PEMPAL

Treasury Community of Practice

Thematic Group on Consolidation

Guidance Note on Consolidation Guidelines

DRAFT

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Abbreviations

CoA	Chart of Accounts
COFOG	Classification of the Functions of Government
COTS	Commercial Off the Shelf [software application]
CSO	Civil Society Organisation
FMC	Financial Management and Control
FMIS	Financial Management Information System
GBE	Government Business Enterprise
GFS	Government Finance Statistics
GGS	General Government Sector
HR	Human Resource
HRM	Human Resource Management
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ICT	Information and Communications Technology
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
INTOSAI	International Organisation of Supreme Audit Institutions
IPSAS	International Public Sector Accounting Standards
IPSASB	International Public Sector Accounting Standards Board
IT	Information Technology
MDG	Millennium Development Goals
MoF	Ministry of Finance of the Republic of Tajikistan
MTEF	Medium-Term Expenditure Framework
PEFA	Public Expenditure and Financial Accountability
PIFC	Public Internal Financial Control
PFM	Public Financial Management
SAI	Supreme Audit Institution
SNA	System of National Accounts (UN)
SOE	State Owned Enterprise
TSA	Treasury Single Account
UCOA	Unified Chart of Accounts
WB	World Bank

1 WHOM IS THE GUIDANCE NOTE MEANT FOR (TARGET AUDIENCE)

The target audience is:

- Citizens of a country
- Civil society organisations that represent citizens
- Legislatures and elected representatives
- Officials and other involved in the preparation of financial reports
- External organisations with a legitimate interest, e.g. other governments and governmental organisations, multilateral organisations, lenders and borrowers

2 GOALS OF THE GUIDANCE

The purpose of this Guidance Note is to assist in the preparation and publication of consolidated financial information about Governments and groups of public sector entities.

Financial accountability has traditionally been very important for implementation of fiscal policy on the central government level, as well as regional and municipal administration levels[1]. Subsequent assessment of effectiveness of fiscal policy and decision making becomes impossible without analysis of financial accountability, which represents the system of economic indicators, allowing for performance assessment, as well as evaluation of financial assets of subjects of accountability and transactions, leading to modification of their volume and value.

The above referred indicators provide complete picture on the value of the resources (facilities, desks, chairs, vehicles, financial resources and etc) and liabilities (arrears in any form) of the public sector, as well as transactions, implemented during the reporting period (tax collection, procurement and sales of desks, debt repayment, allocation of financial resources to deposit accounts and etc), as a result of which the indicators have been reached.

In our everyday life when we talk about financial accountability of state-funded units, we almost always fail to take into consideration one important aspect, namely whether the reporting is consolidated or summary reporting. This aspect is of crucial importance and greatly impacts the results of analysis of financial reporting by the user of either one or another system.

It should be noted, that within the framework of the public sector finances the abovementioned factor can have substantial impact, as the concentration of financial resources and their further reallocation between the group of state-funded entities is of large scale character. As an example of this we cane mention the centralization of taxes and further allocation of grants from tax proceeds to the regional level is a classical model, operational in a whole range of countries.

Many would say that this issue is a banal one, as summary financial reporting represents a sum of indicators of financial reporting of group of state-funded units, while consolidated reporting represented aggregate of indicators of financial reporting of group of state-funded units, as if these were one unit.

Of course the above mentioned is true and there is no need to repeat these well known truths, especially in front of the persons, the sphere of activity of which is in this or that manner related to formation and use of public sector financial reporting.

International Public Sector Accounting Standards (IPSAS), Government Finance Statistics (GFS) and the “European System of National and regional Accounts” (ESA) as issued by Eurostat, and other guiding documents provide in depth explanations on concepts and definitions, fundamental approaches and principles, used in the process of formation of consolidated financial indicators.

[1] Here and afterwards referred to as the public sector

At the same time it should be mentioned, that once we equip ourselves with deep academic knowledge and start applying this knowledge in practice in conditions of the public sector, we quite often come across challenges of practical character and distressfully try to find answers to such no less conceptual issues, as:

Following which criteria and which units should be included in the consolidated public sector financial reporting?

