

## **IPSAS and Government Accounting Reform in Developing Countries**

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### **Abstract**

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.

**Key words:** developing countries, institutional capacity building, government accounting reform, International Public Sector Accounting Standards (IPSAS), accrual accounting

The theme of the 10th biennial Conference on Comparative International Government Accounting Research (CIGAR) was framed as a question: “Is government accounting reform mimicry, fad or necessary?” This question is especially pertinent to developing countries which are urged to make substantial investments in such an endeavour. If such reform “mimicry, it may amount to nothing more than a laughable imitation of Western practices. If it is a fad, it will yield little of lasting value. This paper makes the case that government accounting reform is necessary because it strengthens the institutional capacity necessary for achieving development goals. It also urges the International Public Sector Accounting Standards Board to make financial integrity a top concern and to mandate accrual accounting in developing countries.

### **1. Government accounting reform in developing countries**

#### **1.1. A brief literature survey**

The links between government accounting reform and national development is rarely addressed in existing academic literature and are only implicit in the practitioner literature. Ten years ago, Chan, Jones and Lüder (1996) observed that developing countries had been underrepresented in comparative international government accounting research (CIGAR). The neglect has since been rectified. The Glasgow group has documented the experiences of some former British and French colonies in East Africa

and North Africa (Godfrey, Devlin and Merrouche, 1996, 1999). Britain has also influenced Malaysia (Coombs and Tayib, 1999) and Egypt (Ouda, 2001). The Bodo group has studied post-Soviet Russian government accounting (Bourmistrov and Mellemvik, 2000 and 2001). The Lodz group has long been tracking government accounting developments in Poland (Jarugua, 1988; Nowak and Bakalarska, 2001). China has been the focus of the author's work in recent years (Chan, 1996 and 2000; Chan, Cong and Zhao, 2001; Chan and Li, 2005). This mostly descriptive literature, however, has not produced theories that articulate the relationship between government accounting and a country's political, economic, and social development.

A number of handbooks summarize the experiences and counsel of consultants sent by international organizations to advise developing countries and transitional economies: the World Bank (World Bank, 1998), the International Monetary Fund (Chu and Hemming, 1991), the Asian Development Bank (Schiavo-Campo and Tommasi, 1999), and the Organization for Economic Cooperation and Development (Alien and Tommasi, 2001). Their diagnoses and prescriptions are based on Western practices, which are often viewed as good or even the best in the world. Government accounting reform is regarded as part of improving public financial management; as such, it is assumed to contribute to government performance and at least indirectly contribute to a nation's development.

Both of these bodies of literature convey the impression that, using Western industrial democracies as benchmarks, government accounting in developing countries is less advanced than in developed countries. This observation implicitly hypothesizes that there exists a relationship between a country's government accounting development and its political and economic development.

## **1.2. The nexus between government accounting and national development**

Government accounting refers to a government's financial information systems and financial disclosure practices. Its state of development results from the interaction between the supply of and demand for government financial accountability and transparency. Since it is costly everywhere to produce and disseminate information, governments in all types of political systems lack the economic incentives to do so. However, some political systems exert a greater demand for government accountability and transparency than others; for example, representative democracies are more demanding than authoritarian and totalitarian political systems. In a democracy, the government is obliged to be more responsive to information demands placed upon it. This would be the case in developed countries and developing countries alike. However, the opportunity cost of resources used in improving government financial information is higher in developing countries than in developed countries. Therefore, even if governments in democratic developing countries are willing to undertake government accounting reform, they may be unable to afford it; governments in non-democratic developing countries are both reluctant to undertake and unable to afford government accounting reforms.

The above analysis suggests two different strategies of promoting government accounting reform in developing countries. In countries where the political will exists, only funding and technical support are necessary. In countries where the government lacks both the political will and financial ability, external financial and technical

assistance are necessary but insufficient; domestic political reform may hold the key to improving their government accounting, although conditions associated with external financial assistance may provide additional incentives.

