Draft

Practical Issues related to Consolidation of Financial Reporting in the Public Sector

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For whom are these Guidelines Designated

Goal of the Guidelines

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 European Statistical System (ESS) and other guiding documents provide indepth explanations on concepts and definitions, fundamental approaches and principles, used in the process of formation of consolidated financial indicators.

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.

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

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.

Key Concepts 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.

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.

Controlling entity is an entity that has one or more controlled entities.

Controlled entity is an entity (including those that does not have status of a legal entity, for example, and investment partnership), that is under control of another entity that is referred to as a controlling one.

Minority interest is part of proficit or deficit and net assets/equity of a controlled entity that falls to the share in net assets/ equity, which the controlling entity does not own directly or indirectly through controlled entities.

Methodological Basis for Consolidation in the Public Sector

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)…………

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.

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.

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”).

[2] http://www.imf.org/external/data.htm#guide
[3] http://www.ifac.org/public-sector

ESA……………………………………………………………………………………… ………………………………………………………………………..

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.

School № 1

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

School № 2

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

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.

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.

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

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

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	0 + 1000 = 1000 monetary

	units	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.

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 <u>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.</u>

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).

Scope of Coverage of Consolidation Units

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.

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.

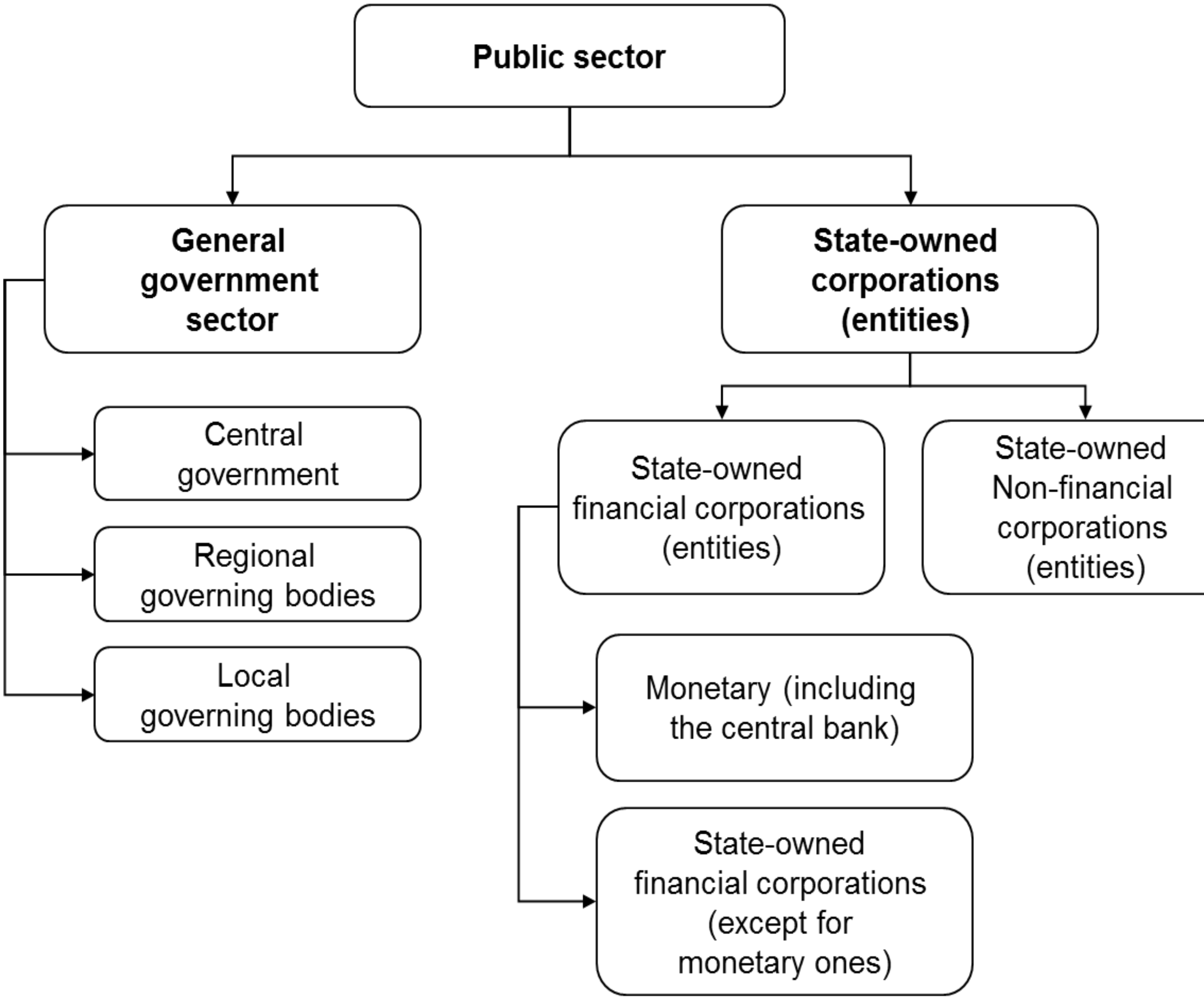

Diagram 1. Public sector and public administration sector (GFSM 2001)

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.

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Let us give an example. The Government owns an airline company "Government Air". Does it belong to the public sector? Yes. Is it a unit of the general government sector or of a public non-financial corporation? The question is open, since it requires additional investigation. And what is the subject of the said investigation?

Let us consider in more details activities of the airline company "Government Air", which could, in a general case, be of market or non-market nature.

This company could be established by the Government for the purpose of providing transportation of exclusively members of the Government. Financing of its activities is carried out by means of granting subsidies for carrying out activities and making capital payments for acquisition of aircrafts.

On the other hand, a company could be established by the Government to provide transportation at preferential prices of certain categories of citizens (pensioners, disabled persons, schoolchildren). The difference between the cost of transportation of passengers and charge levied from them is covered by the Government by means of granting a relevant subsidy.