- What should be consolidated between the relevant units?
- On what level the consolidated procedures should be implemented? Who is implementing consolidation procedures?
- What serves as data base for consolidation?
- How to ensure required quality of consolidation procedures?

This is not the exhaustive listing of questions of practical character, to which those, who are in charge of preparation of consolidated financial reports dedicate their time and financial resources in the course of finding answers.

Within the public sector interactions and linkages are quite complicated and multifaceted even without taking into consideration the fact, that the concept of the public sector is not clearly defined or unambiguous, and it takes a lot of efforts to formalize linkages and formulate consolidated financial reporting.

Purpose of given guidelines is to summarize theoretical experience on elaboration of consolidated financial reporting and to provide practical recommendations on methodological, organizational, and technical aspects related to formation of consolidated reporting in the public sector.

Taking into consideration the declared aim of the guidelines, special attention should be paid to one important aspect: given guidelines is not an attempt of replacing or competing with universally recognized methodological basis, but are just practical guidelines on application of methodology in real institutional settings.

2.1 The need for consolidated information

- Budgetary
- Financial reporting
- Transparency and accountability
- Audit

3 THE MAIN NOTIONS AND DEFINITIONS

Prior to going into the substance of the issue it is necessary to define relevant concept. The definitions provided below are based on IPSAS definitions and IMF Guidelines of GFS. Part of the above mentioned definitions have been modified for ensuring their better understanding in the context of considered issues.

We would like to start from provision of definitions on the key concepts, which we are planning to use in our guidelines.

THE DEFINITIONS IN THIS LIST NEED TO BE CONFIRMED AGAINST COMPARED TO THE PEMPAL GLOSSARY AND OTHER STANDARD DEFINITIONS

Public sector	Unity of public administration and state corporation sectors
Public administration sector	Unity of state and municipal bodies, as well as public and municipal organizations set up by them and other legal entities, activities of which is related to implementation of state or municipal governance functions
State corporations sector	***Unity*** of legal entities, activities of which have the character of market activities and funding and control of which is implemented by the state-run public or municipal authorities
Institutional unit	Economic structure, which is authorized to own assets, undertake commitments and implement economic activities and enter into transactions with other entities on its own behalf. Institutional unit is fully accountable, prepares the full set of reports, including asset and liability balance sheet.
Revenues	Transactions, which lead to increase of net value of assets
Expenditures	Transactions, which lead to reduction of net value of assets
Assets	Resources, controlled as a result of previous events, as a result of which is expected receiving of deferred revenue or benefits
Liabilities	Current debt, resulting from previous events, offset of which shall lead to reduction of resources, containing economic gains or losing of possibility of their use for deriving benefits
Net operating balance	***Revenue*** net of expenditures
Net value of assets	***Difference*** between the value of assets and liabilities

Financial accountability	The system of economic indicators, that allow to asses financial performance, the volume of assets and liabilities of the entity, subject to reporting, as well as transactions, leading to their modification
Consolidated financial accountability	***Financial*** reporting by groups of entities, subject to reporting, which is drawn in such manner, as if the group of entities were one subject of reporting
Financial accountability policy	***Specific*** methods, basis, assumptions, rules and means, used for preparation and submission of financial reports

4 METHODOLOGICAL BASIS FOR CONSOLIDATION

Methodology and practice of consolidation of financial reporting in the public sector is not new. To these issues are dedicated separate chapters of internationally recognized guidelines and standards, as well as different publications.

Within the framework of given guidelines we shall consider following main sources (standards):

- Government Finance Statistics of 2001 (GFS 2001)[2];
- International Public Sector Accounting Standards (IPSAS)[3];
- European Statistical Agency (ESA)…………

4.1 IMF Government Finance Statistics (GFS) Manual

Government Finance Statistics (GFS) is a specialized system of macroeconomic statistics, designated for description of that part of national economy, which is related to activities of the public sector and its administration and is used for assessment of economic activities of public bodies and their impact on the economy of the country.

GFS system is used for formulation of statistical data, which allows to comprehensively and regularly examine dynamics of financial transactions and liquidity of the public sector of the country.

The current edition of GFS was issued in 2001, with various amendments over time. There is a new version of GFS which exists in draft and is planned for formal issue in 2014.

GFS is prepared for public sector administration and public sector.

