Classification System for National Governments

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TABLE OF EXHIBITS

LIST OF ABBREVIATIONS

ABC	Activity Based Costing
GAAP	Generally Accepted Accounting Principles
GFS	Government Finance Statistics
IAS	International Accounting Standards
IMF	International Monetary Fund
PPBS	Programme and Performance Budgeting System
SNA	System of National Accounts
UN	United Nations

1 Overview of classification issues

1.1 Objectives and structure

(1) The objective of this paper is to provide practical guidance for designing, or modifying, classification systems for government financial flows, assets and liabilities. It is envisaged that this guidance will be particularly useful for countries moving from a centrally directed economy, or developing countries implementing modernised financial management systems.

(2) The structure of the paper is as follows:

- Definition of classification systems (Section 1.3).
- Multiple objectives of classification systems (Section 1.4).
- Interaction between classification systems and roles (Section 1.5).
- Alternative classification and analytic models (Section 1.6).
- Impact and benefits of appropriate classification systems (Section 1.7).
- Linkage between classification and planning, budgeting and accounting (Section 1.8).
- Design considerations for classification systems (Section 2).
- Practical problems and issues (Section 3).
- A generalised approach to classification (Section 4).
- An illustrative example of the application of the approach to a country under both cash and accrual accounting (Sections 5 and 6).

1.2 Summary of conclusions

(3) The overall theme of this paper is that, while there are a variety of analytic models that are required from a classification system, it is feasible to design a single and relatively simple classification system that meets all of those needs. However, this does require identification of the needs, and careful design to ensure that they can be met from the system.

1.3 Definition of classification systems

(4) A classification system may be defined as:

The revenue and expenditure categories established by the government to plan revenues, expenditures, financing, and other financial flows in the budget/planning system, and subsequently used as codes in the accounting system to classify actual revenues, expenditures, financing and other flows, and to record assets and liabilities. The classification system also embraces the various analyses derived from such a coding system.

(5) The classification system will manifest itself through:

- The structure and presentation of financial forecasts and budgets in planning and budget documents (sometimes referred to as budget codes).
- The structure of the formal authority by parliament to raise revenues and expend public monies (expenditure authority through an Appropriation Act).
- The chart of accounts (sometimes referred to as nominal ledger codes) used to record revenues and expenditures within the accounting system, and also, if an accrual system is used, to record assets and liabilities.
- Analysis of revenues and expenditures derived from the revenue and expenditure coding system.
- The financial statements of the government.

(6) This paper is restricted to a consideration of the classification systems of central government treated as an entity. Public corporations, social security funds, non-profit institutions and other levels of government are therefore external entities to the system. However, the concepts described could equally be applied to any level of government managed as a separate entity (e.g. state, regional, provincial, or local government) with only minor modifications.

1.4 Multiple objectives of a classification system

(7) Classification systems within government are made complex because of the need to be able to analyse the financial information in a variety of formats for different purposes. This variety can be envisioned in terms of the levels of information, the needs of users, or the technical financial information system.

1.4.1 Levels of information

(8) There are three major levels of information.

Level 1: Economic or macro level, as exemplified by the IMF Manual of Government Finance Statistics (GFS) and the System of National Accounts (SNA).[1]

Level 2: Resource allocation level, exemplified by programme and performance budgeting, three year rolling budgets.

Level 3: Legal and managerial level, exemplified by the tax raising and expenditure appropriations in the budget to specific units of government, and subsequent revenue and expenditure control processes.

1.4.2 Needs of users

(9) User needs impose a separate set of requirements on the classification system. Governments have specific managerial responsibilities in relation to the public sector, for the economy generally, and are accountable to all citizens. This creates a series of user needs.

[1] "System of National Accounts" 1993 prepared under the auspices of the Inter-Secretariat Working Group on National Accounts of the EU, IMF, OECD, UN and World Bank.

- **Government as the executive arm of government** - analysis for fiscal management, revenue raising and borrowing decisions and management, prioritization of expenditures, compliance with legal and good government requirements, and achieving technical efficiency.
- **Parliament as the legislature** - for budget and legislative decisions, and reviews of the executive through, for example, a public accounts committee.
- **External entities** - e.g. major donors, for monitoring of government activities and fiscal management through statistical and other analytic tools.
- **Clients of government** - i.e. stakeholders, for the impact of government financial activities on their areas of concern, and accountability and transparency of government.
- **Managers within the government** - as the basis for policy advice, authorisation for revenue raising and expenditure of public money, achieving technical efficiency in the management and control of activities.

1.4.3 Financial information system

(10) Finally there are the different requirements imposed by the technical financial information system.

- **Planning and budgets systems** - these have a greater, and different, significance for the public sector than the commercial sector, and the planning/budget process will tend to drive the classification system.
- **Accounting system** - governments may maintain their accounts using cash or accrual approaches, or some intermediate system. Asset and liability classifications are required under an accrual approach, but only for financial assets and liabilities under a cash approach.
- **Economic analysis and statistical systems** - e.g. national accounts approach classification issues from a different perspective to budget and accounting systems.

1.5 Interaction between classification, objectives and needs of users

(11) These levels and needs can be represented in a matrix, as in Exhibit 1 below. Note this does not attempt to show the impact of different aspects of the technical information system.

Exhibit 1: Interaction between roles of classification system

Levels	Government as executive	Parliament as legislature	External entities, e.g. donors	Clients of government	Managers within government
1 Macro economic	Fiscal management & policy	Budget approval	Economic management and policies		Policy advice and fiscal management
2 Resource allocation	Prioritization of expenditure	Legislative decisions	Convergence with donor priorities	Impact on areas of concern	Policy advice and management
3 Legal and managerial	Technical efficiency, good government	Public expenditure review	Technical efficiency, good government, transparency, accountability	Good government, transparency & accountability	Authorisation, technical efficiency

(12) The approach within this paper is that a single classification system can be developed, which meets the needs of all users at different levels, and is independent of the technical financial information system. However to achieve this, careful design is required which should not be driven exclusively by the needs of one group of users, or one level of analysis.

1.6 Alternative classification models

(13) Though there is a great variety of classification models, four are identified as being of particular concern:

- the GFS/SNA macro economic analysis model;
- the budget authorisation model;
- the traditional accounting administrative model; and
- the programme and performance budget models.

(14) The IMF Government Finance Statistics (GFS) Manual[2] and the System of National Accounts (SNA)[3]) both provide classification models for governments. The GFS is particularly important because it is the format in which the IMF requires information from government. These two models are consistent with each other[4], and provide a comprehensive analytic framework from the perspective of Level 1 above, and the national economic management needs of users (see Section 1.4 above).

(15) Approval of budgets by Parliament will be structured into a series of votes on expenditures, and approval of specific tax legislation and other revenue raising measures. These have tended to provide the structure of the classification system within budgets.

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[2] Published in 1986, but there is a new version in draft summarised as an Annotated Outline published in 1996.

[3] "System of National Accounts" 1993 prepared under the auspices of the Inter-Secretariat Working Group on National Accounts of the EU, IMF, OECD, UN and World Bank.

[4] Or will be when the new revised GFS is formally issued, see above.

(16) Traditional accounting systems have classified expenditures following the administrative structure of government, and revenues by type of taxation. More recently governments have indicated a tendency to move to accrual accounting systems, but this change does not affect the classification of revenues and expenditures. Accrual accounting does add the need to classify non-financial assets and liabilities.

(17) Programme and performance budgeting provide distinct, but related, expenditure classification models. Programme budgeting seeks to link expenditure with programmes, or activities, even though these may cut across some of the other classification models described above. Performance budgeting links expenditure to specific, usually non-financial, performance targets, which again may cut across other classification models.

(18) In addition to these models, there are a number of technical models developed to deal with specific issues. For example, activity based budgeting and accounting provides an approach to identifying the economic costs of specific activities.

(19) Each of these models has been developed to meet specific identified analytic requirements, and each is valid and important in that context. Therefore these should be seen as complementary rather than competing models. The challenge is to develop a single classification system that is compatible with these various models.

1.7 Impact and benefits of appropriate classification systems

(20) A system of classification within government has as its primary objective to effectively communicate information so as to lead to decisions that are optimal to achieve public policy objectives. Many stated purposes of classification and the resulting financial statements, e.g. transparency, accountability, fiscal analysis, control information, etc., are in fact sub-sets of this fundamental objective.

(21) Information has a cost. The production of budgets, recording and reporting historic transactions, valuing assets and liabilities, are all processes with significant economic costs which require complex systems and skilled human resources. In many developing countries, these skilled human resources are in short supply, and there may be an economic cost not fully reflected in the cash cost, particularly of public servants.

(22) Furthermore, complexity increases the risk of errors in coding, particularly of accounting transactions. If a clerk in a remote Himalayan revenue office, or a small Pacific island treasury, is required to code every transaction using a large number of numeric digits, the chances of coding errors will be high. Finally, excessive complexity may delay the production of information, which may reduce its value to a greater extent than the benefits of more detailed analysis.

(23) The benefits of any system need to be identified, so they can be balanced against the economic costs.

- Appropriate budget classification can assist in making optimal allocation decisions to achieve policy objectives with limited resources, and can identify the costs of specific policies and activities.
- Broader national government economic and fiscal policy decisions can be improved by appropriately classified budgets and accounting reports on recent transactions.
- Management of government operations by public servants can be enhanced by appropriately classified budgets and accounting information.

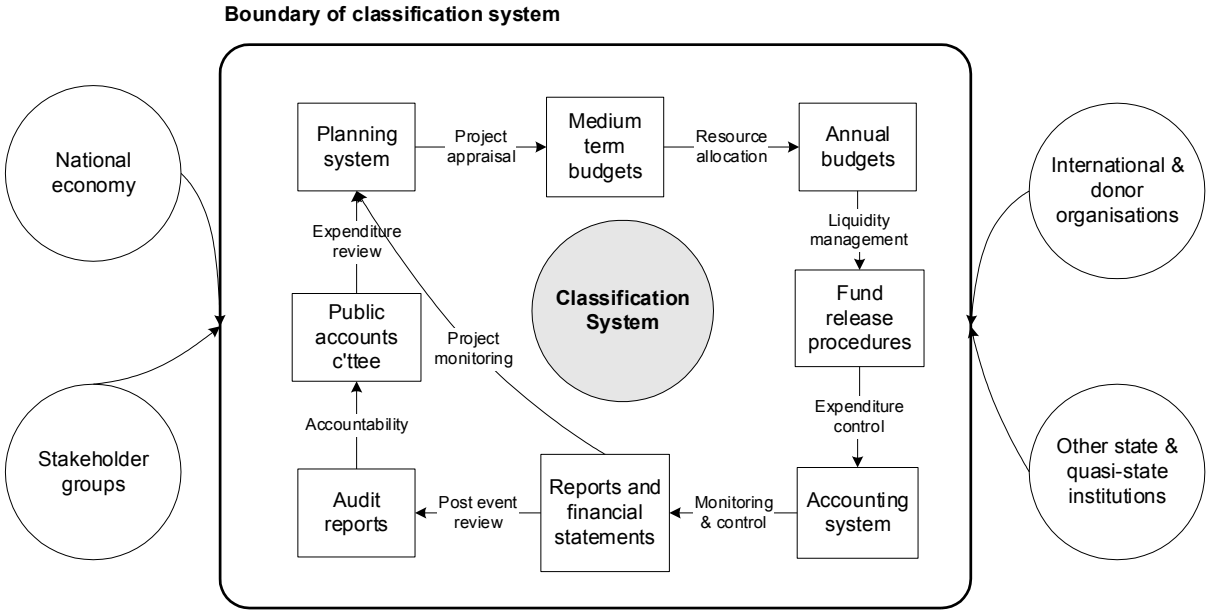
- Appropriate classification can enhance transparency and accountability of government.
- Government liquidity and fiscal management requires appropriately classified accounting information.
- Information is required for analysis by historians of government activities.