And, finally, the company could be established by the Government for the purpose of developing the air transportation market, where at present, foreign airline companies prevail, and it could act as a market-based service provider, after receiving from the Government only certain statutory capital in the form of aircrafts, an office building and, possibly, some part of current assets.

Of course, there could also be combined goals and mechanisms of establishing a government owned airline company that include all above mentioned elements are not excluded either.

Please, pay attention – the Government can own the entity both for the purpose of implementing a certain policy, and for the purpose of generating profit, and it is exactly the <u>correlation between the state policy goals and the goals of obtaining profit that is the basic criterion used in the GSF Manual 2001 to attribute entities to the general government sector or to state-owned corporations.</u>

In the reference materials to the GSF Manual 2001 (Coverage and Sectorization of the Public Sector, IMF, Paul Cotterell (IMF expert), Ethan Wiseman, Tobias Wickens, December 2006 – hereinafter referred to as the reference material to the GSF Manual) mechanisms for determining the general government sector and the state-owned corporations sector are described in details, and we will use these definitions (section B Identification of the general government sector and the public sector. The decision tree for general government entities and for other public entities”).

The starting point when dividing the economy into sectors, is determination of residency of structures that operate in the economy. With respect to each formation that is a resident, the following steps have to be taken.

To determine whether this formation is an institutional unit, in other words, whether it could own assets on its own behalf, take obligations and carry out economic activities and conclude transactions with other entities? If not, then the formation should be classified together with the entity that controls it.

To determine whether an institutional unit belongs to the private or public sector. For this purpose, it is necessary to determine whether it is a general government sector entity or an entity that is controlled by government bodies, or a state-owned corporation. If it belongs to one of these categories, then it is a state-owned entity and is part of the public sector. If not, then it belongs to the private sector.

For each entity of the public sector to determine whether it is market-based or non-market-based producer, in other words, whether it sells all its products or most of its products at economically relevant prices?

If it is a ***market-based producer***, it has to be classified as a state-owned corporation

If it is a ***non-market-based producer***, it is necessary to determine, whether this entity carries out any activity as a non-incorporated structure which has to be viewed as a quasi-corporation.

If yes, then this quasi-corporation should be classified as a state-owned corporation.

If not, then this entity is an entity of the general government sector and should be attributed to the general government sector.

For each state-owned corporation (and state-owned quasi-corporation) to determine, whether it provides financial services.

If yes, then it is a state-owned financial corporation.

If not, then it is a state-owned non-financial corporation.

To facilitate understanding of the named criteria, it is better to use the decision tree or its table presentation.

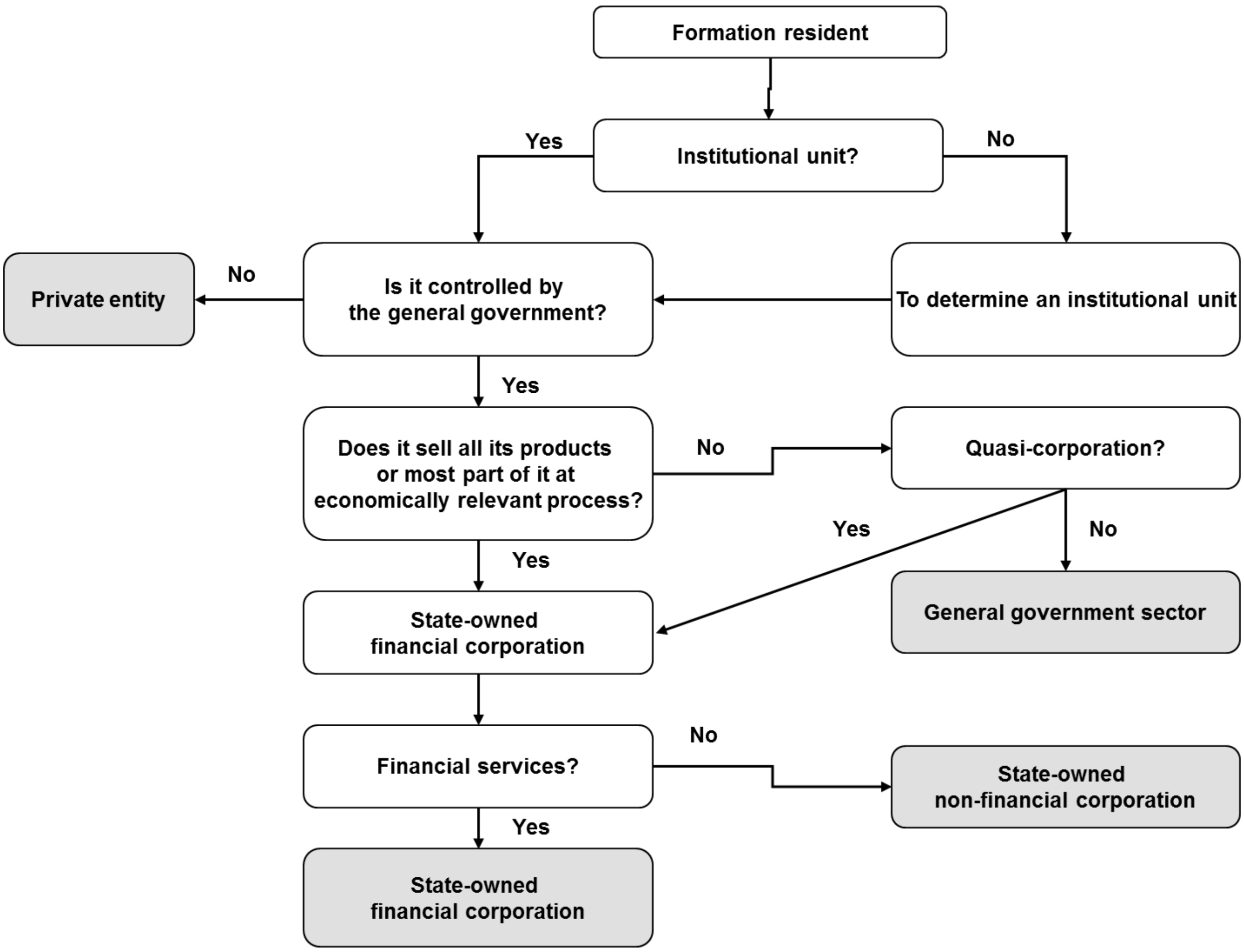

Figure 2. Decision tree.