Key principles of GFS are:

- Accountability is implemented on accrual basis;
- The principle of double entries;
- All flows and inventory is assessed at a market value;
- All transactions, related to transferring of economic benefits from one state-funded unit to another, or deferred benefits are accounted for and the cash value of transactions can be established.

For accounting of flows and inventory, reflected in GFS, are used different methods of classification.

Within the framework of GFS the data on public sector administration and public sector is represented in consolidated manner.

[2] http://www.imf.org/external/data.htm#guide

[3] http://www.ifac.org/public-sector

4.2 International Public sector Accounting Standards (IPSAS)

IPSAS are internationally recognized standards of financial accountability, recommended for use by public sector organizations, except for commercial organizations, where the state has business interest.

- IPSAS allows the public sector organizations to implement the following:
- Provide clear picture of results of financial activities of the government;
- Adoption of informed and effective decisions;
- Provision of more efficient public sector services;
- Provide to citizens access to more volume of information on financial consequences of decisions, reached by the government, as well as financial performance and its results.
- Attain comparable standards in all directions through use of unified system of accrual basis method financial accounting.

Currently IPSAS include about 30 standards, part of which defines requirements related to submission of consolidated financial reporting (IPSAS 6, "consolidated financial statements").

4.3 European System of Accounts (ESA)

(To be written)

5 THE CONCEPT OF CONSOLIDATION

According to definition of GFS, ***consolidation*** is a method of submission of statistical data on group of institutional units in such manner, as if they were one subject of accountability.

- What does it mean? How to represent several state entities as one?
- For the start let's consider a simple example.
- The father received salary in the amount of 10 000 monetary units and gave to his son as pocket money 1 000 monetary units.

If you ask them to report on their income, each of them shall do the summary report and the amount of income shall be 11 000 monetary units. Now, let's prepare a report on them as a household. What was the income of the household? Exactly the amount, not included 10 000 monetary units shall be the consolidated amount of revenue.

On the micro level all the above referred is quite clear, but what happens when from the everyday life example we shift to a more complicated level? Nothing different happens.

Let's consider another example. One of municipal schools granted as a gift to another municipal school computer, the value of which is 1000 monetary units. Both schools belong to consolidated group of entities. Let's prepare separately a summary financial report and consolidated financial report on given transaction in revenue and expenditure parts.

Illustration 1: School № 1

1. Revenue	
2. Expenditure	1000 monetary units
Net operating balance (1 – 2)	-1000 monetary units

Illustration 2:School № 2

1. revenue	1000 monetary units
2. expenditure	
Net operating balance (1 – 2)	1000 monetary units

Illustration 3:Summary financial report on schools (School № 1 + School № 2)

1. revenue	0 + 1000 = 1000 monetary units
2. expenditure	1000 + 0 = 1000 monetary units
Net operating balance (1 – 2)	0 monetary units

In each school occurred interrelated symmetrical economic changes: in one case expenditures and in other case revenues.

What happens when accountability of both schools are consolidated? The consolidated income of schools is 1000 monetary units and net operational balance is 0.

How can we characterize revenues and financial activities of schools of municipal district on the basis of consolidated report? The revenue amounted to 1000 monetary units. A layman may say that in the process of implementation of economic activities the schools of the district had revenue in the amount of 1000 monetary units. In reality, knowing the characters of indicated revenue, how much did the schools earn? Nothing. How did we come to such conclusion? Through reduction of the consolidated revenues of schools by the amount of revenue, received by one school from another.

What happens in the expenditure part? The situation is absolutely similar.

Let's refer to the process of the above mentioned reduction of revenues and expenditures as consolidation, and as a result we shall get a consolidated report, which shows substantial difference of the results in comparison with the summary report.

Illustration 4: Consolidated report on schools (School № 1 + School № 2 – mutual settlement of accounts)

Revenue	1000 – 1000 = **0** monetary units
Expenditure	1000 – 1000 = **0** monetary units
Net operating balance	**0** monetary units

It should be mentioned, that we need to pay attention to one important specificity. Net operating balance of summary report, as well as consolidated report is identical. Taking into consideration the above mentioned we come to conclusion, that <u>as a result of consolidation procedure the value of aggregates remains unchanged.</u>

What happened to the computer itself? Should we "consolidate" computer too? The answer is obvious – we should not. As a result of transfer of computer from the balance of one school to the balance of another school the computer itself did not "multiply" and both in the summary, as well as consolidated balance of schools it shall be accounted for only once.

