Financial management is a crucial element of municipal management. It enables the local government to plan, mobilize, and use financial resources in an efficient and effective manner, as well as fulfill its obligation to be accountable to its citizens. This chapter covers the basics of the municipal financial management process. It discusses the four fundamental components of public sector financial management: budgeting, accounting, reporting, and auditing, and their applications in local government. Each process is discussed separately, and the chapter also brings out their linkages and synergies.

Figure 3.1 depicts the pillars of public financial management. Let us look at them briefly before we delve into more detailed discussions. Budgets provide operational and financial plans for the attainment of the local government’s goals. Budgets are developed based on both financial and nonfinancial information. Financial information includes the estimates of financial resources—both what is available and what is required—to achieve identified priorities. Nonfinancial information includes community priorities, policy, and political considerations.

Accounting involves classification and documentation of various financial transactions of the local government; it provides the basic financial information required for preparation of the budget and financial reports and data to communicate with clients and partners such as lenders or higher-level governments. Accounting information includes specific figures on revenues earned and expenditures incurred within a specific period (usually a financial year) and information on assets and liabilities of the entity. Financial reports provide aggregate figures on the government’s revenues and expenditures, which help readers to understand the “big picture” of the government’s financial position and the efficiency of its financial management. Auditing is the process of independent verification of the
financial information contained in the accounting records and financial reports. It provides assurance to external persons or entities about the credibility of the information.

**Budgeting**

A budget is the annual financial plan of a local government, which defines its operational and development priorities for the ensuing financial year and describes how the plans will be financed. The budgeting process is vital in laying out the city’s choice of expenditure priorities and identifying the resources necessary for the realization of planned expenditures. This section explains the role of budgeting in municipal financial management and helps the reader to understand the objectives of the budget process, the components of a good budget, the steps in the budget process, and the relationship of the budget to other aspects of the financial management process.

**Budgeting: Concepts and Practices**

Budgeting and budgets are vital in the planning, control, and evaluation of government operations, but budgeting practices are not uniform across countries. “The budgeting process provides the medium for determining what government services will be provided and how they will be financed” (Mikesell 2011). Budgeting is the process of allocating scarce resources across unlimited demands; it is a financial and operating plan for a fiscal year (12 months). The budget contains information about the types and amounts of proposed expenditures, the purposes for which money will be spent, and the proposed means of financing. Although budgets are usually prepared for one financial year at a time, the recent trend has been to plan for three to five years as the basis for the annual budgets. That results in the annual budgeting process becoming part of a medium-term planning and program implementation process, helping the entity to achieve continuity in the planning and execution of its development program.

**Budgets as Planning Instruments**

The adoption of a budget implies that decisions have been made—on the basis of a planning process—as to how the organization plans to reach its objectives. The planning function in any government is of critical importance for the following reasons:

- **Public goods.** The type, quantity, and quality of goods and services that the public sector produces are not evaluated and adjusted through the market mechanism.
- **Public interest.** The goods and services provided by the public sector are often among the most critical to the public interest.
- **Immense scope.** The immense scope and diversity of modern government activities make comprehensive, thoughtful, and systematic planning a prerequisite to orderly decision making.
- **Participation.** Government planning and decision making generally take place in a joint
process involving citizens, their elected representatives, and the executive branch.

Thus, budgets help ensure that governments deliver the services that citizens have demanded, through choices made in a democratic process, and that available resources are used efficiently.

**Budgets as Instruments of Fiscal Discipline and Control**

Budgets are instruments of financial control used by both the executive and the legislative branches of a local government. For example, the mayor, the chief financial officer, or the city manager can use the budget to monitor actual expenses, compare them to plans made at the start of the year, and improve operational efficiency. At the same time, the city council can use the budget to keep track of whether the executive branch is using resources efficiently to address the development priorities that the council has established.

The control function in budgeting involves restraining expenditures to the limits imposed by available financing, ensuring that enacted budgets are executed and financial reports are accurate, and preserving the legality of the government’s expenditures. The control function permits development of information for the cost estimates used in the preparation of new budgets and preserves audit trails after budget execution. Box 3.1 presents four principles of a good budget.

**Types of Budgets**

Budgets have been used for centuries, but the forms, types, and scope of budgets have continued to change. This section discusses the various budget types and their merits and shortcomings, including the challenges of implementing them in practice (adapted from Mikesell 2011).

**Administrative**

Budgets can be classified according to the administrative entity that is responsible for management of the particular public service or function. Thus, the budget can be organized according to the agency or department that will implement the work for which the funds are provided, such as the health or water department, the education authority, the waste management department, and so forth.

**Economic**

Budgets can be classified by economic function, that is, by the type of revenues and expenditures, such as taxes, salaries, supplies, and so forth. This kind of classification is also called “line-item” or “object of expenditure” classification.

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**Box 3.1 Principles of a Good Budget**

Those preparing a local government budget should keep the following principles in mind:

- **Principle 1.** Establish broad goals to guide government decision making.
- **Principle 2.** Establish credible approaches for achieving the goals that have been set by developing appropriate policies, programs, and strategies.
- **Principle 3.** Equip the local government with a budget that is consistent with the goals and the approaches that have been decided on.
- **Principle 4.** Enable the local government to monitor and evaluate its performance and to make adjustments to meet contingencies and changing circumstances.

*Source: Adapted from NACSLB 1998.*
**Functional**
The functional classification identifies spending according to the intended purpose or objective, for example, education, health, social services, without specifying the (often several) administrative departments that will receive the resources or the expenditure category for which the budgeted funds will be used.

**Fixed or Flexible Budgets**
*Fixed budgets* are those specifying appropriations of fixed amounts. The appropriated amounts may not be exceeded, regardless of changes in demand for government services. Earmarked grants from a higher government tier are typical fixed budgets, which can be spent exclusively for the target purposes (e.g., education, health, or roads); unspent amounts may be returned to the grantor. *Flexible budgets* permit the local government to adjust the budget allocations during the course of the year, in accordance with program requirements, and thus enable it to adapt to contingencies and unexpected events.

**Line-Item Budgets**
Line-item budgets provide for budget allocations in a very detailed manner, by specific allocation for each expenditure item. These budgets are input oriented and describe minute details; as a result the budget documents are voluminous. Although line-item budgets help governments to exercise financial control over each item of expenditure, they do not provide flexibility to adjust spending in accordance with changes in needs and circumstances and do not provide a “big picture” view of what resources are being used for. Table 3.1 is a copy of the budget snapshot of the city of Bangalore, India.

**Program Budgets**
Program budgets provide budget allocations for a whole program and expect the budget holder to make allocations for the various expenditure categories within it. In this method, local government control is exercised over expenditures for the overall program and not over individual expenditure items. Program budgets are output

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**Table 3.1  Line-Item Expenditure Budget of Bangalore, India**

![Table 3.1 Line-Item Expenditure Budget of Bangalore, India](http://bbmp.gov.in)

Source: http://bbmp.gov.in.
oriented. Although program budgets provide the budget holder with flexibility to manage resources efficiently, they also require efficient accounting and control procedures to prevent waste or misuse of resources. Hence governments often start with an efficient line-item budgeting process and then move into preparing program budgets.

**Operating Budgets**
Local budgets typically consolidate two budgets, an *operating budget* and a *capital budget*. An operating budget (also called a “current budget”) is typically larger and more detailed than a capital budget. Operating budgets include revenues from current year transactions (tax collections, rents received) and provide for expenditures that are necessary for day-to-day operations during the year (wages and salaries, office expenses, maintenance expenditures, etc.).

**Capital Budgets**
Capital budgets include revenues from capital transactions (such as the sale or lease of assets, land, or other property) and provide expenditures for goods and services whose benefits extend beyond one year. That includes allocations for the construction of buildings and acquisition of assets such as plant, machinery, and vehicles. Capital budgets are also called “development budgets” (in some Asian countries). They are nonexistent in many developing countries because they are not legislated by the central government.

Table 3.2 summarizes the main attributes of current and capital expenditures. It is important to distinguish current (also called “operating”) and capital (also called “nonrecurring” or “development”) expenditures and to segregate the current and capital budgets. The table supports the view that segregation is possible and very useful for analyzing the financial position of a local government.

### Table 3.2 Attributes of Current and Capital Expenditures

<table>
<thead>
<tr>
<th>Current expenditures</th>
<th>Capital expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>It is an amount spent to acquire goods or services essential for daily operations and is expensed immediately.</td>
<td>It is an amount spent to acquire or improve a long-term asset, such as equipment or buildings.</td>
</tr>
<tr>
<td>Its effect is temporary—its benefit is received within the accounting year.</td>
<td>Its effect is long term—its benefit is received for a number of years in the future.</td>
</tr>
<tr>
<td>No asset is acquired, nor is the value of an asset increased.</td>
<td>An asset is acquired or the value of an existing asset is increased.</td>
</tr>
<tr>
<td>It has no physical existence because it is incurred for items that are used by the organization.</td>
<td>Except for some intangible assets, it generally has physical existence.</td>
</tr>
<tr>
<td>It is recurring and regular; it occurs repeatedly.</td>
<td>It does not occur again and again; it is nonrecurring and irregular.</td>
</tr>
<tr>
<td>It helps to maintain the business.</td>
<td>It improves the position of the business.</td>
</tr>
<tr>
<td>It is normally charged against revenue in the income statement in the year it is expensed.</td>
<td>A portion of the expenditure (depreciation on assets) is shown in the income statement as an expense, and the balance is shown in the balance sheet on the asset side.</td>
</tr>
<tr>
<td>It does not appear in the balance sheet.</td>
<td>It appears in the balance sheet until its benefit is fully exhausted.</td>
</tr>
<tr>
<td>It reduces the revenue (profit) of the organization.</td>
<td>It does not reduce revenue; the purchase of a fixed asset does not affect revenue.</td>
</tr>
</tbody>
</table>
government, regardless of whether or not national regulation stipulates the two separate budgets.

**Budget Preparation**

This section describes the steps in the budget process, including the budget cycle, the budget manual or circular, the budget calendar, budget formulation practices, budget estimates, budget approval, and supplementary or revised budgets. It addresses budget processes and how they help local governments maintain financial discipline and accountability.

**The Budget Cycle**

Public sector budgeting is organized around a cycle within a fiscal year, which allows the system to absorb and respond to new information and thereby allows the government to be held accountable for its actions. The budget cycle consists of four phases: (1) preparation and submission, (2) approval, (3) execution, and (4) audit and evaluation. The first three phases are discussed in detail here, and auditing is discussed in chapter 8.

Figure 3.2 depicts a budget cycle, a continuous process with interlinked phases that do not necessarily occur during the same budget year. Because local governments are required to approve their budgets prior to the start of the fiscal year, the preparation stage of the cycle takes place prior to the budget year. Similarly, the audit and evaluation stage takes place mostly after the close of the fiscal year. The overall purpose of the budget process is to help decision makers make informed decisions about the provision of services and the development of capital assets, but it also helps promote stakeholder participation in the budgeting process.

**Budget formulation.** Budget formulation has both policy and procedural aspects. The executive leadership (usually the mayor’s office in a city) sets out the detailed policy and program goals that it wants to implement in its jurisdiction. These are usually assembled through a development planning process in which cities prepare medium- and long-term development plans. For example, in India five-year plans are prepared at both the national and provincial levels that lay out the broad development priorities and programs. Based on these five-year plans, provinces and cities prepare annual plans, which in turn form the basis for annual budgets that describe the priorities and programs for a particular fiscal year.

**Figure 3.2 The Budget Cycle**

![Budget Cycle Diagram]

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The National Advisory Council on State and Local Budgeting (NACSLB) in the United States has recommended the following steps to improve the quality of the budget process (Freeman and Shoulders 2000):

- The budget process should consist of activities that encompass the development, implementation, and evaluation of a plan for the provision of services and capital assets.

- A good budget process incorporates a long-term perspective, establishes links to broad organizational goals, focuses budget decisions on results and outcomes, involves and promotes effective communication with stakeholders, and provides incentives to government management and employees.

- The budget process should be strategic in nature, encompassing a multiyear financial and operating plan that allocates resources on the basis of identified goals.

- A good budget process moves beyond the traditional concept of line-item expenditure control, providing incentives and flexibility to managers that can lead to improved program efficiency and effectiveness.

**Budget circular and budget calendar.** The procedural aspect of budgeting relates to translating policies and plans into budget estimates. Around the first quarter of a fiscal year, the finance department of the local government sends a budget circular for the following fiscal year to all local government departments, agencies, or entities. The circular includes (a) the budget planning calendar; (b) instructions for preparing budget plans; (c) an indication of what funds are likely to be available; and (d) overall priority directions from the executive leadership. Large municipalities have to create complex budgets that require the harvest of enormous amounts of data and information from every single unit or department. To manage this lengthy process, it is necessary to plan ahead and set up a calendar with specific dates for each unit, specifying the deadline for submission of their financial data to the accounting department. Table 3.3 provides an example of a typical budget calendar that would be issued during the middle of the year before the fiscal year being considered.

**Entities in Charge of Budget Preparation or Approval**

Local governments usually follow specific guidelines for budget preparation that are provided by higher authorities. Many other players are also involved in the process of preparing the budget. In municipalities in Western countries, the main players are the following:

**City council.** The city council is responsible for adopting the current and capital budgets for the upcoming fiscal year. Its approval is often issued as a local bylaw or ordinance. The council thus is also responsible for approving modifications to the budget under implementation throughout the fiscal year.

**The mayor.** The mayor is primarily responsible for the presentation of the city budget to the city council. She or he may delegate the responsibility to a subcommittee of the council, such as a budget committee or standing committee for finance.

**Heads of departments.** The head of each department, agency, or other independent unit must submit departmental budget plans to the finance officer or the budget committee. The plans should include detailed estimates of the budget needs of the entity for the coming fiscal year (some municipalities require estimates for the next three years as well) and estimates of any revenue anticipated to be collected by the entity.

**Chief financial officer.** The chief financial officer (CFO) usually leads the day-to-day process of budget preparation and works under the direction of the mayor and the budget committee. The CFO is responsible for reviewing and commenting on the city’s budget and its multiyear...
financial plans. He or she is required to submit periodic reports to the council and mayor on the budget execution progress and the state of the city’s economy and finances. The CFO’s report should include analysis and evaluation of the city’s various operations, fiscal policies, financial transactions, and recommendations.

**Legislative Approval of the Budget**

Local governments’ budgets are prepared by the mayor (or the mayor’s designated or delegated representative) and presented before the local government council. After receiving the draft budget document, the council usually turns it over to a committee of the council for scrutiny. The committee will advise the council concerning the budget proposals. In some countries, budgets are prepared by committees of the city council with the help of city executives (such as the standing committee on finance found commonly in local governments in South Asia). As part of its scrutiny, the city council may hold hearings to obtain the advice and opinions of key stakeholders. After completing its examinations, the city council adopts the budget by passing a local appropriations act or council resolution.

