for government-provided services. In a DMC, the implications of poor financial management are much more severe.

This part identifies DMC-specific circumstances that should be considered when accrual budgeting and accounting are being contemplated. It then considers the implementation of accrual accounting in a DMC environment.

## 2. The DMC Environment is Fundamentally Different

### **The general DMC environment is more hostile to successful reform**

In addition to the government management issues faced by developed countries, most DMCs confront special problems due to extremely constrained resources, inadequate skills and information, pressure to spend

more than they can afford on unmet needs, and limited reserves to ride out shocks or unexpected difficulties.

The challenges faced by DMCs are fundamentally different from those of developed countries—the prescriptions and processes that are appropriate for the latter may hold disappointing results in the former. DMCs generally have greater difficulty maintaining fiscal discipline and pursuing efficient budget outcomes. They have weaker control of their budgetary fate, and outcomes that appear to be the result of lax expenditure management often are byproducts of under-development.<sup>85</sup>

Countries transiting from central planning to a market basis (e.g., Uzbekistan) are different too. Many DMCs have small public sectors, but transitional country governments tend to be very large relative to the overall economy. They do not have the option of allowing public management institutions to evolve as the public sector grows, but must replace subsidies with transfers, dismantle state enterprises, establish and administer new tax systems, and forge regulatory institutions that facilitate open, robust markets. The progress made by some transitional countries has been remarkable, but the adjustment of others has been less rapid. However, even the most advanced of the transitional economies still have much unfinished business in managing their finances.

Differences between developed and developing countries both promote and impede reform. On the one hand, developing countries can adopt practices that have evolved over the years and have become widely accepted in the developed world; on the other hand, the special problems facing poor countries may make them inhospitable venues for certain practices.

### **Capacity constraints can be overwhelming**

In comparison to developed countries, DMCs often face extreme capacity constraints: particularly regarding qualified accounting personnel. However, this differs between DMCs. For instance, while the Marshall Islands does not have any qualified accountants in either the public or private sector, Sri Lanka has a large pool of highly qualified private sector accountants.

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<sup>85</sup> Schick, Allen. 1998. *A Contemporary Approach to Public Expenditure Management*. Washington, DC: World Bank.

## **Other priorities may be more urgent**

In addition to having higher capacity, developed countries tend to face less pressing issues compared to DMCs. For instance, Indonesia is struggling with the loss of accountability due to the massive decentralization program. Diverting effort and resources to accrualization may be unwise in the face of these competing priorities.

## **Corruption and vested interests can undermine efforts**

Extensive efforts have been made in the past 2 decades to improve basic government financial management, including budgeting and accounting, in DMCs. However, most of these efforts have failed, or at least failed to deliver significant improvements, in the face of vested interests or corruption. In particular, attempts to improve government transparency and accountability directly threaten the income sources of politicians and bureaucrats. Given the superior ability of accrual-based accounting to reduce corruptive opportunities, vociferous opposition can be expected to reforms of this nature.

## **Conflicting donor activities may reduce coherence**

Most donors have placed improved public sector governance at the top of their agenda. Consequently, there is a danger that the coherence of reform efforts will be undermined by conflicting methodologies and objectives. In contrast, developed countries do not face this challenge, as they do not generally rely on external support.

## **Reform fatigue may impede progress**

The past decade has seen significant changes in the government arrangements of most DMCs—particularly transition economies. To this end, consideration should be given to the desirability of fundamentally changing financial arrangements.

## **Limited infrastructure can reduce options**

Many DMCs face communication and technological constraints, for instance Internet availability and support for modern FMISs. This reduces choices over FMIS selection.

## **Supreme audit institutions may lack capacity**

Many DMCs have very weak SAIs that are characterized by an absence of professionally-qualified accountants.

### 3. Seven Key Recommendations for DMC Governments

Accrual accounting implementations will have similar endpoints, because of uniform standards (see pages 7–14). But starting points will vary markedly reflecting country backgrounds, arrangements and practices. Together with other issues, such as country resources and capacity, these factors will determine suitable implementation paths and timing.

#### Carefully consider implementation strategies

There are two broad implementation models: the big bang approach and the incremental approach.

At one extreme is the **big bang** approach. Typified by NZ, this involved moving all central government entities to full accrual accounting and budgeting in a short period. Accrual financial statements were prepared within 18 months, following which most resources were appropriated on an accrual basis and whole-of-government financial statements and fiscal forecasts were subsequently prepared.

The advantages of the big bang approach include (i) supporting a uniform culture change in government; (ii) achieving quick results; and (iii) avoiding the risk of reversion. Disadvantages include (i) the concentrated workload; (ii) the lack of time to deal with arising issues; and (iii) a danger that political commitment will falter.<sup>86</sup>

The alternative is the **incremental** approach. Implementation timings may vary by organization type and size (for instance, US state entities were classified into three groups, depending on size—each group

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<sup>86</sup> OECD. 2002. *Accrual Accounting and Budgeting: Key Issues and Recent Developments*. Paris.

has different implementation targets).<sup>87</sup> The incremental approach is taken by most countries and typically involves introducing double-entry bookkeeping, gradually identifying and valuing assets, gradually improved financial reports and finally preparing accrual-based budgets.