The following question arises – are there the subjects, which should be consolidated within the framework of balance sheets? The answer of course is positive. The nature of the above mentioned consolidation is practically of the same character, as consolidation of flows, which implies exclusion of all turnover between entities and in the balance sheet mutual claims of entities should be excluded too.

Let's provide one more example: municipal educational institution №1 extended credit to municipal educational institution №2. Without going into the details of consolidation operation let's create a balance sheet, summary balance and consolidated balance of each municipal educational institution.

Illustration 5: Balance of municipal educational institution № 1

Indicator	As of the beginning of the period	As of the end of the period
1. cash assets	1000 monetary units	0 monetary units
2. issued credits	0 monetary units	1000 monetary units
3. received credits	0 monetary units	0 monetary units
4. net value of assets (1 + 2 – 3)	1000 monetary units	1000 monetary units

Illustration 6: Balance of municipal educational institution № 2

1. Indicator	As of the beginning of the period	As of the end of the period
2. cash assets	0 monetary units	1000 monetary units
3. received credits	0 monetary units	1000 monetary units
4. net value of assets (1 + 2 – 3)	0 monetary units	0 monetary units

Illustration 7: Summary balance of municipal educational institutions

Indicator	As of the beginning of the period	As of the end of the period
1. cash assets	0 + 1000 = 1000 monetary units	0 + 1000 = 1000 monetary units
2. issued credits	0 + 0 = 0 monetary units	1000 + 0 = 1000 monetary units
3. received credits	0 + 0 = 0 monetary units	0 + 1000 = 1000 monetary units
4. net value of assets (1 + 2 – 3)	1000 monetary units	1000 monetary units

The analysis of indicators of summary balance allows us to conclude, that municipal educational institutions have cash assets in the amount of 1000 monetary units, and claims in regard to issued credit in the amount of 1000 monetary units, as well as liabilities s in regard to received credit in the amount of 1000 monetary units. What happens in reality? Municipal educational institutions, stated in our example do not have anything, but 1000 monetary units of cash assets. How did we come to such conclusion? The volume of claims and liabilities has been annulled as they are subject to mutual settlement.

Let's create consolidated balance using the proposed approach.

Illustration 8: Consolidated balance of municipal educational institutions

Indicator	As of the beginning of the period	As of the end of the period
1. cash assets	1000 monetary units	1000 monetary units
2. issued credits	0 monetary units	1000 - 1000 = 0 monetary units
3. received credits	0 monetary units	1000 monetary units – 1000 = 0 monetary units
4. net value of assets (1 + 2 – 3)	1000 monetary units	1000 monetary units

Again we would like to draw your attention to the aggregates, i.e. net value of assets - summary value is identical to consolidated value.

As an addition to previously stated, we would like to note, that consolidation implies exclusion of all transactions, as well as all mutual claims (accounts payable and accounts receivable) between the state-funded units belonging to the same group.

Thus, consolidation of financial indicators of a group of subjects envisages mutual exclusion of internal transactions and claims within the group of subjects. The most important property in given case is “internal transactions”, as consolidation can be conducted only in case of “mirror” (symmetrical) flows (for example, such as credits and lending).

6 COVERAGE OF CONSOLIDATION UNITS

6.1 Consolidation entity

Having considered key conceptual issues related to consolidation, a question arises: "Is that all? i.e. all you have to do is exclude transactions between the entities, in composition of the same consolidated group?" yes, that's right, but prior to starting such exclusion, it should be very clearly understood which subjects can be assigned to the same consolidated group.

By providing and everyday life example we can quite easily determine the composition of the entities, transactions of which should be consolidated. What shall be happening on the macro level? Or a country, region or city level?

One of the most conceptual and complicated issues related to formation of consolidated financial reporting is the issue of coverage of relevant state entities within the scope of consolidated financial reporting.