Criteria				
Whether the entity is controlled by the general government?	Whether this enterprise represents an institutional unit?	Whether this enterprise sells goods and services only to the general government or to the population as whole?	Whether this enterprise sells goods and services at market (economically relevant) prices?	Belonging to the sector
A range of values				

Yes/No	**Yes/No**	**To the general government = 1 To the population as a whole = 2**	**Yes/No**	**Yes/Yes/2/Yes =** a state-owned corporation **All other =** general government bodies

Figure 3. The decision-making table.

IPSAS.

Similarly as in the GSF Manual 2001, in IPSAS, a number of criteria is used for determining the scope of coverage of consolidated financial statements, the essence and mechanisms for applying them are presented in IPSAS 6 "Consolidated and Separate Financial Statements".

In accordance with the named standard, the main criterion for determining the scope of coverage of entities that are included in the circuit of the consolidation procedures is the criterion of control.

Subjects of relations in the course of determining control are the controlling and controlled organizations (para 7, IPSAS 6).

A controlling entity is an entity that has one or more controlled entities.

A controlled entity is an entity (including an unincorporated entity such as an investment partnership) which is under the control of another entity known as a controlling entity.

The controlling entity and controlled entities determine group of entities (para 12-14, IPSAS 6), which in its turn could be a controlled entity for some other controlling entity.

In the framework of IPSAS 6, a question whether an entity controls another entity for financial reporting purposes is viewed as a matter of professional judgment based on the definition of control and specific circumstances in each individual case (para 28, IPSAS 6).

The main elements of the definition of control are:

Legal powers mean a right to determine the financial and operational policy of the entity;

Right for getting benefits which are represented by an ability of the controlling entity to obtain benefits from activities of another entity.

IPSAS 6 offers the following set of criteria for making decisions related to availability (lack) of control between entities (para 38-40 IPSAS 6).

Power conditions:

The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity;

The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the board of directors or equivalent governing body, and control of the other entity is by that board or by that body;

The entity has the power to cast, or regulate the casting of a majority of votes that are likely to be cast at a general meeting of the other entity;

The entity has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body, and control of the other entity is by that board or by that body.

Benefit conditions:

The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations. For example, the benefit condition may be met if an entity had responsibility for the residual liabilities or another entity;

The entity has the power to extract distributions of assets from the other entity, and /or may be liable for certain obligations of the other entity.

Power indicators:

The entity has the ability to veto operating and capital budgets of the other entity.

The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.

The entity has the ability to approve the hiring, reassignment, and removal of key personnel of the other entity.

The mandate of the other entity is established and limited by legislation.

The entity holds a golden share (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.

Benefit indicators:

The entity holds direct or indirect title to the net assets/equity of the other entity, with an ongoing right to access these.

The entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation, or in a distribution other than a liquidation.

The entity is able to direct the other entity to cooperate with it in achieving its objectives.

The entity is exposed to the residual liabilities of the other entity.

Generalization of the above-mentioned requirements and their formalization allow to generate the following algorithm of making decisions related to control powers in accordance with provisions the standard – IPSAS “Consoldidated and Separate Financial Statements”.