The budget thus becomes a local bylaw that cannot be changed by any entity below the council. Should it be deemed necessary, the council may adopt a modified budget, which is called a “supplementary” or “revised” budget. In some countries, regulations require issuing a revised budget if either revenues or expenditures deviate from plans substantially (say, by more than

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 4, 2009</td>
<td>Open budgeting process at division level for budget input.</td>
</tr>
<tr>
<td>July 7, 2009</td>
<td>Personnel budget estimates for 2010 to departments for review.</td>
</tr>
<tr>
<td>July 2009</td>
<td>Begin citizen survey to help set budget priorities.</td>
</tr>
<tr>
<td>July 14, 2009</td>
<td>Close division-level budget plans; open department-level budgeting.</td>
</tr>
<tr>
<td>July 20, 2009</td>
<td>Personnel budget for 2010 returned to Finance Department.</td>
</tr>
<tr>
<td>July 28, 2009</td>
<td>City council meeting on budget.</td>
</tr>
<tr>
<td>August 3, 2009</td>
<td>Finalize fees and service charges.</td>
</tr>
<tr>
<td>August 10, 2009</td>
<td>Department budget requests and revenue estimates completed for all funds.</td>
</tr>
<tr>
<td>August 20, 2009</td>
<td>Revenue and expenditure summaries due to CFO for review.</td>
</tr>
<tr>
<td>September 8–10, 2009</td>
<td>Internal budget review with CFO, department heads, and finance committee.</td>
</tr>
<tr>
<td>September 21–25, 2009</td>
<td>Final internal reviews with CFO, department heads, and finance committee.</td>
</tr>
<tr>
<td>September 29, 2009</td>
<td>Special meeting with council to present the 2010 Preliminary Budget.</td>
</tr>
<tr>
<td>October 7, 2009</td>
<td>Present proposed utility fee adjustments to city council.</td>
</tr>
<tr>
<td>October 20, 2009</td>
<td>City clerk publishes notice of public hearing on revenue sources.</td>
</tr>
<tr>
<td>November 1, 2009</td>
<td>Preliminary budget filed with city clerk and made available to the public. City clerk publishes notice of filing of preliminary budget and notice of public hearing on budget.</td>
</tr>
<tr>
<td>November 2, 2009</td>
<td>Status reports and preliminary budget amendment estimates for 2010 budget to council; public hearing on city’s revenue sources and property taxes.</td>
</tr>
<tr>
<td>November 14, 2009</td>
<td>Continuation of public hearing on revenue sources and public hearing on proposed budget and levy of property taxes.</td>
</tr>
<tr>
<td>December 8, 2009</td>
<td>Second public hearing on budget and council adoption of the budget.</td>
</tr>
<tr>
<td>January 1, 2010</td>
<td>Start implementing the new budget.</td>
</tr>
</tbody>
</table>

*Source: Adapted by author from a U.S. city government budget calendar.*

*Note: CFO = chief financial officer.*
Local governments in many developing countries revise the budget just before closing the fiscal year, a practice that undermines the fiscal discipline and control functions of budgeting.

**Budget Execution**

The budget execution process includes the various operations involved in translating the budget statement into decisions and transactions using the budgetary resources. Budget execution commences with the apportionment (fund allocation) process, to ensure that the departments or other units receive allotted funds in a systematic manner, so that planned activities are implemented smoothly and without causing cash flow constraints to the city. The apportionment process enables managers to plan and execute spending and projects in accordance with the availability of resources. Once funds are apportioned, departments make allotments to their operating units on a monthly or quarterly basis, to control spending during the fiscal year.

During budget execution, multiple subsystems of the city operate in cooperation. Local taxes and other revenues are collected. Cash is managed such that funds temporarily not needed are invested. Supplies, materials, and equipment are procured and paid for. Expenditures incurred are recorded in accounting records and consolidated into financial reports.

**Audit**

Audits are the final phases in the budget cycle. An audit is an “examination of records, facilities, systems, and other evidences to discover or verify desired information” (Mikesell 2011). The audit seeks to discover deviations from accepted rules and practices and bring out instances of any illegal or irregular transactions or decisions. Audits aim at holding management accountable and preventing repetition of inappropriate actions in the future. The goals of the audit process may vary depending on the purpose of the audit.

**Participatory Budgeting—Engaging Stakeholders in Budget Formulation**

Participatory budgeting is a democratic process in which citizens or community members are directly involved in decisions about how to spend all or a part of a local budget (www.participatorybudgeting.org). Citizens’ involvement varies in form, depth, and breadth. Many local governments have opened up decisions in entire municipal budgets, involving citizen assemblies in setting overall priorities and choosing new investments. States, cities, counties, schools, universities, housing authorities, and coalitions of community groups have used participatory budgeting to open spending decisions to democratic participation. In some cases the local government sets aside a small portion of the budget and entrusts communities to decide priority projects for their neighborhood. Common forms of citizen participation in the budget process are discussed below, along with some challenges to its implementation. Box 3.2 summarizes an example of participatory planning from Kerala, India.

**Participatory Budgeting: How Does It Work?**

In participatory budgeting, community members make budget decisions through an annual series of local assemblies and meetings. Although there are many models of participatory budgeting, most follow a basic process: diagnosis, discussion, decision making, implementation, and monitoring:

- Residents identify the most important local needs, generate ideas to respond to those needs, and choose budget representatives for each community.
- The representatives discuss the local priorities and together with experts develop concrete projects that address them.
- Residents vote for which of the projects to fund.
- The local government includes them in its budget and allocates funds to implement the chosen projects.
Residents monitor the implementation of the budget projects.

**Where Has It Worked?**

The Brazilian city of Porto Allegre started the first full participatory budgeting process in 1989 for its municipal budget. As many as 50,000 people have participated each year in the orçamento participativo (the Portuguese term for “participatory budget”) that started in Porto Allegre, to decide as much as 20 percent of the city budget. Since 1989, participatory budgeting has spread to more than 1,200 cities in Latin America, North America, Asia, Africa, and Europe (for more details about participation, visit http://internationalbudget.org). Box 3.3 contains more information on the Porto Allegre experience.

The Pakistan budget law mandates that local governments set aside 25 percent of their local development budgets for “citizens community boards” (CCB). Communities apply to use funds from the CCB budget for small road, drainage, and water improvement projects and commit to pay a portion of project cost (say, 15 percent to 30 percent) as their cash contribution. In Nepal, many water supply projects are initiated, financed, and implemented by water user communities, which receive 50 percent grants from the government, pay 20 percent cash, and borrow about 30 percent of total project cost.

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**Box 3.2 Participatory Planning in Kerala, India**

In 1996 India’s Kerala State embarked on a remarkable experiment in local planning and budgeting known as the “People’s Plan Campaign for the Ninth Plan” (PPC). The objective of the PPC was to devolve 35 percent of the state development budget from a centralized bureaucracy to local communities, where local people could determine and implement their own priorities. The PPC developed from a series of local-level planning experiments led by the left-of-center parties in the state, led by the Communist Party (Marxist), which experimented with various forms of community mobilization. The PPC unfolded as a sequence of assemblies, seminars, task forces, local council meetings, implementation and monitoring committees, and the like. The meetings were held at the lowest tier of the local government structure, known as the grama sabha, in rural localities and the ward committee in urban areas.

These meetings, often facilitated by resource persons from a popular NGO, discussed and prioritized the various development needs of the community and presented them to the local government council, which consolidated them into a “Development Report.” Based on these development priorities, the local government council prepared the annual plan and budget and presented them to the citizens. The plans were then sent to the District Planning Committee, which scrutinized them to iron out inconsistencies, fill in gaps, and thus enable the local plans to be more comprehensive.

The PPC radically improved the delivery of public services, brought about greater caste and ethnic equality, facilitated the increased entry of women into public life, and enhanced democratic practice. The PPC brought about such a radical new model of engaging citizens in community development and decision making that even a change of government in 2001 could not overturn the model.

What Are the Benefits?
Elected officials, community organizations, academics, and international institutions such as the United Nations and the World Bank have declared participatory budgeting a model for democratic government. Why? Their endorsements are based on the following:

- **It gives community members a say.** Ordinary people have more voice, and they get to make real decisions.

- **It produces better and more equitable decisions.** Local residents know best what they need, and budget dollars are redistributed to communities with the greatest needs.

- **It develops active and democratic citizens.** Community members, staff, and officials learn democracy by practicing it. They gain more understanding of complex political issues and community needs.

- **It builds communities and strengthens community organizations.** People get to know their neighbors and feel more connected to their city. Local organizations are able to spend less time lobbying, and more time deciding policies themselves. Budget assemblies connect groups and attract new members.

- **It connects politicians and constituents.** Politicians build closer relationships with...
Community members get to know their elected officials and local governments.

- It makes government more accountable and efficient. Local officers are more accountable when community members decide on spending in public assemblies. There are fewer opportunities for corruption, waste, or costly public backlash.

**Budget Preparation Techniques**

Budget preparation techniques and practices apply the general budget concepts and principles to the formulation of a typical municipal budget. This section identifies and discusses the main components of a municipal budget from both revenue and expenditure sides.

The section will bring together the various concepts through a hands-on exercise in budget formulation. It then turns to the concepts and techniques relating to capital budgeting, including various techniques for appraising investment projects and their applicability in the municipal context. Figure 3.3 is a visual impression of a standard budget; it depicts the form followed throughout this handbook. In contrast to the detailed and lengthy line-item budgets, such short, summary or snapshot budgets are used to inform management decisions, for reporting, or for communicating with stakeholders, especially citizens.

**The Revenue Side of the Municipal Budget**

Budget preparation is an iterative process in which draft budget plans and cost or revenue estimates are exchanged vertically between lower-level and higher-level entities, such as departments and their units, or between departments and the city council or its budget committee. Horizontal exchange and coordination across departments, such as service or functional departments and the finance department, are also intensive. Nevertheless, it is the revenue side of the budget that is the logical starting point for three reasons (Lee and Johnson 1998):

- **Preparing entities.** Ascertaining the possible revenues available for appropriation helps the budget preparer to fix the boundaries, in terms of available resources, of the expenditures that the organization can plan.

- **Citizens.** Citizens are usually concerned about taxes and worry about tax hikes.

- **Politicians.** Political leaders are always conscious that program initiatives leading to higher expenditures, and therefore higher taxes, may have negative effects politically.

**Figure 3.3  Standard Budget Structure**

<table>
<thead>
<tr>
<th>Revenues</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current budget</strong></td>
<td><strong>Current expenditures</strong></td>
</tr>
<tr>
<td>Own revenues: taxes, fees transfers from government other revenues (rents) surplus carried forward</td>
<td>Payroll</td>
</tr>
<tr>
<td></td>
<td>Operation and maintenance</td>
</tr>
<tr>
<td></td>
<td>Interest payments</td>
</tr>
<tr>
<td></td>
<td>Deficit carried forward (if any)</td>
</tr>
<tr>
<td></td>
<td>Operating surplus</td>
</tr>
<tr>
<td><strong>Self-financing</strong></td>
<td><strong>Capital expenses</strong></td>
</tr>
<tr>
<td>Capital revenues</td>
<td>Sale of property, land grants loans</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---
The revenue side of a municipal budget usually has four components: (1) own-source revenues, (2) fiscal transfers from higher governments, (3) shared taxes, and (4) debt or borrowing.

“Own-source revenue” refers to the various tax and nontax sources of revenue that municipalities can collect. They may include property taxes, income taxes, retail sales taxes, and others, depending on national revenue assignment (see chapter 1). Nontax sources include user fees and charges, such as the fee that a vegetable vendor pays to use the municipal market, but also proceeds from the lease or sale of assets. Fiscal transfers are the various grants that higher levels of government provide to municipalities, whether unconditional or conditional. Shared taxes include those that are collected by higher levels of government but whose proceeds are shared with local governments based on a formula. Borrowings are the loans and other forms of debt that municipalities can take on to finance their expenditures (chapter 5 and chapter 7 discuss more details).

At the start of the budget preparation process, the budget office (or the finance or revenue department) surveys the historical trend of revenue collection figures to estimate the resources that can be raised. In addition, the budget office tries to estimate the possibility of increasing tax or other rates or expanding the existing tax base. The budget office will also explore the possibility of new sources of revenue. These efforts are essentially of a technical nature, carried out with a view to presenting options to city management. The city management makes the final call on revenue options, considering their technical, economic, administrative, and political feasibility.

**The Expenditure Side of the Municipal Budget**

Simultaneously, the budget office informs the departments (or leaders of projects and programs) about the extent of financial support to be expected in the budget and invites their expenditure proposals. The various operating expenditure items, such as salaries and office expenses, are estimated based on historical and current spending trends. The budget office also takes into consideration expected changes in general economic indicators, such as the rate of inflation, in preparing its spending estimates. The plans and information generated and exchanged at this stage also help the units themselves and the budget office to prioritize programs, projects, and expenditures. Usually the budget office gives certain guidelines in advance (through the budget circular) with respect to the various assumptions, trends, and priorities, and that helps the departments and other units prepare their expenditure proposals. The budget office scrutinizes the proposals and finalizes them, often based on bargaining discussions with the respective departments. Those discussions also help the budget office to plan for expenditure management (see also chapter 5).

As mentioned, in the process of preparing the budget, it is essential to collect data on actual revenues and expenses for the last year or two, as well as to propose an estimate of the next year’s revenues and expenditures that takes into account changes in policies and events adopted by the governing body. The budget needs to show how much money will be available, where it comes from, and how it will be used.

**Capital Budgeting in Municipal Governments**

Capital budgeting is a tool for expenditure planning that often includes a multiyear capital improvement plan (CIP) and preparation of an annual capital budget. The capital improvement plan is important because purchasing, development, expansion, or rehabilitation of physical assets requires large money outlays, often beyond the limits of the annual budget. Hence separate, long-term planning is necessary to ensure that projects are evaluated in a systematic manner, from both technical and financial perspectives, to help the city management select a list of projects that are feasible and within the city’s operating and financial capabilities. Table 3.4 briefly summarizes the logical flow of a capital planning and
budgeting process. Capital improvement planning and capital budgeting are different in scope and time frame, but both largely follow the same logic, processes, and techniques.

The capital budget may be a section of the overall budget (as in figure 3.3) or issued as a separate document. The capital budget should have cost estimates for all infrastructure projects that are proposed, including both the investment cost and implications for the operating budget (Mikesell 2011). Capital budget preparation requires ranking project proposals using capital budgeting techniques such as payback period, the net present value method, internal rate of return, or profitability index. They are discussed in detail in chapters 4, 5, and 6.