At a glance it seems, that the titles of standards, namely International Public Sector Accounting Standards (IPSAS), Government Finance Statistics (GFS) seems to be indicating to the scope of coverage, namely the public finance and public sector. What does this mean in different countries? Where does the private sector start or end? This and many other issues are quite complicated for finding simple answers to them.

Taking into consideration the above mentioned, we shall try to approach the issue of determination of the scope of coverage by referring to the above mentioned guiding documents.

6.1.1 GFSM 2001 (Government Finance Statistical Manual).

GFSM 2001 defines the scope of coverage of state entities through definition of the public sector and public sector administration.

Public sector administration – a unity of public bodies, implementing the function of public administration as the key type of their activities (GFSM 2001, par. 2.9).

For the purpose of analysis the public administration sector can be divided into subsectors of central government (including social services funds), regional and local bodies of governance.

Units of public administration bodies (state-funded entities) – are institutional units, implementing the functions of public administration bodies as the key type of their activities. This means, that they possess legislative, judiciary and executive authority in regard to other institutional units, located within the limits of certain territory; they are charged with responsibility of provision to the public at large, as well as specific households with services and goods on non-market basis; they implement transfer payments for allocation of proceeds and assets; they fund their own activities (in direct or indirect manner) largely at the expense of tax proceeds and other mandatory transfers from units of other sectors GFSM 2001, par. 2.20).

Apart from public administration bodies there are also units, set up by public administration bodies, which are in their subordination. Thus, for the purpose of ensuring of air freight the government may act as a co-founder or as co-owner of an air carrier company, which in its turn shall have a different status, than a public administration body, namely the status of a corporate legal entity.

The above mentioned legal entities are classified in GFSM 2001 as corporations.

Corporations - legal entities, set up for the purpose of production of goods or services for the purpose of their sales on the market. Corporations can serve as a source of income or other financial benefit for all the co-owners. Corporations are in collective ownership of all shareholders, which have the right to appoint directors, responsible for overall management of the corporation. Institutional units, belonging to the public administration bodies or are under their control, which are classified as corporations in the above referred meaning, are called state-owned corporations (organizations) (GFSM 2001, par. 2.14).

All corporations belong either to the category of state non-financial corporations, or the state-owned financial corporations, depending from the type of their key activities.

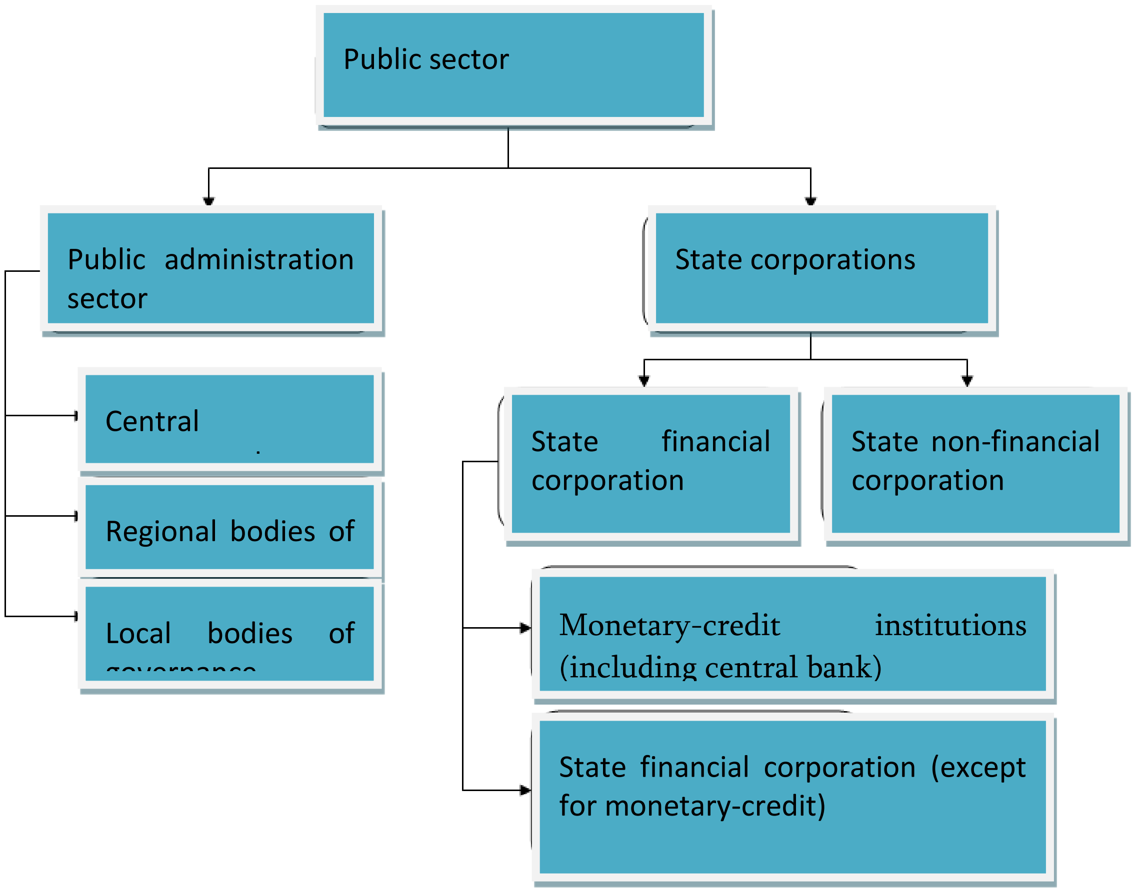
Apart from the above mentioned, the state may act as the founder or owner of legal entities, having different status than corporations, but implementing similar activities as corporations.