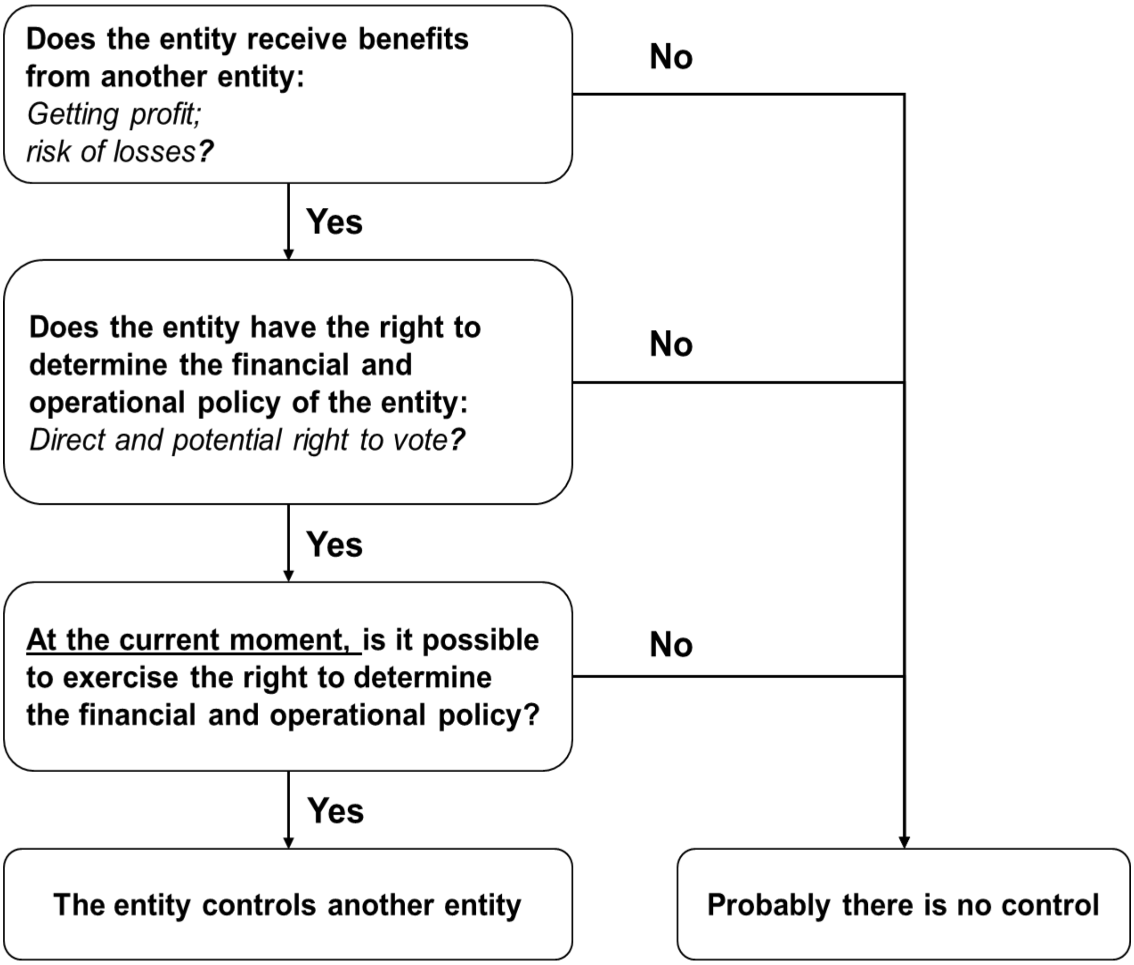

Figure 4. Determining control for the purpose of preparing financial statements (IPSAS 6).

Let us consider as an example the already familiar airline company "Government Air". What controlling functions does the Government perform with respect to it?

Being an owner of the named company, the Government has all powers related to managing operating and financial activities of the company, it bears risk of losses and has the right to get profit, it appoints management of the company, covers losses of the company by means of granting subsidies from the budget, etc.

The Government is a controlling entity, and the airline company is a controlled entity, therefore, their amalgamation creates a group of entities.

ESA.

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Practical questions related to determining the scope of coverage.

Approaches used in generally accepted standards examined above definitely are clear, consistent and coherent.

The main criterion for determining the scope of coverage in the named standards is control, i.e. ability of one entity (controlling entity) to have influence on financial and operating activities of other entities (controlled entities).

The core (root) for building a structure and determining hierarchy of public sector entities for the purpose of preparing financial statements is the Government and bodies of state administration – it is their ability to exercise control over other entities that represents the essence of uniting into one group (public sector, state sector, general government sector, etc.) different legal entities as those that carry out their activities under control of the Government or a public body.

In the framework of the GSF Manual 2001, the outline of consolidation procedures in the public sector is determined through the state sector and the general government sector.

General government sector entities include all bodies of state administration and non-market-based producers controlled by the state.

Totality of general government sector entities and market-based producers controlled by the state comprises the state sector.

In IPSAS the scope of coverage of entities for the purpose of preparation of consolidated financial statements is determined also through criteria of presence of control. At the same time, IPSAS does not determine division of the whole totality of entities into specific sectors – the whole totality of entities controlled by the Government or a public body forms the public sector.

Having armed with the named provisions, let us try to examine a practical question of their implementation – determination of the scope of coverage of entities for the purpose of preparation of consolidated financial statements in the public sector of a specific Government and/or public administration body.

What should we start with? Of course, we should start with defining the notion of a "public sector", "state sector"[4].

And why should we define it? Everything has been formulated and disclosed in the standards that have been examined earlier. Of course, it is true, but if we speak about a specific Government, we need a clear and formal definition that to a certain extent discloses the composition of entities that are included in that very sector at the national level.

Let us examine one example that rather well illustrates the need of formalizing criteria and definitions – an airline company "Government Air". We have already discussed the issue of attributing the named airline company to the public sector and the general government sector.

[4] In the framework of these definitions, the "public sector" and "state sector" are synonyms (see "Main Concepts and Definitions").

And how can one determine that the named company or similar air companies in general belong to the public sector? What formal criteria should be used?

Using criteria offered by the GSF Manual 2001 and/or IPSAS 6, we can give the following definition: the public sector includes air companies whose activities are controlled by the Government.

And what does control mean in this context? Stocks, ownership rights, the right to make decisions about appointment of management, and so on – what in particular? How can a decision "tree" be integrated into the said definition? This is the main task in the course of formalizing the definition of the notion "public (state) sector", which in the general case should provide for integration of the national practice of classifying legal entities, ownership rights and control mechanisms with recommendations of generally accepted standards.

Formalization of the definition of "public (state) sector" at the legislative level is important, *inter alia,* from the point of view of ensuring common approaches to formation by national bodies of consolidated financial statements, government finance statistics, national accounts, monetary statistics.

Let us give an example. At the national level four types of legal entities are identified: public bodies, companies, corporations, non-commercial entities. In the framework of performing state functions, the Government includes ministries, which among other things own shares of corporations or which are owners of certain companies. Participation of the state in non-for-profit organizations is prohibited. At the national level the following definition of a public sector is given: *the public sector includes the Government, governmental ministries, companies owned by the government or by governmental ministries, and also corporations with prevailing share of the Government or governmental ministries.*

As it could be seen from the example, having generalized criteria recommended by standards, the Government applied them to entities of its economy taking into consideration the national legislation.

Based on this model example, and for the purpose of defining the public sector and/or its sub-sectors, it is reasonable to fix at the national level the definition (definitions) that take into consideration specifics of the structure of both general government and possible connections (limitations related to the named connections) between the general government entities and corporate entities.

Not least important aspect in formalization of the definition is use of such criteria that are unambiguously identified at many tested entities. What does that mean? That means that all criteria that you use in the course of formalizing notions should be practically definable and straightforward. In the example given above, the Government permitted uncertainty having specified the criterion of controlled status through "*……predominant economic interest …….*".

In accordance with IPSAS 6, for the purpose of preparation of consolidated financial statements, a group of entities is formed from the controlling entity and controlled entities. Criteria of existence of control are known and we have considered them earlier. Let us repeat one of them:

The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity;

From the "academic" point of view the named criteria are impeccable, but from the practical point of view they are non-applicable – in their activities general government entities should be governed by clear rules and instructions – "*the entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity"* – what exactly is the share of votes? Does more than 42 per cent of votes represent majority? There is no coherence in this question and relevant specification is needed.