### Table 3.4 Logical Flow of the Capital Budgeting Process

<table>
<thead>
<tr>
<th>Phases</th>
<th>Steps</th>
<th>Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planning</td>
<td>Update inventory and assess asset condition.</td>
<td>An inventory of infrastructure with analysis of condition and adequacy of maintenance spending.</td>
</tr>
<tr>
<td></td>
<td>Identify projects.</td>
<td>A project list with rough cost estimates (capital improvement plan).</td>
</tr>
<tr>
<td></td>
<td>Project evaluation</td>
<td>Detailed costing of both construction costs and subsequent operating costs, estimation of any revenue, comparison with strategic plans, and cost-benefit analysis to identify priorities.</td>
</tr>
<tr>
<td></td>
<td>Project ranking</td>
<td>Ranking of projects using capital budgeting techniques.</td>
</tr>
<tr>
<td>Budgeting</td>
<td>Financing</td>
<td>Financing arrangements for projects to be included in the budget.</td>
</tr>
<tr>
<td></td>
<td>Budget</td>
<td>Expenditures included in budget proposals of the appropriate departments, their placement in resource envelope available to government, inclusion of project operating costs in the long-term budget forecasts for period when project is completed and running.</td>
</tr>
<tr>
<td>Execution</td>
<td>Procurement</td>
<td>Process for selection of contractors for projects.</td>
</tr>
<tr>
<td></td>
<td>Monitoring</td>
<td>Review of physical and financial progress of project; coordination of spending with revenue flow.</td>
</tr>
<tr>
<td>Auditing</td>
<td>External audit</td>
<td>Ex-post review of financial records upon project completion.</td>
</tr>
</tbody>
</table>

The capital budget may be a section of the overall budget (as in figure 3.3) or issued as a separate document. The capital budget should have cost estimates for all infrastructure projects that are proposed, including both the investment cost and implications for the operating budget (Mikesell 2011). Capital budget preparation requires ranking project proposals using capital budgeting techniques such as payback period, the net present value method, internal rate of return, or profitability index. They are discussed in detail in chapters 4, 5, and 6.

### Issues, Practices, and Challenges in Municipal Budgeting

Though the principles of budgeting are uniform globally, the reality is not. The rules and practices of budget formulation differ from country to country, and even within a country the basic principles, issues, and challenges may vary. Here we put the differences in the rules and procedures aside and look at a few common issues that affect the budgeting practices of local governments everywhere. This section discusses some practical difficulties that municipal finance officers face, particularly in developing countries, focusing on problems that prevent the preparation of realistic and comprehensive budgets and ways to address them.

**Comprehensiveness**

As a basic principle, the municipal budget should be comprehensive, covering all areas (each service or function) and aspects (revenue, expenditure, short- and long-term impacts) of functioning. Against this principle, municipal budgets in most developing countries deal only with the revenues and expenditures of core governmental functions and do not include ancillary activities carried out by the city. For example, the municipal budget often does not include the expected revenues and expenditures of municipal enterprises such as a water supply company that is organized and managed as an independent company.

The other concern regarding budget comprehensiveness relates to the extent of decentralization and the transfer of powers and functions
to local governments (see chapter 1). Even in decentralized settings, where local governments are expected to take the lead in local development activities, budget allocations from central ministries are often made to line departments and not routed through local governments’ plans and budgets. This often creates fragmentation in planning and execution, as well as tensions between local governments and the line departments.

**Realism**

Budgets are useful to the extent that they are realistic. The four main shortcomings in this regard are political distortions, information shortage, incremental budgeting, and balloon budgeting.

**Politcized budgeting.** Often in developing countries, budget presentation is an opportunity for political grandstanding by the mayor and city council. As a result, the municipal budget document reads more like a wish list of programs and projects divorced from financial reality. Such a situation arises from weak accountability of city management to its citizens and stakeholders and also from soft budget constraint by the higher-level government. In other words, where there is a strong accountability framework and the national government exerts hard budget constraint, city managements hesitate to announce grand plans and projects without ascertaining that they have adequate financial resources.

**Shortage of timely information.** Another hurdle to local budgeting arises when local governments do not know beforehand the fiscal transfers that they will receive from the national government. That occurs because of a weak intergovernmental fiscal relationship, or where central governments do not feel obliged to announce in advance the transfers and entitlement payments due. It weakens the ability of local governments to forecast revenues or forces them to make estimates in their budget documents based on guesses.

**Incremental budgeting.** Local governments sometimes fail to use proper techniques and instruments in preparing budget estimates. Service or line departments and budget officers often project revenues or expenses by simply increasing the actual results of the current year, adding, say, 5 percent or 10 percent to every line. This is not a bad way to start, since it at least might factor in inflation, but a major trouble is that inflation may have different impacts on revenues and expenses and on different revenue and expenditure items. Realistic estimates should reflect good understanding of future events, along with natural uncertainties. For instance, a 20 percent increase in tax revenues could be realistic if the city council has approved a rate increase or if the tax base is expanding because of the dynamic growth of housing.

**Weaknesses in Budget Execution**

The most common weakness in budget execution is a disconnect between the budget document and daily expenditure decisions. The signs include (a) huge overspending in some line items without any discussion or higher-level approval; (b) delays in budget execution due to delayed transfers from the central government; (c) unclear distinction between revenue and expenditure items; (d) a revised budget issued at the very end of the fiscal year with huge changes from the initial budget plan; and (e) a huge deficit at year-end, when a balanced or surplus budget was planned. All are results of weak fiscal control and discipline in the municipality.

The central governments in developing countries often approve development grants very early in the fiscal year, rather than the year before. Development projects thus often start at midyear or in the third quarter of the fiscal year. As a result, development funds remain unspent at the end of the fiscal year, causing a large but artificial surplus in the closing budget. It is particularly confusing if there is no clear distinction between current and development expenses. Quite often weak procurement and cash management systems result in overspending or in delayed budget execution, eventually constraining local governments from
implementing their budgets efficiently and timely. Councils are often forced to alter their budgets and approve a supplementary budget during the fiscal year, undermining the authority of the budget process, as well as its planning and control functions.

Budget Monitoring
Successful budget execution depends to a large extent on robust budget monitoring by top executives (such as the mayor or city manager) and the city council. Especially in large cities, however, budgets involve hundreds of millions in financial resources and plans and projects in a variety of sectors. The magnitude often reduces the ability of the council and executives to monitor budget execution and exercise control. Management information systems, discussed in this section, are useful tools to track budget execution, identify weaknesses promptly, and take remedial action.

Management Information Systems
A management information system (MIS) involves three primary resources: people, technology, and information. Management information systems are different from other systems, such as an accounting or procurement system, because they are used to analyze activities from the perspective of management decision making. MISs help city governments to realize the maximum benefit from their investments in personnel, equipment, and business processes. All local governments use information systems at all levels of operation to collect, process, and store data; an MIS does those things in a timely, systematic, and comprehensive fashion. MIS data are aggregated and disseminated in the form that city managers need to carry out their functions.

The term “MIS” may conjure up the image of sophisticated computers and highly qualified analysts crunching reams of data and producing complicated spreadsheets and charts. Although management information systems can be very sophisticated, they can also be implemented in very simple ways to support efficient and effective decision making. For example, a city government can use an MIS to track the patterns of its revenues and expenditures. Analysis of revenue collections may show that property tax collections are higher in certain wards of the city, compared to others. That could prompt the city management to investigate the reasons for the variation and redistribute resources to help the areas that are not performing well. There are simple techniques, easy to implement, that can provide useful insights into the efficiency of budget execution. (Chapter 8 includes a detailed discussion of performance measurement.)

Budget-Actual Variances
Budget-actual variance analysis is an old and simple tool for budget monitoring. It is often not possible to create a perfect budget because some future events are unpredictable. But a well-developed and realistic one that is based on the actual financial situation, current and past, can be the best road map to efficient financial management. For example, uncertainties or unexpected financial developments, such as an increase in unemployment because of an economic downturn, or major damage to a water treatment plant due to severe weather, can result in revenue shortages and a parallel increase on the expenses side. Such occurrences will cause differences between the budgeted and actual amounts that need special attention when the budget is revisited and refined. But variances that are not generated by such unforeseen events should be minimized.

Two types of variances occur, favorable or unfavorable:

- Favorable variance occurs when actual results are better than budgeted or planned (F). Costs are lower, or revenue is higher, than expected.
- Unfavorable variance occurs when actual results are worse than budgeted or planned (U). Costs are higher, or revenue is lower, than expected.
**Variance analysis** is a tool to evaluate variances in revenues and expenses. It reveals whether the government is operating within its authorized resources. A variance, positive or negative, often calls for explanations. Thus, it is important to analyze and understand the causes of variances and take corrective action. Not all variances are worth investigation, however. For example, a variance of only 1 percent of spending is well within the normal range. A variance of 10 percent or more in spending is likely to signal that something is wrong and warrants attention. Proper variance analysis requires some thought to (a) analyze the variances, (b) identify the causes, and (c) take appropriate action.

Variances can occur for many reasons, such as changes in funding levels due to inflation, population change, or government funding decisions and policies. Changes in the cost of services, labor, or material can also cause variances in budgets.

Table 3.5 presents an example of a variance calculation for expense items of a water utility. The table shows a huge total variance of 35 percent that deserves attention and remedies. First, each cost item needs close scrutiny. For example, we might find that the increased cost of water provision is due to an increased energy tariff, which would be beyond the control of management. Meanwhile, the cost of fee collection has jumped by $11,000, which could be acceptable only if fees collected had experienced an even greater increase.

### Table 3.5 Example of Variances between Budgeted and Actual Expenses for a Water Utility

<table>
<thead>
<tr>
<th>Expense item</th>
<th>Budget ($)</th>
<th>Actual ($)</th>
<th>Variance ($)</th>
<th>Variance (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of water provision</td>
<td>140,000</td>
<td>$190,000</td>
<td>50,000 U</td>
<td>36</td>
</tr>
<tr>
<td>Cost of fee collection</td>
<td>28,000</td>
<td>39,000</td>
<td>11,000 U</td>
<td>39</td>
</tr>
<tr>
<td>Administrative expense</td>
<td>60,000</td>
<td>85,000</td>
<td>25,000 U</td>
<td>42</td>
</tr>
<tr>
<td>Other expenses</td>
<td>12,000</td>
<td>10,500</td>
<td>−1,500 F</td>
<td>−13</td>
</tr>
<tr>
<td>Total</td>
<td>240,000</td>
<td>$324,500</td>
<td>84,500 U</td>
<td>35</td>
</tr>
</tbody>
</table>

*Note: U = unfavorable variance; F = favorable variance.*

**Accounting**

This section discusses the basic concepts and principles of accounting, with an overview of its subject matter. The objective of the section is to introduce the reader to the role of accounting as the basis for documenting, classifying, and organizing financial information in a systematic manner. The section also provides a brief overview of the types of accounting and their relationship to auditing and the various accounting standards.

**Accounting Concepts and Terms**

*The role of accounting in managing organizations.* Accounting systems are used to provide complete, timely, and accurate information concerning revenues, expenditures, assets, and liabilities. Within a local government, accounting records provide information on billing taxpayers and receiving tax payments, paying employees, and paying vendors and contractors for goods, work, and services. Accounting systems also inform management and external stakeholders about the financial resources, the efficiency of the organization's financial management, and its financial position during and at the end of the financial year (Lee and Johnson 1998).

*Difference between accounting and bookkeeping.* People often mistakenly use the terms “bookkeeping” and “accounting” to mean the same thing. Accounting is concerned with identifying how transactions and events should be described in financial reports. It is also concerned
with designing bookkeeping systems that make it easy to produce useful reports and to control an organization’s operations. Thus, accounting is broader than bookkeeping, and accounting requires more professional expertise and judgment. Bookkeeping is the process of recording transactions and other events, either manually or with computers. Bookkeeping is critical to accounting, but it is only the clerical part of the accounting process.

Types of Accounting
Although accounting may seem to be a single term and subject, in fact various types of accounting exist, and each plays a specific role in the financial management of organizations. The most important accounting types include financial accounting, cost accounting, management accounting, and public sector or commercial accounting.

- Financial accounting provides information to management and external stakeholders, such as a city council, shareholders, or citizens, on the receipts, expenditures, assets, and liabilities of a municipality. In other words, financial accounting is concerned with the reporting of financial transactions and the financial position of the municipality, monthly, quarterly, and at the close of the financial year.

- Cost accounting provides information to management on the cost of operations and helps with measuring and controlling the costs of specific services or functions. Cost accounting is an internal function and generates information relating to historical costs of operations and efficiency. Although cost accounting uses information from the financial records, its methods and processes are different.

- Management accounting is a later development of cost accounting in which the data and information from cost accounting are converted into decision reports for management, using various analytical and presentation techniques.

- Public sector accounting and commercial accounting, in their basic principles, are the same. Certain specific accounting practices that suit accounting in government organizations create the differences between the two. One of the most visible differences is that local governments in the developing countries use single-entry cash basis accounting. In contrast, the vast majority of commercial entities use double-entry accrual basis accounting. Furthermore, government accounting is based on the annual budget process, and therefore budget allocations, appropriations, and commitments become very significant.

Key Terms in Public Sector Accounting
Public sector accounting has three building blocks: allocation, appropriation, and commitment. We briefly introduce these three terms because they keep popping up during discussions on municipal financial management; a detailed discussion is beyond the scope of this chapter. It is important, however, to be familiar with their definitions and implications in the budgeting process. Box 3.4 provides some concrete examples for applying these terms.

Appropriation. An appropriation is the total amount of resources a local government department can spend for the entire fiscal year. Spending authorizations granted by the legislature (e.g., the city council) depend on both the budget system and the nature of the expenditure. Authorizations that permit government departments or units to incur obligations and to make payments out of public funds are usually granted through appropriation, a financing source against which expenses must be matched and reported on the statement of operations. The receipt of an appropriation is recorded at the departmental level only.

Allocation. Allocation is a budget execution process to allocate funds to the program level; it is a percentage of an appropriation that is
earmarked for a specific agency or staff office. The receipt of an allocation is usually recorded at the intermediate and activity levels.

Commitments. Commitments or obligations, also known as “encumbrances,” are legal pledges to provide finance. Broadly, a commitment arises when a purchase order is made or a contract is signed, implying that goods will be delivered or services rendered and that a bill will have to be paid later on. The commitment is recorded for the amount of the obligation for one fiscal year.

Budgetary or appropriation accounting. Budgetary or appropriation accounting consists of tracking and registering operations concerning appropriations and their uses. It should cover appropriations, apportionment, any increase or decrease in appropriations, commitments or obligations, expenditures at the verification or delivery stage, and payments. Budgetary accounting is only one element of a government accounting system, but it is the most crucial both for formulating policy and for supervising budget implementation.

Box 3.4 Examples of Appropriation, Allocation, and Commitments

Appropriation example. The federal Environment Protection Agency approved a grant of $200,000 to a city’s Division of Debris Removal. This grant is an appropriation or funding for a specific purpose, to enable the division to assist the city in an emergency cleanup of its hazardous yard trash disposal site.

Allocation example. Usually in the educational system, funds may not be provided to schools based solely on academic need, but rather poverty must be considered as the determiner. The purpose of the “allocations” funds is to help disadvantaged children meet high academic standards through food programs, after-school or summer programs, and the like. The district determines the per pupil expenditure (PPE) as a measuring tool, and then schools are sorted by poverty level. For example, if school A has 75 percent poor children, it receives 1.4 times the PPE in allocation funds; school B, with 35 percent of its students in poverty, receives 1.25 times the PPE, and so forth.

Commitment example. In the United States, central government or federal agencies commit funds for large projects. For example, the U.S. Department of Transportation agreed to commit resources to fund a bridge project in the District of Columbia.

Commitments or obligations accounting. This kind of accounting is essential in keeping budget implementation under control. Most developed countries keep registers of their transactions at each stage of the expenditure cycle, or at least at the obligation stage and the payment stage. Commitments or obligations accounting provides the basis for budget revisions. Decisions to increase or decrease appropriations and the preparation of cash plans must take into account commitments already made.