Quasicorporations - these are structures, which are not corporations and are not set up in any other organizational form provided by the law, function like corporation in the sense of the definition, provided above. Within the system of GFS quasicorporations are considered as institutional units, different from those, to which they are subordinated in accordance with the law. Depending on the type of their activities they are considered as either within the composition of the state non-financial corporations, or state financial corporations (GFSM 2001. Par. 2.16).

The notion of the public sector is interpreted in GFSM 2001 in relation to the public sector administration. Namely, ***public sector is*** a unity of public administration sector, state financial and state non-financial corporations.

As an illustration of the scope of coverage of state units as interpreted by GFSM 2001 may serve a well known scheme of public sector and public administration sector.

Figure 1: Public sector and public administration sector (GFSM 2001)



It should be noted, that while considering given approach arises a question – what are the comprehensive criteria, allowing to conduct testing of specific units for the purpose of establishing of its belonging to specific sector/group.

Let's start from determination of belonging of a unit to public sector as such. Analysis of provisions of GFSM 2001 allows us to conclude, that to the public sector belong following entities:

- Public administration bodies;
- Corporations and organizations belonging (subordinated to) public administration bodies;
- Corporations and organizations controlled by public administration bodies;

As we have already stated above, to the public administration bodies belong institutional units, implementing public administration functions as their key responsibility. For example, the Ministry of Finance, the Ministry of Industry or municipal administrations are public sector units, as each of them implements the function of public administration.

The second criteria is relevant for corporate institutional units and quasicorporations and this criteria is the property ownership right. In GFSM 2001 as criteria for determination of property ownership rights is indicated as the share of state ownership, namely if the ownership of the state in an enterprise exceeds 50%, such institutional unit is a state unit. For example, if the share of state ownership in a company, on extraction of mineral resources exceeds 50%, the company shall be considered as a state corporation.

The third criterion is less formalized, which is control.

According to GFSM 2001 control is defined as the authority to determine overall corporate policy of an entity. The notion of "overall corporate policy" is used in its broad meaning and implies key measures of financial and operational policy, related to strategic goals of a corporation. The authority to define overall corporation policy does not necessarily imply direct control over day-to-day activities of a corporation. It is assumed, that, that as a rule the leading management of such corporations are in charge of management of the corporation in such manner, which shall be in compliance with key goals of specific corporation.

Below we are listing 8 most important indicators, as provided by GFSM 2001:

1. ownership of majority of shares;
2. control over board of directors on another managerial body;
3. control over appointing/dismissal from positions of key personnel;
4. control over key committees of an entity;
5. golden shares or options;
6. regulation and control;
7. control by a dominant client (all sales to one client from the public sector, or group of client from the public sector;
8. Control preconditioned by borrowing from the public administration bodies.