(24) In the design of any system, all of these factors must be taken into account. On the other hand, constraints of cost, practicality, human and technical resources, together with the need for reliability and timeliness will favour a relatively simple system.

1.8 Classification linkages to stages of the financial management cycle

(25) The financial management cycle, as illustrated in Exhibit 2 below, links all stages of the financial management process within a single system. Stages in the cycle have roles in resource allocation, control or accountability. The paragraphs below consider the linkage of classification to each stage in the cycle for these roles.

Exhibit 2: The financial management cycle and links to classification



Planning system and project appraisal

(26) In all countries there must be some mechanism for planning major projects that involve expenditures and benefits extending over a number of years. The approved projects may be structured within a formal plan, such as a “five-year plan” or a “public investment programme” or they may be made and recorded on an ad hoc basis.

(27) Investment decisions should be based on the costs and benefits of the project. There are well established tools to facilitate this evaluation process, but the process must involve prediction of future money flows associated with the project. The decision will not be affected by the manner in which such money flows are classified, but there are reasons even at this stage for presenting such money flows in accordance with the Government's standard classification system, as indicated below.

Medium term budget system

(28) It is increasingly recognised that the annual budget is an inadequate tool for financial planning, and that some medium term framework is required. The premier example is the Australian rolling three-year budget, though some other countries have similar systems, for example the Economic Survey in the United Kingdom. Such forward plans will not normally go to the level of detail in an annual budget, since they are not directly used as a basis for raising revenues or releasing funds. Nevertheless it is very important that they follow the same classification structure as the annual budget.

Annual budget system

(29) Annual Budgets are at the heart of the financial procedures of governments. They are the legal mechanism by which revenues are raised and expenditure authorised. It is therefore of the utmost importance that budgets are presented in as clear a format as possible, to maximise transparency. It may well be that there may be more than one presentation format within the budget, for example by administrative structure and also by programme structure. On the other hand, it would be inappropriate within the budget presented to Parliament to show all of the underlying detail that is necessary in order to be able to release funds to spending units, or to raise specific forms of revenue. The classification system provides an all-embracing structure to facilitate these different requirements.

Fund release, expenditure control and treasury management

(30) There will be an intervening stage between budget authorisation and actual expenditure. This is the fund release stage, procedures by which spending departments are authorised to actually expend the funds authorised by the budget. This is often referred to as the process of warranting. This process is variously used for liquidity management, expenditure control and allocating expenditure to decentralised spending units[5]. In order to maintain the integrity of the system, it is vitally important that the budget classification system is consistently followed through to the fund release stage. This will involve additional detail in the system to identify the decentralised spending units.

[5] One of the problems of using commercial accounting packages for government is that they rarely provide for such procedures, which are not normal commercial practice.

Accounting system

(31) The accounting system is the stage at which actual revenues and expenditures are recorded, using either accrual or cash accounting. It is essential that the same classification system is used as for the budget, in order to make monitoring and control feasible. However, there will be a need for additional classification heads for accounting not required for budget purposes. These particularly relate to asset and liability accounts. Even under a cash accounting system, some asset and liability accounts will be retained, e.g. suspense accounts, advances and deposits[6]. In an accrual accounting system the asset accounts will be much more extensive, and will include fixed assets, depreciation, accounts payable and receivable (creditors and debtors), inventory, and accrued liabilities such as pensions.

Reporting and financial statements

(32) The periodic financial reports and annual financial statements are the tools of the control system. Government accounting systems have traditionally not been seen as reporting systems. Reports are often restricted to monthly reports, often late, without comparisons to budget, and poorly presented. To be useful for control purposes reports must be up to date, produced with a frequency related to the control cycle, and presented with benchmarks so as to be able to identify trends and where action is required. This is only feasible through a consistent and appropriate classification structure.

Audit system

(33) Governments are subject to audit by the Supreme Audit Institution, often the Auditor General. Historically government audit has differed from commercial audit in that the former has concentrated on the propriety of transactions, and the latter on the reliability of the financial statements. The trend is for government auditing to at least embrace a review of, and expression of opinion on, the financial statements. This will include a comparison with budget authorisations, and hence consistency of classification is essential.

Expenditure review system

(34) Most parliamentary systems incorporate some process by which Parliament reviews public expenditures, typically a Public Expenditure Review Committee. Such a Committee will be concerned with the propriety of authorisation and effectiveness of such expenditure. The review will be based on the audit reports, financial statements and budgets of the government.

Conclusions on the financial management cycle and classification

(35) The key point to emerge from this analysis is the relevance of the classification system to every stage in the cycle, and the need for a single system applied consistently. Therefore the system must be appropriate to the requirements at each stage in the cycle. The matrix in Exhibit 3, on the following pages, summarises the impact of classification at each stage of the cycle in terms of resource allocation, control and accountability.

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[6] Under cash accounting these are often referred to as “below the line accounts”.

Exhibit 3: Linkage of stages of financial management cycle to classification

	Expenditure prioritization and resource allocation	Control	Accountability
1. Planning system and project appraisal	Once projects are approved, their financial flows will be included within medium term and annual budgets, and will represent pre-empted resources, thus restricting resources available to be allocated for other activities. The process of identifying the annual flows associated with projects will be facilitated if they are already presented in the classification structure. This also applies if there is a Public Investment Programme the financial implications of which have to be incorporated within a budget. Furthermore, post event comparisons of predicted and actual cash flows can be valuable in improving the quality of future forecasts. This evaluation is only feasible if they are both analysed within the same structure.	Projects should be subject to ongoing monitoring, and this will include comparing predicted and actual cash flows. The accounting system should be used to generate the latter information, and will do so in accordance with the standard classification system.	Accountability is enhanced if financial information about projects is presented in a standardised format.
2. Medium term budget systems	The use of a standardised classification system facilitates comparisons for resource allocation purposes, and also the incorporation of pre-empted project expenditure as indicated above.	Medium term budgets are an important expenditure control tool, forcing an evaluation of the impact of expenditure decisions on resource ceilings. This can only be made effective if medium term budgets can be translated into annual budgets, and this makes a standard classification system essential.	Medium term budgets are part of the transparency of government. They are more effective as a communication tool if presented in a standardised format.
3. Annual budget system	The annual budget is the legal tool for allocating resources. As such it must use the standard classification system.	Budgets are a key control tool. Actual expenditure is compared to budgets (see below), and therefore both must use the standard classification system.	Budgets are the prime mechanism for accountability. This is enhanced by a clear and transparent presentation, which in turn requires an appropriate classification system.

	Expenditure prioritization and resource allocation	Control	Accountability
4. Fund release, expenditure control and treasury management	Resource allocation decisions within the budget can, deliberately or accidentally, be distorted through inconsistent fund releases. Such distortions can be identified through a consistent classification system, combined with financial monitoring procedures.	Fund release is an essential element within the control cycle.	Accountability is achieved by being able to monitor fund releases against original budget authorisations.
5. Accounting system	The accounting system records historic information, and therefore has no direct role in resource allocation. However, such information is a guide to future money flows. Also by comparing predictions and out-turns, the quality of predictions, and hence resource allocation decisions, can be improved over time.	Historic accounting information is a basic element in a control mechanism. Although nothing can change past costs, by comparison with plans trends can be identified and any appropriate corrective action implemented. This makes consistent classification systems essential.	Historic accounting information forms the basis of reporting on financial out-turn, and hence accountability.
6. Reporting and financial statements	Reporting has no direct link to resource allocation, though as noted above may indicate future cash flows.	Reports are the basis of the control system.	Annual financial statements are a very important element in achieving accountability, and are usually the basis of audit and expenditure reviews.
7. Audit system	Auditing has no direct relevance for resource allocation, though a "value for money" audit can provide information to guide future investment decisions.	Audit is a fundamental part of the control process within government.	Similarly audit is a fundamental part of the mechanism for ensuring accountability of public servants.
8. Expenditure review systems	The expenditure review has no direct impact on resource allocation, but the review of effectiveness may provide guidance for future decisions.	This is another important element in the control process.[7]	The public expenditure review process is a manifestation of accountability.

[7] It may be argued that the expenditure review process represents over-control, in that it discourages initiative by the fear of subsequent criticism.

2 Design considerations for a classification system

(36) Taking account of the requirements so far identified, this section reviews the different classification requirements, and relates these to the various classification models. The section will indicate that some of these classification approaches are irrelevant, redundant, or can be combined. This will lead to the next section where a generalised classification structure and approach is proposed.

