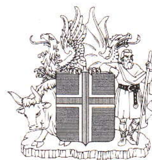

Ministry of Finance

Financial Reporting Reform

The Report of the Financial Reporting Commission

February 1995

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Ministry of Finance
January 1995

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Chapter 1

Introduction and Executive Summary

In 1990, the Financial Reporting Commission recommended to the Minister of Finance that the government's entire system of financial reporting be reviewed. The Minister accepted this recommendation and the Commission has been working on the project since then. To facilitate its work, the Commission established four task forces to deal with specific issues and called upon officials from the relevant economic agencies for assistance as required. The Commission also gathered information on this subject from various international organizations and from several foreign governments.

The Financial Reporting Commission is a statutory board established by the Financial Reporting Act of 1966. Its legal mandate is to advise the Minister of Finance on all matters related to the execution of the Act.

The responsibilities of the Commission are many. It is to make recommendations on whether specific entities should be included in the government's financial reporting and if they should be classified in Group A or Group B. It is also to make recommendations on whether various revenue that the Treasury collects on behalf of other entities should be included in the government's financial reporting. The Commission makes recommendations on the format of the Financial Statements and how revenue, expenditure, assets and liabilities are classified. The Commission establishes guidelines for valuing (and revaluing) assets and liabilities. The Commission is also to issue guidelines on the financial reporting of state enterprises. Finally, the Commission should be consulted on the format of the Budget.

This report presents the Commission's recommendations for comprehensive reform of the government's system of financial reporting.

The Commission's recommendations represent a major overhaul of the government's system of financial reporting and require legislative action. It is, however, impossible to prescribe all financial reporting practices in law. Neither is it desirable to do so since laws are intended to be in effect for an extended period of time whereas the government's financial reporting practices need adjustment more frequently. The Commission believes that the new legislation should represent an

overall framework for the government's system of financial reporting but that specific practices should be prescribed by regulatory authority. The Commission therefore recommends that new legislation be enacted and new regulations issued for the government's system of financial reporting. The Commission furthermore recommends that a manual be published for further guidance and explanation of the new system of financial reporting.

The Financial Reporting Commission has six ex-officio members representing the Ministry of Finance, the State Accounting Office, the National Audit Office, the Bureau of Statistics, the Central Bank of Iceland and the National Economic Institute. These institutions have varying needs for financial information and these varying needs are sometimes in conflict. The Commission has, however, striven to satisfy these varying needs and there is complete agreement on the recommendations presented in this report.

The major thrust of the Commission's recommendations have previously been presented in two forums. First, the Commission has held meetings with the Minister of Finance and the Budget Committee of the *Althingi* to explain its work. Second, the Budgets for both fiscal years 1992 and 1993 have contained a section illustrating the financial impact of the Commission's recommendations if they were already in place.

The major recommendations of the Commission are as follows:

- Financial reporting should, to the extent possible, be in line with international guidelines on definition, classification and presentation of financial information.
- It should also take account of private sector financial reporting practices where practicable. This is especially valuable for judging the relative performance of agencies. The major deviation from private sector practice is that plant, property and equipment will not be reported as assets and depreciated each year. Plant, property and equipment will be reported as expenditure in the year purchased.
- Financial reporting should be on modified accrual-basis, i.e. revenue and expenditure should be recognized as it accrues not when the actual cash flow takes place. The Budget and the Financial Statements should also be presented on cash-basis as has been the case.
- Entities should be defined for reporting purposes in line with international guidelines. This encompasses entities whose operations fall under the decision-making power of the government due to the government's majority ownership of the entity or due to the government's majority financing of the entity.
- Government entities are divided into five groups:

Group A	Central Government (Treasury)
Group B	Non-Financial Public Enterprises
Group C	Lending Institutions
Group D	Financial Enterprises
Group E	Joint-Ownership Companies

- Revenue is defined in line with international guidelines where all revenue is accounted for and systematically classified according to the nature of the revenue. Revenue is defined as all taxes and compulsory fees levied by law and all operating revenue and user fees collected by Group A entities.
- Clear rules are established for the treatment of tax expenditures. Tax expenditures which are linked to the taxpayer's liability for tax (i.e. personal allowance) will continue to be treated as negative revenue while those tax expenditures which are not linked to the taxpayer's liability for tax (i.e. children's benefit and mortgage interest benefit) will in future be treated as ordinary expenditure.
- Expenditure will be classified by administrative unit and economic category as has been the case. In future, they will also be classified by function in line with international guidelines.
- More emphasis will be placed on reporting for assets and liabilities. The Treasury's holdings in non-Group A entities will in future be reported as assets. This requires that their current net worth be reported. Any capital transfers to these entities will in future be reported in line with private sector practice.
- Financial reporting for Group B and Group C entities will be in line with the practices employed by their private sector counterparts.
- The Financial Statements will be characterized by the following:
  - They will have the same scope and employ the same financial reporting practices as the Budget.
  - They will compare actual revenue and expenditures with appropriations and revenue projections.
  - The balance sheet will present information on the Treasury's financial assets and liabilities and holdings in non-Group A entities.
  - Summary information from the Register of Property, Plant and Equipment will be presented in a special statement.

- Special statements will present information on the Treasury's borrowing activity and various obligations and commitments not reported as liabilities.
- Key financial information for Group D and Group E entities will be presented in special statements.
- Non-profit institutions that are majority financed by the Treasury will be required to submit their financial statements for inclusion in the government's Financial Statements.

➤ The format of the Budget will be substantially altered:

- The Budget will be presented on accrual-basis but will continue to be presented on cash-basis as well.
- Authority to borrow funds and grant loan guarantees will be part of the Budget. The separate Credit Budget will be abolished.
- The Budget will present information on Group A, Group B and Group C entities. Information for these entities will be presented in summary fashion in the actual budget statement with more emphasis placed on various supplementary statements. Appropriations classified by administrative unit and functional category will be presented in a supplementary statement while the classification of appropriations by economic category will be presented in special tables.

➤ Interim financial reporting will be based on monthly reports presented on cash-basis and twice-a-year reports presented on accrual-basis

➤ Appropriations will only be granted in the Budget or supplementary budgets. The supplementary budgets authorize changes in appropriations and the transfer of appropriations between years.

➤ A supplementary budget will be presented to the *Althingi* at the end of each fiscal year to give legal confirmation to the Financial Statements. Authorization is thus granted for actual outlays in excess of appropriations and for the transfer or cancellation of unused appropriations. The fiscal year would thus be concluded in a formal manner with the *Althingi* discussing the Financial Statements.

Chapter 2.

Need for Reform

Three decades have passed since the present Financial Reporting Act was enacted into law. New demands have been placed on financial reporting during this time. New financial management practices have been introduced in the public sector, advances in information technology have transformed the financial reporting process and new requirements by international organizations for uniform data from their member countries have been made. The need for financial reporting to show the economic impact of government finances has also taken on greater importance. Finally, the *Althingi* has taken a much more active role in these matters in recent years. The recommendations of the Commission are made in this context.

2.1 Present Legislation

The present Financial Reporting Act dates from 1966. It replaced the Accounting and Audit Act of 1931, the Depreciation Fund Act of 1947 and the Capital Projects Fund Act of 1905. The latter two acts concerned the government's real property holdings. The 1966 Act was 5-6 years in preparation. Officials from all key economic agencies were involved in drafting that legislation. The objectives of the Act were stated as follows: "To best serve the needs of the appropriations authority, financial management, general administrative procedures, economic policy, national accounts preparation and overall economic reporting. The system of financial reporting should be as simple as possible within its overall framework. These objectives are best met by clearer definition of government entities for reporting purposes, improved classification systems, new formats for presenting financial information and more thoroughly defined terms. The Act also aims at creating a more stable environment for financial reporting and to ensure internal uniformity between the financial reporting practices used by the Ttreasury and government enterprises."

The major changes introduced by the new legislation were the following:

- Clear rules for defining government entities for reporting purposes were set. The special status of government enterprises was recognized.
- Various financial reporting terminology, including revenue, expenditure, revenue balance, assets, liabilities and revaluation were defined more thoroughly.

- Various supplementary statements to the Financial Statements were introduced. The legislation aimed to increase the financial accountability of non-government entities that were majority financed by the Treasury. All taxes levied by the government were to be shown in a clear manner.
- Improvements in administrative procedures regarding financial reporting were introduced. A special Financial Reporting Commission was established as a statutory body with ex-officio members to advise the Minister of Finance on the execution of the Act.

The Financial Reporting Act of 1966 has remained unchanged for the most part since it was enacted. The Act has only been amended twice. In 1982, the Act was amended so that all major economic assumptions underlying the Budget be outlined and presented in the Budget. The amendment also called for a statement of all supplemental appropriations to be included in the Financial Statements. A summary statement of civil service overtime, travel expenses and entertainment allowances was also to be included in the Financial Statements.

The Act was amended a second time in 1985. This brought the social security system on-budget whereas it had previously been reported as a separate off-budget entity. The amendment also linked the Budget and the Credit Budget together and called for the Minister of Finance to present to Parliament the Credit Budget at the same time as the Budget.

Present legislation has proven well in many respects. It represented major progress from the financial reporting practices previously employed and it vastly improved the flow of financial information which in turn facilitated control over the government's finances. Changing circumstances nonetheless demand that further reforms be made today.

2.2 Need for Reform

Major advances in information technology and financial reporting practices have occurred in recent years. This applies equally to the public sector and the private sector. Information technology has made it possible to process information instantaneously that had previously been very time consuming or not practicable at all. These advances have, for example, made possible the regular reporting for actuarial estimates of future pension obligations. Information technology has also made financial reporting on accrual-basis possible instead of relying only on cash-basis. Economic reporting in general has also developed and changed greatly in recent years. In addition, local governments have conducted comprehensive reviews of their financial reporting practices, most recently in 1991.

The key reasons for reforming the present Financial Reporting Act are as follows:

1. **Economic Impact of Government Activity.** The allocation of the Treasury's tax revenues is at the core of the government's impact on the general economy. The size of the public sector has increased enormously in recent years. The government's share of GDP has not only been rising but the government has greatly increased the scope of its activities. It is thus important for the impact of the government´s activities to be reported for in a clear and comprehensive manner. The difference between revenue and expenditures, the revenue balance, has traditionally been the key measurement of the government's impact on the economy. This measure is no longer considered satisfactory. The Treasury's participation in the credit markets needs to be taken fully into account as well. The government's borrowing requirement is thus considered to be a better measurement of the economic impact of the government's activities.

