

## Government Accounting: An Assessment of Theory, Purposes and Standards

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### Abstract

Developments in governmental activities in recent years have raised concerns over whether the cash basis of accounting is sufficient for governmental accounting and reporting. Accrual accounting, previously thought to be only suitable in the private sector, has been seen to be an alternative for better reporting of government activities. Although there is a continuing debate over the use of cash versus accrual accounting, accrual accounting has been adopted in the governments of several countries including Australia, New Zealand and the United Kingdom. Government accounting and financial reporting aims to protect and manage public money and discharge accountability in order to achieve ambitious socioeconomic goals, developing countries require public sector institutional capacity for setting and implementing public policy, which in turn necessitates government accounting reform. The social value of government accounting reform therefore lies in its contribution to development goals, including poverty reduction. This rationale has led international and multilateral lenders and donors to endorse International Public Sector Accounting Standards (IPSAS) for adoption by developing countries. An emphasis on assuring financial integrity and a shift to accruals can make IPSAS more useful in government accounting reform in developing countries. All of these are heavily influenced by private sector practices, which favour the accrual basis and consolidated reporting. This article argues for a gradual symmetric approach to accruals and a combination of government-wide and fund reporting. The author also proposes some broad accounting principles to promote political and economic accountability.

**Key words:** Government Accounting, government, accounting reform, International Public Sector Accounting Standards (IPSAS).

### Introduction

Miller (1995) p10 argues that a "healthy" accounting standard setting process needs representation from the entire spectrum of stakeholders to retain its integrity. He concludes that "a transparent due process allows outsiders to see the interactions and compromises among the key participants in the development of acceptable accounting rules". Prior Australian research has raised questions about the veracity of various aspects of the operation of the 'due process' for public sector standard setting. Ryan et.

al. (1999) concluded that there were fundamental problems with the 'due process' as it operated in AAS29, which was released in 1993. There was a lack of input from account preparers and a close working relationship existed between the Treasuries and the standard setters. Carnegie and West (1997) conducted an analysis of the responses to ED 50 in relation to the recognition of infrastructure assets only. They contended that, for this particular issue, the standard setters placed more weight on a sample of 26 responses which were deemed to be "of particular interest" by the staff of the Australian Accounting Research Foundation (AARF) (p32). This led to their raising the concern that the PSASB may not have been responsive to its constituents. The Philippines realized fiscal surpluses between 1994 and 1997, prior to the Asian financial crisis.<sup>176</sup> However, indicators have deteriorated significantly in the past 3 years. The Arroyo administration faces a worsening fiscal position. Unless the Government curbs expenses and improves revenue collection, the 2001 budget deficit could reach P200 billion (\$4.2 billion).<sup>177</sup> The weak fiscal position is creating tensions with multilateral development banks.<sup>178</sup> Moreover, it restricts the Government's ability to address infrastructure issues and poverty reduction. Furthermore, the Philippines experiences significant ongoing problems with corruption. With annual capital expenditure exceeding \$3.5 billion, the procurement of goods and services, and implementation of infrastructure projects, by the Government present significant opportunities for graft.<sup>179</sup> Government accounting and auditing arrangements were formulated in 1947. They have many strengths including the use of doubleentry bookkeeping, a mixed cash-accrual accounting base, a cadre of well-trained accountants, and potential access to a large external pool of trained accountants. Public management arrangements are characterized by institutional and regulatory rigidities. Efforts to modernize the public sector have gathered pace in recent years. Among other things, the Government intends to (i) develop a Medium-Term Expenditure Framework (MTEF); (ii) introduce output and outcome performance measures and targets; (iii) overhaul procurement practices; (iv) introduce 3-year baseline budgeting; (v) modernize auditing practices; (vi) introduce computerized financial management information systems; and (vii) prepare for the introduction of full accrual accounting.<sup>180</sup> The Constitution of the Philippines 1987 mandates the keeping of government accounts, the promulgation of accounting rules, the audit of financial reports, and the submission of reports covering the Government's financial operations and position.<sup>181</sup> In particular, Article IX defines three constitutional commissions as being separate and independent bodies.