Therefore, we can give one more recommendation concerning formalization of the definition of the public (state) sector and its sub-sectors – criteria of attributing entities applied in the course of formalization of notions of the public (state) sector and its sub-sectors have to be practically determinable.

The second group of questions arising after the notion of a public sector is defined is a group of questions related to analytical division of the public sector into sub-sectors.

As it has been noted above, the GSF Manual 2001 treats the public sector as a totality of the general government sector and state-owned market-based corporations.

In its turn, for analytical purposes, the general government sector is divided into central, regional and local governing bodies, and state-owned market-based corporations – into financial and non-financial (see Figure 1).

IPSAS 6 does not set rules or analytical profiles for the sector in question – consolidated financial statements are prepared by groups of entities.

The named approaches possibly meet general needs, but often they do not satisfy particular needs of authors or consumers of consolidated information.

Let us use typical division into sub-sectors proposed in the GSF Manual 2001 (see Figure 1).

How informative is presentation of the whole totality of state-owned corporations in the form of two groups – financial and non-financial? Does such division cover all information needs? Are consolidated indicators of activities of corporations belonging to regional and local governing bodies comparable for the purpose of analysis? How can indicators be identified in the total volume of information, in particular those related to corporate entities controlled by central governing bodies?

Answer to the said questions allows making a conclusion about the need of additional, analytical division of certain sectors (sub-sectors) into sub-sectors.

Taking into consideration the fact that public bodies are classified by levels of public governance, in some cases it seems reasonable to divide multiple state-owned corporations also into sub-sectors depending on the level of public governance they belong to.

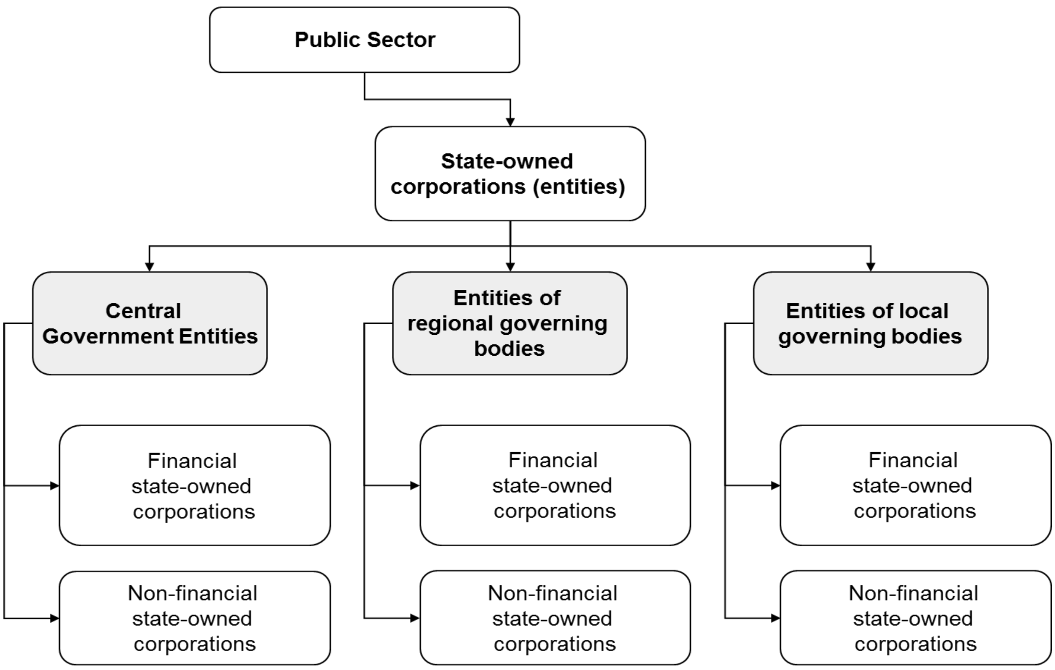

Figure 5. Alternative division into sub-sectors of the state corporation sector.

Now let use examine the general government sector. For the purpose of implementing the state policy, state governing bodies can control both entities that are directly covered by the budget (for example, schools) and entities that receive from the budget financing in a certain form (for example, the company "Government Air" if it is meant only for transportation of members of the Government).

For analytical purposes, it is often necessary to understand not only general, but also individual structure of revenues and expenditures, availability of mutual flows and settlements between budgetary and non-budgetary entities of governing bodies.

Consequently, in the structure of the central government, regional and local governing bodies, maybe for better analysis, it is necessary to distinguish both budgetary and off-budgetary entities within each sub-sector.