2. **Credit Budget Abolished.** At present, the Treasury´s finances appear in two separate pieces of legislation: the Budget and the Credit Budget. It is recommended that the Credit Budget be abolished as a separate legal document and incorporated into the Budget. This ensures that all decisions regarding Treasury finances are taken together and in the same context, whether they relate to operations, investments, borrowings or granting guarantees. The interplay of Treasury finances will become clearer as a result. The *Althingi's* discussion will also become simpler as decisions made in the Budget have a direct impact on contents of the Credit Budget.

3. **Assets and Liabilities.** The Financial Reporting Act of 1966 called primarily for financial assets and financial liabilities to be reported. In addition, a register of property, plant and equipment was to be prepared. Such a register has, however, never been produced in a satisfactory manner. Holdings in non-Group A entities have generally been reported but not revalued. The reporting for liabilities has been more thorough, especially after the inclusion of pension obligations in the 1989 Financial Statements. It is important to stress, in this respect, that the government´s debt has increased substantially in recent years. The government also grants loans to government entities and non-government entities, as well as granting guarantees for third-party borrowing. The impact of the Treasury's increasing borrowing activity on interest rates and the operations of the financial markets has become a focus of attention in recent years. It is thus important for Treasury liabilities to be reported in a very clear manner.

4. **Guarantees and Commitments.** Various guarantees and committments that the Treasury has entered into in the past have fallen on the Treasury in recent years and become issues for debate in the *Althingi*. The Treasury's unfunded pension liability

and guarantees granted for thirdparty borrowing have been most prominent in these debates. Financial reporting that is centered on cashflows only does not deal adequately with transactions such as these and is not acceptable by the *Althingi*.

4. Financial Management. The management of government agencies has been subject to change in recent years. At certain times, centralized control mechanisms such as hiring freezes have been employed. At other times, agencies have been granted more flexibility and independence in their operations. They have, for example, been encouraged to sell their services and earn revenue which they have been allowed to keep. Demands for lower government spending and more efficiency and effectiveness in government operations have increased in recent years. More emphasis is thus placed on judging the relative performance of agencies, i.e. what services they produce in return for the appropriations they receive. The financial performance of individual agencies must be comparable to other agencies and to non-government entities. Financial reporting is thus an important mechanism for judging the relative performance of agencies.

2.3 Legal Authority

The discussion of the Budget and the Financial Statements are one of the principal duties of the *Althingi* each year. The government's financial reporting system has been a feature in these discussions in two ways in recent years. First, the executive branch's legal authority to disburse funds or enter into financially-binding obligations has been questioned in several cases. Second, various financial reporting practices not prescribed in the present Financial Reporting Act have become issues of contention.

Members of Parliament have often debated what the actual budget deficit is. The Minister of Finance has presented one deficit number to the *Althingi* while the Audit Office has presented another one. There are also several cases where the treatment of certain transactions has been debated in the *Althingi*. These debates have centered on technical financial reporting matters rather than on the merits of the respective transactions. This is due to the lack of clear rules on the definition and classification of entities and transactions. The legislation, regulations and manuals emerging from the present financial reporting reforms must be as clear as possible in order to prevent debates such as these from recurring.

The disputes on where the lines should be drawn between the *Althingi* and the executive branch in financial matters is clearly illustrated by the Treasury Disbursements Bill, which was sponsored by several MP's from most political parties in the *Althingi*. The Bill aimed to reduce the executive branch's authority to disburse funds in excess of parliamentary appropriations and to set rules on various financial transactions that are not currently prescribed in legislation. Views on this Bill varied.

There was general support for the overall objectives of the Bill but there was disagreement on how best to achieve those objective.

The Commission discussed this Bill in a special task force and held meetings with the Budget Committee of the *Althingi*. The task force believed that the financial reporting matters that the *Althingi* wanted legislated should be included in a revised Financial Reporting Act and not in a separate piece of legislation. The task force agreed with many of the objectives of the Bill, especially the need to reduce the power to disburse funds in excess of parliamentary appropriations and the need to set general rules regarding certain financial transactions. The task force disagreed, however, with other parts of the Bill, especially those that reduced the operating freedom of agencies in conducting their daily business.

The Bill has not been voted on in the *Althingi*. Many of its provisions have, however, de facto entered into force. The Commission shares many of the objectives of the Bill and this can be seen directly and indirectly in many of the Commission's recommendations. This is especially the case of the basic principle that no obligation should be entered into without budget authority and that appropriations should not be altered or transferred between years without approval in a supplementary budget. The Commission believes that this should be explicitly stated in the Financial Reporting Act and is further discussed in Chapter 9 of this report.

2.4 International Comparability

Financial reporting must meet some general guidelines for international comparability. Iceland is involved in various international organizations that demand data from their member countries. These organizations include the United Nations, the Organization for Economic Cooperation and Development (OECD), the International Monetary Fund (IMF), various Nordic organizations and the EU Statistics Office. Uniform reporting by member countries is the basis for their publications and for accurate comparisons to be made between member countries.

The financial reporting system has to date not followed any prescribed international guidelines. It has been necessary to publish special reports to fulfill the government's reporting obligations to these international organizations. The importance of international comparability of government finances should not be underestimated. It provides valuable information for domestic discussion of the government's finances. It is also important for Iceland to readily supply international organizations with information that fulfills accepted guidelines. This is important not only due to the reporting obligations inherent to membership in these organizations. It is no less important that the reports of these international organizations are used on international financial markets when debt ratings are issued and when decisions on

extending credit are made. Uniform financial reporting based on accepted guidelines is thus an important consideration for access to international financial markets.

2.5 Reform Objectives

This chapter has discussed the need for reform in relation to domestic considerations, changes in financial management practices and international developments. This forms the basis for the following objectives of financial reporting reform:

1. **Comprehensiveness.** The present system of financial reporting does not give a complete picture of the operations of the government. Various entities are not defined as government entities for reporting purposes. The same applies to non-profit organizations that are majority financed by the Treasury. Various committments and obligations that the Treasury has entered into have not been reported. The government's assets have not been reported in a systematic manner. The Budget and the Credit Budget have been separate documents thus fragmenting the public's view of government finances. One of the major objectives of the reforms is that the financial reporting system encompass all government entities and give a complete overview of the government's operations.

2. **Internal Uniformity.** In addition to the non-comprehensive nature of the present system, there are many examples of non-uniform classification of entities in the financial reporting system. Entities have often been classified in Group A or Group B in a haphazard manner. The operations of various agencies have changed markedly over time without their classification being reviewed. The definition and classification of tax revenue and other Treasury revenue has clearly been unsatisfactory. Lack of clear rules regarding the treatment of tax expenditures has led to various discrepancies. Rules regarding the valuation of outstanding claims and tax receivables, and their write-offs, have also been lacking. It is thus an important objective of the present reforms to establish clear rules for the classification and treatment of entities and transactions for financial reporting purposes.

3. **Financial Management.** The increased scope of government activity together with new demands for efficiency and effectiveness in government operations has created new demands on financial reporting. It is important for financial reporting to give a clear picture of each agency's use of assets, in addition to its use of cash appropriations, in order to judge the performance of agencies. To make this possible and to make the performance of agencies comparable, the Commission recommends that financial reporting for agencies be in line with private sector practice.

4. **Comparing Budget with Actual Outcome.** The lack of uniform definition of entities and treatment of transactions has reduced the comparability of financial reporting documents from one year to another and between the Budget, the Financial Statements and various interim financial statements. It is thus a major objective of the present reforms to ensure that there is uniform definition of entities and treatment of transactions. Special problems have been caused by the fact that the Budget is not comparable to the Financial Statements in many respects.

5. **International Comparability.** It is important for Iceland's financial reporting standards to conform to international guidelines. This is important not only for comparing government finances in Iceland with those of other countries and for compliance with the various reporting obligations to international organizations. It is also important because it reduces the amount of time and effort required to make the necessary adjustments to financial reporting documents in order to satisfy demands by international organizations for data.

Chapter 3

Financial Reporting Principles

It is essential for the government's system of financial reporting to be subject to uniform definitions, classifications and treatments of entities and transactions in order to achieve the objectives outlined in Chapter 2. This is best achieved in the following manner:

- Financial reporting should, to the extent possible, be in line with international guidelines.
- It should also take account of private sector financial reporting practices where practicable.
- The Budget and the Financial Statements should be presented on both modified accrual-basis and cash-basis.

3.1 International Guidelines

Three international organizations have been most active in the development of international guidelines for government financial reporting: the United Nations (UN), the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD). Their guidelines have been developed separately in line with the special needs of each organization. The UN is most concerned with government financial reporting in the context of preparing national accounts. The IMF is mainly concerned with monetary and currency affairs and views financial reporting in this context. The OECD is mainly concerned with general economic developments and treats government financial reporting in this context. These organizations have published government financial reporting guidelines that are not uniform in all respects although the underlying financial reporting principles are the same. There has been movement to harmonize these guidelines in recent years as cooperation between the three organizations has increased in this field.

Much work has been done in this respect in the context of the third review of the UN's System of National Accounts (SNA). Most countries now employ the SNA guidelines. Iceland and most other countries use the second review of the SNA but are preparing to take up the third review which was published in 1993. In preparing the third review of the SNA, the UN emphasized cooperation with the IMF, the OECD

and other international economic organizations. The cooperation between these organizations was so successful that the third review of the SNA was published jointly by the UN, IMF, OECD, the World Bank and the European Union. This cooperation has yielded a more uniform system of definitions and classifications for reporting economic, employment and trade information. The UN has also published a new industrial classification system and the European Union is revising its own classification system in line with the new UN system. The IMF has also revised its guidelines for balance of payments reporting in line with the new SNA guidelines. Due to Iceland's membership in the European Economic Area, the European Union classification system will be used in Iceland, including the European System of National and Regional Accounts (ESA) and the NACE industrial classification system. These systems are in line with the SNA guidelines but contain more detailed classifications and joint interpretations for the handling of certain transactions.

No international guidelines exist for government financial reporting that encompass both the operating statement and the balance sheet. There is general agreement on guidelines for preparing the operating statement while no such guidelines exist for preparing the balance sheet. Guidelines vary according to whether they are based on accrual-basis or cash-basis. Guidelines on preparing the operating statement come mainly from the UN, the IMF and the OECD and are uniform in most respects. Definition of government entities for reporting purposes comes from the SNA guidelines which have been largely adopted by the IMF and the OECD. Definition and classification of tax revenue and other Treasury revenue is based on IMF and OECD guidelines which have been adopted in the new SNA guidelines in most respects. Functional classification of expenditure is based on a special UN system, the *Classification of Functions of Government*.