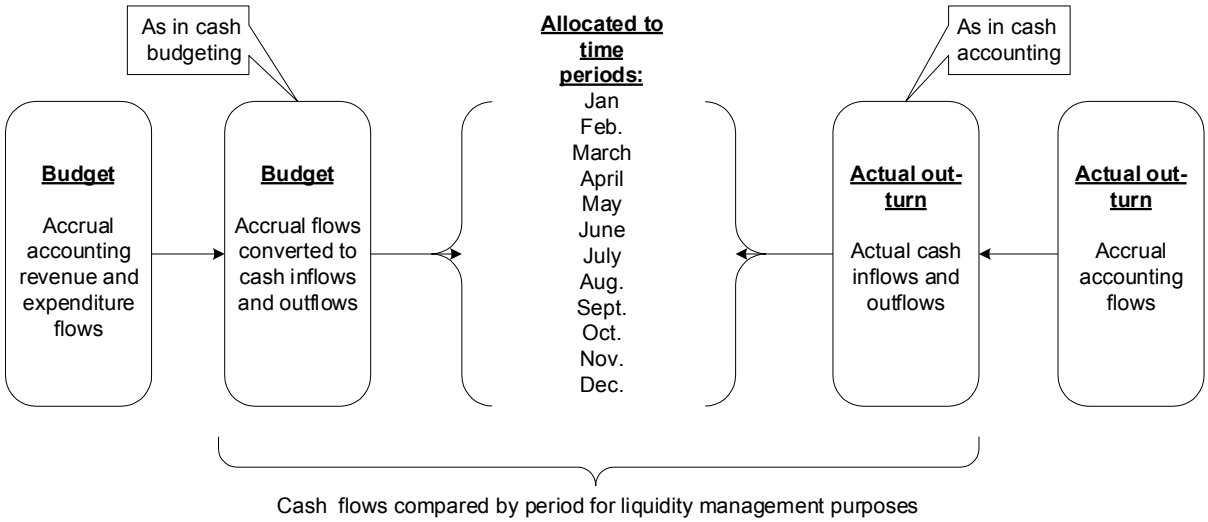
2.1 Classification by time

(37) Timing of transactions is significant in four contexts.

- Timing of budget receipts and payments is important to profile financing requirements through the year.
- Timing of actual payments is important as part of the "tracking" process from budget authorisation through fund release to actual expenditure.
- Timing of transactions and flows is important so that the cut-off between accounting periods can be established, and transactions are recorded in the appropriate period.
- Where projects extend over more than one accounting year, then the money flows will need to be classified by accounting period as well as in total.

(38) Budgets need to be profiled over time periods. Note that accounting transactions are automatically profiled by the date on which they are recorded. Note also that for liquidity management purposes, it is the timing of the actual cash flows, not the accrual transaction, which is critical. Exhibit 4, below, illustrates the problem.

Exhibit 4: Classification of flows by time for liquidity management



(39) One of the arguments for the use of cash accounting for governments is that it directly provides the cash flow information required for fiscal and liquidity management. However, it should be noted that commercial enterprise have always had to manage liquidity whilst using accrual accounting, so liquidity management under accrual accounting is not a new or insurmountable problem.

(40) The financial management of multi-year projects does not sit easily with conventional accounting systems, which are focused on the annual financial year. For projects total expenditures need to be monitored and tracked over the life of the project. Therefore the classification system must allow for such expenditures to be aggregated and monitored against total budgets, but divided into annual periods for traditional budget and accounting purposes. This issue is more one of project management and financial system design than classification, but it is important that projects and their related money flows are consistently classified over their life.

(41) It would not be normal to profile revenues and expenditures within the classification system. Instead this would be a separate exercise within the budget process.

2.2 Revenues

(42) Revenue classification is generally more straightforward than expenditure classification, in that there is no real alternative to classification by type of revenue source. Under the proposed revised GFS all revenue is initially divided into capital or current, and then within each sub-divided into tax, social contributions, non-tax and grants. This differs from the previous GFS, where there were just four major categories of tax, non-tax, capital and grants. The new system requires that both tax and social contributions are divided into capital or current, and grants are included within non-tax revenue, which is similarly divided. The new approach is summarised in the matrix in Exhibit 5, below.

Exhibit 5: Matrix showing major categories of revenue under revised GFS

Categories	Current	Capital
Tax	Taxes on income, profit & capital gains Property and wealth taxes Taxes on goods and services Taxes on international trade	Estate, inheritance and gift taxes Non-recurrent taxes on property
Social contributions	Compulsory social contributions Voluntary social contributions	(no examples)
Non-tax	Interest, dividends and rent from public enterprises Sales of market establishments Administrative fees, fines, etc	Disposal of produced assets Disposal of non-produced assets Capital transfers other than grants
Grants	Current grants from abroad Current grants from other levels of national government Current grants from international organisations	Capital grants from abroad Capital grants from other levels of national government Capital grants from international organisations

(43) Conceptually, the division of all revenue into capital and current is of doubtful value. The nature of most Government revenue is that it is non-requited, i.e. not linked to specific expenditure. It is not clear what useful purpose is achieved by dividing non-requited revenue in some arbitrary manner between capital and revenue. However, any classification system would normally divide revenues by type of taxation, and grants by classification of grantors. This would almost certainly provide more than enough analysis to aggregate into the proposed revised GFS format.

2.3 Financial assets and liabilities and financing flows

(44) The GFS divides financial assets according to the purpose for which they are held:

- those held for policy purposes, which are shown as "*net acquisition of financial assets for policy purposes*"[8]; and
- those held for liquidity management, which should be shown under financing.

(45) The GFS admits it is difficult to identify these two groups on the basis of types of assets, and therefore the distinction must be based on "motives underlying the transactions". The 1986 GFS Manual provides some guidance. In practice most financial assets will be held for policy purposes, and liquidity management assets will relate to specific purposes, e.g. as a fund to meet pension liabilities as they mature.

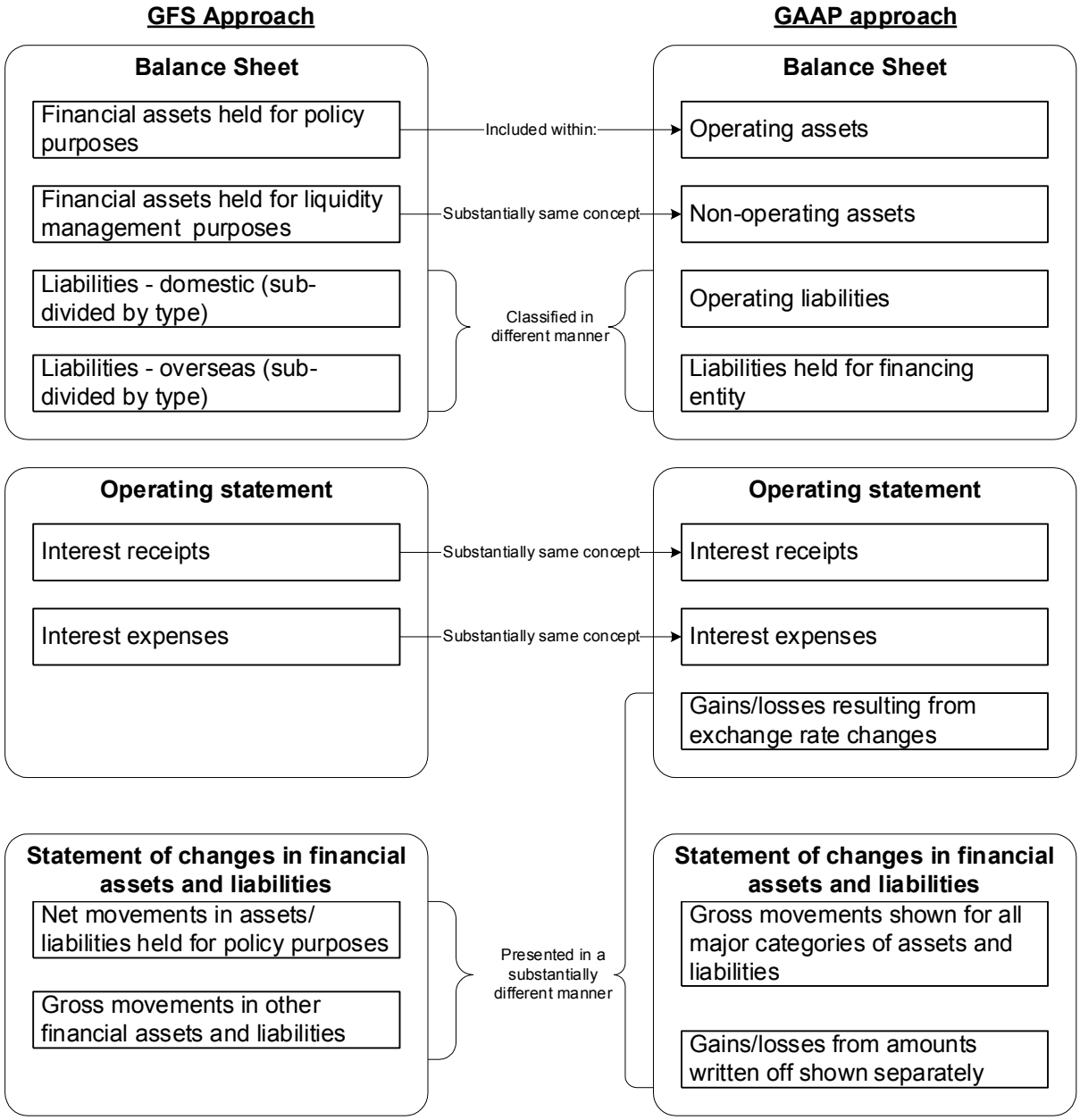
(46) Liabilities, on the other hand, are classified within the GFS primarily on the basis of domestic or foreign. Interestingly the GFS contains no guidance on the functional classification of interest payments. Though these may be embraced within an economic classification, it is necessary to define consistently where interest payments are recorded within the different government functions.

(47) The GFS treatment of financial assets and liabilities, and related flows, is significantly different from that applied under GAAP to accounts. Under GAAP there are "operating assets", i.e. those used in the operations of government, and non-operating assets, which would include assets held for liquidity management purposes. Similarly liabilities need to be divided between operating liabilities (commercial entities treat these as synonymous with "current liabilities", i.e. those with a maturity less than 1 year, but this may not be an appropriate assumption for governments), and financing liabilities.

(48) The GFS does not distinguish between operating flows recorded in the operating statement, and other changes in the amounts of assets and liabilities. Interest receipts and payments form part of operating expenditure and revenues. On the other hand changes in the amount of assets are not operating flows, and would be identified separately through separate schedules, linked to balance sheet movements. Exhibit 6 relates these different approaches.

[8] GFS Annotated Outline para 280.

Exhibit 6: Alternative treatment of financing



(49) There is no incompatibility between these different approaches, which reflect different information needs of different groups of users. Provided the classification system contains sufficient information for either purpose, then either analysis can be derived as required.

2.4 Assets and liabilities

(50) Traditionally the analytic framework for governments is based on a cash model for both budget and accounting. Whilst there is general recognition of the limitations of the cash model, only very few governments have moved to accrual accounting, and there are no agreed standards. For example, the New Zealand model is significantly different to the UK "Resource Accounting" approach. Also a number of governments use intermediate systems between cash and full accrual models.

(51) Governments of both developing countries and those moving from a centrally directed economy will need to consider very carefully whether a move to an accrual accounting system is either desirable, or indeed feasible. This paper sets out classification systems under either approach.

(52) Accrual accounting[9] provides an internally consistent analytic framework for classification, which clearly distinguishes capital and revenue transactions. Revenue transactions over a period of time are summarised in an operating statement. Capital transactions and movements over the same period are separately identified and summarised. In total these revenue and capital movements represent the change in assets and liabilities over the period. This is identical to the change in net worth in the balance sheets at, respectively, the beginning and end of such period.