### **1.3. Millennium Development Goals and Poverty Reduction Strategies**

Currently there is an opportunity to promote government accounting reform in developing countries by linking it to the United Nations Millennium Development Goals (MDG). These goals seek to: eradicate extreme poverty and hunger; achieve universal primary education; promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/AIDS, malaria and other diseases; ensure environmental sustainability, and develop a global partnership for development (Sachs 2005, pp. 211-213). Many of the goals have quantifiable objectives. For example, the poverty reduction goal calls for reducing by half, between 1990 and 2015, the proportion of people who suffer from hunger and whose income is less than one U.S. dollar a day. With the assistance of the U.N. Development Program and others, each low-income country would prepare poverty reduction strategies (PRS) to achieve the above goals.

According to the United Nations anti-poverty advisor Jeffrey Sachs, a complete poverty reduction strategy based on the Millennium Development Goals has five parts: (1) a differential diagnosis that identifies needed policies and investments; (2) an investment plan that indicates required amounts and timing; (3) a financial plan that estimates the size of the financing gap to be filled in part by donors; (4) a donor plan that details multiyear donor commitments; and (5) a public management plan that specifies governance and administrative mechanisms to implement the strategy (2005, pp. 273-274). Government accounting reform belongs to the last component.

Underdevelopment of government accounting probably contributes to, and results from, what Sachs calls fiscal traps and governance failures, which he blames for some countries' Underdevelopment. A fiscally trapped government lacks the resources to pay for infrastructures and other public goods and services critical to economic development. Governance failures manifest themselves in corruption, weak judicial systems that define Property rights and enforce contracts, and the inability to perform basic government functions (Grindle, 2000). In the extreme, the state fails as well, causing even greater economic failure.

### **1.4. The social costs and benefits of government accounting reform**

It is not widely recognized that a sound government accounting system is an important Part of a country's institutional infrastructure. Rather, government accounting is commonly perceived as a bureaucratic function. To make matters worse, like the foundation of a house or the sewer lines under the street, the accounting system as a critical institutional infrastructure is often invisible until it fails: when public money is lost and wasted, when taxes are not collected, or when employees are not paid on time. Better accounting systems can quite readily lead to improvements in a government's financial management. However, the accounting system's contribution to the

achievement of higher-order goals, such as poverty reduction, is necessarily indirect and long-term. So it is difficult to see its social benefits.

Furthermore, in poor countries, government accounting reform poses a moral dilemma. Because of its costs, such reforms compete with food for the hungry, medicine for the sick, and clean water for urban slum dwellers. In such an environment, how can one justify spending money to improve the way a government keeps its accounts and produces annual financial reports?

This moral predicament is resolved by the social benefits of government accounting. Government accounting itself does not reduce poverty. Government accounting contributes to a country's socioeconomic development through its effect on public financial management and accountability. Effective government accounting makes it possible to manage the government's finances smoothly and provides audit trails to prevent and detect financial misconduct. In light of the pervasiveness and severity of government corruption in many developing countries (Rose-Ackerman, 1999), financial integrity assurance is a critically important function of their government accounting systems. Only ethical and competent public management can efficiently and effectively implement programs to reduce poverty reduction and achieve other socioeconomic goals. Sachs declared: "No country should receive greater funding unless the money [for poverty reduction] can be audited."

It is important for accountants to educate the public and public officials about the social value of government accounting. The accounting system is in effect the "nerves of government" - to use Karl Deutsch's phrase (Deutsch, 1966) - because it is the core of a government's financial command and control centre. A government accounting system can be rudimentary or sophisticated. As in business (Simon, 1954), a good government accounting system at the minimum keeps accurate financial scores; a better government accounting system directs the attention of policy makers and managers to problem areas; and at its best, a government accounting system provides information useful for decision making.