All in all, the UN, the IMF and the OECD have established uniform guidelines in most respects. The treatment of certain items may differ and the reporting formats may be different as well. For example, there are uniform guidelines for reporting on cash-basis and accrual-basis. The IMF and OECD use the cash-basis guidelines whereas the new SNA guidelines use accrual-basis. These different formats are based on the different uses these reports serve. The reports of the IMF and OECD aim to show the size of the government sector and its impact on the economy whereas the UN reports are more concerned with presenting a complete picture of the national economy at a given time.

The Commission believes that financial reporting in Iceland should be based on international guidelines, where such guidelines are available, for the following reasons:

- The guidelines have been developed in a broad context. They take account of the very nature of the respective entity or transaction, which prevents decisions from being made in a haphazard manner.
- The guidelines are internally uniform.
- The guidelines increase the comparability of government finances from one time period to another and between Iceland and other countries. They also reduce the time and effort needed to satisfy reporting obligations to international organizations

It should be noted that using uniform guidelines for financial reporting, whether they are international or purely domestic in origin, will always give rise to judgment calls in cases of uncertainty. The domestic environment can also differ from the international context to such a degree that it becomes necessary to deviate from the international guidelines in some respects.

No international accounting standards have been formulated for public sector financial reporting. The work of two committees should, however, be mentioned in this regard: the Public Sector Committtee of the International Federation of Accountants and the INTOSAI Committee on Accounting Standards. These committees have been comparing the accounting standards employed by the private sector and the public sector. It is likely that international accounting standards for public sector financial reporting will emerge in the coming years. The Commission's recommendations have to be implemented with regard to this.

3.2 Private Sector Financial Reporting Practices

International guidelines for public sector financial reporting are of most use in the definition and classification of entities and transactions. Private sector financial reporting practices give much more insight into the treatment of individual transactions. They are very useful, for example, in formulating guidelines for the treatment and valuation of various assets and liabilities, write-offs, and the reporting format of the balance sheet.

Due to its very nature, the government's system of financial reporting will never be completely based on private sector practice. The objective of the government's financial reporting is to show the government's tax revenue and other revenue and how they are allocated for various services to the community. It also needs to show the impact of the government's operations on the general economy. Private sector financial reporting on the other hand needs to show the company's profitability and return on shareowner's equity as well as the company's assets and how they are financed.

In addition to the insight that private sector practice provides for formulating government financial reporting guidelines, and is discussed in the following chapters, there are other reasons why they should be considered more closely than before. Increased emphasis is being placed on the efficient and effective operations of government agencies. This new emphasis demands that the performance of one agency be comparable to that of another agency and to private sector alternatives. In this respect, it is therefore desirable to make use of the experience of private sector financial reporting practice.

3.3 Cash-Basis and Accrual-Basis

The Treasury's financial reporting system has been based on *cash-basis* as well as *accrual-basis* to a limited extent. Cash-basis is designed to show revenue and expenditures when the actual cash changes hands. Accrual-basis is designed to show revenue and expenditure when it accrues, i.e. obligations that have been entered into irrespective of when the actual cash changes hands. These two reporting methods are also used in the private sector. Corporate operating statements are based on accrual-basis, i.e. they show all accrued revenue and all expenditures incurred irrespective of whether the actual cash has changed hands during the reporting period. The corporate cash-flow statement is similar to cash-basis reporting applied in government financial reporting.

Both these accounting methods have their advantages and disadvantages. In Iceland, the Budget has been presented on cash-basis. The emphasis is on receiving parliamentary authority to disburse funds. This reporting method also facilitates control over the Treasury's finances as it is relatively easy to check actual outlays against appropriations and apportionment plans. The cash-basis method is also well suited to show the short-term economic impact of the Treasury's operations. This is especially true for its impact on domestic demand and monetary affairs. Cash-basis reporting is thus important for the conduct of economic policy. If all revenue were received when it accrued and all expenses paid when they incur, then cash-basis reporting would give a fair view of the Treasury's financial position.

In Iceland, as elsewhere, there is a significant time lag from when revenue accrues and until it is received and from when expenses are incurred and until they are paid. This is the main weakness of cash-basis financial reporting. It does not show the impact on the Treasury's financial position of commitments and obligations entered into during a reporting period but that do not become payable until a later date. Thus, cash-basis reporting does not show the Treasury's total activity nor the long-term impact of this activity on the Treasury's finances.

Accrual-basis reporting is designed to solve this problem. Its major feature is that revenue and expenses are reported when they accrue instead of when actual cash changes hands. This reporting method illustrates the Treasury's total activities in a given reporting period and the future financial impact of the various commitments and obligations entered into during the reporting period. This reporting method is much more complex than cash-basis reporting. It is not sufficient to simply follow the inflow and outflow of cash; all obligations entered into have to be recorded and reported.

The emphasis on parliamentary appropriations, control over cash disbursement and the relative simplicity of the cash-basis method have no doubt been the major reasons why most countries have reported their government finances on cash-basis rather than accrual-basis. This is, however, not considered a satisfactory means of financial reporting as evidenced by the fact that a growing number of countries are adopting a modified form of cash-basis reporting whereby they incorporate some features of accrual-basis reporting. Advances in information technology have also made it easier to keep track of all obligations. There appears to be widespread agreement in the industrialized countries that government financial reporting should move to accrual-basis. The major reason for this is the need to report various commitments and obligations entered into during a given year but not becoming payable until a later date. Many industrialized countries have also been adopting market-type mechanisms to the operations of the government thus giving impetus to accrual-basis financial reporting.

The nations that have been leading the movement to accrual-basis financial reporting include New Zealand, the UK, Australia and the USA. New Zealand has gone the furthest. It has fully adopted accrual-basis financial reporting. For example, real property is reported as assets and only the annual depreciation as expenditure. The UK has recently announced the introduction of full accrual-basis financial reporting in order to better measure the use of financial resources and the relative performance of agencies. This means that real property will be reported as assets and only the annual depreciation as expenditure. The UK will also be introducing capital charges to recover the cost of capital tied up in agencies as New Zealand has already implemented. This is to make the finances of agencies more comparable. It is important to note that while the UK plans to adopt full accrual-basis financial reporting for its agencies, it does not intend to do so for the consolidated financial statements of the government. The treatment of assets and depreciation is primarily believed to be of importance in comparing the operations of agencies and judging their performance. It is not believed to be of importance for the consolidated financial statements of the government.

The Commission has discussed the advantages and disadvantages of cash-basis and accruals-basis financial reporting, especially in light of the domestic emphasis that the Budget and the Financial Statements reflect the Treasury's total activities and the future financial impact of commitments and obligations entered into. The Commission recommends that the Treasury should adopt accrual-basis for its financial reporting. Cash-basis financial reporting, i.e. pure cash-flow, should continue to be used as well.

Accrual-basis financial reporting is a significant step and is believed to yield many benefits. It will give a better overview of the government's operations, it will promote uniformity in financial reporting and facilitate understanding of the interplay of government finances and the general economy, both in the short-term and in the long-term. The Budget and the Financial Statements will both be reported on accrual-basis so these documents will be fully comparable. Private sector financial reporting practice will continue to be used in all respects for enterprises owned by the government.

3.4 Further Financial Reporting Principles

This chapter has discussed the major components of the Commission's recommendations for new government financial reporting principles. This section discusses several issues where it has been decided to deviate from full accrual-basis principles.

Assets and Depreciation. As has been stated earlier and is fully discussed in Chapter 6 of this Report, the Commission recommends that more emphasis should be placed on reporting for assets. In addition to the financial assets presently reported, the Treasury's holdings in non-Group A entities should be reported as assets in all cases and revalued where necessary. On the other hand, property, plant and equipment should not be reported as assets but continue to be reported as an expenditure when purchased. As a result, there will be no depreciation reported in the government's financial statements.

This is a major deviation from accrual-basis reporting which the Commission recommends should otherwise be adopted. In corporate financial statements, property, plant and equipment is treated as an asset with only the appropriate level of depreciation reported as an expense each year. The operating statement thus shows only each year's use of assets as an expenditure, irrespective of when the asset was paid for.This method of financial reporting has many advantages. For the government, it would make it easier to compare the performance of one agency with that of another agency and with private sector alternatives.

Reporting depreciation, however, requires that assets be valued and their useful lifes estimated. This is in many cases not practicable for government assets, i.e.

various infrastructure projects, museums, national parks, etc. It is also questionable what purpose it would serve to depreciate these assets in the Treasury's operating statement. Reporting the annual depreciation of assets, instead of the purchase of assets, also goes against the objective of showing how all tax revenue is allocated in a given year.

As stated before, many countries are moving in the direction of accrual-basis financial reporting. Only one country, New Zealand, has fully adopted accrual-basis financial reporting. The Commission believes that such a move is not appropriate at this time in Iceland for the reasons described above.

The Commission recommends that all plant, property and equipment be treated as expenditure in the operating statement when it is purchased. This means that plant, property and equipment will not be reported in the balance sheet and that no depreciation will be reported in the operating statement. It is, however, recommended that a register of all non-reported assets be prepared and classified by the administrative units employing those assets. It will then be possible to adjust the financial statements of the agencies to reflect depreciation and thus make their financial statements more comparable to private sector entities.

Real Interest Rates and Price Level Adjustments Private sector practice for reporting interest expense is unusual in Iceland. Corporations report all interest expense, whether it is nominal interest on non-indexed loans or real interest on indexed loans, as expenditure in the operating statement and the price level adjustment on outstanding loan balances as well. The net result is that only the real interest rate is reported as an expense. This practice was originated in Iceland when inflation was very high. Overseas, where loans are generally not indexed, all interest expense is reported as expenditure and no adjustment is made for changes in the price level. This means that the real cost of borrowing is overstated but this has not been a problem as inflation has generally been low. The accumulated effect over the life of the loan can, however, be substantial.

Government financial reporting for interest expense follows neither domestic private sector practice nor overseas practice. Real interest on indexed loans is treated as an expenditure while all interest on non-indexed loans is treated as an expenditure. The price-level adjustment of indexed loans is charged directly to the capital account.

Domestic private sector practice is the preferred method for reporting interest expense. There is, however, uncertainty on whether this practice will be permitted after Iceland´s membership in the EEA. As a result, present practice should not be changed to private sector practice at this time. Overseas practice should not be adopted by the government either, unless the private sector does so as well. Present practice should therefore be continued for the time being.

Gross and Net Reporting There has been a tendency in Iceland to report various transactions on a net basis, i.e. to treat tax expenditures as negative revenue and user fees as negative expenses. This practice should be stopped except in cases where this is clearly in line with the nature of the transaction involved. The key reasons for this are as follows.