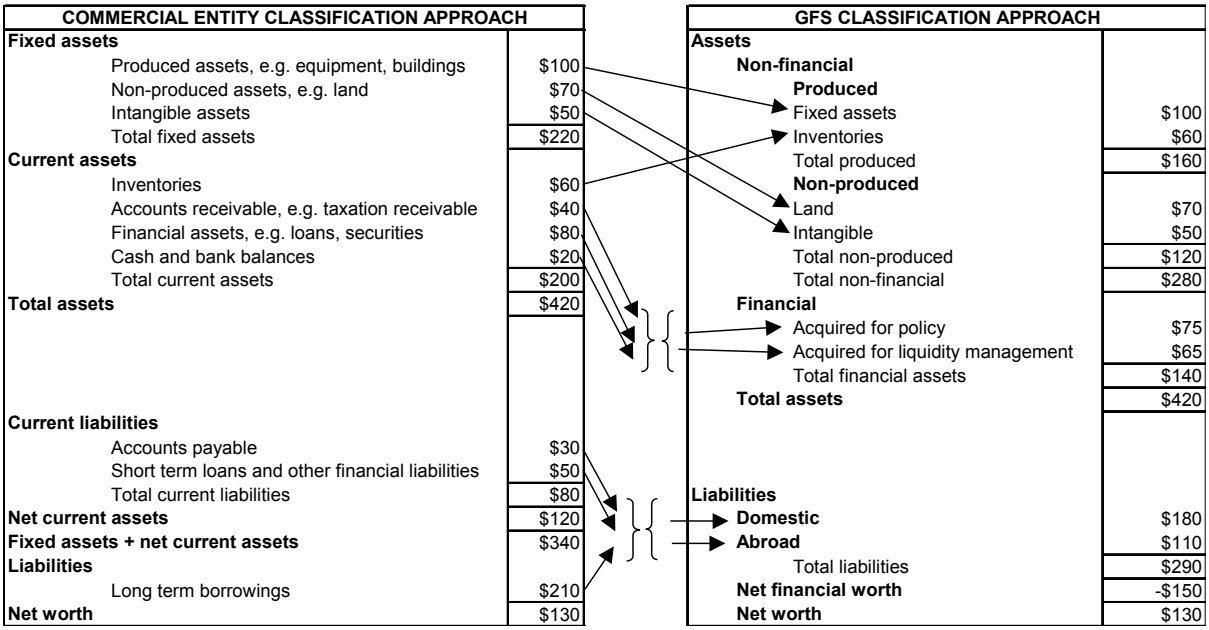
(53) Both the proposed revised GFS and the SNA are based on an accrual accounting model. In fact the impact of the accrual model as compared to the cash model on the classification system is very limited. There will be some additional revenue flows under an accrual model, for example depreciation charges, pension liability provisions. Under accrual accounting, it will be necessary to establish classifications for all assets and liabilities. Under cash accounting, only financial assets and liabilities, and a very limited range of current assets and liabilities (e.g. advances, deposits) will be recorded. Such assets and liabilities do not form part of the budget system, but are required for the accounting system.

(54) It should be noted that it is possible to generate accrual accounting information for GFS analysis by a series of adjustments to information provided by a cash accounting system. Therefore the GFS adoption of accrual accounting should not be seen as making it a mandatory requirements for government if they wish to provide GFS analysis.

(55) The classification of assets and liabilities within the GFS and SNA appears very different to that used for commercial entities, since it focuses on the distinction between financial and non-financial assets. Commercial entity classification of assets and liabilities focuses on their nature and liquidity. Exhibit 7 compares the GFS classification to that used for commercial entities.

[9] The term “accounting” is used to embrace both historic and predictive accounting, i.e. budgeting.

Exhibit 7: Assets and liabilities – alternative classification approaches



(56) Note that both models arrive at the same net worth, but involve significantly different approaches to classifying and analysing the assets and liabilities. The commercial entity model emphasises the purpose for which the asset is held, and the liquidity, and for liabilities focuses entirely on liquidity. The GFS model focuses on the relevance of the assets and liabilities to national economic management.

(57) Both models provide useful information for different purposes. The commercial entity model can be applied to governments, and is particularly relevant for relating assets to flows and their related costs for sub-units of government, i.e. for financial management. On the other hand the analysis under the GFS model is also useful. Therefore the classification system for government needs to be able to provide analysis under both the GFS and commercial models.

2.5 Functional and administrative structure

(58) Budgets are normally "voted" on the basis of the administrative structure of government. From a managerial perspective it is important to identify responsibility for both revenue and expenditure. Managerial responsibility is also linked to the administrative structure. Therefore the administrative/responsibility classification will form the basis of most traditional accounting style classification systems, and it is important that such analysis is available.

(59) The GFS focuses on a functional analysis of expenditure, as indicated below:

1. General government services
2. Defence
3. Public order
4. Education
5. Health
6. Social security
7. Housing and community amenity
8. Recreational, cultural and religious
9. Fuel and energy

10. Agriculture, forestry, fishing
11. Mining and mineral resources
12. Transport and communication
13. Other economic affairs
14. Expenditure not classified above

(60) It is likely that the functional and administrative structures will be similar, but rarely will they be identical. However, for budget and accounting purposes, revenues and expenditures must be analysed down to the lowest level of government specified in the central budget. Typically this would be down to the level of at least Departments and Projects, and often below this level.

(61) It would be surprising if these could not be aggregated to provide either an administrative/responsibility analysis or a GFS functional analysis. Therefore both the required analyses should be able to be derived from a single system.

2.6 Economic classification of expenditure

(62) Both the GFS and traditional accounting classify expenditure into major accounting categories, e.g.

1. Wages, salaries, and employer contributions
2. Purchase of goods and services
3. Repairs and maintenance
4. Interest and rent
5. Subsidies
6. Current grants

(63) In addition the GFS provides categories for "capital expenditure". As indicated earlier, accounting approaches would not treat capital movements as expenditure, but they would still need to be categorised by major type.

(64) Many countries analyse expenditure into much more detailed categories than the GFS. This is not a classification problem (though such detailed classification is rarely of managerial value) provided that the detailed categories can be aggregated into the GFS categories.

2.7 Development budgets and projects

(65) Particularly in developing countries, projects are a significant and distinct sub-unit within governments. Such projects are typically partly or wholly funded by one or more external donor organisations and they may involve a mixture of government personnel and resources, and externally employed personnel.

(66) A number of countries deal with such projects through a separate "Development Budget". Although this would be expected to relate only to capital expenditure, in practice they often contain recurrent expenditure. Thus a classification matrix emerges as illustrated in Exhibit 8, below.

Exhibit 8: Recurrent and development budgets

Type of budget	Capital expenditure	Recurrent expenditure	Total
Non-development budget (often called "Recurrent Budget")	20	90	110
Development budget	50	30	80
Total	70	120	190

Note: figures are only for illustrative purposes

(67) It can be seen that where the two budgets are used, two alternative classification models emerge:

- Capital/recurrent
- Development/non-development

(68) The development/non-development dichotomy is not recognised within GFS, nor has it any financial management significance. It detracts from the more important distinction between capital and revenue. Very often development budgets are just a collection of projects, and it is not unusual for the classification system in the development budget to differ from that in the recurrent budget. This engenders confusion.

(69) Either development budgets should be integrated within a single budget, or at least they should be made consistent with a revenue/capital distinction, and the same sub-classifications used within each budget. However, many countries use a two budget system, and the classification system must be able to handle this situation.

(70) With or without a development budget, projects are important accounting entities, and they do need to be identified, and both resources directed to them and expenditure incurred separately classified. Projects form operating units within the accounting system.

2.8 Programme and performance budgeting

(71) Programme and performance budgeting are not synonymous. They are treated together in this section because they each imply a different classification structure.

(72) Programme budgeting is a technique first developed in the USA. In essence programme budgeting seeks to move the focus away from administrative structures or economic classification of costs, and instead to focus on the government as a series of "programmes", or activities. Each programme requires certain resources in order to achieve the target programme outputs. The resources related to a particular programme may cut across conventional administrative or functional classifications of expenditure. Such an approach can assist in resource allocation decisions, since inputs can more specifically be related to outputs[10].

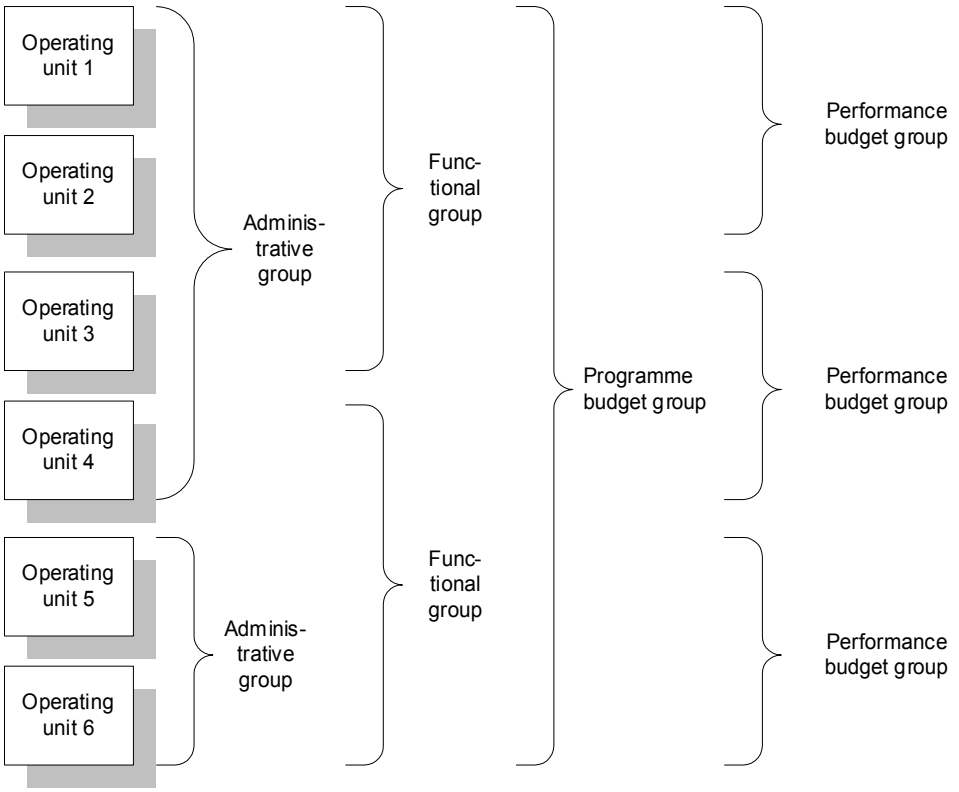
[10] The original concept of PPBS (Programme and Performance Budgeting System) is a very defined system, but the term "programme budgeting" has become a general description of the approach indicated in the text.