Thus it takes a certain amount of foresight and insight to make investments in government accounting reform: the foresight to anticipate the consequences of bad or no accounting and the insight to link accounting to government performance and eventually the achievement of societal goals. Government accounting can contribute to a country's socioeconomic development by providing information to public managers and those who hold them accountable to perform the fundamental functions of the state. As a support function, accounting does not have values of its own, and does not decide the allocation of resources. However, once these decisions are made, the accounting system performs the critical function of following the money. As such, accounting and its allied functions - including information system design, internal control, pre- and post-audit, revenue administration, and public expenditure management - ensure that resources are used for their intended purposes. If the purpose is socioeconomic development, accounting can help meet this goal by ensuring legal and contractual compliance, facilitating financial management, and promoting transparency and accountability.

## **2. IPSAS adoption as government accounting reform**

### **2.1. Elements of government accounting reform**

Government accounting reform in developing countries requires political and management support. Success depends on the ability to mobilize support from political leaders, who set the tone by demanding greater accountability and transparency. Their political determination will stand a better chance of realization if it is reinforced by the support of ministers and senior managers to change the way the government operates. Because of its technical nature, the “marketing” of reform proposals to politicians and senior managers is a challenging task.

Resource support is also critical to successful government accounting reform. Sufficient budgetary support is necessary to acquire software and hardware, and to hire a qualified staff. In many developing countries, the shortage of technical personnel imposes a severe constraint; thus human resources are another obstacle to overcome.

Reform involves changing policies and procedures of government accounting. Most countries have some type of rules and regulations for their government accounting systems, even though their institutional arrangements for setting such rules and regulations may be different. The International Public Sector Accounting Standards Board urges all nations to adopt IPSAS. Since IPSAS is the centrepiece of the worldwide accounting profession’s efforts to influence government accounting reforms in developing countries (Sutcliffe, 2003; IPSAS Board, March 2005), the next section examines the relevancy of IPSAS to developing countries.

## **2.2. IPSAS and developing countries**

IPSAS are primarily intended for adoption by developing countries. Most English-speaking developed countries already have government accounting standards that are either similar to, or more rigorous than, IPSAS. Even if their national standards are quite different from IPSAS, the other developed nations are under little external or domestic pressure to adopt IPSAS. Developing countries, on the other hand, face a different situation. The World Bank endorses the use of IPSAS in accounting for its financial assistance to developing countries. Furthermore, IPSAS is held up as the best government accounting ideas that the global accounting profession has to offer. IPSAS therefore has become recognized benchmark for evaluating and improving government accounting in developing countries.

The initial goals of IPSAS were to promote greater government accountability in all countries, improved quality and reliability in accounting and financial reporting, better financial and economic performance, better financial management and discipline, and international harmonization of reporting requirements (IFAC, 1996, p. 2). Have these laudable objectives led to the development of IPSAS that are relevant to developing countries? The author’s preliminary assessment is largely negative.

Even though IPSAS was not meant only for developing countries, one may reasonably infer from its financial sponsorship that developing countries were intended to be its primary beneficiaries. Thus it is puzzling why developing countries did not receive emphasis early, despite the sponsors’ institutional responsibilities and apparent interests. In recent years, the IPSAS Board has addressed developing countries in two ways. First, it issued a set of comprehensive “cash basis IPSAS” in 2003. Since the requirements of that standard are closer to current practice and are less costly to implement, it runs the

risk of becoming the de facto IPSAS for developing countries. If that were the case, it would be an unfortunate situation indeed, as the next section will argue. Second, the IPSAS board is in the process of preparing a standard on the disclosure of external assistance under the cash basis of accounting (IFAC, Exposure Draft 24 issued in February 2005). The cash basis will by definition exclude the recognition of grants receivable and loans payable, and other non-cash assets and liabilities. These two standards can hardly be regarded as an adequate response to the needs of government accounting reform in developing countries.