- It is generally not in line with the nature of the respective transaction involved.
- It makes financial reporting more unclear as it hides various transactions instead of illuminating them.
- It understates the level of government activity.
- It is not in line with international guidelines.

Accordingly, it is recommended that tax expenditures that are not linked to the taxpayer's liability for the respective tax be treated as ordinary expenditure. Tax expenditures that are linked to the taxpayer's liability for the respective tax will continue to be treated as negative revenue. It is also recommended that various revenue that has been treated as negative expenditure be treated as tax revenue or as operating revenue with the respective agency receiving an equivalent appropriation.

Deviations from International Guidelines on Classifications. The government's system of financial reporting should be in line with international guidelines regarding the classification of revenue and expenditure. These guidelines are, however, not uniform in all respects and they are employed in different manners according to the different purposes they serve. The Government Financial Statistics (GFS) guidelines of the International Monetary Fund (IMF) should be followed regarding the classification of revenue and the classification of expenditure by function. These are the only guidelines specifically designed for government financial reporting. The GFS classification of expenditure is in line with the United Nations System of National Accounts (SNA). These guidelines are, however, not fully uniform in regards to the classification of revenue. For example, inheritance taxes are classified as taxation in the GFS guidelines and in the Commission's recommendations, but as financial transfers in the SNA guidelines. The Commission recommends that financial reporting follow accrual-basis principles which is in line with the SNA guidelines. Information will also be presented on cash-basis which is largely in line with the GFS guidelines.

The Commission's recommendations deviate from the SNA and GFS guidelines in exceptional cases. The gain or loss on the sale of holdings in enterprises, or write-down of such holdings, should be reported as revenue or expenditure. The write-down of outstanding financial assets should be reported as expenditure in all cases. The SNA

guidelines call for these transactions to be reported directly in the capital account as a revaluation item except in cases where the write-down of financial assets is part of a voluntary agreement. In such cases, they should be reported as financial transfers. The GFS guidelines do not discuss these transactions as they follow cash-basis principles. The GFS guideline call for the purchase or sale of holdings to be reported as capital transfers.

The Commission recommends that appropriation to social welfare entities such as the Student Loan Fund and the Low-Income Housing Fund be treated as expenditure when they are appropriated. The SNA guidelines call for such appropriations to be treated as expenditure only to the extent that the respective entity suffers a deficit in its operations that year.

These deviations mean that the Financial Statements will differ from the National Accounts. This can be a significant difference, especially if financial assets are being systematically written-down as was the case in FY1993. In such cases, the National Accounts report a better performance than the Financial Statements. Deviations such as this are common in other countries. The revenue balance of the Financial Statements is not a reliable indicator for comparing the finances of governments. The reported borrowing requirement is, however, the same in the Financial Statements and the National Accounts. This is a more reliable indicator for comparing government finances than the revenue balance.

Chapter 4

Treasury Revenue

The Commission recommends that the definition and classification of Treasury revenue be in line with guidelines issued by the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD). These guidelines have two primary objectives: all revenue levied by the government should be reported for and that this revenue be systematically classified according to the nature of the revenue. These guidelines are followed by the IMF and the OECD in collecting data from member countries and in the reports they issue on this subject. The adoption of these guidelines will make Iceland's figures comparable to those issued by the IMF and OECD with no adjustments being required. The Commission believes it is important to follow internationally recognized guidelines for the definition and classification of Treasury revenue.

4.1 Definition and Classification of Revenue

In line with the above, the Commission recommends that Treasury revenue be defined as follows:

- all taxes and fees levied by law
- all operating income, capital income, transfers and user fees collected by Group A entities.

This definition is designed to include all revenue collected by the government. This gives a complete overview of the operations of the government and its impact on economic activity. The definition is much more comprehensive than the one presently used for reporting purposes. The objective is to ensure that no tax levied by law, other than those levied by local governments, will fall outside the Treasury's financial reporting system. This definition is based on the following concepts:

- taxes refer to those fees that are imposed by law with no corresponding service being provided
- the public sector consists of two levels of entities: central government and local government-entities. The above definition includes as tax revenue various sector-based fees imposed by law on corporations. Examples include various price

equalization fees. These fees are defined as tax revenue irrespective of whether the fees are distributed back to the corporations that paid them or not. The principles in this respect are as follows: (a) the fees are imposed by law, (b) no corresponding service is provided and (c) the government is intervening in the operations of the free market by imposing the fee.

The recommendations of the Commission are based on guidelines issued by the IMF and the OECD. These guidelines divide revenue into four groups: tax revenue, operating revenue, other revenue and user fees. The Commission recommends sub-dividing other revenue into two groups: sale of assets and capital transfers. The Commission recommends that user fees be reported as negative expenditure as discussed further later in this chapter.

Treasury revenue is thus classified as follows for reporting purposes:

1. **Tax Revenue**
2. **Operating Revenue**
3. **Sale of Assets**
4. **Capital Transfers**

Tax Revenue. This refers to taxes imposed on individuals and corporations by law with no corresponding service being provided. Most taxes are readily classified in this category. Examples include income tax, net wealth tax and value-added tax. The classification of certain other taxes is not as clear. This usually involves cases where a certain service is provided in return for the tax levied (i.e. earmarking), but the link between the tax paid and the cost of the service received is not direct. If the cost of providing the service is equal in value (or greater) than the charge levied, then it should not be classified as tax revenue. If the charge levied is substantially higher than the value of the service provided, then it should be classified as tax revenue.

Operating Income. This refers to fees paid by individuals and corporations for services they require and only government-entities provide. Examples of services such as these include the issuance of passports and driver's licenses. The fees levied must not be higher than the cost of providing the service. The fees will otherwise be classified as tax revenue. The fees must also be for services that are mandated by law. If the fee is not for services that are legally mandated, then the revenue should be classified as a user fee. Also classified as operating income is revenue from investments (rental income, dividend income, interest income) and revenue from penalties imposed by the government.

Sale of Assets. This refers to the sale of fixed assets, the disposal of surplus supplies, the sale of land and various natural resources. This also refers to the gain on

sale of holdings in non-Group A entities. Revenue from the sale of these assets should be defined as Treasury revenue as the costs incurred in purchasing them were classified as Treasury expenditures.

Capital Transfers. This refers to irrecoverable transfers received by the Treasury from non-governmental entities. Prime examples are payments from local governments for their participation in various cost-sharing projects.

4.2 User Fees

User fees refer to revenue that government entities earn by providing a market-related service which individuals and corporations can purchase at their own discretion. There is no legal mandate to either use the service or finance the service. There is a direct link between the expenditure incurred in providing the service and the revenue earned from selling the service. Examples include the sale of document by the Bureau of Statistics and the sale of plants by the Forestry Service. User fees are a means of recovering the costs incurred in providing the service. It is therefore recommended that revenue from user fees be classified as a negative (offsetting) expenditure for the entity providing the service. This classification also provides an incentive for government entities to earn their own revenue.

It is not always clear whether revenue should be classified as user fees or as operating income. The guiding principle is whether the fee is mandated by law (operating income) or not (user fees).

4.3 Tax Expenditures

There has been a tendency to report taxes on a net basis in Iceland. This means that all tax expenditures have been reported as negative revenue instead of being reported as expenditure. This treatment of tax expenditures can give a very distorted view of the reported yield from individual taxes. It is also important that tax expenditures be reported clearly as they can have a substantial impact on the Treasury's cashflows.

The Commission recommends that tax expenditures be treated in two ways according to the nature of the respective tax expenditure. This is in line with international guidelines. First, it is recommended that tax expenditures that are directly linked to the taxpayer's liability for the respective tax be reported as negative revenue as is presently the case. These tax expenditures can only be used to offset the taxpayer's liability for a given tax and can be considered an integral part of the tax system as they are the means for adjusting the respective tax base. Prime examples include the personal allowance, the supplementary allowance for seamen, the allowance for purchasing shares in authorized companies and the allowance for investments in special savings instruments. Although it is recommended that these

deductions be reported as negative revenue, it is nonetheless recommended that each tax expenditure be reported as a separate line item thus showing the yield from the various taxes on both gross and net basis.

On the other hand, it is recommended that tax expenditures which are not linked to the taxpayer's actual liability for the respective tax be treated as expenditure. These tax expenditures are in reality no different from ordinary entitlement programs except that they are administered through the tax system. Prime examples include the children's benefit and the supplementary children's benefit, which is determined by the number of children in a family and the family's income. The same applies for the mortgage interest benefit.

The recommendations outlined above have been relatively clear as to which items should be reported as negative revenue and which should be reported as expenditure. There is, however, a large gray area in this respect. Various deductions in the value-added tax system and in the excise tax system exemplify this. It is clear that such deductions are limited to the taxpayer's liability for the respective tax. These deductions, however, often constitute pure subsidies that are simply administered through the tax system and have no inherent value for tax administration purposes. However, in line with IMF and OECD guidelines, it is recommended that these deductions be reported as negative revenue instead of expenditure for the time being.

4.4 Lost Tax Claims

The Treasury writes-off each year substantial tax claims and the penalties accompanying them. These write-offs can be divided into two groups. First, claims lost as the result of taxpayer bankruptcy. Second, general provisions for claims where successful collection is unlikely. These write-offs have not been conducted in a systematic manner. Clearer rules have, however, emerged in recent years which should lead to more stability in the amount of write-offs each year.

Write-offs have been reported as negative revenue. This is, however, not in line with international guidelines. The United Nations System of National Accounts (SNA) calls for general provisions for lost claims to be reported as expenditure but any extraordinary write-offs to be charged directly to the capital account as revaluation. The Commission recommends, however, that all write-offs, including any accompanying penalties, be reported as expenditure.

4.5 Financial Impact

The recommendations outlined above will have a major impact on the amounts reported as revenue and expenditure in the Budget and Financial Statements. The main changes are the following:

- The more comprehensive definition of Treasury revenue includes various taxes and fees that were previously not reported. This raises the amount of reported revenue substantially. Reported expenditure increases correspondingly as the additional revenue is disbursed.
- Reforms in the treatment of tax expenditures reduce the number of items counted as negative revenue. They will instead be counted as expenditure items. Both reported revenue and expenditure increase correspondingly.
- Reforms in the classification of revenue leads to items previously counted as negative expenditures (i.e. user fees) being reported as Treasury revenue instead, either as tax revenue or operating revenue. Reported expenditure increases correspondingly as the funds are disbursed.

The changes outlined above will illustrate the government's revenue in a more clear and comprehensive manner. This, in turn, gives a better overview of the operations of the government and its impact on economic activity.