### **From Accountability to Accounting**

The global rise of government accounting is fundamentally due to the greater demand for accountability in a democracy and market economy. Democratic governance and market transactions require and foster the norm of reciprocity the expectation of exchange of benefits of comparable value upon which accountability is based. Accounting information can be used to monitor and enforce the terms of economic, social and political contracts. When a government engages in market transactions whether buying or selling services, lending or borrowing money it is subject to economic accountability. When it levies taxes to finance public services, it incurs political accountability. The development of government accounting is related to the

constitutional form of government that provides for separation of powers, and checks and balances among the legislative, executive, and judicial branches of government (Chan and Rubin, 1987). While all governments engage in some degree of planning and control, only democratic governments are mandated to open their books directly to auditors and indirectly to

the public through financial reports. Fiscal transparency is therefore an attribute of limited government, for to give out information is to cede authority. Government officials rationally

do not volunteer more information than is required or in their interest. It is therefore not surprising that, while some accounting is done on a voluntary basis, financial disclosure is often made only in response to demand. The regulatory structure for government financial disclosure mirrors the pattern of accountability in government and the political system. In an administrative hierarchy, the superior holds subordinates accountable and requires feedback information on their performance. A legislature monitors the conduct of the executive branch, for example, in executing the approved budget. Furthermore, a government has the incentive to disclose information in order to induce others to provide resources to it. These include potential buyers of government securities; vendors of goods and services on credit; and grantors of financial aid. In these voluntary exchanges, information is used to predict a government's ability to carry out the terms of contracts. After the transactions are made, accounting information is used to monitor contractual performance. Governments are less inclined to disclose financial information to those without leverage over it, at least in the short-term, such as individual taxpayers. It is here that mandatory standards seek to increase the information access of those who are least able to demand it, or to enforce their right to know. The exercise of accountability requires institutions in both senses of the term: namely, organizations; and rules of the game (World Bank, 2002, p. 4). In government accounting, these refer to standard-setting bodies and the standards they promulgate. These institutions of government accounting in individual countries are extensively documented in the CIGAR literature and will not be covered in this article. It is, however, important to describe the general purposes of government accounting, in order to contrast it with

commercial accounting. The Commission on Audit shall have the power, authority, and duty to examine, audit, and settle all accounts pertaining to the revenue and receipts of, and expenditures or uses of funds and property, owned or held in trust by, or pertaining to, the Government, or

any of its subdivisions, agencies, or instrumentalities, including government-owned or controlled corporations with original charters, and on a post-audit basis: (a) constitutional bodies, commissions and offices that have been granted fiscal autonomy under this Constitution; (b) autonomous state colleges and universities; (c) other government owned or controlled corporations and their subsidiaries; and (d) such nongovernmental entities receiving subsidy or equity, directly or indirectly, from or through the Government, which are required by law or the granting institution to submit to such audit as a condition of subsidy or equity. However, where the internal control system of the audited agencies is inadequate, the Commission may adopt such measures, including temporary or special pre-audit, as are necessary and appropriate to correct the deficiencies. It shall keep the general accounts of the Government and, for such period as may be provided by law, preserve the vouchers and other supporting papers pertaining thereto. (2) The Commission shall have exclusive authority, subject to

the limitations in this Article, to define the scope of its audit and examination, establish the techniques and methods required therefor, and promulgate accounting and auditing rules and regulations, including those for the prevention and disallowance of irregular, unnecessary, excessive, extravagant, or unconscionable expenditures or uses of government funds and properties Section 3. No law shall be passed exempting any entity of the Government or its subsidiaries in any guise whatever, or any investment of public funds, from the jurisdiction of the Commission on Audit.

Section 4. The Commission shall submit to the President and the Congress, within the time fixed by law, an annual report covering the financial condition and operation of the Government, its subdivisions, agencies, and instrumentalities, including government-owned or controlled corporations, and nongovernmental entities subject to its audit, and recommend measures necessary to improve their effectiveness and efficiency. It shall submit such other reports as may be required by law.

### **Organizational Roles and Responsibilities**

The following organizations play central roles in budgeting, accounting and auditing arrangements. The COA audits the general accounts of the Government, promulgates accounting rules and regulations, and submits the annual financial report of the Government, its subdivisions, and agencies (including government owned or controlled corporations).

**The Department of Finance (DOF)** The DOF is responsible for (i) formulating, institutionalizing, and administering fiscal policies in coordination with other concerned subdivisions, agencies, and instrumentalities of the government; (ii) managing the financial resources of government; (iii) supervising the revenue operations of all LGUs; (iv) reviewing, approving and managing all public sector debt; and (v) rationalizing, privatizing and ensuring the public accountability of corporations and assets owned, controlled or acquired by the Government.<sup>187</sup> The DOF oversees three operating bureaus: the Bureau of the Treasury (BTr), the Bureau of Internal Revenue (BIR), and the Bureau of Customs.