Accounting Standards and Standard Setters
Accounting standards enable accountants to apply a common approach to their treatment of financial transactions, thereby ensuring comparability of financial reports. Although the basic principles of accounting are universal, their application in public and private sector organizations and specific business situations is determined by accounting standards. Accounting standards are usually set by national-level, standard-setting bodies, the ministry
of finance, or the office of the auditor general in developing countries. In the United States, the Government Accounting Standards Board (GASB) sets standards for government accounting, and the Financial Accounting Standards Board (FASB) sets standards for the private sector. At the global level, the International Accounting Standards Board (IASB) sets the International Financial Reporting Standards. Similarly, the International Public Sector Accounting Standards (IPSAS) are issued by the IPSAS board, which is a part of the International Federation of Accountants (IFAC) (www.ifac.org). Box 3.5 offers a glimpse of the historical emergence of accounting.

The relationship between accounting and auditing. Auditing is a process of independent verification of financial processes and statements. Thus, auditing commences after the accounts have been prepared and finalized. The audit can be internal or external; the verifier can be an internal person (independent of the entities that complete financial reports) or an external entity, typically a private or central public auditing office. The purpose of an audit is primarily to provide assurance to stakeholders of the credibility of an organization’s financial statements. The organization prepares annual financial statements based on the information in its accounting records. The external audit is an independent verification of them. The auditor expresses an opinion concerning whether the financial statements present a true and fair view of the organization’s financial affairs.

Accounting Principles and Practices
This section elaborates the basic principles of accounting and forms the foundation for the remaining discussions on accounting. It strives to help the reader understand the building blocks of accounting for financial transactions. Simple numerical examples illustrate the theory, and exercises help to test one’s grasp of the principles discussed.

Accounting is based on a few basic principles:

- **Business entity principle.** This principle requires that every organization be accounted for separately and distinctly from its owners. It also requires a local government to account separately each entity it may control. The reason behind this is that separate information for each entity is relevant to decisions that the entity would make.

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**Box 3.5 Accounting in Historical Perspective**

The first known accountants worked for the religious authorities in ancient Mesopotamia (now Iraq), making sure that people paid their taxes (of sheep and other agricultural produce) to the temples. In trying to keep track of who owed what, they had to issue receipts and IOUs (“I owe you”—a promise to pay) and accidentally invented writing.

Thousands of years later, in late medieval Italy, double-entry bookkeeping emerged.

The man who first wrote down the method, Luca Pacioli, was a Franciscan friar. Double-entry bookkeeping recognizes that all transactions have two aspects—a credit and a debit—and in a properly constituted set of books, the two sets of figures always balance. For those of a particular turn of mind, the balance has a beauty, maybe even divinely inspired.

*Source: [http://news.bbc.co.uk/go/pr/fr/-/1/hi/magazine/8552220.stm](http://news.bbc.co.uk/go/pr/fr/-/1/hi/magazine/8552220.stm).*
• **Objectivity principle.** It requires the information in financial statements to be supported by evidences (invoice, receipt, etc.) other than someone’s imagination or personal opinion. The reason for it is to make financial statements useful by ensuring that they present reliable information.

• **Cost principle.** This principle requires the information in financial statements to be based on costs incurred in transactions, consistent with the objectivity principle.

• **Going concern principle.** This principle requires accountants to prepare financial statements under the assumption that the business will continue operating. It is not especially relevant for local governments, as they are expected to exist ad infinitum. However, some of the enterprises that local governments may establish (for example, a local water company) are susceptible to failure and closure.

**Accounting Practices**

This section introduces the reader to the practice of basic bookkeeping, the chart of accounts and the various books of accounts, computerized accounting, and the preparation of trial balances. It discusses the standard formats or templates for basic accounting records such as the journal, ledger, and cash book and summarizes good principles of maintaining accounting records. This section will help the reader to understand the organization of accounting information through the Chart of Accounts, and consolidation financial records through the Trial Balance and Final Accounts. Finally, a brief discussion sheds light on the role of information technology in the recording and compilation of accounting information, with a reference to standard accounting software packages and integrated financial information systems (IFMIS).

**Entries.** Regardless of the type of organization or the type of financial transaction, accounts are maintained within sets of books called “journals” and “ledgers.” Journals are the **books of original entry**, and ledgers are called **books of final entry**. Transactions are initially recorded in journals when they occur and are later posted to the relevant accounts in the ledgers. Table 3.6 is a snapshot of a journal in which transactions are entered in chronological order from original vouchers.

Accountants using manual systems may still write the same entry several times—first in the journal and then into various ledgers. Computerized systems do this by one keyboard entry that immediately generates all of the required subsequent entries automatically.

**T-accounts.** In the simplest form, an account looks like the letter T. When a T-account is used, increases are placed on one side of the account and the decreases on the other side. That makes it easy to determine the balance of the account. The balance of an asset account is the amount of the asset owned by the entity on the date the balance is calculated. The balance of a liability

<table>
<thead>
<tr>
<th>#</th>
<th>Date</th>
<th>Voucher no.</th>
<th>Description</th>
<th>Debit amount</th>
<th>Credit amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>8/3/2012</td>
<td>1529</td>
<td>Mr. Brown, property tax payment</td>
<td>400</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>8/5/2012</td>
<td>37245</td>
<td>Mr. Green, water bill payment</td>
<td>125</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>5/6/2012</td>
<td>525</td>
<td>Electricity (street lighting) bill</td>
<td></td>
<td>1,325</td>
</tr>
<tr>
<td>4</td>
<td>8/5/2012</td>
<td>6473</td>
<td>Ms. Watt, rental bill payment</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>8/7/2012</td>
<td>1530</td>
<td>Mr. Moron, property tax payment</td>
<td>820</td>
<td></td>
</tr>
</tbody>
</table>
account is the amount owed by the entity on the date of the balance.

In the T-account, the left side is called the debit side, abbreviated Dr, and the right side is called the credit side, abbreviated Cr. When amounts are entered on the left side of an account, they are called debits, and the account is said to be debited. When amounts are entered on the right side, they are called credits, and the account is said to be credited. The difference between the total debits and the total credits recorded in an account is the account balance. In other words, there is a debit balance when the sum of the debits exceeds the sum of the credits and a credit balance when the sum of the credits exceeds the sum of the debits. Figure 3.4 shows the accounts after Mr. Moron paid half of his annual property tax dues.

**Single-Entry versus Double-Entry Accounting**

Single-entry accounting systems record transactions line by line, in the order of occurrence, to a simple journal or cash book. Small organizations and some local governments follow single-entry accounting. Rather than use modern accounting systems, they record only one aspect of a transaction in the account books. They may also maintain separate records for some transactions, such as lists of arrears or receivables, or payables, or asset records (discussed in chapter 6). Those records, however, are not integrated into the financial statements and at best are attached as memo items to financial reports. Thus, the single-entry system does not provide a comprehensive picture of the financial affairs of the entity and for that reason is not a preferred method of accounting. Recall that we have said that any financial transaction essentially has two aspects—the debit aspect and the credit aspect. Modern systems of accounting recognize both the debit and credit aspects, as in the example in table 3.6, and record each transaction as an entry into two (or more) separate ledger accounts. This is called the double-entry accounting system.

**Principles and Procedures of Double-Entry Accounting**

Double-entry accounting, also known as the double-entry system of bookkeeping, is a system in which each transaction has two fundamental aspects, the receiving of a benefit and the giving of a benefit. Both aspects are recorded in the same set of books. In accounting, the one who receives is a debtor, and the transaction is recorded as a debit on a particular account (dr). The one who gives is a creditor, and the transaction is recorded as a credit on another account (cr). Under the double-entry system, every debit must have a corresponding credit and vice versa, and the total of the debit entries and the credit entries must be equal. In deciding which account has to be debited and which account has to be credited, the accounting equation below should be used:

\[
\text{assets} = \text{liabilities} + \text{equity}.
\]

The components of the accounting equation can be summarized in the balance sheet. Table 3.7 shows a simple balance sheet of an independent housing management unit of a municipality. In practice, however, local government organizations tend to have more complex balance sheets than that one.

The fundamental principle of the double-entry system lies in analyzing the two changes involved in a business transaction and properly recording both of the changes in the books of accounts. For the accounts to remain in balance, a debit (dr) change in one or several accounts must be matched with a credit (cr) change in

![Figure 3.4 Example of a T-Account](image-url)
one or several other accounts. Therefore, after a series of transactions, the sum of all the accounts with a debit balance will equal the sum of all the accounts with a credit balance.

The main terms used in double-entry accounting are the following:

**Journal.** This is the book in which all transactions are recorded at first, using the double-entry format of debit and credit.

**Ledger.** This is the second process, in which the journal entries are posted to another book known as a ledger. In the ledger, all the accounts are classified and individually maintained. Each ledger (account) has two identical sides—a left side (debit) and a right side (credit), and all the transactions relating to that account are recorded chronologically.

**Trial balance.** This is the third process, in which the arithmetical accuracy of the books of account, at a point in time, is tested by means of a trial balance. It is an informal accounting schedule or statement that lists the ledger account balances and compares the total debit balance with the total credit balance.

**Final accounts.** In the final process, the result of the full year's operational activities is determined through final accounts—the “statement of receipts and payments” (called an “income statement” in business accounting) and a balance sheet; these are described in detail in the section on financial reporting.

### Examples of Double-Entry Bookkeeping

Let us look at some examples that illustrate the double-entry system of recording business transactions into debit and credit accounts (see tables 3.8 through 3.12).

**Example 1:** The Municipal Company purchased $7,000 worth of machinery and paid in cash.

*Analysis of transaction:* Increase in assets (equipment) by $7,000, and decrease in assets (cash) by $7,000.

**Example 2:** The company borrowed $15,000 from a bank.

*Analysis of transaction:* Increase in assets (cash) by $15,000, and increase in liabilities (payables, that is, borrowings) by $15,000.

**Example 3:** The company paid a utility bill of $1,000 by check.

*Analysis of transaction:* Increase in expenses by $1,000 and decrease in assets (cash) by $1,000.

**Example 4:** The company generated sales revenue the amount of $12,000; 60 percent of sales was received in cash, and 40 percent on credit.

*Analysis of transaction:* Increase in revenue (sales) by $12,000, increase in assets (cash) by $7,200 ($12,000*60 percent), and increase in assets (receivables) by $4,800.

**Example 5:** A partner invested $20,000 in the company.

*Analysis of transaction:* Increase in assets (cash) of $20,000; increase in owner’s equity of $20,000.
The Chart of Accounts

The chart of accounts is basically a structure of identifying numbers assigned to each account to identify various functional areas or segments of the local government. The charts of accounts for local governments are often regulated by higher government entities and issued in laws or ordinances, for example, by the ministry of finance or the office of the auditor general. Because the numbers are assigned in order, local governments are allowed, and even encouraged, to add more detailed subaccount numbers into the regulated chart of accounts.

The chart of accounts in a small municipality may be very simple. The left side of table 3.13 shows a general structure of main accounts; the right side indicates the structure of the numbering of various accounts and subaccounts. A longer number indicates a lower rank of subaccount. Thus, users such as local governments can add more numbers to the end of some account numbers to enable more specific segregation of various transactions, such as the cost of energy use by office buildings (account 1501) or by schools (account 1502).

Bases of Accounting

Accounting systems could be quite different in scope and methodology. Accounting of financial transactions can be different depending on the basis of accounting. The “basis” refers to the

<table>
<thead>
<tr>
<th>Table 3.8</th>
<th>Purchase of Machinery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ledger entry</td>
<td>Debit</td>
</tr>
<tr>
<td>Equipment</td>
<td>$7,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 3.9</th>
<th>Borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ledger entry</td>
<td>Debit</td>
</tr>
<tr>
<td>Cash</td>
<td>$15,000</td>
</tr>
<tr>
<td>Borrowing</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 3.10</th>
<th>Paying a Utility Bill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ledger entry</td>
<td>Debit</td>
</tr>
<tr>
<td>Expenses (utilities)</td>
<td>$1,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 3.11</th>
<th>Sales of Goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ledger entry</td>
<td>Debit</td>
</tr>
<tr>
<td>Cash</td>
<td>$7,200</td>
</tr>
<tr>
<td>Receivables</td>
<td>$4,800</td>
</tr>
<tr>
<td>Revenues (sales)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 3.12</th>
<th>Equity Received</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ledger entry</td>
<td>Debit</td>
</tr>
<tr>
<td>Cash</td>
<td>$20,000</td>
</tr>
<tr>
<td>Owner’s equity</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 3.13</th>
<th>Chart of Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts</td>
<td>Numbers</td>
</tr>
<tr>
<td>Assets</td>
<td>100–199</td>
</tr>
<tr>
<td>Liabilities</td>
<td>200–299</td>
</tr>
<tr>
<td>Revenues</td>
<td>300–399</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>400–499</td>
</tr>
</tbody>
</table>
timing of recording a financial transaction, that is, whether it is recorded at the time of its occurrence or at the time of the exchange of cash. The former is called **accrual-based accounting**, and the latter is called **cash-based accounting**. These are the two main systems, but there are others that are somewhere in between, which may be called “modified accrual” or “modified cash basis.”

**Cash-based accounting.** In cash-based accounting, record keeping works on a strictly cash-in, cash-out basis. That is, financial transactions are recorded only when money actually changes hands:

- Income is recorded only when money (cash or a check) or revenue is actually received. Therefore, a tax bill issued is not recorded as revenue, only the tax actually paid in and appearing in cash or in the bank account of the municipality.
- Expenses are recorded only when they are actually paid. Thus, an electricity bill received is not recorded as an expense until and unless it is actually paid to the electricity company.

**Accrual-based accounting.** In the accrual-based accounting system, transactions are accounted as revenues or expenses independent of the movement of cash:

- Income is recorded when it is earned, even if the money has not yet been received.
- Expenses are recorded when they are incurred—not necessarily when they are actually paid.

In accrual-based accounting, total revenues and expenses are shown in the financial statements whether or not cash was received or paid out in a particular accounting period. In other words, income is reported in the period when it is earned, regardless of when it is received, and expenses are deducted in the period when they are incurred, whether they are paid or not. Using accrual-basis accounting, an organization records both revenues and expenses when the transactions occur. Accrual accounting is the most common method used by businesses and is increasingly used by local governments as well.

For example, if a municipality sells an old truck for $5,000, under the cash method, that amount is not recorded in the books until the buyer pays the money to the municipal cashier or the cashier receives a check from the buyer. In contrast, under the accrual method, the $5,000 is recorded as revenue immediately, when the sale is complete (the contract is signed, and the buyer takes the truck), even if the money is only received a few days or months later. The same applies to expenses. If the water department receives an electric bill for $1,700, under the cash method, the amount is added to the books only after the department has actually paid the bill. Under the accrual method, the $1,700 is recorded as an expense the day the bill is received.

**Modified accrual-based accounting.** Although most local governments in developing countries use cash-based accounting, several developed countries have been moving toward the use of an accrual basis. However, a strict accrual basis is not feasible for many local governments, and thus most of them have been using modified accrual accounting. That generally means that they account all expenditures, regardless of whether cash is paid out, but recognize revenue only when it becomes both available and measurable, rather than when it is earned. The reason for this choice is their limited ability or capacity to collect billed and due revenues, such as taxes, water or solid waste fees, and so on.