The benefits of the incremental approach include: (i) accruals can be pilot tested for several years until finally unveiled, during this time problems can be identified and addressed; (ii) the cash system can be maintained in parallel thereby reducing risks. The disadvantages of the incremental approach include: (i) if government opts to maintain two parallel systems this can be overwhelming in terms of resources and management, however, this can be overcome by gradually altering existing systems (e.g., Sweden); (ii) culture change may not take hold; and (iii) momentum may be lost, especially if implementation takes an extended time.

The big bang approach worked well in NZ's case, but it is important to note that three favorable factors contributed to this success. First, a fiscal crisis gave the reforms momentum. Second, political support was bipartisan and unequivocal. Third, public service employment and procurement reforms gave agencies flexibility over resources. In particular, they were able to recruit accounting personnel readily from the private sector and procure accounting systems. These factors may not be present in other environments (particularly in DMCs), in which case the lower-risk incremental approach may be more appropriate.

A quality assurance procedure is desirable, and implementation benchmarks should be included in the implementation strategy as

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<sup>87</sup> GASB. 1999 June. *GASB 34 Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. Washington, DC. Effective Dates:

- Phase 1—Financial statements for periods beginning after 15 June 2001, for governments with total annual revenues of \$100 million or more in the first fiscal year ending after 15 June 1999. Different provisions apply for reporting general infrastructure assets at transition.
- Phase 2—Financial statements for periods beginning after 15 June 2002, for governments with total annual revenues of \$10 million or more but less than \$100 million in the first fiscal year ending after 15 June 1999. Different provisions apply for reporting general infrastructure assets at transition.
- Phase 3—Financial statements for periods beginning after 15 June 2003, for governments with total annual revenues of less than \$10 million in the first fiscal year ending after 15 June 1999. Different provisions apply for reporting general infrastructure assets at transition.

an incentive mechanism. In particular, this can create a sense of competition among entities.

### **Political commitment is essential**

If political will is important for financial management reform in developed countries, it is essential in DMCs. In particular, political will is needed to combat vested interests. To this end, it is essential that implementation and communication strategies are designed so that early benefits can be realized. Moreover, implementation strategies should not depend solely on one administration—government changes are frequent in DMCs.

### **Intentions and objectives must be communicated**

Significant emphasis should be placed on communicating the intentions and objectives of the reform process. In comparison to developed countries, a wider group will need to be consulted—a particular effort should be made to gain support from donor organizations.

### **Suitably qualified accounting personnel are necessary**

Suitably qualified accounting personnel will be needed. First, training and recruitment requirements should not be overestimated (see page 50). Second, mechanisms must be designed to either recruit or contract accountants from the private sector. If, as in the case of the Marshall Islands, qualified accountants are not available, consideration should be given to delaying implementation until suitable capacity is present.

### **Accounting information systems should be appropriate**

Attempts are often made to implement accrual accounting on the back of an FMIS implementation. These efforts often fail or involve significant cost or time overruns—particularly when attempts are made to implement complex systems. In the first instance, efforts should be made to supplement existing systems. Moreover, in the DMC setting, it is essential that FMISs can be supported in the country.

### **Supreme audit institutions must be suitably resourced**

The SAI will play a key role in the implementation of accrual accounting. However, the professionalization of an SAI may take many years. For instance, the Fiji Islands and NZ took several years to fully staff their audit offices with qualified accountants.

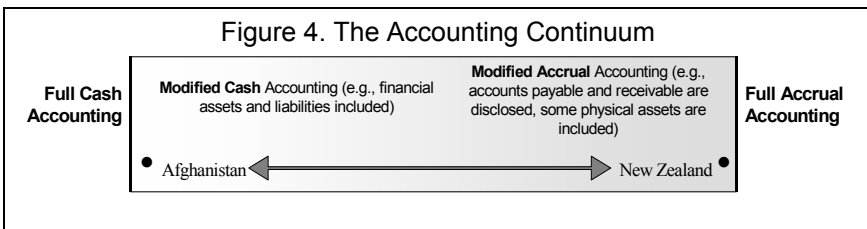
In the absence of a suitably staffed and resourced SAI, serious consideration should be given to deferring implementation.

### The exercise should be part of wider reforms

Implementing accruals cannot be seen as a technical accounting exercise. It needs to involve a “culture change” in government and be linked with wider public management reforms. For accruals to be worthwhile and successful, the new information that accruals brings forth needs to be used to improve government decision-making. This change will not necessarily happen automatically. It needs to be actively promoted, especially at the level of policymakers and senior officials.