Chapter 5

Treasury Expenditure and Classification of Government Entities

The objective of reporting for expenditures is to show how the government's tax receipts are put to use and its impact on the economy. The government's impact on the economy is both direct and indirect. The direct effects include taxation, purchases of goods and services, transfer payments to non-government entities, participation in the capital markets and ownership of various enterprises. The indirect effects consist of the government's general economic policy and various legislative and regulatory interventions. The economic impact of the government's activities will never be fully reflected in its financial reporting and this is especially true of the indirect effects. They can, however, be captured much more clearly than at present. The government's system of financial reporting has to give an overview of the Treasury´s finances and its interaction with other entities in the economy. This means that the government's financial reporting should always depict the cash flows between the Treasury and other entities in the economy. A major thrust in financial reporting is thus to classify expenditures based on their relative importance to economic activity and to ensure that the activities of all government entities are included.

5.1 Classification of Government Entities

Government entities are presently divided into Group A and Group B for reporting purposes. The lines between the two groups of entities are often unclear. This definition has also been criticized for not encompassing all government entities. For example, government-owned commercial banks and limited liability companies have not been included in the government's financial reports. The recommendations of the Commission aim to include these entities in the government's system of financial reporting.

In line with international guidelines, the Commission recommends that the following definition of government entities be used for reporting purposes:

Government entities are those whose operations fall under the decision making power of the government due to the government's ownership of the entity or due to the government's majority financing of the entity.

It is recommended that government entities be divided into five groups as follows:

Group A **Central Goverment (Treasury)**
Group B **Non-Financial Public Enterprises**
Group C **Lending Institutions**
Group D **Financial Enterprises**
Group E **Majority-Owned Companies**

Group A Central Government (Treasury). Group A entities encompass core government operations. They are for the most part financed by tax revenue irrespective of whether the tax receipts are directly earmarked to these entities or not. Tax revenues primarily finance constitutional bodies, ministries, executive agencies, capital projects and transfers to non-government entities. These entities can, however, earn user fees to offset the cost of providing certain services. User fees will, however, always be a limited means of financing their activities. In other words, Group A entities perform general services for the community that are jointly financed through tax revenue. Group A entities can be divided into the following categories for reporting purposes:

Constitutional bodies, ministries and executive agencies. This covers the operations of the legislative, executive and judicial branches. The legislative branch encompasses the Parliament and its subsidiary agencies. The executive branch encompasses the Office of the President, the Cabinet, ministries and executive agencies charged with carrying out public policy. The judicial branch encompasses the Supreme Court and the eight District Courts.

Capital Funds. This covers funds that have been established to finance various capital projects. These funds can either provide grants or debt-financing for the respective projects. Such funds are also established for specific capital projects in order to control their finances. An example is the National Library Capital Fund.

Subsidy Funds. This covers funds that have been established to grant financial assistance to individuals and organizations for specific purposes. These funds are most common in the cultural, health care and industrial sectors. An example is the National Film Fund.

Non-Profit Organizations. Non-profit organizations that are majority financed by grants from the Treasury should be required to submit their financial statements

to the State Accounting Office. The Treasury is financially responsible for these organizations in accordance with specific laws or contracts.

Transfers. This encompasses transfers from the Treasury to non-Group A entities, i.e. to Group B non-financial public enterprises, Group C lending institutions, local governments, individuals, organizations and private-sector companies.

In exceptional cases, certain Group A entities are not financed by general tax revenue but by user fees that are set to achieve full cost recovery. These entities should, however, be reported as Group A entities according to international guidelines. These entities can be divided into the following categories for reporting purposes:

Price Equalization Funds. This group encompasses funds that have been established to support uniform price levels for certain goods and services throughout the country. These funds are generally financed by earmarked revenue. The Petroleum Price Equalization Fund is an example of this type of entity.

Regulatory Agencies. This group encompasses agencies that have been established to provide various regulatory services to industry. They are not financed by general tax revenue but by those who utilize their services. An example is the Industry Insurance Regulatory Agency.

Internal Service Organizations. This group encompasses entities that have been established to provide service to other Group A entities and derive most of their revenues from such sources. Examples include the Procurement Agency and the Buildings Management Agency.

Group B Non-Financial Public Enterprises This group covers all non-financial public enterprises except joint ownership companies. These enterprises operate in a market environment and their revenues are derived primarily from sales of goods and services to individuals and private sector companies. Some of these enterprises enjoy a monopoly position while others operate in a competitive environment. The tariffs of these enterprises are generally set to cover all costs. Examples include the Icelandic Broadcasting Service and the Electric Power Works.

Group B entities are more independent from direct government intervention than Group A entities. The enterprises generally have a board of directors appointed by the responsible minister or by Parliament. Unlike Group A entities, they can borrow funds as authorized in the Credit Budget. The government's intervention in these enterprises is mainly directed at their tariffs, dividend policy, investments and borrowing activity. Group B entities move to Group E when they are converted into limited liability companies with the Treasury retaining majority ownership.

Group C Lending Institutions. This group consists of financial institutions other than banks. These institutions operate on the capital markets where they borrow funds for onwards relending to individuals and private-sector companies. These institutions may enjoy government guarantees on their borrowing activity and may lend funds at below-market rates. Examples include the State Housing Fund, the Student Loan Fund and the Fisheries Investment Fund.

State lending institutions are created by Acts of Parliament and have boards of directors appointed by the responsible minister or by Parliament. Their disposable funds consist of their operating surplus and, to a much larger degree, the funds they borrow domestically or overseas. In some cases, the Treasury provides direct funding for these enterprises or guarantees their borrowing. The borrowing activity of these enterprises is controlled in the Credit Budget.

Group D Financial Enterprises. It is important to differentiate between financial enterprises and other entities because of the different nature of their function in the economy. The International Monetary Fund (IMF) in its reporting separates these institutions from other entities in order to depict their operations and financing activity more clearly. These entities can be divided into three groups: *monetary institutions, government-owned commercial banks and other government-owned financial enterprises.* In addition to the Central Bank, this includes various deposit-taking and securities-issuing enterprises and various enterprises providing insurance services. Examples include the two government-owned commercial banks, the Landsbanki and Bunadarbanki. It also includes the Postal Giro System and the Fishing Vessels Insurance Organization.

Group E Majority-Owned Companies. This group encompasses limited liability companies and joint-ownership companies where the Treasury retains a 50% or greater ownership interest. These companies operate on a similar basis as Group B enterprises except that their ownership structure and legal form is different. The government can clearly exercise control over these companies. As owner, the Treasury will generally demand a certain rate of return from its investment in these companies. Group E companies enjoy much greater freedom in their operations than Group B entities. It is rare for the government to intervene in their operations at all. These companies have boards of directors appointed by the responsible minister or by Parliament. Summary financial information on Group E companies will be provided in the government's financial reporting. Examples include Icelandic Fertilizers Ltd. and Icelandic Alloys Ltd.

5.2 Classification of Expenditure

Government expenditure is commonly classified by administrative unit, by function and by economic category.*Classification by Administrative Unit.* This classification shows expenditures for each administrative unit, i.e. ministries and agencies. Interest expense will, however, be reported separately instead of being reported as part of the Ministry of Finance´s general expenditure as is presently the case. This will make the interest expense for the government as a whole more clear as well as the operations of the Ministry of Finance. This practice is common overseas.

Classification by Function. This classification is a good indicator of the government's policy agenda as trends in expenditures for a given activity can be shown for a certain time period. This classification facilitates international comparisons and is not affected by organizational changes in the government's administration. In other words, this classification is not affected by an activity being performed by one ministry or by several, or whether functions have been transferred between ministries and executive agencies. This ensures the comparability of expenditures for a given activity over a certain period of time. The Commission's recommended system for classification by function is based on the United Nations *Classification of the Functions of Government (COFOG).*

Classification by Economic Activity. This classification shows whether government expenditures are financing consumption or investment activity, either by public sector entities or by private sector entities. This classification is based on the nature of the respective expenditures and their impact on product markets, capital markets and the distribution of income. This classification divides government expenditure into the following categories: wages and salaries, purchases of goods and services, interest expenditures, transfers to corporations, local government and individuals. This classification also depicts the clear connection between the government's financial reporting and the national accounts. The government's financial reporting has traditionally included this classification and should continue to do so.

Chapter 6

Treasury Assets and Liabilities

This chapter discusses the balance sheet and how it is prepared. The Commission has striven for its recommendations to be in line with international guidelines on financial flows as issued by the IMF and the UN. These guidelines, however, do not extend to the balance sheet. As a result, the Commission has relied on the financial reporting standards used by private sector entities to a great extent. The emphasis in the government's balance sheet is different from that of corporate enterprises, as their purpose is different. The major difference is that property, plant and equipment will continue to be treated as an expense in the the Treasury's operating statement, rather than as an asset in the balance sheet. The Treasury's reported capital is thus defined differently than in corporate financial statements.

6.1 Present Reporting Practice

Chapter VI of the Financial Reporting Act of 1966 discusses the Treasury's balance sheet. The chapter calls for assets and liabilities to be treated in a similar manner as in corporate balance sheets, but with important exceptions. Property, plant and equipment should not be reported as assets in the balance sheet, but as an expense in the operating statement. Transfers to Group B entities should also be treated as an expense in the operating statement. Reporting for the Treasury's holdings in various non-Group A entities has not been uniform. These holdings are generally reported at the original cost of the capital paid. For example, the Treasury's shareholding in the Sudurnes Regional Heating Corporation is reported at 200,000 krónur [USD 3,000] and the Treasury's 50% shareholding in the National Power Company is not reported at all. Capital in foreign-based entities is, however, restated each year in line with changes in exchange rates. The Treasury's property, plant and equipment and its holdings in various non-Group A entities is thus reported very differently from what would be the case in the private sector. As a result, the Treasury's capital, i.e. the difference between assets and liabilities, is not comparable with the reported capital of private sector companies.

Present legislation calls for the Treasury's reported assets to include cash on hand, bank deposits, other deposits, stocks in incorporated limited liability companies, securities and loans granted. Reported liabilities are to include bank overdrafts, other

short term payables and loans outstanding. These assets and liabilities should, to the extent possible, be valued in line with their real worth at year end. They can also be reported in accordance with the provisions of tax law, if the difference is not significant. This reporting method is meant to show the difference between the Treasury's financial asssets and financial liabilities at a given time.

Chapter VIII of the Act discusses the Treasury's property, plant and equipment which is treated as an expense in the operating statement, i.e. fully depreciated at the time it is purchased. Such assets are to be recorded in a special register to be published at least once every ten years with the estimated value of these assets, based on their depreciated replacement value.