**Trial balance.** As discussed, in a double-entry accounting system, every transaction is recorded with equal debits and credits. As a result, one knows that an error has been made if the total of
the debits in the ledger does not equal the total of the credits. Also, when the balances of the accounts are determined, the sum of the debit balances must equal the sum of the credit balances. This equality is tested by preparing a trial balance. When a trial balance does not balance, it indicates an error in the account balances. The error(s) may have been in journalizing the transactions, in posting to the ledgers, in determining the account balances, in copying the balances to the trial balance, or in adding the columns of the trial balance.

However, a trial balance is not by itself a proof of complete accuracy. Some compensating errors do not affect the equality of the trial balance because they affect the debit and credit sides equally. Locating errors and rectifying them are part of the work that accountants do in preparing the final accounts and are not dealt with in detail here.

**Manual versus Computerized Accounting Systems**

The increasing use of computers in accounting is a significant trend that changed accounting practices beginning in the latter half of the twentieth century. Some Asian countries still rely on manual accounting, often with computer assistance, such that simple Excel tables are created to generate reports, but the legally binding records are manual. Box 3.6 shows the manual ledger of a municipality in Pakistan, with handwritten entries and the fingerprints of illiterate customers. Computerization has changed the

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**Box 3.6 Manual Bookkeeping in Pakistan**

*Photo by Mihaly Kopanyi 2010.*

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defining characteristic of accounting from a focus on recording financial transactions to serving structured information to management and stakeholders.

This interface of accounting with information systems includes people, procedures, equipment, and their interactions. Modern accounting systems are designed to capture data relating to financial transactions and to generate from these data a variety of financial, managerial, and tax accounting reports and visual summaries. These can take different forms, from low-cost accounting software packages in small organizations to very expensive and complicated enterprise resource planning software in big ones. These systems computerize activities such as recording transactions in the journal and ledger, generating the trial balance, and preparing the financial statements. In addition, most accounting software packages come with modules on budgeting, inventory, billing, and the like, increasing their usefulness for municipalities.

Good Practices in Maintaining Books of Accounts
In this section we summarize practical approaches, experiences, and good practices in local government accounting.

- **Basics first.** It is important for municipalities to make sure that they are able to fulfill basic accounting functions such as preparing journals and ledgers, posting transactions on a daily basis, tallying cash balances at the close of a business day, and the like, which will make them better prepared to move into advanced accounting practices such as accrual-based accounting or integrated financial management systems.

- **Double-entry accounting system first.** Local governments should start with cash-based double-entry accounting, recording both aspects of transactions. Often this is misunderstood as implementing accrual-based accounting, but that is a completely different approach and more difficult to implement. It is better, first, to gain experience working with a cash-based double-entry system and then enhance the municipal accounting system in a stable and systematic manner.

- **Computerize after strengthening business processes.** Although computerization of accounting procedures improves efficiency, if local governments computerize without changing their underlying processes, the effectiveness of the whole system is reduced, since the inefficiencies of the old system persist ("Garbage in garbage out"). Therefore, local governments embarking on computerization should start with a detailed analysis of their financial procedures and systems and identify ways to improve them before computerizing the process.

- **Revenues and expenses are recorded at the time they are earned and due.** This principle is critical in accounting and should be the cornerstone of an organization's accounting for transactions. Often financial officers and city managements are under pressure to paint a rosy picture of their finances. That pressure causes them to recognize revenues much before they are actually collected, or not to pay or record expenses when they are due. If payments due are delayed because of a shortage of cash, or if contractors are paid without delivery of services to prevent budget allocations from being turned back to the ministry of finance at the end of the fiscal year, it is equally problematic. These practices distort the true financial position of the local government and should be avoided.

- **Final accounts should be comprehensive.** The annual financial statements of any entity are intended to provide a comprehensive picture
of the entity's financial performance for the stated period. Local governments may have subsidiaries or related enterprises whose finances are not reported in or along with the financial statements. Again, such practices distort the financial picture of the local government. For example, if a municipality owns a water distribution company, even though the company is a separate entity, because it is fully owned and controlled by the municipality, its financials should be included and reported as part of the municipality’s off-budget financial reports.

• **Final accounts should be prepared in a timely manner.** Final accounts should be prepared within a reasonable time after the close of the financial year. Although companies are usually required by law to prepare their annual financial statements within a reasonable period (usually three to six months after the close of the financial year), local governments often do not conform to such stringent standards. Timely annual financial statements let stakeholders know the financial performance for the past year. If statements are delayed, their informational value is eroded.

• **Accounts should be audited by independent external auditors.** An annual audit by independent external auditors enhances the credibility of financial statements. The auditors’ management letter or opinion also provides valuable feedback that should be acted on. Where no definite arrangement exists for annual external audits, local governments should voluntarily initiate audits of their financial statements, in consultation with the Supreme Audit Institution or with the professional organization of auditors in their country. To enhance transparency and accountability, the municipality should also publish the audit report and opinion in a forum or location where the community and other stakeholders can access them.

• **Invest in capacity building and training.** Staff skills and capacities are very important for the effective and efficient performance of any system. As municipal governments improve their accounting systems and processes, it is important to strengthen the technical and managerial skills and capacities of the staff who manage the systems. Junior staff should be trained in the technical processes of bookkeeping and accounting, and higher-level staff should be trained in financial management concepts and practices to equip them to use accounting data to improve the organization’s efficiency and effectiveness.

• **Treat accounts as an information system.** Accounting forms the backbone of the financial record system of any organization. At the same time, the value of accounting is in management’s use of accounting information for decision making. In municipal governments, accounting records should not be seen just as historical records of financial transactions. They should be seen as the organization’s financial information system, providing valuable information regarding operational and financial efficiencies and conveying the financial performance of the organization to citizens and stakeholders.

**Detailed Discussion of Accounting Books and Financial Statements**

This section further addresses the details of accounting and bookkeeping practices. In a business, it is normal to encounter a significant volume of transactions of various kinds that have an impact on the entity’s financial position. Recording all of the transactions to the general ledger directly may cause mistakes; that is the reason why the process of recording transactions is divided into two steps. First, transactions are recorded in the general journal, which is one of the accounting prime entry books. Second, entries from the general journal are posted to the general
ledger, which is composed of the corresponding accounts (or categories) that constitute the balance sheet and income statement. To illustrate, let us assume that a city with double-entry accounting collected property taxes of $20,000 and paid employee benefits of $5,000 on November 20.

**Journal**

All the business transactions are recorded in the general journal daily and in chronological order. Although the structure and form of a general journal vary depending on business needs, the recording of some data in a journal is mandatory. Table 3.14 shows an example of a general journal template with columns for the mandatory data. They are (a) date of transaction; (b) names or reference numbers of the accounts that are debited and credited; (c) a description of the transaction; and (d) columns for debits and credits to record the exact amounts of each business transaction.

**General Ledger**

The next step after recording all the business transactions in the general journal and using the T-accounts is to post the transactions to the general ledger accounts.

T-accounts also form part of the year-end posting. During the posting process, one can use the T-accounts to help minimize errors in posting corresponding transactions. The second step thus is to post the journal entries to the general ledger using the T-accounts, as shown in table 3.15. Notice that every transaction is posted both as a debit and as a credit, for example, cash debit $20,000 and property tax credit $20,000.

General ledger accounts classify accounting data into categories, the chief ones being assets, liabilities, equity, revenues, and expenses.

Table 3.16 is a sample of a general ledger template that includes columns for the date and explanation of transaction and debit and credit columns, and shows the balance of the account after the transactions have been posted. The table shows that at the end of the day on November 20, there was a $15,000 cash balance. It is important to notice that “Payroll and employee benefits” is a debit account, and thus the positive balance is a debit, whereas the property tax ledger is a credit account, in which the positive balance is a credit. Finally, the sums of balances are equal: $5,000 + $15,000 = $20,000.

**Cash Book**

The cash book is a ledger in which all cash transactions (whether cash received or paid) are primarily recorded according to date. It is both

<table>
<thead>
<tr>
<th>Table 3.14</th>
<th>General Journal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Description</td>
</tr>
<tr>
<td>Nov. 20</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Property tax revenue</td>
</tr>
<tr>
<td>Nov. 20</td>
<td>Cash</td>
</tr>
<tr>
<td></td>
<td>Payroll and employee benefits</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 3.15</th>
<th>Posting Transactions in Three T-Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash account</td>
<td>Payroll and employee benefit expenses</td>
</tr>
<tr>
<td>Nov. 20</td>
<td>$20,000</td>
</tr>
<tr>
<td>$15,000</td>
<td>Balance</td>
</tr>
</tbody>
</table>

Municipal Financial Management
Table 3.16  Sample Ledger Accounts

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cash account</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Particulars</td>
<td>J/F</td>
</tr>
<tr>
<td>Nov. 20</td>
<td>Property tax</td>
<td>$20,000</td>
</tr>
<tr>
<td></td>
<td>Balance</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dr</th>
<th>Payroll and employee benefits (debit account)</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Particulars</td>
<td>J/F</td>
</tr>
<tr>
<td>Nov. 20</td>
<td>Cash</td>
<td>$5,000</td>
</tr>
<tr>
<td></td>
<td>Balance</td>
<td>$5,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Dr</th>
<th>Property tax revenue (credit account)</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Particulars</td>
<td>J/F</td>
</tr>
<tr>
<td>Nov. 20</td>
<td>Cash</td>
<td>$20,000</td>
</tr>
<tr>
<td></td>
<td>Balance</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Note: J/F denotes Journal or Folio reference (if any).

Table 3.17  Sample Cash Book

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Particulars</td>
</tr>
<tr>
<td>Nov. 20</td>
<td>Property tax—cash</td>
</tr>
<tr>
<td></td>
<td>Balance</td>
</tr>
</tbody>
</table>

A book of original entry, in which all cash transactions are recorded as soon as they take place (similar to a journal), and a book of final entry, in which the cash aspect of all cash transactions is finally recorded, without posting in the ledger as a cash account. The cash book is one of the most important accounting records for local governments using manual accounting systems.

If we were to take the same transactions given above and record them in a cash book, it would look like table 3.17. The columns of the cash book are as follows:

Date: The date of the transaction.

Particulars: The name of the opposite account against which a cash transaction occurred. A narration of the transaction should be written in this column, below the name.

V. No. (Voucher Number): The voucher number of each item of receipt and payment is also written (cash memo number, payment voucher number, or receipt voucher number).

L.F. (Ledger Folio): This is the page number of the ledger where the opposite account has been opened. This will make it possible to locate the account from the ledger.

Amount: The amount of the transaction. When cash is received, the amount is recorded on the debit side, and when cash is paid, the amount is recorded on the credit side.
**Receipts and Payments Account**

The receipts and payments account statement shows a summary of inflows and outflows under the various account heads. It includes headings that begin with the cash in hand (opening balance) at the commencement of the year and end with the closing balance at the end of the year.

Local governments prepare a *receipt and payment account* at the end of the year for the purpose of disclosing the results of their financial transactions. Table 3.18 summarizes the consolidated payments and receipts account of a small municipality. This is a very simple, easy-to-follow snapshot, with sufficiently detailed, specific revenue and expenditure items.

Similarly to the cash account, receipts in a receipts and payments account statement are shown on the debit side, and payments are shown on the credit side. Cash receipts and cash payments of both a capital and a revenue nature are also recorded here. However, this statement does not include any unpaid expenditures or any unrealized income related to the period.

**The Financial Statements**

Local governments with double-entry accounting systems typically prepare four financial statements at the end of the fiscal year: *Trial Balance*, *Statement of Receipts and Expenditures*, *Statement of Financial Position* (balance sheet), and *Cash Flow Statement*. Local governments publish or submit to higher government tiers the *Statement of Receipts and Expenditures*, *Cash Flow Statement*, and the *Statement of Financial Position*.

**Table 3.18  Consolidated Receipts and Payments Account for the Year Ended December 31, 2010**

<table>
<thead>
<tr>
<th>Receipts</th>
<th>Amount</th>
<th>Payments</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Opening Balance:</strong></td>
<td></td>
<td>Program Expenses:</td>
<td></td>
</tr>
<tr>
<td>- Cash</td>
<td>500</td>
<td>Salaries: Program staff</td>
<td>18,300</td>
</tr>
<tr>
<td>- Bank</td>
<td><strong>25,500</strong></td>
<td>Salaries: Admin. staff</td>
<td>11,000</td>
</tr>
<tr>
<td>Local contribution</td>
<td>10,250</td>
<td>Road develop. works</td>
<td>27,000</td>
</tr>
<tr>
<td>Grants from:</td>
<td></td>
<td>Education centers</td>
<td>13,000</td>
</tr>
<tr>
<td>- Local agencies</td>
<td>15,500</td>
<td>Health program</td>
<td>9,700</td>
</tr>
<tr>
<td>- Foreign agencies</td>
<td>55,700</td>
<td>Other Expenses:</td>
<td></td>
</tr>
<tr>
<td>- Govt. dept.</td>
<td>22,000</td>
<td>Stationery</td>
<td>2,400</td>
</tr>
<tr>
<td>Interest from:</td>
<td></td>
<td>Traveling expenses</td>
<td>15,000</td>
</tr>
<tr>
<td>- Bank</td>
<td>150</td>
<td>Fuel &amp; maintenance</td>
<td>7,200</td>
</tr>
<tr>
<td>- Investment</td>
<td>1,400</td>
<td>Rent</td>
<td>4,200</td>
</tr>
<tr>
<td>Loans and Advances:</td>
<td></td>
<td>Loans and Advances:</td>
<td></td>
</tr>
<tr>
<td>Loans taken</td>
<td>45,000</td>
<td>Loans to staff</td>
<td>15,600</td>
</tr>
<tr>
<td>Loan refund from staff</td>
<td>10,000</td>
<td>Loans returned</td>
<td>14,800</td>
</tr>
<tr>
<td>Advances for administration expenses</td>
<td>5,300</td>
<td>Purchase of land</td>
<td>35,000</td>
</tr>
<tr>
<td>Sale of furniture</td>
<td>3,400</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>194,700</td>
<td><strong>Total</strong></td>
<td>194,700</td>
</tr>
</tbody>
</table>

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**Trial Balance**

The previous section described how transactions are first entered in journals and the cash book and then posted in the ledger in their respective accounts. At the end of the accounting year, these accounts are balanced. To check the accuracy of postings in the ledger, a statement is prepared containing balances of all ledger accounts on a particular date. A trial balance consists of a debit column with all debit balances of accounts and a credit column with all credit balances of accounts.

Table 3.19 is a trial balance of City XYZ, prepared for the 2009 fiscal year by February 28, 2010. The balance of the statement tells little about the financial position of the city, but it indicates that the credit and debit entries are correct because they are balanced. The next section explains how the trial balance is developed, based on the balances of the various ledger accounts, using a sample of T-accounts and the balance of the cash account. This example signifies the importance of checking the accuracy of the posting of transactions and the relationship between the ledgers and the trial balance sheet.