(73) An example of programme budgeting would be treating a number of distinct activities and projects relating to education, drainage, agriculture, in one geographic area as all being part of a "Rural Development Programme". This can create problems in classifying expenditure. If the activities within the programme extend over several Ministries, and include some activities which are not in themselves development projects, then financial responsibility will be hard to define. In such a situation it can also be very difficult to classify expenditure by programmes, and it may require a unique classification system "grafted" on top of the more conventional classification system.

(74) Performance budgeting seeks to deal with similar issues to programme budgeting, but does so by relating financial inputs to outputs, with the latter being defined in either financial or non-financial terms. Performance budgets will tend to be linked to responsibilities, and are therefore less likely to cut across other classification systems. However, new tools may be needed to identify the costs related to outputs, e.g. activity based costing, and this may require the aggregation of costs in a different manner.

(75) The appropriate classification approach is the "building block". Costs are broken down to operating units (building blocks) which are then aggregated, using "look-up tables" within a computer system, in different ways for different purposes. Under this approach there is no reason why the same basic classification structure cannot be used for any combination of programme and performance budgeting together with more conventional classifications. This is illustrated in Exhibit 9, below. Note that the term "operating units" could be replaced by the term "cost centres" used by accountants.

Exhibit 9: Building block approach to classification



Note: for simplicity of presentation it is assumed that the cost centres for each cost grouping are contiguous

2.9 Sources of finance

(76) The simplest approach to financing is to regard all finance as being part of a "pool" from which all expenditure is incurred. This simplistic approach is based on the concept of the fungibility of funds. Under this approach a government would treat all receipts as going into a "Consolidated Fund", from which all expenditure is incurred. Note that this is the approach generally followed by commercial entities.

(77) However, in practice this is rarely feasible to use such a simple "pool of funds" approach, for a number of reasons:

- There may be Funds other than the Consolidated Fund specified by law, e.g. a Development Fund
- Some donors may require that their funds are directed only to specific activities or expenditure, and it will be necessary to track them to verify their use.

(78) Therefore the classification system must be capable of relating sources of funding to specific expenditure items.

2.10 Money transactions compared to those in kind

(79) Some budget transactions do not result in cash flows. Examples would be technical assistance programmes funded by bilateral donors, or commodity aid. In order to incorporate such transactions within the budget, but not use them as part of the managerial control system, they must be separately identified at the budget stage. Three types of transactions need to be identified:

- Monetary transactions which pass through the accounting system.
- Loan transactions which do not pass through the government bank accounts, but do involve creating government liabilities and must be controlled.
- Grants and technical assistance which neither pass through the government bank accounts nor create liabilities. These should be recognised and incorporated in the accounting system as far as feasible, but not used for managerial control purposes.

2.11 Other flows, assets, and liabilities

(80) If a full accrual accounting system is to be adopted, there will be a number of flows, assets and liabilities which have not traditionally been recognised by governments. The following provide some examples, but not a comprehensive list.

(81) Under accrual accounting, tax revenues are recognised when assessments are raised, but it must also be recognised that a proportion of assessments will be legally reduced or cancelled, and others will never be collected because of default. Therefore a provision (i.e. a negative asset) needs to be established based on statistical forecasts of the proportion which will never be collected. This will have to be treated as both a reduction in the revenue flow, and also a reduction of the asset of taxation due.

(82) Many governments have a liability to pay pensions to government employees. Also most governments do not have investments from which to pay such pensions. Instead these unfunded pension liabilities will be paid out of future taxation. In such instances an actuarial valuation of the liability should be included within the balance sheet liabilities. When established this represents a reduction in the Consolidated Fund, or its equivalent.

(83) These and other flows and assets and liabilities will have to be included within the classification system.

3 Practical classification problems and issues

(84) This section serves to identify a number of the classification problems that have been observed in different countries, their implications, and practical solutions which can be obtained without a complete system re-design.

1. **Inconsistency of classification between years**

   Particularly where computer databases are not in use, it is possible to vary the codes given to projects and operating units from year to year, so as to fit in new projects or administrative arrangements. This makes it impossible to track expenditures over time for any given entity.

   The only solution is to establish a hierarchical structure, which allows for additions and changes without altering the whole coding system.

2. **Inconsistency of classification between different parts of the system**

   It is surprisingly common to find different classification systems, for example for development and recurrent budgets, or used for planning and budgeting, or even between budgeting and accounting.

   This is a failure to recognise financial management as an integrated system. The different parts of the system have to work together to develop a mutually satisfactory system.

3. **Overly complex classification systems**

   As systems have developed over time, classifications have been added, leading to a system which is excessively complex. For example, in one country every one of more than 60 pay allowances was separately coded and budgeted.

   There is always great reluctance for users to give up detailed analysis. A compromise may be to relegate detail to decentralised or subsidiary systems.

4. **Classification entirely based on the GFS functional classification approach**

   Where countries have sought to revise their classification system, the GFS has presented itself as a coherent analytic framework on which they have to report, and hence has been used as the basis of the classification system. However, this is a misuse of the GFS, and fails to recognise the other legitimate user needs.

5. **Failure to distinguish non-monetary flows in budget**

   Budgets will normally include certain non-monetary flows that do not pass through the accounting system, e.g. commodity aid, technical assistance projects. Unless these are separately identified, control reports based on the accounting system will not be comparing like with like.

6. **Poor budget presentation**

   Budgets are often poorly presented. Typical problems include excessive detail, failure to identify costs to any specific entities, failure to relate expenditures to revenues. These problems often reflect the structure of the classification system, and it may be impossible to adequately improve budget presentation without a corresponding re-design of the classification system.

7. Overly centralised classification systems

In many cases much more detail will be required at an operating unit level than is required at a central level. In so far as the accounting system is decentralised, only the level of detail essential should be held centrally. Subsidiary classifications and detail should be allowed on a decentralised basis, provided they are consistent with the central classification structure.

8. Programme budget classification added as another layer

Because programme budgeting has often been introduced as a separate exercise, the classification requirements for it have been added to existing systems. However, provided the operating units and projects are identified within the classification system, it should be possible to derive the programme budget from the existing structure.

9. Large miscellaneous items

It is common to find some miscellaneous classifications (which may be described using various titles) which are relatively large in value, and contain information which needs to be further analysed.

4 Generalised approach to classification

4.1 Factors which affect classification system design

(85) The above sections have set out issues relating to classification systems under both cash and accrual accounting. From this a generalised model can be developed, though it must be recognised that there will always be factors specific to any given country. These include:

- the extent to which the classification is prescribed by law, as may happen with countries for example which follow the French Plan Comptable;
- whether accrual or cash accounting is to be used as the basis;
- any specific requirements, for example the use of programme budgeting;
- the budget and administrative structures, rules as to delegation of financial responsibility, and other matters specific to any given country;
- the extent to which the system is centralised or de-centralised (if the latter much of the detail can be dealt with at the decentralised level); and
- restrictions imposed by technology, e.g. an accounting package.

(86) The following are suggested as important points that need to be taken into account when designing a classification system. The following sub-sections consider general issues and requirements.

- The need for a balance between simplicity and the analytic requirements.
- The extent to which detailed analysis can or should be decentralised.
- The perceived needs of users (both internal and external to government).
- Government legislation, regulations and organisational structures.
- Technology to be employed.

4.2 Balance between simplicity and analytic needs

(87) Simplicity reduces the cost of the system, and also the possibility of coding errors. As a result information can be more reliable and available more quickly. On the other hand, the analytic needs of users must be achieved.

(88) In order to achieve simplicity, maximum use can be made of look-up tables, as illustrated above. Also consideration needs to be given to using ranges within a set of numbers, e.g. to identify revenue and expenses, assets and liabilities. This can considerably shorten the length of any code.

4.3 Decentralisation

(89) To the extent that financial management and accounting systems are decentralised, decisions about classification can also be similarly decentralised. Under such decentralised systems, only the minimal framework needs be established as a centralised system. The detail can be left to subsidiary units. However, the legitimate need for central analytic capability must also be taken into account in deciding the extent to which classification can be decentralised.

(90) Thus, under a decentralised system, expenditure might be analysed to department level and then within departments only to the extent required for proper control and planning purposes. Detailed management of operating units would be left to the departments, though it may be appropriate to establish a coding structure that they should follow.

4.4 User needs for information

(91) Information is provided through the reports generated from the classification system. That information is produced to meet specific user needs, and those needs should be taken into account when designing the appropriate classification structure.

(92) Some user needs are well articulated and clear, e.g. those contained within the GFS, requirements for budgets presented to the legislature, financial statement requirements, and so on. It is good practice to formally identify such needs in the process of designing a classification system. On the other hand, important user needs may not even be recognised by the users themselves. In our experience the idea of using accounting information as a tool in departmental or project management will often be a new concept. Therefore users may not properly articulate many needs, especially relating to more innovative financial management approaches.

4.5 Legislation, regulation and organisation

(93) Any classification system must follow existing legislation, regulations and organisational structures. In general it is not open to the person carrying out the classification to change these factors. There are however exceptions.

(94) Designing a classification structure can often identify anomalies in organisations, e.g. overlapping responsibility. A classification redesign may present an opportunity to initiate appropriate organisational changes. Also there are often antiquated rules and procedures, which can be replaced as part of the introduction of a new classification.

4.6 Overall classification structure

(95) Within the above parameters, the broad framework of the classification structure should follow the major categories within the budget and financial statements. These are likely to include:

- revenues, including grants;
- expenditures, which should be divided between revenue and capital;
- financing flows;
- assets and liabilities ;

- capital flows (accrual basis only);
- flows not involving transactions (accrual basis only);
- net worth; and
- funds received, disbursed and held in trust.

(96) It is a useful exercise as the basis of the classification structure to re-design the format of the budgets and annual financial statements. In many countries these documents do not serve as effective communication tools. A re-design makes them more effective, and identifies the fundamental classification requirements.

4.7 A generalised model

(97) The following sections provide an illustrative example of a generalised approach, under both cash and accrual accounting.

5 Illustrative approach to classification - cash accounting

5.1 Standardisation of classification

(98) A move to integrating financial systems requires classification consistency. This has two implications.

- The initial system design must take account of all user needs, not just those within one section of government.
- There must be a prescribed system for amending classifications and adding new classifications.