6.2 Recommendations for New Reporting Practice

The Treasury's holdings in non-Group A entities should be reported as assets. Exact rules are prescribed for the reporting of such holdings, i.e. Group B non-financial public enterprises, Group C lending institutions, Group D financial enterprises, and Group E majority-owned companies. These holdings should also be valued in line with private sector practice.

Private sector companies in Iceland that are long-term investors, value stocks at cost and then restate them in line with changes in the general price level. This is the general rule and is applied as long as the real value of the stocks is believed to be higher than the reported value. Market value, when available, is the best determinant of the real value of stocks. Alternatively, its value has to be determined differently. The value of the entire portfolio of stocks should be considered in this respect rather than the value of individual stocks. The value of one stock can increase while the value of another decreases. Only a change in the value of the portfolio as a whole is reported in the financial statement. This avoids having to report for short-term fluctuations in the value of individual stocks.

The following goals should be considered for guidance in this respect:

- The same financial reporting methods should be used for the Treasury's holdings in companies incorporated as limited liability companies and companies enjoying a different legal form.
- Financial reporting methods should avoid short-term fluctuations in the financial performance of these companies from impacting the Treasury's operating statement.
- If an ownership interest loses value, then it should be written-off correspondingly and the Treasury's operating statement should reflect this loss.The value of the holdings to be included in the Treasury´s balance sheet has to be determined at the time this new reporting system is implemented. The reported value of each holding

should be a certain percentage of the Treasury´s ownership interest in the capital of the respective company. It is necessary to determine this percentage on a case by case basis as the operating and financial risk inherent to each enterprise varies. Utilities, for example, are stable natural monopolies and the reported value of the Treasury's holdings should be based on a relatively high percentage of its ownership interest in these enterprises.

These recommendations will, when implemented, result in a substantial increase in the Treasury's reported assets. This can either be reported as extraordinary income in the operating statement or charged directly to the capital account as a revaluation item. Reporting this as extraordinary income would severly distort the actual performance of the Tresury. As a result, it is recommended that it be reported directly in the capital account.

The Treasury's holdings will then be restated at the end of each fiscal year in line with changes in the general price level. This restatement should be reported directly in the capital account. Future capital transfers to these enterprises should be reported as assets and not as expenditure. Appropriations for providing subsidized services should, however, continue to be reported as expenditure.

The Treasury's holdings should be grouped into several homogenous portfolios. This is to avoid the need for reporting short-term fluctuations in the value of individual holdings in the Treasury's operating statement.

If the reported value of a holding becomes higher than the Treasury's share of its capital, it should be written-down appropriately with the loss reflected in the Treasury's operating statement. An increase in the capital of an enterprises should, however, not be reflected as an increase in its reported value and as extraordinary income. The Treasury can therefore only report revenue from these assets in the form of dividends or gains on the sale of the holdings.

At the end of each fiscal year, all holdings shall be reviewed to see whether the reported value is too high or whether the holding is lost, for example due to prolonged losses or bankruptcy. The value of such holdings should be corrected and the asset written down correspondingly.

The Commission's recommendations ensure that the legal form of an entity does not affect the reported value of the Treasury's holdings, i.e. whether the enterprise is incorporated as limited liability company or not. There are two exceptions to this general rule. First, appropriations to finance subsidized services that enterprises provide should be treated as expenditure, not as a capital transfers. Examples of this include subsidies for electrical heating and fertilizers. Second, appropriations to meet the interest rate differential of lending institutions that serve a purely social welfare

function. It is recommended that such appropriations be treated as expenditure, and not as a capital transfers. Examples include the Student Loan Fund, the Institute for Regional Development and the Housing Fund for Low-Income Families.

These recommendations will have a significant impact on the Treasury's balance sheet as these holdings are presently reported only to a very limited extent. These are, however, very substantial assets in many cases. It should also be noted that these recommendations are in line with private sector financial reporting practice.

Finally, the Commission stresses the importance of maintaining the register of property, plant and equipment as prescribed by present law. All of the Treasury's assets should either be reported in the balance sheet or in the register.

6.3 Definition of Assets and Liabilities.

Assets and liabilities are defined as follows for reporting purposes:

Assets:

Current Assets: This includes cash on hand, bank deposits, accounts receivables and other assets to be realized within a year. Major subgroups include: cash and deposits, accounts receivable, taxes receivable, next year's repayments from loans granted and accrued interest receivables.

Long-Term Financial Assets: This includes assets that will be realized after one year. Next year's payments from loans granted are not included, as discussed above.

Holdings in non-Group A entities: This includes the Treasury's holdings in limited liability companies and other non-Group A entities.

Stocks. Purchases of stocks shall be reported at cost and restated each year in line with changes in the general price level. Their value should also be reviewed each year in preparation of the Financial Statements. If this review shows that the value of the stock has decreased substantially, and that this is not of a temporary nature, or that the stock is even lost, then the corresponding loss should be reported in the operating statement and the asset written down accordingly. The difference between the revenue from the sale of stock and the reported value of that stock, will be reported as a net loss or gain on the sale of that stock in the Treasury's operating statement.

Other holdings. This includes the Treasury's holdings in Group B non-financial public enterprises, Group C lending institutions, Group D financial enterprises and Group E majority-owned companies. The Commission calls for the value of these holdings to be reported as a certain percentage of the Treasury's ownership interest in the capital of the respective entity. The reported value of these holdings will then

change in line with any new capital transfers from the Treasury and changes in the general price level.

Shares in international development banks. Shares in international development banks that are repayable, i.e. if and when the institution is dissolved, should be reported as assets. At the end of each year, these holdings should be restated in line with changes in the general price level. However, payments to international development banks that are not repayable shall be reported in the operating statement as an expenditure.

Liabilities:

Short-Term Liabilities. Short-term liabilities include liabilities that are payable within a year. Examples include bank overdrafts, taxes to be refunded, unpaid expenses, accounts payable and marketable Treasury bills. Next year's repayment of outstanding long-term debt and accrued interest payable is also reported in this category.

Long-Term Debt. This category includes all debt with maturities of one year or longer. Next year's repayments are not included, as discussed above.

Pension Obligations. The Treasury guarantees the finances of the Civil Service Retirement Plan which is largely unfunded. These pension obligations were first reported in the 1989 Financial Statements. The reported obligation is the total obligations of the Plan in respect of Treasury (Group A) employees, less Plan assets.

Capital. Each year's operating balance is reported in the capital account together with any restatements for foreign exchange and price level changes. As stated earlier,

Balance Sheet

Assets	Liabilities and Capital
1. Short-Term Assets Cash, bank deposits et al. Accounts receivable Other short-term assets	4. Short-Term Liabilities
2. Long-Term Financial Assets	5. Long-Term Liabilities
3. Holdings in non-group A entries	6. Capital

Financial Position = Short-term assets (1) - Short-term liabilities (4) - Long-term liabilities (5).
Capital = Total Assets (1+2+3) - Total Liabilities (4+5)

the Treasury's capital account is not comparable to its private sector counterparts, primarily because property, plant and equipment is fully expenses at the time of purchase.

6.4 Register of Property, Plant and Equipment

Present legislation calls for a register of property, plant and equipment, not reported in the balance sheet, to be prepared at least once every 10 years. This register has never been produced in a satisfactory manner. Only a list of land, buildings and natural resource rights owned by the Treasury is maintained in computerized form.

A similar register of other non-reported assets is not available. It is important that such a register be produced. Guidance must be issued on how such assets should be registered in accordance with current legislation and accounting principles. The purpose of this register is to´increase control over the Treasury´s non-reported assets. Agencies should be encouraged to consider more the non-reported assets that they have at their disposal. This register would also provide valuable information if it is possible to report a value for these assets, and see how they change from year to year.

The register is intended to include all assets not reported in the balance sheet. The major categories, in addition to land, buildings and natural resource rights, include motor vehicles, machinery, furniture, computers and office machines, equipment and other assets.

The register will provide a comprehensive list of all non-reported assets thus fulfilling the legal obligation to do so. The register is divided by the administrative units employing the assets, i.e. ministries and agencies, and taken together it shows all non-reported assets owned by the Treasury. The register can serve as a basis for estimating depreciation expense for individual agencies in order to make their finances comparable to private sector companies.

Chapter 7

Format of the Budget and Finacial Statements

The objective of government financial reporting is to provide the *Althingi* and the public with a clear picture of the government´s operations and finances. It is also an important tool for financial management and control. The present format of the Budget and the Financial Statements dates from a time when the government's activities were fewer and simpler. As a result, the present format does not satisfy the *Althingi*'s and the public´s demand for financial information.

Significant changes should be made to the format of the Budget and the Financial Statements. The purpose of the changes is to give a better overview of the government´s operations and finances and to make the Budget and the Financial Statements comparable. This is facilitated by having a uniform format for the Budget and the Financial Statements.

Many of the recommendations set forth in previous chapters will, when implemented, lead to changes in the format of the Budget and the Financial Statements. The following are the main changes:

- *The Budget will be on accrual-basis but will also present information on cash-basis.* This should give a fuller and clearer picture of the government's policy agenda and decisions regarding government finances.
- *Government entities will be divided into five groups, A-E,* as discussed in Chapter 5. The Budget and the Financial Statements will report for Groups A, B and C. The Financial Statements will also present summary financial information for Group D and E entities. This will give a fuller picture of the government's activities and their impact on economic activity.
- *New definition of entities* will lead to more government entities being reported as Group A entities. This would substantially lengthen Article 4 of the Budget, where appropriations are itemized, if the present format were to be retained. As a result, the format of the Budget should be changed and made more compact. The Commission recommends that the Budget be in three parts: a relatively short legal text, an appendix providing supplementary information on revenue and expenditure, and various special tables, as further described in this chapter.

- *Credit Budget abolished.* The Commission believes that the Credit Budget should be abolished as a separate legal document and incorporated into the Budget. The government's finances will thus all be contained in one piece of legislation. This will make the *Althingi*'s discussion more effective as the results of the Budget inevitably impact the Credit Budget. This is a natural development and is facilitated by the recent organizational changes in the *Althingi*.
- *Budget and Financial Statements presentation format will be uniform.* Their presentation should also be based on private sector practice as far as is practicable.
- *Financial reporting for non-Group A entities* will be in line with private sector financial reporting practice. The operating statement, balance sheet and cashflow statement of Group B and Group C entities will be presented in the Treasury's Financial Statements together with key financial indicators for Group D and Group E entities.

7.1 Financial Statements

The Financial Statements are the final report on the government's finances for each fiscal year. It is a basic source of information on the government's finances as a whole and for individual agencies. The Financial Statements enable the government's finances to be judged by their economic impact and by changes from one reporting period to another. It is also the framework for the *Althingi* to monitor whether its decisions in the Budget and supplemental budgets have been implemented. It is of prime importance that the presentation format of the Financial Statements be as clear as possible.