<table>
<thead>
<tr>
<th>Account title</th>
<th>Debits</th>
<th>Credits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>42,260</td>
<td></td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Office supplies</td>
<td>840</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Payroll &amp; employee benefits</td>
<td>20,500</td>
<td></td>
</tr>
<tr>
<td>Consultant fees</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Property tax</td>
<td>12,000</td>
<td></td>
</tr>
<tr>
<td>Business licenses</td>
<td>5,200</td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>67,200</td>
<td>67,200</td>
</tr>
</tbody>
</table>

**Relation between Ledger Accounts and the Trial Balance**

Table 3.20 summarizes the City XYZ example. The T-accounts shown resulted from entering the city’s transactions, which were then posted to ledger accounts. From the balances of ledger accounts summarized in table 3.20, the city’s trial balance can easily be prepared. Readers should take the time to follow the T-account balances to reconcile how the trial balance is prepared.

**Financial Statements**

The Statement of Receipts and Expenditures is a key part of a comprehensive annual financial report, which presents the financial statements of the local government. Each year, every governmental organization prepares a Statement of Receipts and Expenditures and supports it by important analysis (such as the management discussion and analysis, or MD&A, in municipal governments in the United States) and in the notes to the financial statements.

The Statement of Receipts and Expenditures reports on total revenues and total expenses. Governmental organizations issue it with a focus on the entire organization, including all kinds of activities and all kinds of revenues and expenditures during the fiscal year. In short, the statement shows how much money they have earned (revenue) and how much they have spent (expenses). Table 3.21 is a sample income statement prepared in part from the data presented in table 3.20. Added data show opening balance, transfers, and expenses not shown in table 3.20.

The statement of activities first establishes the change in fund balance as a result of revenue and expenditure balances, then adds the fund balance at the beginning of the reporting period (fiscal year). The sum of these two yields the end-of-period fund balance of $40,500.
The Statement of Revenues and Expenditures thus gives a sense of how well the local government entity, as a whole, is operating and reports the following items:

- Revenues such as contributions, program fees, membership dues, grants, investment income, and amounts released from restrictions.

- Expenses such as expenditures, encumbrances, other financing uses, and all expenses of a business type, such as salaries, utilities, and so forth. Expenses can also be reported in categories such as major programs, fundraising, management, and general.

- The bottom line resulting from all the revenue and expenditure items would be the change in the fund balance—the surplus or deficit.

### The Statement of Financial Position (Balance Sheet)

The Statement of Financial Position or balance sheet reflects the structure of an organization’s assets and the financing sources used to finance those assets, as of a particular date. And as the name indicates, there should be balance between its parts because this financial statement reflects the essence of the accounting equation, which is

\[
\text{assets} = \text{liabilities} + \text{equity.}
\]

The net assets of a government organization are equivalent to the net worth (equity) of a commercial organization. The Generally Accepted Accounting Principles (GAAP) suggest that net assets be classified as unrestricted (UR),
temporarily restricted (TR), or permanently restricted (PR). Local governments in many countries must classify their assets according to GAAP (as is discussed in more detail in chapter 6). Figure 3.5 illustrates the components of net assets and highlights their meanings.

The term “Statement of Financial Position, or balance sheet” is one used by nonprofit organizations. The statement’s purpose is to report assets, liabilities, and net assets as of a specified date. The Statement of Receipts and Payments depicts the overall status of the organization’s surplus (or deficit) by looking at revenues and expenses over a period of time (fiscal year). The Statement of Financial Position depicts the overall status of the organization’s finances at a fixed point in time (the end of the fiscal year). It totals all the assets and subtracts all the liabilities to compute overall net assets and surplus or deficit.

Table 3.22 shows a sample of a small local government entity’s Statement of Financial Position (balance sheet), with restricted and unrestricted, and designated and undesignated assets; it also shows the total assets and the net assets. From the table one can make a number of observations. The table includes current assets (50,000), of which total 40,000 is unrestricted and designated for operations (25,000) and for Board (15,000). There are 10,000 restricted assets, grants from the central government earmarked for specific expenditures.

**A Brief Introduction to the Fund Accounting Model in the United States**

In the United States, municipalities follow an accounting model called “fund accounting,” in which revenues and expenditures are reported under different funds (box 3.7). A fund is a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources. Thus, a local government should have only one general fund, but it may have many other types of funds. For example, a city may maintain a separate, special revenue fund for each restricted revenue source, a separate capital projects fund for each major capital project, and a separate debt service fund for each issue of outstanding bonds.

Table 3.23 shows a balance sheet in fund-based accounting of a U.S. city. The general fund in a local government embraces most major government functions, such as police, street maintenance, sanitation, and so on. The balance sheet displays financial assets and liabilities, with memo items on other assets, and it provides decision makers with very specific information on the sources and uses of funds and accrued liabilities.

**Municipal Accounting in Developing Countries**

This section discusses problems that local governments are facing in developing countries in applying modern accounting principles

---

**Table 3.21 Statement of Receipts and Payments (dollars)**

<table>
<thead>
<tr>
<th>Revenues</th>
<th>Unrestricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earned revenue</td>
<td>17,200</td>
</tr>
<tr>
<td>Contributions</td>
<td>10,250</td>
</tr>
<tr>
<td>Program revenues</td>
<td></td>
</tr>
<tr>
<td>Other sources</td>
<td>3,400</td>
</tr>
<tr>
<td>Interest and dividend income</td>
<td>1,550</td>
</tr>
<tr>
<td>Grants</td>
<td>93,200</td>
</tr>
<tr>
<td>Loans and advances</td>
<td>60,300</td>
</tr>
<tr>
<td>Released from restricted funds</td>
<td></td>
</tr>
<tr>
<td>Total unrestricted revenue</td>
<td>185,900</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Program expense</td>
<td>22,700</td>
</tr>
<tr>
<td>Development expense</td>
<td>27,000</td>
</tr>
<tr>
<td>Management and general</td>
<td>29,300</td>
</tr>
<tr>
<td>Loans and advances</td>
<td>65,400</td>
</tr>
<tr>
<td>Other expenses or fund uses</td>
<td>27,000</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>171,400</td>
</tr>
<tr>
<td>Change in fund balance</td>
<td>14,500</td>
</tr>
<tr>
<td>Fund balance, beginning of period</td>
<td>26,000</td>
</tr>
<tr>
<td>Fund balance, end of period (surplus or deficit)</td>
<td>40,500</td>
</tr>
</tbody>
</table>
and practices. Although the discussion briefly touches upon current debates on these issues, it focuses on how to address them from a municipal management perspective rather than on policy.

**Cash or Accrual Basis**
Finding a suitable accounting method is a common issue for municipal governments in developing countries. Local governments have traditionally applied single-entry cash-based accounting, as that is the method that central governments follow. As decentralization progressed and local governments started acquiring their own identity, the need to adopt accounting systems and procedures more suited to their business requirements became important. Advisers and consultants often think of local governments as being similar to private enterprises and for that reason have recommended double-entry accrual-based accounting for local governments.

Although it is true that double-entry accrual-based accounting is the state-of-the-art method, whether such accounting is feasible in a local government context also must be considered. Just to name a few main impediments: estimating the value of municipal assets and establishing opening balance sheets are hard to do quickly. Therefore, instead of rushing to implement sophisticated forms of accounting such as full-accrual accounting, it is advisable to build up the capacities of the accounting system and the staff by first transitioning to a double-entry cash basis and then perhaps to a modified accrual basis. The experience of the local government in preparing accounts using double-entry cash-based accounting will enable it to move comfortably to more sophisticated methods.

Figure 3.5  Logical Frame of Net Assets

Source: GASB 1999.
### Box 3.7 The Fund Structure of State and Local Governments in the United States

**Governmental Funds**

Purpose: To account for and report governments’ operating and financing activities financed predominantly through taxes and intergovernmental grants.

- **Basis of accounting/measurement focus**: Modified accrual/current financial resources
- **There are five kinds of governmental funds:**
  - **General fund**—to account for and report all financial resources not accounted for and reported in another fund
  - **Special revenue funds**—to account for and report the proceeds of specific revenue sources that are restricted or committed for specified purposes other than debt service or capital projects (e.g., gas tax revenues required to be used for road repairs)
  - **Debt service funds**—to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest

(continued next page)
Box 3.7 (continued)

- **Capital projects funds**—to account for and report financial resources that are restricted, committed, or assigned to expenditure for capital outlays, including the acquisition or construction of capital facilities, such as buildings and highways, and other capital assets

- **Permanent funds**—to account for and report resources restricted in that only the earnings on investments, not the principal, may be used to support the reporting government’s programs for the benefit of the government or its citizenry (e.g., maintenance of a public cemetery or park).

**Proprietary Funds**

Purpose: To account for and report governments’ activities that are similar to those carried out in the private sector and financed predominantly through user charges.

Basis of accounting/measurement focus:

- **Full accrual/economic resources**

There are two kinds of proprietary funds:

- **Enterprise funds**—to account for and report business-type activities that serve the public at large (e.g., an electric utility)

- **Internal service funds**—to account for and report goods and services provided to departments of the same government (e.g., a centralized purchasing function or motor pool).

**Fiduciary Funds**

Purpose: To account for and report resources held by governments as trustees or agents for another party or parties.

Basis of accounting/measurement focus:

- **Full accrual/economic resources**

There are two kinds of fiduciary funds:

- **Trust funds**, including
  - **Pension (and other employee benefit) trusts**—to account for and report resources accumulated to pay pension, health care, and other benefits to the government’s retired or disabled employees (e.g., a local government’s pension plan for its employees)
  - **Investment trusts**—to account for and report investment pools in which other governments participate (e.g., a state government pool open to local governments within the state)
  - **Private purpose trusts**—to account for and report resources held for individuals or external organizations (e.g., a scholarship fund for employees’ children, funded by a donation from a citizen)

- **Agency funds**—to account for and report resources held on a short-term basis on behalf of individuals, organizations, or other governments (e.g., taxes collected on behalf of another government). These funds have only assets and liabilities—no revenues or expenses.


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**Accounting for Operations and Maintenance Costs of Fixed Assets**

Most local governments pay a great deal of attention to their capital budgets and to asset creation; often very little attention is paid to asset management. Just as asset creation is critical to building up the local government’s capacities for delivering services, asset maintenance and replacement are necessary for sustaining the service delivery capacities created. Therefore,
### Table 3.23  Example of a Government Funds Balance Sheet (USD thousands)

<table>
<thead>
<tr>
<th></th>
<th>General</th>
<th>Health and urban dev. programs</th>
<th>Community redevelopment</th>
<th>Route 7 construction</th>
<th>Other government funds</th>
<th>Total government funds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>3,418.5</td>
<td>1,236.5</td>
<td></td>
<td></td>
<td>5,606.8</td>
<td>10,261.8</td>
</tr>
<tr>
<td>Investments</td>
<td></td>
<td>13,262.7</td>
<td>10,467.0</td>
<td>3,485.3</td>
<td></td>
<td>27,215.0</td>
</tr>
<tr>
<td>Receivables (net)</td>
<td>3,644.6</td>
<td>2,953.4</td>
<td>353.3</td>
<td>11.0</td>
<td>10.2</td>
<td>6,972.5</td>
</tr>
<tr>
<td>Due from other funds</td>
<td>1,370.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,370.8</td>
</tr>
<tr>
<td>Receivables from other governments</td>
<td></td>
<td>119.1</td>
<td></td>
<td></td>
<td>1,596.0</td>
<td>1,715.1</td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payable to other governments</td>
<td></td>
<td>94.1</td>
<td></td>
<td></td>
<td></td>
<td>94.1</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td>4,250.4</td>
<td>6,273.0</td>
<td>250.0</td>
<td>11.0</td>
<td></td>
<td>10,784.4</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>7,753.2</td>
<td>6,428.4</td>
<td>440.5</td>
<td>1,115.6</td>
<td>1,074.8</td>
<td>16,812.5</td>
</tr>
<tr>
<td>Fund balances:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reserved for:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventories</td>
<td>182.8</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>182.8</td>
</tr>
<tr>
<td>Liens receivables</td>
<td>791.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>791.9</td>
</tr>
<tr>
<td>Encumbrances</td>
<td>40.3</td>
<td>41.0</td>
<td>119.3</td>
<td>5,792.6</td>
<td>1,814.1</td>
<td>7,807.3</td>
</tr>
<tr>
<td>Debt service</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3,832.1</td>
<td>3,832.1</td>
</tr>
<tr>
<td>Other purposes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,405.3</td>
<td>1,405.3</td>
</tr>
<tr>
<td>Unreserved, reported in:</td>
<td>640.3</td>
<td>1,035.3</td>
<td>1,330.7</td>
<td>2,366.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-------</td>
<td>---------</td>
<td>---------</td>
<td>---------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General fund</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Special reserve funds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital project funds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total fund balances</td>
<td>1,655.3</td>
<td>1,076.3</td>
<td>13,175.5</td>
<td>9,362.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liab &amp; fund balance</td>
<td>9,408.5</td>
<td>7,504.7</td>
<td>13,616.0</td>
<td>10,478.0</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Amounts reported for government activities are different, because:

- Capital assets used in governmental activities are not financial resources and therefore are not reported in the funds. **161,082.7**
- Other long-term assets are not available to pay for current period expenditures and therefore are deferred in the funds. **9,348.9**
- Internal service funds are used by management to charge the cost of certain activities such as insurance and telecom to individual funds; the assets and liabilities of the internal service funds are included in governmental activities in the statement of net assets. **2,994.7**
- Long-term liabilities, including bonds payable, are not due and payable in the current period and therefore are not reported in the funds. **(84,760.5)**
- Net assets of governmental activities **123,558.8**

*Source: Authors, adapted from Freeman and Shoulders 2000.*
local government financial management should include adequate provision for the operation, maintenance, and replacement of the assets they have created. From an accounting perspective, this would require that the municipality make adequate provision for operating costs (based on the data generated through its cost control systems) and for the depreciation of fixed assets. Chapter 6 discusses asset management in detail.

**Weaknesses in Accounting Standards and Practices**

While there is no disagreement that reforms are necessary to improve the quality of municipal accounting, a common impediment to such reforms is the absence of well-defined accounting standards and procedures for local governments in most developing countries. Usually accounting standards and procedures are designed for national governments, with local governments expected to follow along. In such cases the utility of the standards for local governments is often reduced because they are not fully responsive to local government requirements, especially in areas such as cost accounting by service and local function, accounting of billing for and collection of fees and charges, local pension funds, and the like. Hence, wherever no specific standards and procedures exist for local government accounting, special efforts should be made to define them by taking into consideration the requirements of local governments. Fixing such weaknesses by reforming the accounting system is full of challenges, in particular when a computerized, automated accounting system is replacing a manual system.

**Using Accounting Information for Management Decision Making**

This section discusses using accounting information to support management decisions. Some of the material will be revisited in subsequent chapters (including chapters 5, 6, and 8). Here we focus only on cost accounting and on some analytic tools. The section introduces some of the basic concepts in cost accounting, such as standard costs, cost centers, direct and indirect costs, costing of overhead, and activity-based costing. Some advanced management accounting techniques, such as break-even analysis, are briefly outlined.

**Cost Accounting and Cost Management**

Cost accounting provides key information for managers, helping them both in operation decisions and in analyzing operational efficiency. In a cost accounting system, the costs of providing services are managed by measuring each service separately, enabling the manager to monitor the cost of delivering particular services such as water, solid waste management, housing, education, or health care. Cost accounting gives the decision maker analytical information that can be used to increase the efficiency of operations.