**The Bureau of the Treasury (BTr)** The BTr plays a pivotal role in the cash operations of the national government. It is responsible for (i) receiving and keeping national funds; (ii) managing and controlling disbursements of national funds; and (iii) maintaining accounts of financial transactions of all national government offices, agencies, and instruments.

**Department of Budget and Management (DBM)** The DBM is responsible for the design, reparation and approval of the accounting systems of government agencies. It is also responsible for coordinating and implementing the annual budget process. Furthermore, the Department manages the process of cash disbursement as well as monitoring compliance with appropriations.

**Development and Budget Coordinating Council (DBCC)** The DBCC comprises representatives from DBM, DOF, Bureau of Treasury, NEDA, and BSP. All agency budgetary requirements must pass through the Council. Its objectives are to (i) set budget parameters based on available resources; (ii) conduct budget hearings; and (iii) submit the resulting consolidated budget to the House of Representatives (particularly the Committee on Appropriations).

### **Accounting Information Systems**

The national government accounting system is largely paper based. Financial reports from national agencies, including those with computerized systems, are manually processed and consolidated by COA. Existing computerized systems are of varying types.<sup>191</sup> This variation is to be expected in such a diversified environment comprising a wide range of organizations with differing roles and objectives.

### **Government versus Commercial Accounting**

Business accounting has often been used as a benchmark for evaluating government accounting. Two hundred years ago, Thomas Jefferson (quoted by Arthur Andersen, 1986) wished to see 'the finance of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently to control them'. Is it possible that government and business accounting are fundamentally alike in unimportant respects as public and private management are (Allison, 1980)? What are the important respects that set government accounting apart from its business counterpart?

In order to serve the three identified purposes, financial accounting and management accounting cannot be so neatly compartmentalized in the public sector, where management accounting refers to budgeting and control, rather than accounting solely in the service of managers. The budget is an expression of public policy and political preferences. It is an instrument of fiscal policy on revenue and spending to achieve macroeconomic objectives. It provides benchmarks for performance measured partly by the accounting system. Given their close relationship, it is often difficult to tell where budgeting ends and accounting begins. They reinforce each other in demonstrating and discharging fiscal accountability to the government's stakeholders, who are more numerous and diverse than the owners of a firm. Indeed, governments do not have owners.

The absence of ownership in government makes it problematic to apply the accounting equation (assets = liabilities + owners' equity) and its corollary (profit = revenues - expenses) to the public sector. An exception may be local governments. These are municipal corporations chartered by the state to perform certain public services, which in many cases are private goods (for example water) or only quasipublic goods (for example elementary education). These entities have clear origins, and own identifiable assets and liabilities. Unfortunately, the assets and liabilities of the national government of a sovereign state are difficult to identify and harder still to measure in financial terms. With regard to assets, except in rare instances (such as the United States' purchase of Louisiana from France, or Alaska from Russia), few nations acquire new territories through buy-and-sell transactions. Most occupy their ancestral lands and some acquired their territories through military conquests or colonization. Historical costs, even if data are available, are not meaningful, yet market prices, even if justifiable, are hard to come by. The same problems arise in the case of natural resources and heritage assets. On the liability side, it is not easy to draw the line between a national government's contractual or legal obligations and its political commitments and social responsibilities for the general welfare. In contrast to corporations' limited liabilities, governments in a democracy are prone to expand their responsibilities, resulting in larger budgets and frequent deficits (Buchanan and Wagner, 1977).

Accounting principles allow a business, whether private or state-owned, to recognize revenues only to the extent of goods or services provided. Governments uniquely provide public goods and finance them through taxation. Public goods are consumed collectively, and non-payers cannot be excluded—hence requiring tax financing.

These characteristics sever the link between service delivery and revenue recognition, making it impossible to match revenues and expenses (Sunder, 1997). This accounting problem is also exacerbated by the involuntary nature of many transactions between government and people. The government's operating statement tracks resource flows, and only incidentally measures the government's service efforts and accomplishments.

These unique characteristics of government are the primary source of the differences between government and commercial accounting. These differences, argues Sunder (1997, p. 198), 'do not constitute prima facie evidence that the former are defective and should be altered to conform to the latter'. More specifically, Nobes (1988, p. 198) challenged the assertion that 'Anglo-Saxon

commercial accounting involving accruals-based annual financial statements is necessary for accountability, control and decision-making relating to government'. From the research perspective, theories underlying government accounting standards are mostly normative, in contrast to the development of positive theory in (business) financial accounting. The latter (Watts, 1977; Watts and Zimmerman, 1978, 1990) draws its inspiration from the contract-cost theory of the firm originating from Coase (1937). A similar incipient conceptual revolution started tentatively with Zimmerman's (1977) paper linking government financial reporting to

political incentives. It is time to resume the search for a positive theory of government accounting standards. One way would be to build on the work of Chester Barnard and Herbert Simon.