The Financial Statements should be based on three key statements, as is the case in private sector financial reporting:

- *Operating Statement.* This shows accrued revenue and expenses incurred for a given fiscal year.
- *Balance Sheet.* This reports the Treasury's financial assets, holdings in non-Group A entities and the Treasury's liabilities, at the end of a fiscal year. The difference between these assets and liabilities is the Treasury´s capital.
- *Statement of Cashflows.* This shows cash flows from operations, investments and financing activities.

These statements are internally linked. An increase in borrowing will be reported as an increase in cash on hand and as an increase in liabilities. The results of the operating statement and any restatements are the main reasons for changes in the capital account of the balance sheet.

Other supplementary statements are intended to provide further information and explanations to the reader on the financial position of the Treasury.

The Commission recommends the following format for the Financial Statements:

Financial Statements

General Statements

1. Operating Statement
2. Balance Sheet
3. Statement of Cashflows

Explanatory Notes

1. Statement of Accounting Principles
2. Statement of Loans and Guaranteesa.
   a) *Statement of Long-Term Borrowing Activity*
   b) *Statement of Long-Term Lending Activity*
   c) *Statement of Commitments and Obligations*
   d) *Statement of Guarantees*
3. Other Statementsa.
   a) *Statement of Holdings in Non-Group A Entities.*
   b) *Statement of Plant, Property and Equipment*
   c) *Statement of Changes in Capital*
4. Various Supplementary Statements

Overview of the Financial Statements

The Operating Statement presents the Treasury's revenue and expenses. *Revenue* is divided into three groups.

- *Tax revenue.* This refers to taxes imposed on individuals and corporations by law with no corresponding service being provided.
- *Operating revenue.* This refers to compulsory fees paid by individuals and corporations for services they are required by law to use and only government entities provide. This also refers to revenue from investments and fines.
- *Other revenue.* This refers to revenue that is not classified as either tax revenue or operating revenue. Examples include sale of assets and capital transfers.

Treasury Operating Statement

	Notes	Actual 1993	Budget 1993	Actual 1992
Revenue:				
Tax Revenue				
Individual of Income Tax		000.000	000.000	000.000
Corporate Income Tax		000.000	000.000	000.000
Social Security Tax		000.000	000.000	000.000
Net Wealth Tax		000.000	000.000	000.000
Value-added Tax		000.000	000.000	000.000
Other Taxes on Goods and Services		000.000	000.000	000.000
Other Taxes		000.000	000.000	000.000
Total Tax Revenue		**000.000**	**000.000**	**000.000**
Operating Revenue				
Dividend Income		000.000	000.000	000.000
Interest Income		000.000	000.000	000.000
Other Operating Income		000.000	000.000	000.000
Total Operating Income		**000.000**	**000.000**	**000.000**
Sale of Assets		**000.000**	**000.000**	**000.000**
Capital Transfers		**000.000**	**000.000**	**000.000**
Total Revenue		**000.000**	**000.000**	**000.000**
Expenses:				
Constitutional Bodies		000.000	000.000	000.000
Prime Minister´s Office		000.000	000.000	000.000
Ministry of Education		000.000	000.000	000.000
Ministry of Foreign Affairs		000.000	000.000	000.000
Ministry of Agriculture		000.000	000.000	000.000
Ministry of Fisheries		000.000	000.000	000.000
Ministry of Justice		000.000	000.000	000.000
Ministry of Social Affairs		000.000	000.000	000.000
Ministry of Health and Social Securities		000.000	000.000	000.000
Ministry of Finance		000.000	000.000	000.000
Ministry of Transportation		000.000	000.000	000.000
Ministry of Industry		000.000	000.000	000.000
Ministry of Commerce		000.000	000.000	000.000
Ministry of Statistics		000.000	000.000	000.000
Ministry of the Environment		000.000	000.000	000.000
Interest Expenses		000.000	000.000	000.000
Total Expenses		**000.000**	**000.000**	**000.000**
Revenue Balance		**000.000**	**000.000**	**000.000**

Expenses are classified by administrative unit, i.e. ministries and agencies. Interest expense is, however, shown separately. User fees are reported as negative expenditure for the respective administrative unit. This is revenue from market-based services provided at the discretion of the buyer. In addition to classification by administrative unit, expenses will be classified by functional category and by economic category. All purchases of plant, property and equipment will be reported as expenses at the time of purchase. This is a significant difference from private sector financial reporting practice where such purchases are classified as assets when purchased with only the appropriate level of depreciation reported as an expense each year. As the assets are fully expensed at the time of purchase, there will be no reported annual depreciation.

The Revenue Balance is the difference between revenues and expenses. This is not comparable to corporate profits or losses as plant, property and equipment is fully expensed at the time of purchase.

Balance Sheet. Assets are divided into short-term assets, long-term financial assets (loans granted), and holdings in non-Group A entities. Liabilities are classified as short-term liabilities and long-term liabilities.

Capital is the difference between reported assets and liabilities. The capital account will be negative as reported assets include only financial assets and holdings in non-Group A entities. Purchases of plant, property and equipment are fully expensed at the time of purchase, as previously stated. As non-reported plant, property and equipment is very substantial, the Treasury's reported capital says very little about the Treasury's true level of assets and its ability to pay its obligations. To compensate for this, it is recommended that a register of property, plant and equipment--with reported values--be prepared annually. Changes in the Treasury's reported capital is mainly the result of two transactions. First, the Treasury's revenue balance is charged to the capital account each year. Second, adjustments for exchange rate and price-level changes are charged there.

Statement of Cashflows. The purpose of the Statement of Cashflows is to depict the levels of cash flowing through the Treasury. Cashflow is divided into four groups:

- Operating Activities. This shows cash on hand as a result of operations, i.e. the revenue balance in the operating statement. All items that are non-cash in nature, such as accrued interest and losses from asset write-offs, are subtracted from that amount.

- Investing Activities. This shows the cash-flows from loans granted and capital injections.

Treasury Balance Sheet

	Notes	Actual 1993	Actual 1992
Assets:			
Current Assets			
Cash on hand		000.000	000.000
Taxes Receivebler		000.000	000.000
Interset Receivebles		000.000	000.000
Interim Loans		000.000	000.000
Other Current Assets		000.000	000.000
Current Maturities of Long-Term Loans		000.000	000.000
Total Short-Tearm Assets		**000.000**	**000.000**
Long-Term Assets			
Long-Terms loans granted		000.000	000.000
Stocks		000.000	000.000
Other owership Interest		000.000	000.000
Shares in International Development Banks et al.		000.000	000.000
Total Long-Term Assets		000.000	000.000
Total Assets		**000.000**	**000.000**
Liabilities:			
Short-Term Liabilities			
Bank Overdrafts		000.000	000.000
Unpaid Expenses		000.000	000.000
Interest Payables		000.000	000.000
Treasury Bills		000.000	000.000
Other Short-Term Liabilities		000.000	000.000
Current Maturities of Long-Term Loans		000.000	000.000
Total Short-Term Liabilities		**000.000**	**000.000**
Long-Term Borrowings			
Long-Term Domestic Borrowings		000.000	000.000
Long-Term Overseas Borrowings		000.000	000.000
Total Long-Term Borrowings		**000.000**	**000.000**
Pension Liabilities		**000.000**	**000.000**
Capital			
Opening Balance		000.000	000.000
Revaluation		000.000	000.000
Revenue balance		000.000	000.000
Total capital		**000.000**	**000.000**
Total Liabilities and Capital		**000.000**	**000.000**

- *Cashflows* from Pension Obligations. This shows the real change in the reported pension obligation each year.
- *Cashflows* from Financing Activities. This shows the level of new borrowing activity and repayments of past borrowings.

Explanatory Notes to the Financial Statements

Accompanying the Financial Statements will be various explanatory notes. They are an integral part of the Financial Statements and can be divided into three groups:

Statement of Accounting Principles. This will outline the accounting principles used for financial reporting, i.e. methods used for the restatement of asets and liabilities for exchange rate and price level changes.

Statements of Loans and Guarantees. Several statements will accompany the Financial Statements to provide additional information on the Treasury's borrowing, lending, guarantees, commitments and obligations. These include:

- Statement of Long-Term Borrowing Activity. This itemizes the Treasury's outstanding loans. Domestic debt will be classified by type of debt instrument and foreign debt by type of currency. A separate statement will show the repayment schedule for these borrowings.
- Statement of Long-Term Lending Activity. This itemizes the loans that the Treasury has granted and shows their repayment schedule.
- Statement of Commitments and Obligations. This will show the financial value of various agreements that the Treasury has entered into and are not reported as liabilities. This includes various cost-sharing agreements entered into with municipalities.
- Statement of Guarantees. This will show the guarantees that the Treasury has entered into for third-party borrowing activity, and related activities, that may eventually fall on the Treasury.

Other Statements and Various Supplementary Classifications. Other statements providing further details of the Treasury's finances will accompany the Financial Statements. This includes classification of revenue by source and the classification of expenses by functional category and by economic category. In addition, separate statements will itemize the Treasury's holdings in non-Group A entities, the Treasury's plant, property and equipment, and changes in the Treasury´s capital position. Other statements will also be included.

Non-Group A entities. Financial reporting for Group B, C, D and E entities will be in line with the financial reporting practices of their respective private sector counterparts. The operating statement, balance sheet and statement of cashflows will be published in the Financial Statements for Group B and C entities. Summary financial information will be provided for Group D and E entities.

7.2 Budget.

The Budget will be composed of three parts: the legal text itself; supplementary information on Treasury revenue and expenses, classified by administrative unit and by functional category; and various special tables.

The supplementary information will be contained in an appendix to the legislation. This is the same practice as is today used for various grants for capital projects. The special tables will show still more detailed information on appropriations, classified by economic category and by administrative unit.

The Commission recommends the following format for the Budget:

Articles	
Article 1	Operating Statement
Article 2	Statement of Cashflows
Article 3	Summary Statement of Group B Non-Financial Public Enterprises Finances
Article 4	Summary Statement of Group C Lending Institutions Finances
Article 5	Borrowing, Relending and Guarantees
Article 6	Entitlement Limitations
Article 7	Purchase and Disposal of Real Property
Article 8	Other provisions

Appendices	
1	Treasury Revenue by Source
2	Treasury Expenses by Administrative Unit
3	Other Supplementary Information on Group A Operations
4	Supplementary Information on Group B Non-Financial Public Enterprises
5	Supplementary Information on Group C Lending Institutions

Special Tables	
1	Treasury Finances Summary Table
2	Treasury Expenses by Functional Category
3	Treasury Expenses by Economic Category
4	Earmarked Revenue
5	Composition of Treasury Revenue
6	Consolidated Borrowing Activity

Articles

Article 1.