### **2.3. Accrual accounting for developing countries**

Other than citing infeasibility due to cost and other constraints, the IPSAS Board and its predecessor have not offered theoretical justifications for exempting the governments of developing countries from using the accrual basis of accounting. In the author's view, this is not a defensible position, for allowing cash-basis accounting undermines the objectives of promoting government financial accountability. Regardless of the basis of accounting it uses, a government is responsible for its payables owed to lenders, suppliers, employees, grantees, and others creditors. The lack of complete, reliable, and timely information about these financial obligations weakens the debtor government's ability and incentive to discharge its responsibility. Conversely, the lack of complete, reliable, and timely information about non-cash financial resources - investments, taxes receivable, accounts receivable, and loans receivable - hampers the government's collection effort, and reduces its ability to convert these resources into cash to pay off the liabilities. The inability to match financial assets and liabilities in terms of amounts and timing is a fundamental cause of liquidity and solvency problems, which can become full-blown fiscal crises. Governments in poor developing nations have a need, perhaps even a greater need, for accrual accounting information.

The current co-existence of cash-basis IPSAS and accrual-basis IPSAS results from the Public Sector Committee's refusal to acknowledge the legitimacy of "multiple points along the spectrum between cash accounting and accrual accounting" (IFAC Public Sector Committee, 2000). It is inappropriate, in the author's view, to present alternative bases of accounting in black and white terms. There are valid reasons why there are, and should be, multiple intermediary degrees of accruals. Governments hold different kinds of financial resources of varying liquidity and have different types of economic resources. Similarly, governments have financial obligations of varying definitiveness and maturity. It is misguided to insist on the cash versus accrual dichotomy.

It is not advisable for developing countries to push accruals to the point of recognizing and reporting infrastructure assets and heritage assets. It is only appropriate to accrue assets and liabilities to the extent that benefits exceed costs. As indicated in Exhibit 1, there are degrees of accrual, ranging from mild to moderate to strong. Recognition and accurate measurement of current financial resources and current liabilities would be the starting point of any accrual accounting project. Later on, long-term financial resources and liabilities could be added. Afterwards, operating fixed assets (e.g. government office buildings and equipment) and contingent liabilities can be recognized and reported. This gradual symmetrical approach is preferable for developing countries. Gradualism takes into account cost considerations, the need to accumulate

experience, secure political support, and build systems and human resource capacity. Symmetrical recognition of assets and liabilities of similar nature (e.g. accounts receivable and accounts payable) and similar timing (e.g. current assets and current liabilities) prevents incomplete and distorted presentation of financial position.

**Exhibit 1. Degrees of Accrual**

Degree	Assets Recognized	Liabilities Recognized
Mild accrual	Current financial resources	Current liabilities
Moderate accrual	Long-term financial resources in addition to current financial resources	Long-term liabilities in addition to current liabilities
Strong accrual	Capital resources in addition to current and long-term financial resource	Contingent liabilities in addition to current and long-term liabilities

For reasons stated earlier, all governments should immediately adopt “mild accruals” in accounting for and reporting current assets and liabilities. Governments should then move with all deliberate speed to “moderate accruals” in order to bring long-term financial assets and liabilities onto their accounts and financial statements. However, “strong accruals” should be done cautiously, in light of the many conceptual and measurement problems.

The systematic classification of assets and liabilities will not only clarify the varying degrees of accrual for accounting and reporting purposes. Such an exercise has an important, perhaps more important, side benefit: the government will have databases of its resources and obligations, and will be in a better position to achieve appropriate levels of liquidity and solvency.

In conclusion, mild accruals and moderate accruals are a necessity, not a luxury, even in developing countries. An accrual accounting system can accommodate the accounting for cash; however, a cash accounting system cannot encompass accruals. Therefore, the author urges the IPSAS Board to rescind the cash basis IPSAS and bring its provisions under the rubric of accrual accounting.