**Role and importance of cost accounting of service delivery.** While financial accounting such as this chapter has discussed helps an organization prepare financial statements that give an aggregate view of its revenues and expenses and the resultant surplus or deficit, cost accounting helps an organization obtain a detailed view of the underlying costs that flow into the aggregate financial reports. Such detailed cost information can be used to control costs and to determine appropriate pricing for products and services. In a local government, cost accounting information provides valuable insights to the finance officer, the city management, and the managers of specific service entities on the true costs of providing services. It helps the city government to estimate the extent of cost recovery and sustainability of a service by comparing the cost of operating it with the fees and charges received for it.

Cost accounting information helps the finance officer control costs and make operations more
efficient, reducing pressure on the city’s budget and avoiding the politically difficult steps of raising user fees and taxes. Cost accounting systems are forward looking and therefore help finance officers model future costs and prices and analyze the financial position of the entity in different scenarios. However, cost accounting systems are still in their infancy in local governments in most developing countries. They need the attention of policy makers. For instance, municipal accounting systems derived from central government accounting do not support accounting of the specific costs of basic services such as water, solid waste management, or public transport. The discussions below give a broad overview of some of the relevant cost concepts.

**Basic cost accounting techniques.** Cost accounting systems can differ based on the nature of an entity’s operations. In an entity that carries out mass production with common work (such as most municipal services, from solid waste disposal to water and sanitation), the system of process costing is adequate. In contrast, if an organization carries out specific services designed for individual customers (such as information technology or construction work), a job order cost accounting method is often used. Although these cost accounting systems are useful by themselves, they have deficiencies, especially when shared costs are involved (i.e., various departments or processes share a service), making it difficult to apportion the costs of jobs and processes accurately. Such deficiencies have led to the introduction of activity-based costing.

**Activity-based costing.** Activity-based costing (ABC) systems refine costing systems by focusing on individual activities as the fundamental cost objects. An activity is an event, task, or unit of work with a specified purpose, for example, removal of wastes from a part of a city, registration of births and deaths, and so forth. ABC systems calculate the costs of individual activities and assign costs to cost objects, such as products and services, on the basis of the activities undertaken to produce each one. For this purpose, the cost accounting systems group activities into cost pools and use them as the basis for assigning costs.

For example, a city government may use the same trucks, loaders, labor, and equipment for maintaining parks and sports, health, and school facilities. Hence it may set up a maintenance pool fund and allocate the cost of trucks (fuel, labor, repair) by distance in kilometers of transport used. It may allocate the cost of loaders and other equipment based on the time of use for each maintenance project in the areas covered. The logic of ABC systems is that the basis for the allocation of costs is usually the key cost driver, and so the allocation leads to more accurate costing of activities. Though an elaborate discussion about advanced cost accounting is beyond the scope of this chapter, it is useful for local government executives to understand that such sophisticated techniques exist and make accounting of service delivery costs more accurate. In that way they can help improve the quality of municipal financial management.

**Cost centers and responsibility accounting.** As discussed above, one objective of a cost accounting system is to break down the cost details of a product or service, so that management can identify costs that can be controlled. An uncontrollable cost is one the manager cannot influence. For example, in a municipal government, office expenses are a controllable cost, but insurance premiums on the city’s trucks are not controllable because they are not set by the city government. Even then, the manager might save costs by competitive selection of insurance companies.

The concept of controllable costs and expenses provides the basis for a responsibility accounting system, in which managers are responsible for the costs and expenses that fall under their control. Prior to each reporting period, the organization develops plans that specify the expected costs
or expenses under the control of each manager. Those plans are called responsibility accounting budgets. The responsibility accounting system accumulates costs and expenses to include in timely reports to managers about the costs for which they are responsible. The reports are performance reports and compare actual costs and expenses to the budgeted amounts. Managers use performance reports to focus their attention on specific, actual costs that differ from budgeted amounts and decide corrective actions to bring the costs down.

**Techniques for Efficient Management Decision Making**

Accounting is the language of any business, but increasingly accounting is also assuming greater importance in the management of local governments because they are providing services to their citizens from limited resources. Setting up basic accounting systems allows the efficient recording and compilation of financial data; the data need to be analyzed, structured, and presented to make them useful for management decision making. Several financial analysis techniques help management to draw meaningful conclusions. The techniques include ratio analysis, trend analysis, financial modeling, and ranking investment projects using capital budgeting techniques, breakeven analysis, and other methods. We will discuss breakeven analysis, one of the simplest techniques, which can be used in almost any organization. Other techniques will be discussed in chapters 5 through 8.

**Break-even analysis.** Break-even analysis is a technique widely used in business settings, especially by production management and management accountants. It is a helpful tool in deciding whether or not to purchase equipment, for example, a compactor truck, because it computes how close the operation would be to its break-even level with and without the truck. Break-even analysis simply calculates the level of service or production at which total variable and fixed costs are equal and the business makes neither a profit nor a loss. That is the break-even point. The calculation depends on carefully distinguishing costs that are variable (that change when the output changes) and costs that are fixed (that are not directly related to the volume of output). The simplest computation of the break-even point is

\[
\text{break-even point} = \frac{\text{total fixed costs}}{\text{sales} - \text{variable costs}}.
\]

In local governments, financial planning is of major importance. Breakeven analysis reveals how revenue and costs vary with a change in service level, that is, what effect a change in a service or the mix of services will have on revenues. Ideally, the goal is to find a level of output at which the government will reach breakeven—that is, total revenues are equal to or exceed total costs.

Municipal services should approach cost recovery rather than produce extra revenues. However, moving around breakeven may risk generating a deficit, raising a demand for subsidies, or undermining the sustainability of services. Thus, breakeven analysis is also a useful tool to measure which programs are self-supporting and which are subsidized or need to be. By studying the relationships among costs, service volume, and revenue, municipal management can better approach many planning decisions. Breakeven analysis can also be useful when city managers are making lease-or-buy decisions or are dealing with other common issues of day-to-day city management.

Figure 3.6 shows a break-even chart, a graphical representation of costs \(C\) at various levels of output, together with the variation of income \(A\) from sales or fees. The intersection of the two lines represents the break-even point, at which neither profit nor loss is made. Thus, the entity is facing with losses as long as the volume of output or sale is less than \(Q_0\) and begins to realize net revenues when output or sales exceed \(Q_0\).
The reason is that services always have an initial investment, which generates a fixed cost even if there is no production.

**Financial Reporting**

This section builds on previous discussions of accounting to take it to the next level, using accounting information to compile financial reports. Before the content and techniques of preparing financial reports, the importance of financial reporting for transparency and accountability in the public sector is addressed. Also touched on are the roles of participants in the reporting regime, including higher-level governments, line ministries, the parliament and other legislative bodies, oversight institutions such as the auditor general, and the citizens themselves, as well as financial reporting as a tool to communicate with stakeholders.

**Financial Reporting: Concepts and Practice**

Financial reporting provides a consolidated set of information to a wide range of stakeholders that require information about an entity. Financial reports are means of communicating to the users of financial information material that they use to make choices among alternative uses of scarce resources. The objective stems largely from the needs and interests of those users, who lack the ability to gather the information they need and therefore must rely, at least partly, on the entity’s financial reports. Financial reports are also means of performance monitoring (the subject of chapter 8). The potential users of financial reports and their information needs include the following:

- **Investors.** For companies, investors are interested in the entity’s ability to generate net cash inflows because their investment decisions relate to the amounts, timing, and uncertainties of those cash flows.

- **Creditors.** Creditors provide financial capital to a local government by lending it cash (or other assets). Like investors, creditors are interested in the amounts, timing, and uncertainty of a municipality’s future cash flows. To a creditor, a borrower is a source of cash in the form of
interest, repayments of borrowings, and price premium of debt securities.

- **Suppliers.** Suppliers provide goods or services rather than financial capital. They are interested in assessing the likelihood that what a municipality owes them will be paid when due.

- **Employees.** Employees provide services to a municipality, and so they are interested in information to assess its continuing ability to pay salaries and wages and provide incentive payments, retirement, or other benefits.

- **Citizens.** To citizens, a municipality is a source of services. Citizens are interested in assessing the ability of the local government to continue providing those services, as they have a long-term involvement with the municipality and depend on it for services.

- **Governments, their agencies, and regulatory bodies.** Governments and their agencies and regulatory bodies are interested in municipal activities because they are responsible in various ways for ensuring that economic resources are allocated efficiently. They also need information to help in regulating activities, determining and applying taxation policies, and preparing national income and similar statistics.

The above categories of information users and their requirements are applicable in both the private and public sectors, although the kind of information required of a municipal government may be different than what is required from a business enterprise. For example, the national government would be interested in how efficiently the municipality has used intergovernmental transfers to meet development requirements, whereas the citizens may be more interested in knowing about the money spent on local development works.

Financial reporting is but one source of information to permit decision making. Users of financial reports also need to consider pertinent information from other sources, such as information about general economic conditions or expectations, political events and the political climate, and the industry outlook.

Users of financial reports also need to be aware of the characteristics and limitations of the information in them. To a significant extent, financial reporting is based on estimates, rather than exact measurements, of the financial effects on entities of transactions and other events and circumstances. Hence users of financial reporting have to read the financial statements as a whole, especially the notes and annexes in which the bases and assumptions for the estimates are described.

**Characteristics of Good Financial Reporting**

According to the Financial Accounting Standards Board (FASB), the following are the qualitative characteristics required in good financial reporting (FASB 2000; Skousen et al. 2000):

- **Relevance.** To be useful in making investment, credit, and similar resource allocation decisions, information must be relevant to those decisions. Relevant information can make a difference in the decisions of users by helping them evaluate the potential effects of past, present, or future transactions or other events on future cash flows (predictive value) or confirm or correct their previous evaluations (confirmatory value). Timeliness—making information available to decision makers before it loses its capacity to influence decisions—is another aspect of relevance.

- **Faithful representation.** To be useful in making investment, credit, and similar resource allocation decisions, information must be a faithful representation of the real-world economic phenomena that it purports to represent. The phenomena represented in financial reports are economic resources and obligations and
the transactions and other events and circumstances that change them. To be a faithful representation of those economic phenomena, information must be verifiable, neutral, and complete.

Verifiability implies that different knowledgeable and independent observers would reach general consensus, although not necessarily complete agreement, either
(a) that the information represents the economic phenomena that it purports to represent without material error or bias (by direct verification); or
(b) that the chosen recognition or measurement method has been applied without material error or bias (by indirect verification).

To be verifiable, information need not be a single-point estimate. A range of possible amounts and the related probabilities can also be verified.

Neutrality is the absence of bias intended to attain a predetermined result or to induce a particular behavior. Neutrality is an essential aspect of faithful representation because biased financial reporting information cannot faithfully represent economic phenomena.

Completeness means including in financial reporting all information that is necessary for faithful representation of the economic phenomena that the information purports to represent. Therefore, completeness, within the bounds of what is material and feasible, considering the cost, is an essential component of faithful representation.

• Comparability. Comparability, including consistency, enhances the usefulness of financial reporting information in making investment, credit, and similar resource allocation decisions. Comparability is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena. Consistency refers to use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities. Comparability is the goal; consistency is a means to achieving that goal.

• Understandability. Understandability is the quality of information that enables users who have a reasonable knowledge of business and economic activities and financial accounting, and who study the information with reasonable diligence, to comprehend its meaning. Relevant information should not be excluded solely because it may be too complex or difficult for some users to understand. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely.

• Materiality. Information is material if its omission or misstatement could influence the resource allocation decisions that users make on the basis of an entity’s financial report. Materiality depends on the nature and amount of the item, judged in the particular circumstances of its omission or misstatement. A financial report should include all information that is material in relation to a particular entity—information that is not material may, and probably should, be omitted. To clutter a financial report with immaterial information risks obscuring more important information, thus making the report less useful in decisions.

• Benefits and costs. The benefits of financial reporting information should justify the costs of providing and using it. The benefits of financial reporting information include better investment, credit, and similar resource allocation decisions, which in turn result in more efficient functioning of the capital markets and lower costs of capital for the economy as a whole. However, financial reporting and financial reporting standards impose direct
and indirect costs on both preparers and users of financial reports, as well as on others such as auditors and regulators. Thus, standard setters seek information from preparers, users, and other constituents about what they expect the nature and quantity of the benefits and costs of proposed standards to be, and consider in their deliberations the information that they obtain.

Financial Statements in Action—Policy Perspective

The financial statements of any organization are the income statement, the balance sheet, and the cash flow statement. We have introduced them in the context of accounting, and we now discuss them from a policy perspective.

Local governments prepare various reports for different purposes and target audiences:

Management/internal reporting. In addition to the annual financial statements that are used for reporting to the municipality’s external stakeholders are several forms of internal reporting. Various departments prepare periodic financial reports and submit them to the financial officer and the mayor for their internal review (weekly, monthly, and quarterly). The local government also prepares and submits reports to higher levels of government reporting on the use of fiscal transfers and other resources received. These reports serve the purposes of monitoring bodies and are not usually shared with other external stakeholders. Box 3.8 summarizes a case in Bangalore, India.

Budgetary reporting. The executive reports to the city council regarding progress in budget execution during the course of a financial year in monthly budgeted/actual reports and variance analyses. These reports are also internal, helping the city council know whether the approved budget is being executed in accordance with

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Box 3.8 PROOF—A Campaign for Transparency and Accountability in Bangalore

The Public Record of Operations and Finance (PROOF) campaign was launched in Bangalore, India, in July 2002, by four NGOs—Public Affairs Centre, Janaagraha, Centre for Budget and Policy Studies, and Voices. PROOF is a campaign for transparency in municipal governance, conducted in close partnership with the local government to enable government and citizens to work together and ensure that public money is being used for public goods.

PROOF requires that municipal finances related to public services are published and scrutinized by organized groups and the public at large. It focuses on three areas: obtaining quarterly financial statements from the government, developing performance indicators to assess municipal undertakings across the city, and public discussions. These include comparing the city’s Revenue and Expenditure Statement to original budget figures and the balance sheet, with detailed information about current and long-term assets and short- and long-term liabilities.

Performance indicators were initially developed for two sectors: education, to assess the performance of Bangalore schools, and health, to assess the performance of the city’s government hospitals. The aims of the reviews are to improve public financial accountability and performance, bring government and the public closer together, and provide benchmarks to develop and reshape public expenditure priorities.

plans and whether revenues and expenditures are being realized in accordance with budget projections. Variants of budget reporting include program reporting and performance reporting. Program reporting describes the execution of a specific program (for example, school rehabilitation). Performance reporting records progress against plans or measured performance targets (such as collection of arrears). These reports are discussed in detail in chapter 8.

Citizen reporting. Citizens are among the most important stakeholder groups and have a key interest in knowing the state of affairs of their local government. For example, how well does the city government deliver services, and how efficiently does it use resources (including the taxes collected) for the development of the community? Quite often, however, citizens find it difficult to understand formal financial statements and audit reports prepared for professionals. To bridge the gap, proponents of social accountability, such as some civic organizations, have started to encourage municipalities to simplify complicated financial statements. Box 3.8 summarizes the example of the PROOF transparency initiative in India. The organization disseminates brochures, briefs, and leaflets that use nontechnical language and easy-to-understand formats such as charts, pictograms, and simple tables with key numbers. Similar initiatives are taking place in such countries as Nepal and Ghana.