For example, if the government possesses less than 50% of share in a corporation, extracting mineral resources, but at the same time the Prime Minister has the right to appoint to their positions all members of the board of directors, such corporation by its nature belongs rather belongs to the state owned corporations, than private corporations.

If it is more or less clear how to define belonging to private or public sector (it is clear, to which subsector of public administration does the Ministry of Foreign Affairs belong), it is rather complicated to decide whether some institutional unit belongs to subsector of corporations or public administration sector.

Let's have a look at an example. The state owns air carrier company «Government Air». Does it belong to a public sector? Yes. Is it a unit of public administration sector or it is a state non-financial corporation? To find an answer to this question additional examination needs to be conducted.

Within the framework of GFSM 2001 key criteria of assigning a unit to public administration sector or financial or non-financial corporation sector is the following:

6.2 IPSAS

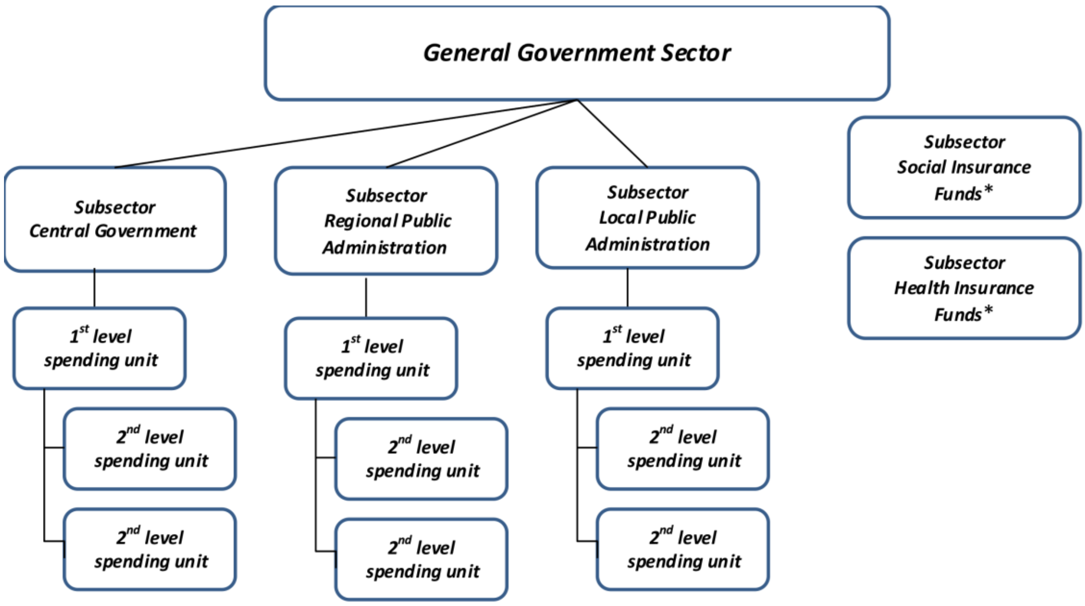
Let's apply to IPSAS 6- "Consolidated financial statement". What does the public administration sector includes according to given standard?

7 STRUCTURE OF CONSOLIDATION

Consolidation encompasses all spending units in the general government sector.

Consolidation follows "tree" structure at each hierarchic level of spending units in the general government sector.