**3. Toward Effective Government Accounting**

**3.1. The general nature of IPSAS**

The IPSAS program has evolved in two stages. From 1996 to 2002, the IF AC Public Sector Committee essentially imported international business accounting and financial reporting standards into the public sector by making relatively minor modifications. Since 2003, the IPSAS Board has consciously focused on issues that are unique to the public sector. These issues include taxation and other non-exchange transactions, the implications of the budget for financial reporting, and social policy commitments. Both of these stages are in the realm of financial accounting, which has been called the language of business.

To the public at large and to most government officials, the budget still is the primary financial document of government. The rising importance of financial accounting in the public sector, as epitomized by the emergence of the IPSAS on the world scene, reflects the belief in the power of objective financial recordkeeping, which has been credited with inducing business-like behaviour (Crosby, 1997, p. 200). IPSAS are based on double-entry bookkeeping, which is considered one of the “measures of reality” that made modern business practices possible (Crosby, 1997). By grounding financial data on past transactions and events, government financial accounting provides a reality check against the more speculative future forecasts and plans in budgeting. This seems to be the unstated justification of patterning IPSAS after International [Business] Financial Reporting Standards.

Government financial accounting is also distinguishable from government financial statistical systems. These systems include the Government Finance Statistics of the IMF and national income accounts. What sets financial accounting apart from them is that, as a “social and institutional practice” (Hopwood and Miller, 1994), accounting is an instrument of accountability. The promotion of accountability through greater transparency, which accountants traditionally call “foil disclosure,” is an explicitly stated goal of IPSAS. In particular, IPSAS emphasizes the accountability of government to citizens, voters, their representatives, and the general public (IFAC, 2003, pp. 35 and 19).

In targeting these underserved potential users, the IPSAS Board has taken on a great challenge. These users are underserved because some governments have apparently decided that the costs of informing them outweigh the benefits to the governments themselves. The IPSAS Board is in effect seeking to tip the balance of power between government and certain stakeholders by stressing their right to know. The dilemma is that governments that have a greater need to improve their record of financial accountability and transparency are likely to be the ones that are more reluctant and less able to adopt IPSAS. Given its lack of enforcement power, the Board has wisely allied itself with development aid providers. These organizations have the incentive and ability to demand good accounting and informative financial reporting by their beneficiaries. At the same time, they also recognized that multiple and overlapping requirements are burdensome to developing countries. The IPSAS process has provided a coordination mechanism to reduce the costs of accountability. This is apparently the reason why the World Bank, the International Monetary Fund, the UN Development Program, and the Asian Development Bank have been supporting the IPSAS process. For them, IPSAS serves as a common instrument for fostering transparency and accountability of the programs and activities they finance and of the government at large. To their credit, these international organizations have solved the free-rider problem that would otherwise bedevil the production of IPSAS as a global public good.

Among the two dozen IPSAS, the most important standards are the first and second ones, which require governments to issue government-wide financial statements under the accrual basis at the end of a fiscal year. Implementing these standards would in effect compel a government to open its books to outsiders. As mentioned earlier, IPSAS seeks to balance some governments’ possible reluctance to tell and the public’s right to know. However, the IPSAS treats transparency as a self-evident virtue of government. Unfortunately this view is not universally shared around the world. Most governments use accounting to control their own activities, but some countries have the political



culture and laws to encourage or require external financial reporting. The IPSAS Board, as well as its sponsors and supporters, are making a bold assertion that fiscal accountability and transparency is a universal norm. What are needed now are actions to make IPSAS more useful where this norm is not observed to a satisfactory degree.

### **3.2. Making IPSAS (more) useful for developing countries**

Developing countries face the daunting challenge of raising the standard of living of their peoples. The UN Millennium Development Goals and Poverty Reduction Strategies can be realized only if governments and government officials have the necessary capacity to manage scarce resources, especially financial resources. Herein lies the contribution of accountants and auditors to institutional capacity building programs. The success of government accounting reform depends on political and management support, in addition to the availability of budgetary and human resources, and information technology. Government accounting systems' hardware is useless without software applications, and software is mindless without accounting standards.