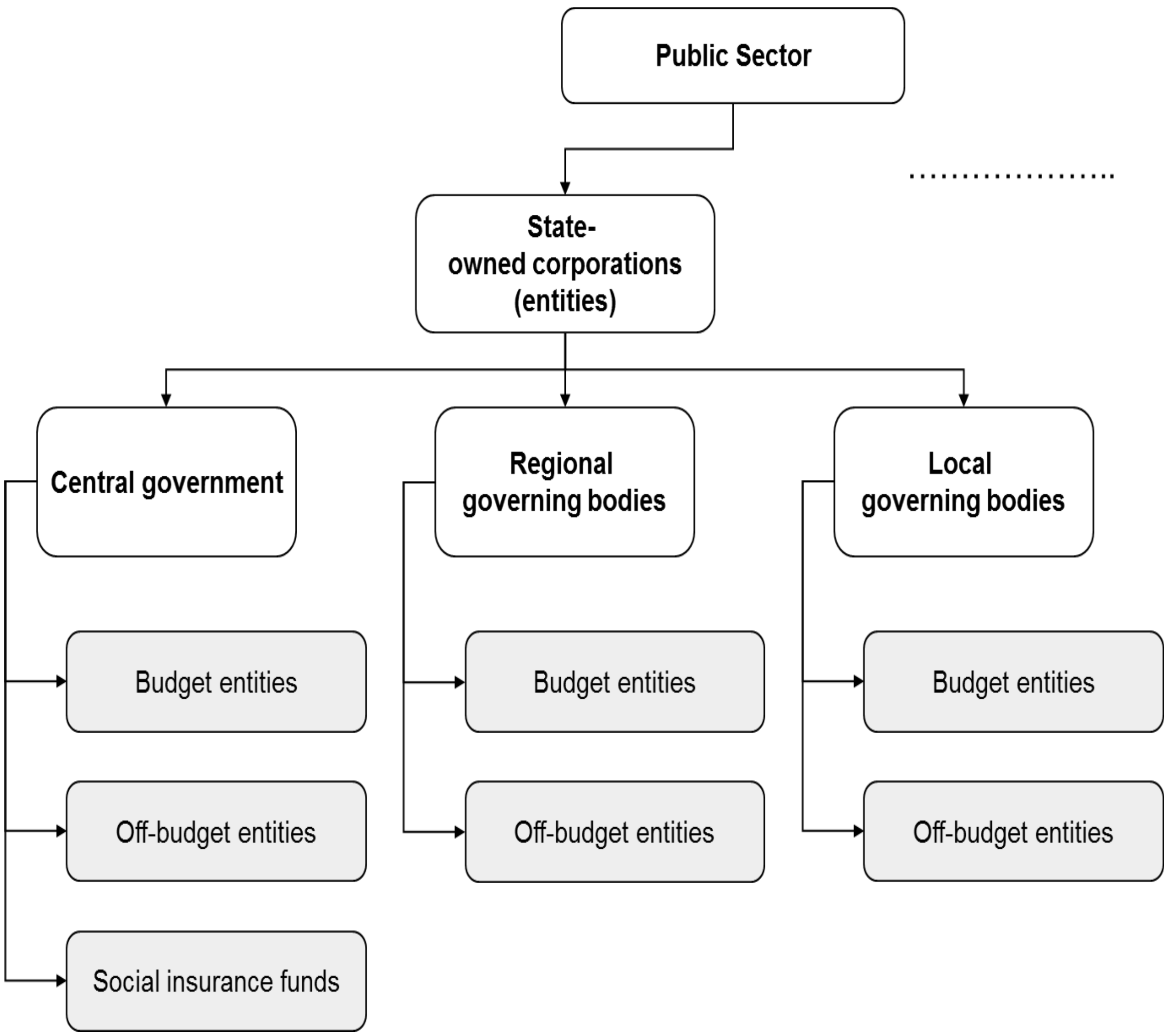

Figure 6. Alternative division into sub-sectors of the general government sector.

As it could be seen from the diagrams above, analytical division of the public sector into sub-sectors has multiple options, and none of these options can be universal.

On the other hand, based on recommendations of standards and experience of certain countries and corporations with complex and distributed organizational structure, the following set of practical recommendations on analytical division of the public sector is possible for the purpose of distinguishing sub-sectors:

In the course of structuring the public sector, it makes sense to establish a balance between convenience of work of developers and needs of consumers of consolidated information;

In the structure of the (public) state sector it seems reasonable to identify sub-sectors of entities that perform state functions and of state-owned commercial entities;

In the sector of entities that perform state functions, if there are entities that are not budget entities, it is reasonable to divide each sub-sector not only by levels of state governance (central, regional, local), but also possibly by attribution of these entities to budgetary and non-budgetary;

It makes sense to divide social insurance funds also by levels of state governance, which determine their financial and operating policy;

It makes sense to divide state-owned commercial entities both into financial/non-financial, and also by levels of state governance that determine their financial and operating policy.

When decisions are made on specific issues, it is useful to take into consideration experience of other countries given below related to determining the public sector and its sub-sectors, and to make a final decision taking into consideration national specifics.

Country	Definition of the public sector and its sub-sectors at the national level	Analytical division of the public sector into sub-sectors	Notes
Azerbaijan	Definition and composition of the public sector are not set (and are not specified in any law or any other document).	For the purpose of preparing consolidated budget reports by groups of budget entities, and also for the purposes of public finance statistics the approach recommended by the GFSM 2001 is applied.	At present, the work is being done on improvement of legal frameworks for the purpose of more detailed coverage of data.
Ukraine	The definition of the general government sector and its sub-sectors is approved by the Order of the State Committee of Statistics of Ukraine of April 18, 2005, “On Approval of the Classification of Institutional Sectors of the Economy of Ukraine”. In accordance with approved national accounting standards in the public sector (NASPS), spending units of the public and local budgets, treasury bodies and state special purpose funds were identified as public sector entities, and it is in full compliance with the approved classification	For the purpose of preparing consolidated statements according to government finance statistics the approach recommended by the GFSM 2001. For the purpose of preparing consolidated statements according to the national system of accounts, the approach recommended by the System of National Accounts 93 is applied.	At present, the work is being carried out related to implementation of the National Accounting Standards for the Public Sector. It would allow preparing consolidated budgetary reports on the public sector as a whole. At present, consolidated financial statements include only two sub-sectors (state and local budgets). The State Special Purpose Funds prepare separate consolidated reports, the data from which is used for preparing consolidated statements

	and GFSM 2001.		on the public sector as a whole.
Russian Federation	There is no set definition of the public (state) sector.	For the purpose of preparing consolidated budget reports by groups of budget entities, and also for the purposes of public finance statistics the approach recommended by the GFSM 2001 is applied.	At present, the work is being carried out on formalizing definitions of sectors and sub-sectors at the national level, in particular: The budgetary sector; The general (municipal,) government sector; The state (municipal) sector.
Republic of Moldova	The definition of the public sector is not specified in the legislative or regulatory frameworks.	For the purpose of preparing consolidated budget reports, and also for the purposes of public finance statistics the approach recommended by the GFSM 2001 is applied.	At present, changes and amendments to the legislation are being considered, which envision a more precise definition of the public sector.
Georgia	The definition of the public sector is not specified in the legislative or regulatory frameworks.	For consolidated budgetary reports of a group consisting of budgetary entities, and also for reporting on public finance statistics the approach recommended by the GFSM 2001 is applied.	Currently the reform related to expansion of the coverage of the Treasury Single Account is being implemented, so that the TSA would also cover local governments, autonomous formations, and subjects of public law. Therefore, the coverage of the budget compliance reports would increase.
Croatia	The public sector includes the state budget, local and regional units, budgetary and off-budgetary users of the state budget and budgets of local and regional formations.	The general budget includes the central budget (state budget ministries and their divisions) and off-budgetary users of the state budget and budgets of local and regional formations.	It is defined in the Law on the State Budget and GFS 2001. However, if we do not take this definition, the public sector also includes public enterprises.