Municipal Financial Reporting Formats
This section summarizes financial reporting in the context of municipal government policy. It focuses on content such as the reporting of receipts, payments, assets, and liabilities and the formats and standards used. It discusses good practices in municipal financial reporting, including linking it with performance reporting (discussed more in chapter 8). Some problems that local governments in developing countries face in the preparation of comprehensive financial statements are also addressed.

Formats and Standards in Municipal Financial Reporting—Good Practice Examples
In the United States, the Government Accounting Standards Board (GASB) sets the financial reporting standards for municipal governments. In June 1999, GASB issued Statement 34 “Basic Financial Statements—and Management Discussion and Analysis—for State and Local Governments” (GASB 1999). GASB 34 brought about a significant change in the format and content of local government financial reporting. It was the result of a continuous effort by standard setters in the country to fully meet the needs of financial statement users.

Box 3.9 describes how the government of South Africa has achieved significant progress toward standardized municipal financial reporting.

Each local government prepares two governmentwide financial statements, \textit{statement of net assets} and \textit{statement of activities}, that integrate the revenues and expenses of governmental activities, as explained previously. These statements provide an aggregate picture of the revenues and expenditures of the local government as a whole.

Fund financial statements provide detailed reporting on specific economic activities carried out by a local government, as explained above and shown in table 3.23. These activities are grouped together and reported in eight different fund financial statements. For example, the \textit{enterprise fund} accounts for revenues and expenditures relating to any commercial-type operations (such as water and sewer service or local bus service) run by a city government with user charges or fees. Similarly, there are \textit{fiduciary funds}, \textit{agency funds}, \textit{special revenue funds}, and the \textit{pension fund}, which is a trust fund outside the municipal budget.

Management discussion and analysis (usually referred to as “MD&A”) is a unique aspect of the reporting requirements introduced by GASB 34. MD&A provides an analytical overview of a government’s activities through the year and an
introduction to the figures and results reported in the financial statements. It provides an analysis of the government’s financial activities based on currently known facts, decisions, or conditions and helps users assess whether the government’s financial position has improved or deteriorated during the year.

**Links between Performance Reporting and Financial Reporting**

It is important to remember that finance constitutes only one aspect of a local government’s responsibilities and performance. Hence reporting of a government’s activities should also include its performance in the achievement of its development goals and programs. The importance of such a results-based approach to government activities is now being recognized all over the world, and several initiatives on performance reporting are being introduced. For example, the Service Efforts and Accomplishments reporting initiative of GASB in the United States attempts to introduce standards for performance reporting along with the standards for financial reporting for local governments. The goal is to assist users of the information (including citizen groups, state legislators, city council members, and other interested persons) to evaluate the efficiency of the

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**Box 3.9 Municipal Finance Management Act, South Africa**

The National Treasury of the Government of South Africa has played a pivotal role in the introduction of financial management reforms across government since 1994 and in local government since 1996. The reform initiative has been implemented through the Municipal Finance Management Act No. 56 of 2003 (MFMA), which is supported by the annual Division of Revenue Act. These pieces of legislation have been aligned with other local government legislation, such as the Structures Act, Systems Act, and Property Rates Act and their regulations, to form a coherent package.

The national treasury’s primary objective was to secure sound and sustainable management of the financial affairs of government—national, provincial, and local. That includes regulatory interventions, manuals, guidance, circulars, workshops, seminars, training, internship programs, and hands-on support to municipalities. The national treasury has developed a phased implementation strategy of financial and technical support for local governments, based on the MFMA, including conditional grants, subsidies, technical guidelines, policy advice, and the placement of international advisers with some municipalities. The strategy takes into account the differing capacities of municipalities to implement the reforms, as well as the need for institutional strengthening, building municipal capacity, and improving municipal consultation, reporting, transparency, and accountability.

The MFMA aims to modernize budget, accounting, and financial management practices, placing local government finances on a sustainable footing to maximize the municipalities’ capacity to deliver services. It also aims to put in place a sound financial governance framework by clarifying and separating the roles and responsibilities of the council, mayor, and other officials. The MFMA is required by the country’s constitution, which obliges all three tiers of government to be transparent about their financial affairs. It also forms an integral part of the broader reform package for local government outlined in the 1998 White Paper on Local Government.

services that governments provide and to assess governments’ effectiveness in achieving their goals and objectives. Chapter 8 discusses performance measurement in more detail.

Auditing

Auditing helps to ensure that funds are not subject to fraud, waste, and abuse or to error in reporting. Auditing in the public sector also helps to ensure that the entity carries on its business in compliance with the established rules and procedures of public financial management. Without going into the technical details of the auditing process, the discussion in this section focuses on the use of audit reports as tools of accountability, the differences between various types of audits and their relationships, and the audit models in the public sector. It also addresses the meaning and significance of audit opinions, the various types of audit opinions, and audit standards.

Auditing—Basic Concepts and Practices

Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events. It consists of a series of sequential steps, including evaluation of internal controls and testing the substance of transactions and balances. The auditor communicates the results of his or her audit work to interested users through the audit report. The findings of the auditor are expressed in the form of an opinion concerning the fairness with which the financial statements present the organization’s financial position, operating results, and cash flows.

Auditing in the private sector is used largely to ensure that the financial statements issued by a firm fairly reflect its financial position. In the public sector, other objectives are equally important, such as compliance with the rules and procedures for public expenditures, and are included in the scope of the audit. Another purpose of auditing in the public sector is ensuring that public funds are not misused or misappropriated.

Types of Audits

A financial audit is a historically oriented, independent evaluation performed for the purpose of certifying the fairness, accuracy, and reliability of the financial data. Financial audits focus on whether financial statements prepared by an entity reflect the financial position of the organization. Auditors examine the accounting treatment of various transactions in the entity’s financial statements and whether the information disclosed in the financial statements reflects the underlying transaction. This is the most common form of audit.

A compliance audit focuses on whether the entity complied with certain rules and procedures regarding the spending of money. This kind of audit is usually done in the public sector, so that the auditor verifies the compliance of the entity with the government’s established rules and procedures for financial management.

A management audit is a future-oriented, independent, and systematic evaluation of the activities of the organization prepared to help it attain its objectives. A management audit is also called a “performance audit.” It evaluates the organization’s performance against its stated plans and analyzes the reasons for any variance in performance, with the aim of drawing lessons for the future.

The auditor’s findings are communicated through the audit report. The audit report is the culminating step in the audit process, and expressing an audit opinion is the auditor’s overriding goal. The audit report concisely describes the auditor’s responsibility, the nature of the examination, and the auditor’s findings. The form of the audit report is standardized in many countries.

The introductory paragraph identifies the financial statements covered by the audit report and clearly differentiates management’s responsibility for preparing the financial statements from the auditor’s responsibility for expressing an opinion on them. The scope paragraph states whether the audit was conducted in accordance
with accepted auditing principles. The opinion paragraph conveys the auditor’s findings.

For instance, an audit report issued by the company KPMG to the City of Roanoke, Virginia, in the United States, illustrates the structure, details, and depth of an audit report and the messages and issues discussed with management. One interesting finding was the following:

The City calculates its allowance for uncollectible receivables based on historic data and specific account analysis. We evaluated the key factors and assumptions used to develop the allowance, including possible management bias in developing the estimate, in determining that the allowance for uncollectible receivables as of June 30, 2011 is reasonable in relation to the financial statements of the city. (Roanoke City Department of Finance reports 2011, http://www.roanokeva.gov/85256A8D0062AF37/CurrentBaseLink/N27W8PBL294/LGONEN)

We can draw two lessons from this statement: First, the city carries out a careful analysis and makes some assumptions in estimating the uncollectible receivables (arrears). Second, the source data, the analysis procedure, and the assumptions are evaluated by the auditor as adequate.

Types of Audit Opinions and Their Significance
Upon completion of the audit fieldwork, the auditor must decide whether or not an opinion can be rendered. If an opinion cannot be rendered, the auditor must clearly 

\textit{disclaim an opinion} and give the reasons for the \textit{disclaimer}. If an opinion is rendered, the auditor must decide whether to issue an \textit{unqualified}, a \textit{qualified}, or an \textit{adverse} opinion.

\textbf{Unqualified opinion.} An unqualified audit opinion expresses the auditor’s belief that the financial statements present a true and fair view of the entity’s financial position.

\textbf{Qualified opinion.} The auditor expresses a qualified opinion if the financial statements contain material differences from accepted accounting standards and practices. Materiality is judged according to whether the differences might affect the conclusions drawn by users of the financial statement.

\textbf{Adverse opinion.} An adverse opinion is expressed when the financial statements contain serious differences from accepted accounting standards. In rendering an adverse opinion, the auditor states that the financial statements do not fairly present the entity’s financial position and results of operations, in accordance with accounting standards and principles.

The standards and practices of audit reports and opinions described above are not found in many developing-countries’ public sectors. The audits are not risk based, and the auditor’s findings do not make any distinctions between material findings and nonmaterial findings. The auditor simply lists his \textit{observations} in the form of \textit{audit paragraphs} or \textit{audit queries} and gives them to the audited entity at the conclusion of the fieldwork. That is considered a \textit{preliminary audit report}, and the audited entity is expected to provide suitable replies to the audit queries raised within a specified time period. If the auditor is satisfied with the replies received, the audit paragraphs or audit queries are dropped, and a final audit report is prepared and submitted to the audited entity. In that system, the auditor does not express an opinion on the financial statements of the entity but instead carries out a “100 percent” check on all financial transactions from both financial and compliance points of view.

Municipal Audit Practices
This section discusses the role of audits in local governments with specific reference to the issues developing countries face. It centers on the weaknesses in public sector audit systems in developing countries, the impediments to regular and timely audits, and the role of the supreme audit institutions (SAIs) in public sector auditing.
External audits play a significant role in enhancing the accountability of municipal governments, in addition to providing valuable feedback to city management on the quality of the city's financial management. However, the experiences in most developing countries indicate that audits do not always play the critical part that they are expected to play for a variety of reasons.

**Delayed audits**

In most developing countries, government entities such as supreme audit institutions or the office of the auditor general audit municipalities. These agencies often are responsible to audit a large number of ministries, departments, central government agencies, and provincial governments. As a result, municipal audits often have a lower priority than others and are often conducted well after the close of the financial year. In fact, in quite a number of cases, audits have been delayed by years.

**Compliance audits**

External audits carried out by public sector auditors are often compliance audits in which the auditors verify whether the entity’s expenditures are in accordance with the government's rules and procedures. Although verifying that is important, municipal governments also require audits to provide assurances on their financial statements, particularly if they plan borrowing or issuing debt. Local citizens and other stakeholders, such as lenders, are interested in knowing about the quality of the municipality's financial management. They expect the annual external audit to provide the necessary assurances. Hence municipal governments should undergo both financial and compliance audits, done together or separately.

**Capacity shortage**

Public sector audit agencies often are short on capacity, another factor that causes weak municipal audits. Weak capacities appear in both skills and numbers of auditors. Because public sector audit agencies more often than not carry out compliance audits, undertaking financial audits often poses a challenge to their knowledge and skills. Because the agencies frequently have the responsibility to audit numerous agencies of higher-level governments, they often find it difficult to program municipal audits within a reasonable period after the close of the financial year. A possible solution to this issue is to involve private sector auditors in carrying out the external audits of municipalities, as in the case in Bangladesh summarized in box 3.10. The practice has been successful in several countries but is not widespread. Governments and supreme audit institutions should establish policies and frameworks (including audit standards for municipalities) to facilitate the engagement of private sector auditors.

**Audit Follow-Up**

Audit follow-up is a critical part of the audit process. In the management letter, the auditor points out specific issues that the city management needs to rectify to improve the quality of its financial management and reports. City executives must respond to the audit observations diligently and have them rectified by the time of the subsequent audit. In the public sector, it often does not happen as expeditiously as desired. The reason is that executives often take audits as a criticism of their actions and do not want to admit that they were wrong. Without well-specified public sector audit standards in many developing countries, auditors can make audit observations without understanding the nature and context of an administrative action. That makes it difficult for executives to address the auditor’s queries satisfactorily, and some audit queries are left pending for months or years.

Some developing countries have introduced the practice of audit conferences, in which the auditor, the audited city, and the supervising line ministry sit together to go over the audit observations and resolve issues through discussions. Such a process expedites, and reinforces the importance of, a prompt response to audit observations.
by city executives. In many local governments, audits are handled by the executives, with little involvement by the municipal council. That needs to change; the council should be fully abreast of the audit observations and make it a priority to ensure that the executives take prompt corrective actions. As a good practice for strengthening social accountability, audit observations and the corrective measures taken could be shared with citizens and other stakeholders, published on the city’s website or on public notice boards.

**Takeaway Messages**

Budgets are developed based on both financial and nonfinancial information and determine how local services will be provided and financed in a fiscal year. The budget is often a local ordinance or bylaw approved by the council or equivalent body of a local government. It is a guiding, financing, executive, monitoring, and evaluation tool that allocates funds and responsibilities and induces actions by local entities and persons to achieve the set goals.

Budgeting weaknesses in developing countries include unrealistic plans and estimates, a shortage of timely information, politicized targets, and balloon revenue targets. Implementation weaknesses include overspending, delayed execution, unclear items, and persistent deficits.

The primary role of the accounting system is to provide and record timely and accurate information on revenues, expenditures, assets, and liabilities to inform stakeholders about the sources and uses of financial resources. The main types of accounting include financial accounting, cost accounting, managerial accounting, and tax accounting. Accounting systems include single-entry and double-entry accounting and cash-based or accrual-based systems, or combinations.

The most advanced system is double-entry accrual-based accounting, but double-entry
A more realistic option for the local governments in developing countries. Cost accounting and fund accounting are more sophisticated systems that provide more specific information on key activity areas and functions and eventually on local government effectiveness overall.

Computerized accounting (and management information) systems offer convenient solutions in which each transaction is entered only once and automatically posted in various accounts, journals, and ledgers. Computerized systems are generally more accurate than manual systems. Moreover, they shift the focus of accounting from registering transactions to providing timely and structured information to those who need it, such as the mayor and executives, the council, and citizens.

Financial reports are key communication and control tools for local governments. The three main external financial reports are the Statement of Activities, the Statement of Financial Position, and the Cash Flow Statement. Many other reports are used internally, including budget/actual, trial balance, asset register and maintenance, or cost center reports. Accounting and financial reporting are often regulated by national institutions that prescribe standard formats and procedures.

The financial reports are the subjects of auditing, which is a process of systematic collection and evaluation of information on the financial transactions and the financial reports. The three main types of audits include the financial audit, the compliance audit, and the management audit. The results are presented in an audit report, which may include an unqualified, qualified, or adverse opinion by the auditor.

The audit report provides valuable feedback to management and calls for corrective actions. For external stakeholders, an audit report with positive statements is an assurance that the financial reports fairly represent the financial position of the local government. That is a vital message for investors and creditors. Local governments in developing countries are often audited by state auditors who focus on verifying compliance with public sector rules rather than the quality of finances, hence the need for simple self-assessments in order to ensure the accountability of public funds.

References