(99) In designing the system it will need to be recognised that the needs of, for example, planners in evaluating project proposals will be different from those of other financial managers. However, there is no reason why a basic classification structure cannot be used in project proposals, even if it contains additional data, which can then be followed through to financial plans and budgets once the project is approved. This means that the accounting system can be used for financial monitoring of projects against approved proposals.

(100) Classifications will require amending, additions and deletions. This must be centrally controlled to ensure consistency is maintained, and a set of procedures and organisational arrangements must be put in place for this purpose. Also the system must be sufficiently flexible to allow for changes and additions over time.

5.2 Example of a cash classification system

(101) The following example is based on a classification system introduced within a LDC, but modified to make it more generic. It was designed to be simple because of the fact that much of the original data entry would be done manually, and because of inexperience of staff with using structured coding systems. The overall classification structure is shown below, and then explained in more detail in the subsequent sections.

(102) The country in question uses the cash accounting basis. There is a separate Recurrent and Development Budget, as is very common.

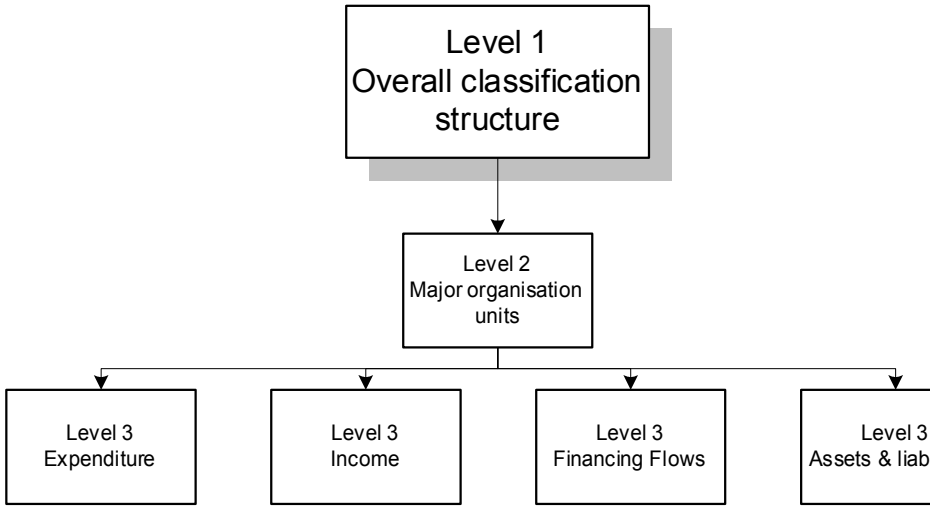
Exhibit 10: Illustrative classification structure - cash accounting

Code level	Expenditure (Recurrent & Development)		Income		Financing flows		Assets and liabilities	
	Description	**Digits**	**Description**	**Digits**	**Description**	**Digits**	**Description**	**Digits**
1	Budget Level	1	Budget level	1	Budget Level	1	Budget Level	1
2	Spending Organisation	2	Collecting organisation	2	Organisation	2	Organisation	2
3	Division or Project	3	Broad GFS classification	1	Major categories of flows	1	Type of asset or liability	2
4	Funding	1	Detail GFS classification	2	By financing instrument	2	Specific assets and liabilities	4
5	Detail of Expenditure	2	Country X forms of revenue	3	By sector	2	(reserved)	2
6	Geographic analysis (District)	2	(reserved)	2	(available for relating to specific financial assets and liabilities)	3		
	Total digits	11	Total digits	11		11		11

(103) The total code length is 11 digits. However, the full code would never need to be entered by an individual. In particular the Level 8 geographic code is only used after budget approval for fund release, and in the accounting system is pre-coded in returns from Districts.

(104) Under the approach used in this example, the classification structure is all inflows and outflows down to Level 2 (Organisation), but then diverg Expenditure, Income, Financing Flows and Assets & Liabilities. This is illustrate

Exhibit 11: Overview of structure – cash accounting



Level 1 – Overall classification level

Code	Description
1	Income
3	Expenditure - Recurrent Budget
4	Expenditure - Development Budget
7	Financing flows
9	Assets & liabilities (balances not flows)

(105) This initial single digit is used to identify to which of the main catego transaction relates. There are five categories, though it would be possible further at this level. Note that even though this is a cash accounting examp assets and liabilities. These would sometimes be referred to as "below-the-lir They would include bank balances, loan balances, advances, suspens unallocated stock. They are required for accounting purposes, and are not budget.

Level 2 - Ministry or organisation

Code	Description
14	National Assembly
17	Supreme Court
18	Attorney General
21	Department of Auditor General
22	Public Service Commission
31	INTERNAL DEBT
41	EXTERNAL DEBT - Institutions
42	EXTERNAL DEBT - Foreign Governments
50	Ministry of Finance
55	Ministry of Home Affairs
56	Ministry of Foreign Affairs
57	Ministry of General Administration
60	Ministry of Defence

(106) This level identifies the Ministry and sub-divisions thereof, and thus follows the administrative structure of government. This will be the basis of expenditure control. This breakdown should be in sufficient detail to enable a look-up table to be created linking this analysis to the GFS functional analysis. Therefore it may be necessary to go below the level of Ministries to Departments or Divisions, and in some countries two digits would be insufficient.

(107) Within the list there are a number of "quasi Ministries", e.g. National Assembly, Supreme Court. Most countries will have organisations of this type. Note also that debt has been classified as though it were an organisation. This is to simplify its identification.

(108) This is the lowest level to which a general classification applies. Below this the classification differs between:

- Expenditures
- Revenues
- Financing flows
- Assets and liabilities

These are dealt with separately in the sub-sections below.

5.3 Expenditure flows classification

Level 3 - Organisational units or projects

(109) Organisational units and projects are the level below Ministries/Divisions/ Departments identified at Level 2. They are individually identified using a three-digit code within each spending organisation. Therefore to identify an organisational unit or project both the Level 2 and Level 3 codes are required.

(110) Note that there is no specific code for programmes. Programmes will comprise a number of projects, and possibly non-project organisational units. A look-up table will be used to link the codes at this level and level 3 to specific programmes, without the need for a separate code for programmes as such.

(111) No examples are provided of organisational units and project codes because these will be specific to each country.

Level 4 - source of finance

Code	Description	Whether recorded in accounting system
1	Government payment	Yes
3	Direct payment by donor from external cash grant (includes technical assistance)	No
5	Direct payment by external commodity* grant	No
7	External loan received in cash by government	Yes
9	External loan - direct payment by lender for commodities*	Yes (but in many countries systems procedures are weak in this area)

* Commodity in this context includes such items as plant and equipment

(112) This information is important for two reasons. Firstly, it is important for governments to identify the utilisation of different sources of finance. Secondly, for reporting and managerial control reasons. All of these flows should be budgeted, but not all will be recorded in the accounting system. In order for meaningful comparisons of actual flows against budgets, items not passing through the accounting system must be identified. This issue has been discussed earlier in the text (Section 2.9).

Level 5 - detailed or economic codes

Code	Main description	Sub-description
RECURRENT		
10	Personnel	Salary
11		Allowances
12		Daily Allowance
13		Subsistence
14		Medical
20	Other goods & services	Travelling (Local)
21		Travelling (Foreign)
22		Utilities (Water & Electricity)
35		Miscellaneous
CAPITAL		
80	Land	Acquisition
81	Land	Development
82	Major constructions	Highways
85	Buildings	Purchase & Construction
86	Vehicles	Purchase
87	Plant Machinery & Equipment	Purchase
89	Public enterprises	Investment in shares
90	Public enterprises	Loans
91	Public enterprises	Grants and subsidies
92	Public enterprises	Other transfers
93	Investments (other than in public enterprises)	Shares
94	Investments (other than in public enterprises)	Loans
95	Grants (other than to public enterprises)	Capital

(113) The above are only examples of the codes that would be included. Economic codes identify the type of expenditure. The classifications should be consistent with the GFS economic classifications. It is desirable to avoid excessively detailed economic codes.

(114) Non standard detail tables will be compiled for each Head of Expenditure where standard detail is inappropriate. Each table is specific to a particular organisation. They use the range 40 to 79 in the above coding structure.

Level 8 – Geographic analysis

(115) Country X is divided into Districts as administrative units. These are the basis for fund release. After the budget is passed by Parliament, spending authority is allocated to the Districts by the spending Ministries. Two digits are sufficient to identify all Districts, since there are less than 100.

5.4 Income flows

(116) Income flows share expenditure codes for Levels 1 and 2. Level 2 defines the collecting organisation. Below that level income flows have a unique classification structure, as illustrated below.

(117) In the case of income flows there is a more limited range of control objectives. From a control perspective it is important to link collections to collecting responsibilities, which is achieved through the level 2 organisational analysis. Beyond that the needs of macro economic analysis and analysis for managerial purposes are largely coincident, and therefore the GFS provides an appropriate analytic framework. This is reflected in the structure below.

Level 3 – GFS overall analysis of income flows

Code	Description
1	Tax – revenue
2	Tax - capital
3	Social contributions – revenue
4	Social contributions – capital
5	Non-tax – revenue
6	Non-tax – capital
7	Grants – revenue
8	Grants - capital

(118) This is a single digit analysis of income flows which accords exactly with the GFS structure

Level 4 – GFS detailed analysis of income flows

(119) A further two digits are used to analyse income flows in accordance with the detailed GFS structure. This is not repeated as it follows the GFS tables.

Level 5 – income flows specific to country

(120) At level 5 the GFS analysis is sub-divided into the specific tax, non-tax, social contributions and grants as provided by the legislation specific to Country X. Three digits are sufficient to provide this analysis, though a further two digits are available if required.

5.5 Financing flows

(121) It is convenient to bring all financing flows together within a single classification grouping. Financing flows refers to transactions which change the stock of financial assets and liabilities, whether internal or external. This group embraces principal sums lent and repaid, but not interest charges - these are dealt with through either expenditures or income as appropriate. The loan asset and liability balances are dealt with under assets and liabilities, below.

(122) In some countries the detailed accounting records of domestic debt, liquid financial assets, and some other financial assets and liabilities will be maintained by the central bank. These may not be linked to the government accounting system and, rather, form a separate accounting sub-system[11]. There should be a section within the Ministry of Finance which also maintains this information at a more aggregated level, but with sufficient information for inclusion within the financial management system. However recorded, these assets and liabilities do form part of the government balance sheet, and the related flows must form part of both budget and accounting systems.

(123) From an accounting perspective it is essential that either the government or the central bank identifies every separate loan, so that a record is maintained of sums borrowed or lent, and repaid. In a conventional double entry accounting system this would be achieved by establishing an account for each loan, and recording within that account all principal sums as transactions, e.g. a repayment of a loan to a government would be debit bank, credit loan account. Flows would not be recorded as such, but would be extracted from the loan accounts.