Levels of consolidation

Consolidated flows and stocks

GSF Manual 2001.
IPSAS.
ESA.
Practical issues related to identification of items for consolidation

Exemptions from consolidation requirements

Consolidation methodology

In the framework of determining the procedure for preparation of consolidated financial statements, a significant issue is setting the consolidation methodology, which to a certain extent is also an element of determining requirements to the composition of flows and stocks subject to be consolidated.

What is the substance of the matter? What exactly is the consolidation methodology? Let us consider an example.

Let us assume that the company "Government Air" that is already familiar to us, based on the criteria set by us is an entity of the general government sector and is controlled by the Ministry of Transport that owns it.

The balance sheet of the Ministry of Transport is formed with the following indicators:

Indicator	Amount
Assets	
1. Non-financial assets	2000,0
2. Financial assets	1000,0
Out of them: Share of "Government Air»	600,0
Liabilities	
3. Liabilities	700,0
Out of them: To "Government Air»	400,0
4. Equity	2300,0

Balance sheet of the airline company "Government Air":

Indicator	Amount
Assets	
1. Non-financial assets	1500,0
2. Financial assets	600,0
including: receivables of the Ministry of Transport	400,0
Liabilities	
3. Liabilities	1500,0
4. Equity	600

Consolidated balance sheet prepared by the Ministry of Transport as a controlled entity:

Indicator	Amount (Ministry of Transport)	Amount (airline company “Government Air”)	Total
Assets			
1. Non-financial assets	2000,0	1500,0	3500,0
2. Financial assets	1000,0	600,0	1600,0
including: receivables of the Ministry of Transport		400,0	400,0
Shares of “Government Air”	600,0		600,0
Liabilities			
3. Liabilities	700,0	1500,0	2200,0
Out of them: to “Government Air"	400,0		400,0
4. Equity	2300,0	600,0	2900,0

Let us form a consolidated balance sheet. And what is subject to be excluded? Right – mutual liabilities. And what is included into mutual liabilities? Definitely – receivables/payables (in absolute terms – 400 units). And what else? Since the Ministry of Transport owns 100 % share of the airline company. Hence, on the side of the Ministry of Transport there are shares (in absolute terms – 600 pcs.), and on the side of the airline company – corresponding capital (the same – 600 pcs.). Consolidating the named indicators, we will get the consolidated balance sheet of the group consisting of the Ministry of Transport and the airline company “Government Air”.

Indicator	Consolidated indicators	Subject to be excluded	Consolidated indicators
1. Non-financial assets	3500,0	x	3500,0
2. Financial assets	1600,0	1000,0	600,0
including: receivables of the Ministry of Transport	400,0	**400,0**	X
Shares of “Government Air”	600,0	**600,0**	X
3. Liabilities	2200,0	400,0	1800,0
Out of them: to “Government Air"	400,0	**400,0**	X
4. Equity	2900,0	**600,0**	2300,0

In the examined example everything is crystal clear. Let us make it a little bit more complicated. And what if the Government represented by the Ministry of Transport owns not 100%, but a 60 % share of the airline company? In this case, how should we consolidate entities into a group? Will indicators of the airline company be included in the group in full? The answer is not that obvious. Let us have a look at the documents that we use.

In accordance with IPSAS 6 (para 43-57), in the course of preparation of consolidated financial statements, financial statements of the controlling and controlled entity are merged line by line by means of summing up similar items of assets, liabilities, net assets/capital, revenues and expenditures (consolidated report).

Indicator	Amount (Ministry of Transport)	Amount (airline company “Government Air”)	Total
Asset			
1. Non-financial assets	2000,0	1500,0	3500,0
2. Financial assets	1000,0	600,0	1600,0
including: receivables of the Ministry of Transport		400,0	400,0
Shares of “Government Air”	600,0		600,0
Liabilities			
3. Liabilities	700,0	1100,0	1800,0
out of them: to “Government Air”	400,0		400,0
4. Equity	2300,0	1000,0	3300,0

For consolidated statements to represent financial information on the group of entities as on a single entity, the following steps have to be taken:

The book value of investments of the controlling entity into each controlled entity is excluded, as well as the share of the controlling entity in net assets, equity of each controlled entity;

Indicator	Consolidated indicators	Subject to be excluded	Consolidated indicators
1. Non-financial assets	3500,0		3500,0
2. Financial assets	1600,0	**600,0**	1000,0
Including: receivables of the Ministry of Transport	400,0		400,0
shares of “Government Air”	600,0	**600,0**	
3. Liabilities	1800,0		1800,0
out of them: to “Government Air”	400,0		400,0
4. Equity	3300,0	**600,0**	2700,0

Minority interests are determined in the proficit or deficit of consolidated controlled entities for the reporting period;

Minority interests are determined in net assets/equity of consolidated controlled entities separately from net assets/equity of the controlling entity.

We have to remind that the minority interest – part of the proficit or deficit and net assets/equity of the controlled entity that is attributable to the share in net assets/equity, which the controlling entity does not own directly or indirectly through controlled entities.