Figure 2: Consolidation Structure

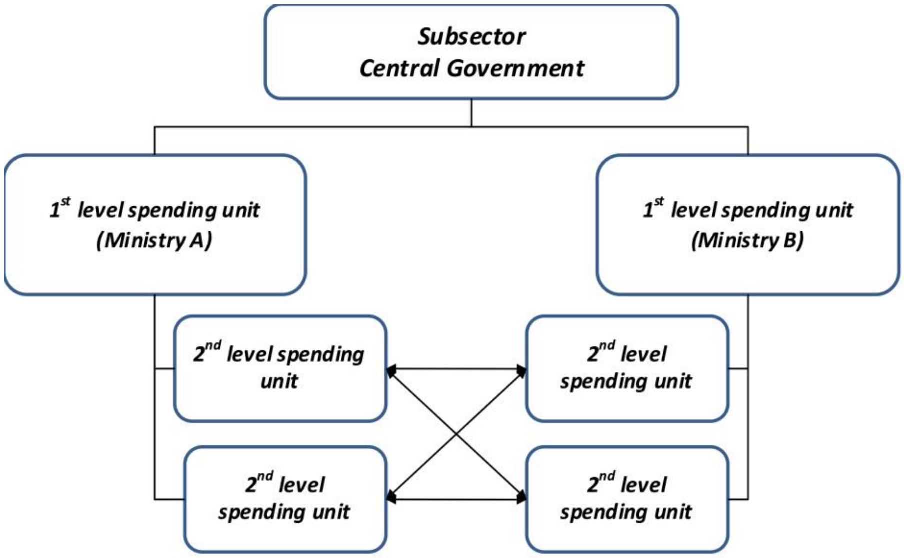


**Social insurance and health insurance funds* can be included in subsectors at different levels or grouped in a separate subsector within the general government sector

5.3. There are 2 types of consolidation: intra- and intersectorial.

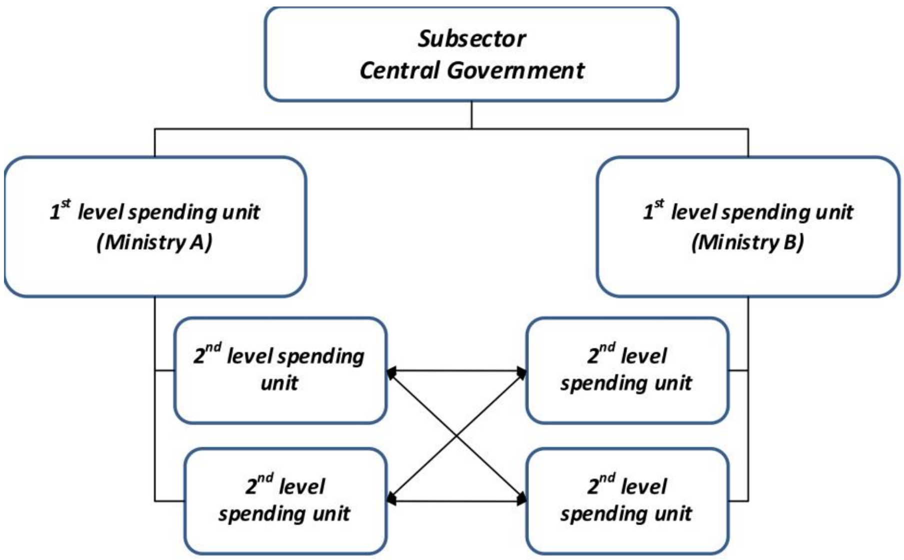
5.3.1. Intrasectorial consolidation covers different spending units of the same level from a certain subsector, e.g.: ministries within the national budget.

Figure 3: Intrasectorial Consolidation



5.3.2. Intersectorial consolidation covers different sectors, e.g.: national and local budgets.

Figure 4: Intersectorial Consolidation



5.4. Each 2nd level spending unit (beneficiary) provides financial reports to a higher 1st level spending unit, i.e. to central sectorial public authorities, regional and local public authorities (ministry, department, financial division), which then generalize the reports and submit them to the relevant government entity (Ministry of Finance) for further generalization and consolidation of the respective operations at each and general level.

5.5. Thus, intrasectorial consolidation comes first, then followed by intersectorial consolidation.

8 FLOWS AND STOCKS SUBJECT TO CONSOLIDATION

Types of flows and stocks to be consolidated

Technical issues

i. Consistent accounting policies
ii. Consistent year end

9 EXCEPTIONS FROM CONSOLIDATION REQUIREMENTS

9.1 Investment entities (sovereign investment funds)

9.2 Temporarily owned entities

9.3 Partial, divided or joint ownership or control of entities

9.4 Valuation of entities not consolidated

10 THE METHODOLOGY OF CONSOLIDATION

11 PUBLICATION OF CONSOLIDATED INFORMATION

11.1 Requirements and need for publication of consolidated information

11.2 Consolidated budget information

11.3 Consolidated financial reports

i. Whole of government
ii. Sub-entities

12 PRACTICAL ISSUES

12.1 Differences and special circumstances

13 REFERENCES AND PUBLICATIONS