At about the same time Goase wrote his famous paper explaining the existence of the firm in terms of transaction costs, Barnard (1938) identified the functions of the executive as securing the co-operation of the stakeholders of an organization. Barnard's work is currently enjoying a revival, primarily through the efforts of Oliver Williamson (1990). Much earlier, Simon (1945) applied Barnard's insight to government in his book *Administrative Behavior*. In Simon's view, an organization is in equilibrium if Barnard's executive succeeds in securing the contributions of stakeholders by offering them adequate inducements to stay in the organizational coalition. A business can be viewed in the same way (Gohen and Gyert, 1965). In both types of organization, the challenge for managers is to negotiate satisfactory terms of contracts to keep the coalition intact. In such a theory, owners are important as contributors of equity capital, but they are not the only group managers try to please. In other words, the owner-centred theory of the firm and the single-principal agency theory are a special case of the Barnard- Simon organization theory.

This theory can be used to identify potential users of government's financial information by postulating that they use the information to predict their inducements from government (Ghan, 1981). Recently, Sunder (1997) applied contract-cost theory to explain and justify the differences between accounting for government and nonprofit organizations and business accounting. Much more research is needed before the multiple-stakeholder perspective can have an impact on standards. In the meantime, government accounting has shifted closer to the business (financial) accounting model.

### **Internal Auditing**

The Internal Auditing Act 1962 (RA 3456) introduced internal auditing requirements to the national government. A 1965 amendment (RA 4177) extended the Act's coverage to government-owned and controlled corporations (GOCCs) and local government units (LGUs). In 1992, President Aquino directed that government internal-control systems be strengthened (AO 278) – the Association of Government Internal Auditors (AGIA), among others, was instructed to ensure that internal audit practices, methods, and procedures be improved through continuing education and be conducted in accordance with internal auditing standards.

192 The AGIA represents internal auditors in government and promotes their professional development. It had 1,177 members at January 1999.

### **Public Financial Management Reform Program**

The objectives of the Government's public financial management reforms are to (i) allocate and manage expenditures via a Medium Term Expenditure Framework (MTEF); (ii) strengthen feedback mechanisms for budget formulation through enhanced budget and performance monitoring; (iii) improve the performance management environment by simplifying budgeting rules; (iv) introduce incentives for better performance management; and (v) increase management flexibility to ensure performance results.<sup>197</sup> The reforms are based on a benchmarking study of the Philippine expenditure management system vis-à-vis its neighboring countries (Australia, Korea, Malaysia, New Zealand, Singapore, and Thailand) in terms of the three important expenditure outcomes: maintaining fiscal discipline, facilitating strategic prioritization at the oversight level, and enhancing the implementation efficiency of line agencies.<sup>198</sup> The reform program comprises several activities as follows: <sup>199</sup>

- Sectoral budget ceilings. Six-year sectoral budget ceilings were introduced for the Fiscal 2000 budget. These sectoral budgets were developed with the multi-sector Planning Committees of the National Economic and Development Authority (NEDA). These Committees include representatives from Congress, local government, academia, the private sector and nongovernment organizations. The process involved various government implementing agencies in a participative and proactive manner.

Three-year budget baselines. The 6-year sectoral ceilings served as the basis for allocating resources to implementing agencies using a budget baseline approach.

- Strengthening evaluation mechanisms. First, locally funded projects will be subjected to the same approval process that applies to those funded from foreign sources. Second, the performance measurement will be mainstreamed. A set of performance indicators will have to accompany all new policies or projects that are submitted to NEDA or DBM. The ultimate objective is to foster an evaluation culture.

- Improving government accounting and internal control. Adopting private sector accounting and reporting practices, such as full accrual accounting will enhance the usefulness of accounting information. It will also enable organizational outputs to be meaningfully costed.

- Separating accounting and auditing functions. COA, the Philippines' supreme audit institution, undertakes accounting, internal control and auditing functions in government. These groupings are incongruous.