(124) Because of the need to report financing flows, and also the fact that the accounting records may be kept in part at the central bank, the required analysis of financing flows needs to be established and systemised. How the information is obtained then becomes a matter for the budget and accounting systems.

(125) As with income items, so with financing flows the major control requirement is satisfied by the analysis of financing flows to Ministry/Department/Division. Further analysis is required for debt management and macro economic analysis. Debt management is likely to be achieved by a separate sub-system, and the budget and accounting systems must be able to interface and exchange data with such a debt management sub-system.

(126) The GFS provides a suitable analytic framework for analysing financing flows, which may be expanded as required by a specific country. The approach to classifying financing transactions has changed somewhat under the new GFS. It is assumed that all borrowing by a Government is for policy purposes, but acquisition and disposal of financial assets may be for policy or liquidity management purposes.

(127) A government acquires and disposes of financial assets for liquidity management purposes within a financial year to deal with revenue and expenditure flows that show different time patterns, or in the longer term, for example, to acquire sinking funds assets to meet pension liabilities. The basis is a matter of intent, though the GFS identifies factors which may be evidence of intent.

[11] In entity terms the central bank is managing these accounts as agent of the government, but the relationship is often not clearly defined.

(128) Finally, the GFS requires only net flows, but for managerial purposes gross flows need to be distinguished. Therefore the initial analysis identifies the major groups of inflows and outflows.

Level 3 - broad classification of financing transactions

Code	Description
1	Acquisition of financial assets for policy purposes
2	Disposal of financial assets for policy purposes
3	Acquisition of financial assets for liquidity management purposes
4	Disposal of financial assets for liquidity management purposes
6	Increase in financial liabilities
7	Decrease in financial liabilities

Level 4 - classification of financing flows by type of instrument

(129) Two digits provide the analysis on the basis suggested by the GFS. Further detail can be included if required for the government concerned. The analysis is set out in the GFS Manual, and is not repeated herein.

Level 5 - classification of financing by sector

(130) A further two digits are provided for this type of classification, also required for GFS and macro economic purposes. Again the detail is in the GFS manual.

Level 6: classification of flows in relation to specific financial assets and liabilities

(131) Though not applied in Country X, it would be feasible to provide further analysis relating flows to specific loans. This could be used to replace the above categories of analysis, by replacing them with look-up tables. However, for most countries this would not be feasible because of the extent to which asset and liability records are maintained by the central bank.

5.6 Assets and liabilities

(132) Under a cash accounting system, there are only a limited range of assets and liabilities. However, these will be sufficient to enable the development of a balance sheet. Asset and liability accounts do not feature in the budget, but are required within the accounting system. Their inclusion, and the development of a balance sheet, confirms arithmetic accuracy of the double entry system.

(133) Assets and liabilities have already been identified at Level 2 to the main organisational units. As no cost is imputed to such assets, it is not necessary under a cash accounting system to identify them to lower level organisational units. Therefore they will be categorised into broad groups at level 3 using two digits.

Level 3: classification of assets and liabilities

Code	Main description	Sub-description
FINANCIAL ASSETS		
10	Loans	To state enterprises
11		To other levels of government
12		To other domestic institutions
13		Foreign loans
20	Investments in equity	To state enterprises
21		To other domestic entities
22		To foreign entities
25	Other financial assets	Domestic
26		Foreign
BANK ACCOUNTS AND BALANCES		
30	Bank accounts	Central bank
31		Other state owned banks
32		Other domestic banks
33		Foreign banks
ADVANCES, DEPOSITS, AND SUSPENSE ACCOUNTS		
40	Advances	To other levels of government
41		To public enterprises
42		Other advances
50	Deposits	From other levels of government
51		From public enterprises
52		Other deposits
60	Suspense accounts	Investment in shares
UNALLOCATED STOCK		
70	Unallocated stock	

(134) These classifications may be varied as appropriate.

Level 4 - assets and liabilities identified

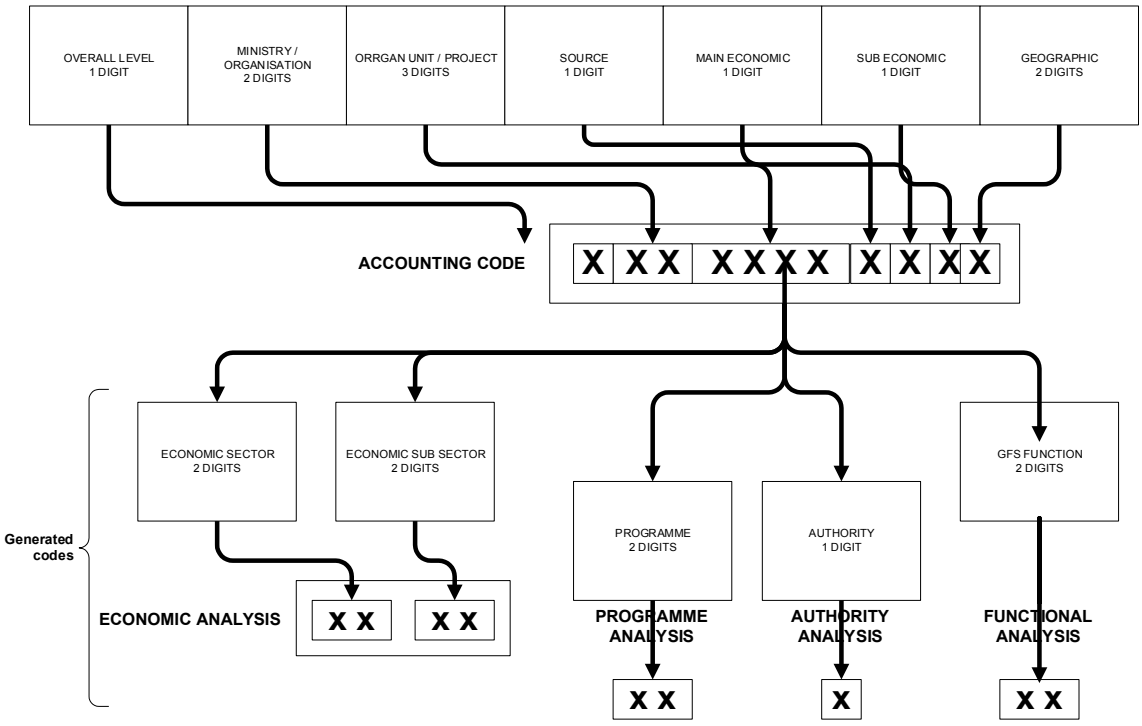
(135) Assets and liabilities will be classified so they can be identified individually within the accounting system. The number of digits required will vary from country to country.

5.7 Deriving analytic models

(136) From this relatively simple classification structure it is possible to meet all of the requirements for analysis that have been indicated within the text above. The diagram below in Exhibit 12 indicates how this can be achieved using a series of look-up tables. Codes are automatically generated by the system to provide a range of analysis from the basic accounting code.

(137) This approach is taken from a specific country, and would need to be varied for other countries. However, it does indicate how one classification structure can be used to meet the range of analytic needs.

Exhibit 12: Deriving analytic models - expenditure cash model



6 Modification of illustration for accrual accounting

6.1 Impact on example of an accrual approach

(138) The above example was based on a cash accounting system. This section considers the impact on the classification structure of moving to an accrual accounting approach.

(139) Classification takes place within the analytic framework of an accounting model. There are a variety of bases used in the accounting model, and in one respect there is a clear dichotomy, which is represented by the two polar systems of cash based or accrual accounting. There are intermediate positions, but it is simplest to view the two alternatives in terms of this simple dichotomy. This paper is not concerned with the choice between these accounting bases, but rather the impact of the alternatives on the classification requirements.

(140) Traditionally government accounting has been cash-based (though in practice almost all government accounting systems contain some elements of accrual accounting[12]). This approach partly stems from the dominance of the budget in government financial management (see above), which only records economic flows. Most government budget and accounting systems continue to be cash based. The 1986 GFS was also based on cash accounting, but the 1993 SNA and the new GFS currently in draft are based on an accrual approach.

(141) There is now quite extensive theoretical support for the use of accrual accounting by governments. New Zealand has moved totally to accrual accounting, and other countries are in the process of changing. The UK for example is moving to "resource" budgeting and accounting, which is a form of accrual accounting. The following sections review the impact of the accrual analytic framework on classification, and the specific additional classification requirements imposed by an accrual model[13].

(142) In many countries the constitutional definitions of the requirement for a budget to authorise expenditures and taxes, and definitions of the Consolidated Fund imply a cash based approach. It may be necessary to change legislation, or even the constitution, but this is a matter on which legal advice will have to be taken for each country situation.

6.2 Accrual analytic framework

(143) The distinction between flows and balances is very explicit in the accrual accounting model. Flows represent inflows or outflows of assets and liabilities over a period, whereas balances are the value placed on assets or liabilities at a point in time. Under the accrual model, flows represent the change in balances over time.

Exhibit 13: Link between flows and balances

Net assets at time t_{n+1} - Net assets at time t_n = Flows over period 1

[12] Government accounting system often contain "below the line" accounts, which are actually asset and liability accounts, to handle transactions which would not be recognised under a pure cash based system, e.g. advances.

[13] This section does not contain a full explanation of the differences between accrual and cash based accounting.

(144) This contrasts with the cash model, which only measures financial flows, assets and liabilities. The accrual model also clearly differentiates revenue flows, reflected in the "Operating Statement", from capital flows, which are recorded as schedules identifying such changes.

(145) This fundamental relationship leads to the accrual analytic framework used for commercial entities of balance sheets and operating statements (the latter representing flows over a period). This is the model used by New Zealand in producing its government financial statements. It provides classification requirements of:

- assets and liabilities;
- economic revenue and expenditure flows; and
- transactions other than economic flows.

(146) The balance sheet is a statement at a point of time, whereas the operating statement relates to flows over a period of time. Therefore the title of the two statements needs to identify, respectively, the point of time or period of time to which they apply. Movements in assets not reflected in the operating statements, particularly capital transactions, e.g. acquisition of fixed assets, lending and borrowing, would be detailed in separate schedules attached to the above statements. A cash flow statement links these together and provides useful supplementary information. Such a statement is mandatory for commercial entities under International Accounting Standards.

(147) The impact of the move to accrual accounting on classification is relatively limited, and the changes may be summarised as follows:

- a much more comprehensive listing of assets and liabilities;
- certain income and expenditure flows become capital flows; and
- an additional range of flows not involving transactions.

(148) These are summarised in the table below, and then the changes are explained in the following sections. Note that only the changes are explained, since most of the classification structure remains unchanged.