IPSAS is a relative newcomer to the club of domestic and international accounting standard-setting bodies. Under the initial leadership and influence of mostly English-speaking countries, the IF AC Public Sector Committee chose to emphasize year-end consolidated financial statements. This kind of reporting addresses only external financial accountability at best. The historical orientation of financial accounting information further limits its *usefulness* for control and planning, which require real-time and future-oriented information. Summarized financial statements are often not sufficiently disaggregated to match the scope of responsibility of managers. IPSAS-based financial statements are really not designed to demonstrate the accountability of subordinates to their superiors, and of the executive to the legislature. As such, IPSAS can make only a limited contribution to institutional capacity building in developing countries.

IPSAS assumes the existence of a robust system of internal control in a government's financial management and accounting system. As recent corporate financial scandals in the United States, such as Enron and WorldCom, have demonstrated, the reliability of accounting-based financial statements can be undermined by the manipulation of underlying transactions. This situation can also happen in public sector financial reporting. Considering the vulnerability of the government in developing countries to financial misconduct, the reliability of numbers in their financial statements cannot be taken for granted, even if IPSAS are used. For this reason alone, the accounting profession has a stake in the global fight against government corruption.

According to Reuters (2003), the World Bank estimated that "some 5 percent of gross domestic product worldwide is lost to corruption such as misuse of funds and embezzlement." As a result of such statistics, fighting corruption has become a priority of international organizations and many developing countries. At the end of the year 2003, 114 nations signed the United Nations Convention Against Corruption. The World Bank established a financial integrity office to investigate allegations of corruption. A recent study by Keefer and Khemani (2004) of the World Bank's Development Group found that "... Even in developing countries that are democratic, politicians often have the incentives to divert resources to political rents and to private transfers that benefit a few citizens at the expense of many."

Official corruption threatens a government's legitimacy and authority, and reduces the amount of public money available to fund public services. Incompetent financial management is costly in terms of the inefficiency and disruptions it induces in the government itself and the economic system. Mismanagement of cash results in financial losses. Imprudent financial investments can lead to greater risk exposure and reduced returns. Delayed or under-collection of taxes reduces the amount of available financial resources and increase liquidity and solvency risks. Failure to pay bills when they are due can potentially create liquidity or solvency problems for employees, contractors and other creditors. Defaulting on interest payments and principal repayments to bond holders harms creditworthiness and may raise the cost of borrowing. For all these reasons, government accountants, auditors and financial managers are on the front-line of the fight against corruption.

Currently, IPSAS seems to take for granted that transactions are duly authorized and properly executed. The role of accounting standards is to decide whether to recognize the consequences of these transactions and, if so, how to measure and report these effects. Accounting standard setters are certainly aware of the possibility that transactions may be "structured" to take advantage of what accounting standards allow. But it is primarily the auditor's role to deal with this phenomenon. Similarly, unauthorized transactions and improperly executed transactions are matters of concern to auditors and management. This attitude overlooks the auditor's reliance on the capability of the accounting system to generate audit trails.

Besides the broader economic and social considerations, the detrimental effects of financial misconduct on government financial reports should motivate the IPSAS Board to pay explicit attention to financial integrity. Specifically, the board might undertake or encourage research on the implications of financial integrity, or lack thereof, for IPSAS. In principle, weak internal controls may lead to unreliable numbers in financial statements. Less is empirically known about how and to what extent government accounting numbers are distorted by unethical behaviour.

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.

## Exhibit 2. Stakeholders of Government

Stakeholder	Contribution to Govt.	Inducement from Govt.
Voters	Political legitimacy	Public goods and services
Taxpayers	Financial resources	
Service recipients	Political support	
Donors, grantors	Financial resources	Cooperation in resource use
Lenders	Financial resources	Repayment and interest
Employees	Services	Compensation
Contractors	Goods and services	Payments

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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