In our case, the minority interest is 40% or:

Indicator	Minority interest	Minority interest
1. Non-financial assets	1500,0	600,0

2. Financial assets	600,0	240,0
Including: receivables of the Ministry of Transport	400,0	160,0
3. Liabilities	1100,0	440,0
4. Equity	1000,0	400,0

Taking into consideration the minority interest, consolidated amounts would look as follows:

Indicator	Aggregate indicators	Subject to be excluded in the part of investments in the controlled entity	Minority interest subject to be excluded	Consolidated indicators
1. Non-financial assets	3500,0		**600,0**	**2900,0**
2. Financial assets	1600,0	**600,0**	**240,0**	**760,0**
Including: receivables of the Ministry of Transport	400,0		**160,0**	**240,0**
shares of "Government Air"	600,0	**600,0**		
3. Liabilities	1800,0		**440,0**	**1360,0**
out of them: to "Government Air"	400,0			**400,0**
4. Equity	3300,0	**600,0**	**400,0**	**2300,0**

Intra-group balances in accounts, transactions, revenues and expenditures within the group of entities should also be fully excluded.

In our case, after consolidation, payables of the group 'the Ministry of Transport and the airline company "Government Air"' to minority shareholders of the airline company "Government Air" should be equal to 40% of the payables of the Ministry of Transport to the airline company "Government Air" (160 units).

Indicator	Balances of intra-group receivables / payables
1. Non-financial assets	
2. Financial assets	**240,0**
including: receivables of the Ministry of Transport	**240,0**
shares of "Government Air"	
3. Liabilities	
out of them: to "Government Air"	**240,0**
4. Equity	

Hence, taking into consideration consolidation on intra-group balances we would get:

Indicator	Consolidated indicators (without taking into account the share of the controlling entity in the controlled entity and the minority interest)	Balances of intra-group receivables / payables	Consolidated indicators (final)
1. Non-financial assets	2900,0		**2900,0**
2. Financial assets	760,0	240,0	**520,0**
including: receivables of the Ministry of Transport	240,0	240,0	
shares of "Government Air"			
3. Liabilities	1360,0	240,0	**1120,0**
out of them: to "Government Air"	400,0	240,0	**160,0**
4. Equity	2300,0		**2300,0**

After summarizing the steps that were taken, we would get the final table of consolidated indicators.

Indicators	Aggregate indicators	Subject to be excluded in the part of investments in the controlled entity	The minority share subject to be excluded (40% of indicators of the airline company)	Balances of intra-group receivables / payables	Consolidated indicators
1. Non-financial assets	3500,0		600,0		**2900,0**
2. Financial assets	1600,0	600,0	240,0	240,0	**520,0**
including: receivables of the Ministry of Transport	400,0		160,0	240,0	
shares of "Government Air"	600,0	600,0			
3. Liabilities	1800,0		440,0	240,0	**1120,0**
out of them:	400,0			240,0	**160,0**

to “Government Air”					
4. Equity	3300,0	600,0	400,0		**2300,0**

Examples given by us obviously determine the general approach, which has to be used when preparing indicators of consolidated financial statements – indicators of the consolidated balance sheet correspond to indicators of the summary balance sheet less the following:

The amount of the book value of investments of the Ministry of Transport (600 units) in the airline company and the share of the Ministry of Transport in net assets, equity of the airline company “Government Air” (600 units):

The amount of the minority interest in net assets/equity of the airline company “Government Air” (40 %);

Balances of intra-group receivables/payables (400 units general debtor/creditor relations. Out of them 240 units represent the intra-group receivables/payables).

Consolidated financial statements: generalized sequence of actions

Having examined issues of general methodological nature together with issues related to their practical implementation, it appears reasonable to consider also issues of organizational-methodological nature, which need to be addressed when arranging for preparation of consolidated financial statements in the public sector, in particular, definition of institutional mechanisms of preparation and presentation of consolidated financial statements of the public sector at the national level.

1. Establishing an obligation related to preparation and submission of consolidated financial statements by the Government.

For the purpose of ensuring preparation and disclosure of indicators of consolidated financial statements at the national level, the Government and the Parliament should determine the duty of the Government to prepare and present to the Parliament consolidated financial statements, and also to disclose indicators contained there to the general public.

It is quite possible that the Government could limit itself with just public disclosure of indicators of the said reports without submitting them to the Parliament, but in any case, it appears reasonable to stipulate in a law the obligation to prepare and publish consolidated financial statements.

2. Establishing the scope of coverage of the public (state) sector and its sub-sectors by consolidated financial statements, criteria for attributing entities to the named groups.

The Government, the Parliament and the general public should clearly determine and understand the scope of coverage of consolidated financial statements, i.e. they should have an idea concerning what entities and based on what criteria are included in the public sector. We have already examined above the problems related to this issues, and possibly these recommendations would help to address this issue more efficiently.

In addition, it is reasonable from the practical point of view to ensure at the national level maintenance of generally accessible registry of public (state) sector entities, which would allow all stakeholders to be informed about the composition of the public (state) sector and about the grounds for including entities in it.

3. Establishing an obligation to prepare and submit consolidated financial statements by the general government sector entities and by state-owned corporations.

The Government should establish a requirement for state entities and state-owned corporations related to mandatory preparation and presentation of consolidated financial statements.

In addition, the Government should determine the levels of consolidation, i.e. to identify public bodies that have to provide for preparation of consolidated and/or aggregate financial statements by groups of entities.

4. Determining the composition of consolidated financial statements.

The Government should determine the composition of consolidated financial statements, which could include both a minimal set of reports (Balance Sheet, Income Statement, explanations), and expanded set of reports that takes into consideration local specifics (for example, for the purpose of more detailed disclosures of information on the state debt).

5. Determining requirements to the procedure of preparation and presentation of consolidated financial statements by public (state) sector entities.

The said procedure for preparation and presentation should provide for integration of provisions of items 3 and 4 shown above.

6. Determining requirements to the composition of flows and stocks subject to be consolidated.

In the framework of recommendations given earlier (see Flows and Stocks Subject to be Consolidated) and in the framework of setting the procedure for preparing consolidated financial statements it is necessary to determine flows and stocks subject to be consolidated between entities that are included in the public (state) sector.

Publication of statements. Disclosure requirements

Practical issues. Differences and special circumstances

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