- Improving procurement procedures. The DBM has launched the Electronic Procurement System to improve the efficiency and transparency of the government procurement process.200

### **Issue Synopsis: Government Budgeting and Accounting**

Chapter VIII – Issues and Recommendations – identifies and describes constraints and proposes corrective actions. With minor departures, these include the following selected issues that have already been identified by the UNDP-sponsored studies:

- The Commission on Audit is responsible for promulgating accounting and auditing rules. These responsibilities are defined in Article IX of the Constitution 1987. The coexistence of these responsibilities is inconsistent with the concept of auditor independence.
- The absence of computerized accounting information systems, combined with complex accounting regulations (i) relegates the role of most government CPAs to that of highly qualified bookkeepers. Little time is left for value-added activities, such as financial analysis; and (ii) means that financial reports are rarely prepared in time to be useful for decision-making purposes.
- There is no consistent set of accounting standards for budgeting and reporting. Major reporting differences result.
- Auditors spend the majority of their time on compliance auditing (checking transactions). Minimal time is spent on financial attest auditing as more effort is applied to value-for-money audits.
- Comparatively attractive starting salaries attract high-quality personnel into government accounting. A flat earnings structure means that higher-level salaries are far from competitive. This creates retention problems and provides a supportive environment for graft and corruption.

### **Summary and Proposals**

Over the past 25 years, there have been some notable institutional and conceptual innovations in government accounting, contributing to its greater visibility and influence. Its emphasis has shifted from bureaucratic control to accountability reporting to the public. In some countries, government accounting standards are no longer set by government officials, but by relatively independent boards. While acknowledging the importance of cash the lifeblood in government as in business contemporary accounting standards aim at tracking the long-term consequences of decisions and actions. Government officials are held accountable for their stewardship of both

financial and capital assets. Finally, it is not enough to keep the books accurately; the books have to be open to the public. When the public does not have the time or ability to inspect the

accounts, governments have to make the task easier by preparing comprehensible as well as comprehensive financial statements.

Many challenges remain, especially at the global and international level. A major issue is the proper balance between international norms and domestic practices arising from national political ideology, economic system and culture. As a mechanism of governance, government accounting is subject to political forces that distribute power, and economic forces that determine the supply of and demand for resources. Therefore,



unless accounting standards boards ally themselves with the institutions that can withhold something of value to a government a grant, a loan, an unqualified audit opinion, a favourable bond rating their pronouncements would remain ineffectual. Unfortunately, at the international level, there are relatively few levers available to

a body such as the IFAC Public Sector Committee to enforce its standards. However, accountants could make the case that fiscal accountability is an international norm applicable to all governments regardless of their political and economic system.

Once this transcendent value of fiscal accountability is embraced, it is a technical matter to work out the means of implementation. These include not only yearend financial statements the current focus of IPSASs—but also budgets, internal controls and external audits. I urge the IFAC Public

Sector Committee to rectify its neglect of the budget and to include 'actual versus budget' comparisons in financial statements. Furthermore, putting aside differences of opinions on accounting choices, the entire body of detailed standards should be framed by a set of broader principles aimed at promoting government fiscal accountability, such as:

- The objectives of government accounting are to safeguard the public treasury and pr(oper)ly, to accurately measure and communicate the government's financial condition so as to demonstrate financial accountability, and to facilitate decisionmaking.

- A government should prepare and publish its budgets, maintain complete financial records, provide full financial disclosure, and subject itself to independent audits.

- The form and content of financial reports should be guided by the rights and need to know of intended users.

- The accounting system should measure the cash and other financial consequences of past transactions and events, including, but not limited to, budget execution.

- The accounting system should be capable of keeping track of the levels and changes in assets, liabilities, revenues and expenditures or expenses, relative to budgeted amounts.

These principles do not prescribe accounting choices. Rather, they provide a foundation for

deliberating and setting government accounting standards.

Generally, accounting standards take on a greater social role as accountability requirements in countries that require higher standards of ethical behaviour. Government accounting standards in effect become government accountability standards. (Recently the U.S. General Accounting Office was renamed Government Accountability Office.). Government must answer for the resources or authority it receives from others in the society and economy. Government provides both public goods and private goods, in return for the authority to govern, as well as economic and financial resources, Government accountability requirements are expressed as the terms in the political contracts, social contracts, and economic contracts that government enters into with its stakeholders (see Exhibit 2). The asset-liability perspective of accrual accounting described in Exhibit 1 is compatible with this contract theory of government: the government's assets come from the stakeholders' voluntary and involuntary contributions, and its liabilities originate from providing incentives to the stakeholders. In conclusion, fundamental to the development of accrual accounting in developing countries is the ability to identify and measure the government's assets and liabilities. Corruption tends to result in the understatement of government's assets or the overstatement of government's liabilities. Unless financial integrity is assured, the

credibility of government's financial information suffers. Thus both financial integrity assurance and accurate accrual accounting are accountants' professional contribution to developing countries.

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