## 4. A Possible Implementation Approach

The inherent constraints of the DMC environment will rarely make the big bang implementation approach suitable. Moreover, while only two accounting bases have an agreed conceptual basis—cash and accrual accounting—from a practical perspective, most government financial statements are prepared on a modified cash or modified accrual basis (see Figure 4).



Nevertheless, most accrual opponents address their objections towards the full accrual accounting basis, without recognizing that benefits can be gained with minimal effort by incorporating additional information in government financial statements. Indeed, the absence of accounting standards does not (and should not) preclude governments from gradually moving to the accrual accounting basis.

The incremental approach involves making progress along the accounting continuum, as capacity and resources allow. In relation to the new accrual-based GFS, the IMF recognizes that implementing the revised system will take some time and will need to progress at a pace determined by the differing needs and circumstances of each country. In

particular, many countries will need to revise their underlying accounting systems to reflect the accrual basis of recording and revised classifications.<sup>88</sup> Taken by most countries, the incremental approach can involve the stages outlined in Table 7.

Table 7. An Incremental Approach to Implementing Accrual Accounting

Step	Effect
1. <b>Develop a detailed action plan.</b> The plan should consider likely legislative changes. It should also identify communication initiatives.	Will identify potential problems so that they can be addressed in a timely manner. It will also enable resource requirements to be identified.
2. <b>Implement the cash-based IPSAS.</b> Ensure that cash is recorded on a consistent basis. Most importantly, determine the reporting entity and reconcile all cash balances.	Will address several of the shortcomings of the cash accounting basis
3. <b>Alter reporting formats.</b> Retain the cash accounting basis, but alter charts of account and reporting formats to reflect accrual principles.	Gives information preparers and users time to familiarize themselves with new reporting formats. It also enables information gaps to be easily identified.
4. <b>Strengthen SOE accounting.</b> Improve public enterprise accounting and reporting in line with private sector (accrual) accounting standards.	Likely to yield immediate gains through the identification of quasi-fiscal activities and government liabilities
5. <b>Supplement existing information.</b> Supplement existing accounting information with accounts receivables and payables, thereby introducing basic double-entry bookkeeping and rudimentary accrual accounting.	Provides useful decision-making information on revenue and expense arrears, with minimal additional effort
6. <b>Identify new asset purchases.</b> Begin categorizing new fixed asset purchases into appropriate expenditure categories (e.g., land, buildings, computer hardware and software).	Provides a sound basis for future identification, classification, valuation and depreciation of fixed assets
7. <b>Identify contingencies.</b> Identify, value and disclose contingent liabilities and guarantees.	These are usually very important in DMCs. Risk identification is the first stage in risk management.
8. <b>Identify major assets and liabilities.</b> Identify and value significant assets and liabilities, beginning with financial items and pension obligations.	It is likely that a few major assets and liabilities will comprise most of the balance sheet.

<sup>88</sup> IMF. 2001. *Government Finance Statistics Manual*. Washington, DC. paras 1.31–1.33.

Step	Effect
9. <b>Identify other assets.</b> Gradually identify and value other assets, including property and infrastructure assets.	It may take several years for an accurate register of fixed assets to be assembled.
10. <b>Incorporate assets into the financial statements.</b> Incorporate all assets, including fixed assets, into the financial statements and begin expensing depreciation.	Full financial statements are prepared.
11. <b>Prepare accrual budgets and introduce accrual appropriations.</b> Once accrual accounting and reporting is firmly established.	It may take some years until the legislature accepts accrual appropriations, given that a country's appropriation system is constitutionally fundamental.

IPSAS = International Public Sector Accounting Standards; SOE = State-owned enterprise.

## 5. Conclusion

There is a trend for developed-country adoption of accrual budgeting and accounting. Many DMCs are, or are considering, following suit.

While recognizing the benefits of accrual budgeting and accounting, this report emphasizes the additional constraints and barriers faced by DMCs. In particular, over the past 2 decades, significant efforts have been made to improve basic recordkeeping and cash accounting in DMCs—but these efforts have often failed due to a lack of ongoing commitment, resource constraints, complexity and strong opposition from groups with vested interests. Not surprisingly, some experienced commentators view DMC adoption of accrual budgeting and accounting as unrealistic.

This report concludes that DMCs adopting accrual budgeting and accounting should do so in a realistic and practical manner, as resources and capacity allow. This is why this report supports a step-by-step approach. Most importantly, the process should be incremental, allowing professional capacity (such as in the SAI) to be developed.

To this end, IFAC's recent approval of the cash-based IPSAS provides a sound basis for improving DMC government accounting. Importantly, the IPSAS identifies supplementary accounting disclosures (such as commitments) that can be gradually introduced. By doing so, DMC governments will be able to improve their financial information in a manner consistent with eventual adoption of accrual accounting.