Exhibit 14: Illustrative accrual accounting classification structure

Code level	Expenditure (Recurrent & Development)		Income		Financing flows		Assets and liabilities		Capital flows		Flows not involving transactions	
	Description	Digits	Description	Digits	Description	Digits	Description	Digits	Description	Digits	Description	Digits
1	Budget Level	1	Budget level	1	Budget Level	1	Budget Level	1	Budget Level	1	Budget Level	1
2	Spending Organisation	2	Collecting organisation	2	Organisation	2	Organisation	2	Organisation	2	Organisation	2
3	Division or Project	3	Broad GFS classification	1	Major categories of flows	1	Division or Project	3	Division or Project	3	Division or Project	3
4	Funding	1	Detail GFS classification	2	By financing instrument	2	Categories of assets and liabilities	3	Categories of related assets or liabilities	3	Division into major categories	2
5	Detail of Expenditure	2	Country X forms of revenue	3	By sector	2	(reserved)	2	(reserved)	2	(reserved)	3
6	Geographic analysis (District)	2	(reserved)	2	(reserved)	3						
	Total digits	11	Total digits	11		11		11		11		11

(149) The total code length remains 11 digits. The same classification structure remains unchanged down to level 2 for the additional flows.

6.3 Overall classification level

(150) The overall classification level will have to be expanded to cope with th of flows to be recorded, as follows.

Code	Description
1	Income
3	Expenditure - Recurrent Budget
4	Expenditure - Development Budget
6	Financing flows
7	Assets & liabilities (balances not flows)
8	Capital flows
9	Flows not involving transactions

6.4 Changes to expenditure and income flows

(151) There are no changes to the expenditure and income classifications certain transactions are no longer classified under these heads. The mo examples are:

- acquisition cost of fixed assets;
- acquisition costs of inventory; and
- proceeds from disposal of fixed assets.

(152) On the other hand, there are some additional classifications of exp revenue items. Again the most important are:

- depreciation charges;
- gain or loss on disposal of fixed assets;
- charge for items consumed from inventory; and
- cost of changes in pension fund liabilities.

(153) The expenditure classification analysis at Level 5 will have to be modifi these additional items. Note that depreciation will need to be charged to organi and projects with the clear implication that assets and liabilities must be ide level.

6.5 Changes to assets and liabilities

(154) There will be a significant expansion in the range of assets and liabilitie now include:

- fixed assets, divided into major groups, and shown at cost or valuation accumulated depreciation;

- land and rights related to land, e.g. mineral deposits;
- intangible fixed assets;
- inventory;
- accounts receivable;
- accounts payable; and
- other liabilities e.g. pension liabilities.

Level 3 - assets and liabilities

(155) As indicated above, assets and liabilities need to be related to organisational units and projects. Therefore the Level 3 classification will follow exactly the same structure as that used at Level 3 for expenditure items.

Level 4 - classification of assets and liabilities

Code	Main description	Sub-description
FIXED ASSETS		
101	Land and mineral rights	Land
102		Mineral rights
103		Other rights relating to land
110	Infrastructure assets	(classified as appropriate)
120	Intangible assets	(classified as appropriate)
130	Buildings, plant, machinery and equipment	Buildings
131		Plant
132		(and so on, classified as appropriate)
FINANCIAL ASSETS		
150	Loans	To state enterprises
151		To other levels of government
152		To other domestic institutions
153		Foreign loans
160	Investments in equity	To state enterprises
161		To other domestic entities
162		To foreign entities
163	Other financial assets	Domestic
164		Foreign
CURRENT ASSETS		
200	Inventories	
210	Accounts receivable	
220	Other current assets	(classified as appropriate)
BANK ACCOUNTS AND BALANCES		
250	Bank accounts	Central bank
251		Other state owned banks
252		Other domestic banks
253		Foreign banks
ADVANCES, DEPOSITS, AND SUSPENSE ACCOUNTS		
300	Advances	To other levels of government
301		To public enterprises
302		Other advances
310	Deposits	From other levels of government
311		From public enterprises
312		Other deposits
320	Suspense accounts	(classified as appropriate)
CURRENT LIABILITIES		
500	Accounts payable	To other levels of government
501		To public enterprises
502		To external agencies
503	Short term loans and other financial liabilities s	(classified as appropriate)
LONG TERM LIABILITIES		
600	Loans and credits	(classified as for financing flows above)
CONSOLIDATED AND OTHER FUNDS		
900	Funds	Consolidated
901		Development
902		(other funds specific to a country)

(156) Since accrual accounting has historically originated in commercial accounting, the classification of assets and liabilities has tended to mimic that of company accounts. The GFS provides an alternative analytic approach (see Section 2.4, above). The classification structure of assets and liabilities should enable the presentation in either of these formats.

(157) Note that the digits have been expanded to three to handle the extra detail. This would almost certainly be so in practice as some of the categories are expanded to provide additional information relevant to a specific country.

(158) Although assets will be analysed to organisational unit and project level, it will be apparent that some of the above categories only exist at a central level. This should not present any problem provided an organisational unit code is established for central government assets and liabilities.

6.6 Capital flows

(159) Capital flows refer to expenditures on fixed assets, or receipts from their disposal. An accounting system does not classify or record capital flows as such. Instead, they are derived from movements in the asset accounts. However, as with financing flows, so it is convenient in a government system to actually track capital flows through specific classifications. Hence there will be established classifications to track capital flows relating to fixed assets.

Level 3 - capital flows

(160) Capital flows will be matched to the organisational unit or project to which they relate. The same structure as for assets and liabilities (and hence expenditure) should be used.

Level 4 - capital flows

(161) The classification structure for capital flows should exactly match the classification of the fixed assets to which they relate. These are set out above under assets and liabilities, and so are not repeated.

6.7 Flows not involving transactions

(162) Within an accrual system, changes in values of assets and liabilities will occur without any actual transactions. These movements, or flows, need to be identified. Examples would include:

- physical loss or depletion of an asset, e.g. destruction in war or through a natural disaster;
- revaluation of an asset or liability, e.g. because of general price level changes; and
- recognition of an asset or liability not previously recognised, e.g. pension fund liability, bad debts.

Level 3 - flows not involving transactions

(163) Again these need to be related to the organisational unit or project, using the expenditure classification at Level 3. Below this, there will be a very limited analysis at level 4 depending on the actual flows within any particular country.

Level 4 - flows not involving transactions

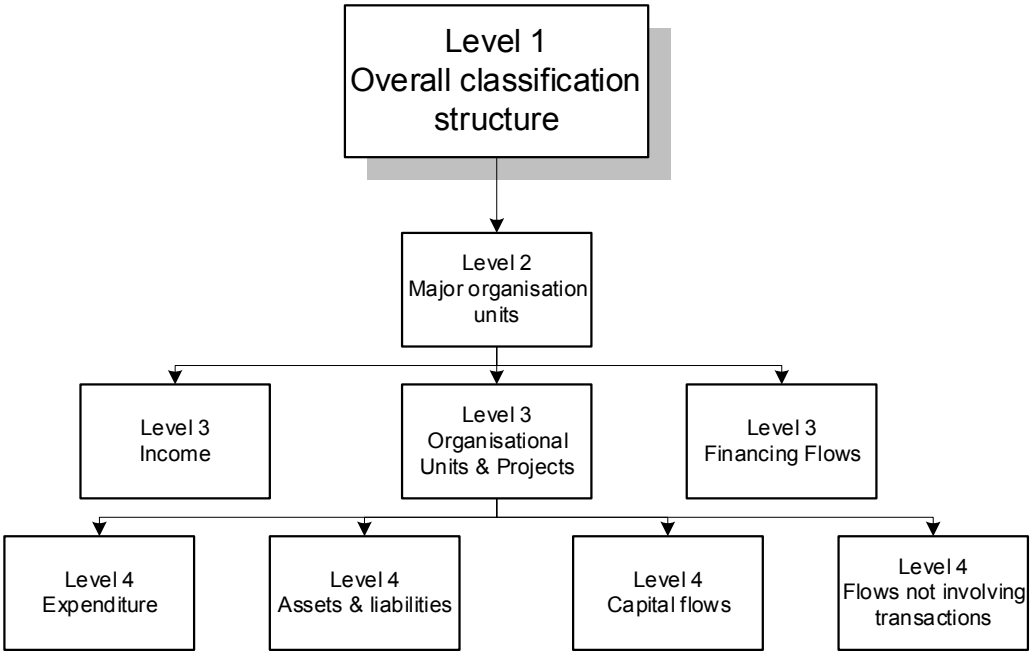
Code	Description
10	Revaluations resulting from general changes in price levels
20	Revaluations from other causes
30	Revaluation resulting from physical diminution of asset/increase of liability
40	Revaluation resulting from physical increase of asset/decrease of liability
50	Changes in provisions for the collectability of accounts receivable
60	Accounts receivable written off
70	Changes in provisions for pension liabilities
80	Other flows not resulting from transactions

(164) These should be regarded as examples of the categories. These would almost certainly have to be further sub-divided, hence the use of two digits.

6.8 Overview of accrual accounting classification structure

(165) The diagram below can be compared to the cash accounting analysis, above in Exhibit 11.

Exhibit 15: Diagram of accrual accounting classification



6.9 Conclusions on illustration as basis for generalised model

(166) As indicated above, any classification system will have to be specific to a country. However, many of the requirements are common to all countries. These illustrations have provided examples of how the general principles can be applied to a specific country situation.

(167) It is suggested that these provide a generalised model that can be adapted as necessary.

7 Conclusions and summary

(168) As indicated in Section 1.2 above, the approach would be to show that a single classification system can meet the varying needs of users, different levels of information, and technical analytic systems. The above illustrations indicate how this can be achieved under either an accrual or cash accounting system.

(169) These are merely illustrations - they are not intended to be prescriptive. The organisation of the levels, and analysis within them, must vary between countries. Nevertheless, the basic analytic requirements are likely to remain substantially similar.

(170) Key to this approach is the use of "look-up" tables to derive alternative analyses. How these are applied will depend on the software applications being used. Whereas they could be built into a database system, if an accounting package is used they might require a specially designed report, or the transferring of data to some other system for the analysis. These are essentially technical details.

(171) It is particularly important to recognise that under this approach a system can be designed for legal, managerial and accounting purposes, which can still provide the information required for the GFS/SNA macro analysis, and for programme budget purposes.

(172) It is our view that the primary purposes of a classification are to:

- enable macro fiscal management;
- to facilitate expenditure prioritization;
- to provide a legal framework for expenditures, borrowing and revenue collection;
- to improve technical efficiency of both revenue raising and expenditures, particularly by focusing on managerial responsibility; and
- to provide a framework for accountability and transparency.

(173) The illustrations above indicate that this can be achieved within a single, relatively simple, classification system.