Operating Statement.

This article shows the Treasury's estimated operating statement, i.e. revenues and expenses. The operating statement is presented on both accrual-basis and cash-basis.

Revenue shows the revenue by major classes. Revenue on accrual-basis shows the estimated revenue accruing during the fiscal year while cash-basis shows the estimated revenue to be collected during the fiscal year.

Expenses are classified by administrative units, i.e. ministries. Interest expense will, however, be reported separately instead of being reported as part of the Ministry of Finance's general expenditure as is presently the case. This will both make the interest expenses for the government as a whole more clear and the operations of the Ministry of Finance more clear. Expenses on accrual-basis show the estimated expenses incurred or obligations entered into during the year while cash-basis shows the estimated expenses to be paid during the year.

Revenue Balance is the difference between accrued revenue and expenses incurred. Neither revenue nor expenses will be shown in detail in the Budget's legal text. More detailed information is to be presented in the appendices and special tables.

Article 2.

Statement of Cash-Flows.

The format of this statement is generally in line with private sector practice. This shows the cashflows from operations. Non-cash items, such as accrued interest and losses from asset write-offs, are subtracted from this amount. Added to this are cashflows from investments and cashflows from pension obligations, which should be emphasized by showing them separately. Investments include purchases of stock, capital transfers and loans granted.

The sum of this is the Treasury's net borrowing requirement. This is the measurement that is believed to give the best picture of the Treasury's impact on the economy. When repayments are added, it shows the gross borrowing requirement, i.e. all borrowing activity that is required by the Treasury. Cashflows from financing activity show how this is financed and the change in cash on hand.

Article 3.

Summary Statement of Group B Non-Financial Public Enterprises Finances.

This article shows key financial information on the finances of Group B entities and those elements of their finances that require legislative action. This include profits or losses, dividends paid to the Treasury, investments and borrowing activity, if any.

Treasury Operating Statement

Article 1
The Treasury's revenue and expenses are estimated as follows
for FY19XX as per appendix 1 and 2

	accryal-basis	Cash-basis
Revenue		
Tax Revenue		
Individued Income Tax	0	0
Corporate Income Tax	0	0
Social Security Tax	0	0
Net Wealth Tax	0	0
Value-Added Tax	0	0
Other Taxes on Goods and Services	0	0
Other Taxes	0	0
Total tax Revenue	0	0
Operating Revenue		
Dividend Income	0	0
Interest Income	0	0
Other Operating Income	0	0
Total Operating Income	0	0
Sale of Assets	0	0
Capital Transfers	0	0
Total Revenue	0	0
Expenses:		
Constitutional Bodies	0	0
Prime Minister's Office	0	0
Ministry of Education	0	0
Ministry of Foreign Affairs	0	0
Ministry of Agriculture	0	0
Ministry of Fisheries	0	0
Ministry of Justice	0	0
Ministry of Social Affairs	0	0
Ministry of Health and Social Securities	0	0
Ministry of Finance	0	0
Ministry of Transportation	0	0
Ministry of Industry	0	0
Ministry of Commerce	0	0
Ministry of Statistics	0	0
Ministry of the Environment	0	0
Interest Expenses	0	0
Total Expenses	0	0
Revenue Balance	0	

Treasury Statement of Cashflow

Article 2

The Treasury´s cashflows are estimated as follows for FY19XX.

Cashflows from Operating Activities:	
Revenue Balance	0
Non-cashflow Operating Items:	
Various Write-offs	0
Changes in Operating Assets and Liabilities:	
Accounts Receivables, Net	0
Accounts Payables, Net	0
Total cashflows from operating activities	**0**
Cashflows from investing activities:	
Short-Term Loans Granted	0
Long-Term Loans Granted	0
- Repayments of Loans Granted	0
Purchase of Stocks + Ownership Interests	0
Sale of Stocks + Ownership Interests	0
Total Cashflows from Investing Activities	**0**
Person Obligations	0
Net Borrowing Requirement	**0**
Cashflows from Financing Activities:	
Short-Term Borrowings	0
Long-Term Borrowings	0
- Repayments	0
Total Cashflows from Financing Activities	**0**
Net Movements in Cash Field	**0**
Opening Cash Balance	0
Closing Cash Balance	0

Treasury Statement of Cashflow

Article 2

The Treasury's cashflows are estimated as follows for FY19XX.

Cashflows from Operating Activities:	
Revenue Balance	0
Non-cashflow Operating Items:	
Various Write-offs	0
Changes in Operating Assets and Liabilities:	
Accounts Receivables, Net	0
Accounts Payables, Net	0
Total cashflows from operating activities	**0**
Cashflows from investing activities:	
Short-Term Loans Granted	0
Long-Term Loans Granted	0
- Repayments of Loans Granted	0
Purchase of Stocks + Ownership Interests	0
Sale of Stocks + Ownership Interests	0
Total Cashflows from Investing Activities	**0**
Person Obligations	0
Net Borrowing Requirement	**0**
Cashflows from Financing Activities:	
Short-Term Borrowings	0
Long-Term Borrowings	0
- Repayments	0
Total Cashflows from Financing Activities	**0**
Net Movements in Cash Field	**0**
Opening Cash Balance	0
Closing Cash Balance	0

No other aspect of their finances will be included in the legal text but further information will be provided in appendices.

Article 4.

Summary Statement of Group C Lending Institutions Finances.

This will be similar to Article 4 except that information on their lending activity will also be presented.

Article 5.

Borrowing, Relending and Guarantees.

This article will encompass authorizations presently contained in the Credit Budget, i.e. Treasury borrowing authority, relending activity and guarantees on third party borrowing.

Article 6.

Entitlement Limitations.

This article limits appropriations and distribution of earmarked revenue that is mandated in separate acts. Earmarked revenue should, however, be reported in a clearer fashion than is presently the case. See Special Table 4.

Article 7.

Purchase and Disposal of Real Property.

This article authorizes the Minister of Finance to purchase and dispose of real property et al. This is similar to Article 6 of the present Budget, except that all amounts will be presented on both accrual-basis and cash-basis.

Article 8.

Other Provisions.

This article is specifically intended for showing the tax index for the coming fiscal year.

Appendices.

As previously stated, appropriations to specific agencies and programs will not be shown in the legal text, but rather in an appendix to the legal text. This is similar to the treatment of various capital appropriations in the present budget format. This is intended to increase the clarity of the Budget.

The appendices will contain the following:

1. **Treasury Revenue by Source.** This will show a full itemization of Treasury revenue, both on accrual-basis and cash-basis.

2. **Treasury Expenditure by Administrative Unit.** This will show Treasury expenditure classified by administrative unit, i.e. ministries and agencies. Expenses will be reported on accrual-basis. User fees will be reported as negative expenditure.

3. **Other Supplementary Information on Group A Operations.** This will show itemization of various appropriations, i.e. capital investments by project.

4. **Supplementary Information on Group B Non-Financial Enterprises Finances.** This will show the financial plans and cashflow statements of each Group B non-financial public enterprise.

5. **Supplementary Information on Group C Lending Institutions Finances.** This will provide the same information for Group C entities as Appendix 4 provides for Group B entities.

Special Tables

In addition to the information provided in the appendices, there will also be various special tables to provide still further information on the government's finances. They are as follows:

1. **Treasury Finances Summary Table.** This is similar to Article 1 of the present Budget, except that it will be shown on both accrual-basis and cash-basis.

2. **Treasury Expenditure by Functional Category.** Treasury expenditure is to be classified by function in line with the United Nations Classification of Function of Government (COFOG) guidelines. This shows expenditure for a certain function regardless of which ministry or agency provides it. For examples, education expenditure will include not only the Ministry of Education but also the special agricultural schools of the Ministry of Agriculture.

3. **Treasury Expenditure by Economic Category.** This will show the classification of expenditure by economic category.

4. **Earmarked Revenue.** The Commission believes that earmarked revenue should be reported in a clearer manner than at present. As a result, this table will list each agency and its earmarked revenues. It will be reported on both accrual-basis and cash-basis, i.e. accrued revenue and revenue received. The table will also show its cashflows, i.e. cash at hand at beginning of year, cash received during the year, any limitations per Article 6 of the Budget and cash available. An estimate of the use of earmarked revenues during the year is to be provided and the estimated end-of-year balance. This is to ensure that information is available at any time on the balance of earmarked revenue accounts.

5. **Composition of Treasury Revenue.** This table will show in summary fashion accrued revenue and revenue received, classified by major revenue sources.

6. **Consolidated Borrowing Activity for Group A, B and C Entities.** This will show the estimated new borrowing activity and repayments of outstanding debts for Group A, B and C entities on a consolidated basis.

7.3 Interim Financial Reporting

As previously stated, financial reporting should be on both accrual-basis and cash-basis.

Accrual-basis requires considerable time and effort as detailed information has to be received from ministries and agencies. Pension obligations, interest expense and cost-sharing projects have to be reported on accrual-basis as well. It is recommended that interim financial statements on accrual-basis be provided only twice a year, in the spring and in the fall.

Cash-Basis interim reports will, however, be produced monthly as is presently the case. This ensures that information on Treasury finances is available as soon as possible. Its format will be based on the statement of cash-flows and its three main categories:

- Cashflows from Operating Activities will show revenue received, classified by major revenue sources, and expenses paid, classified by ministry and agency.
- Cashflows from Investing Activities will show movements in short-term receivables/payables, new lending, repayments of outstanding debt and capital transfers.
- Cashflows from Financing Activities will show the borrowing activity of the Treasury.

The total of the first two cash-flow categories shows the borrowing requirement of the Treasury while the total of all three shows the change in cash on hand.

Expenses will be defined on pure cash flow basis. Major obligations and commitments entered into will be listed in the explanatory notes.

The Commission recommends the following format for this statement:

Monthly statement of Cashflow from Operations:

Revenue:	
Tax Revenue	0
Operating Revenue	0
Sale of Assets	0
User Fees	0
Total Revenue	**0**
Expenditure:	
Ministry A	0
Ministry B	0
Ministry C	0
Total Expenditure	**0**
Total Cashflows from Operating Activities	**0**
Cashflows from Investments:	
Accounts Receivables/Payables,net	0
Holdings in Non-Group A entities, net	0
Long-term Loans Granted	0
-Repayments of Loans Granted	0
Repayments of Loans Taken	0
Total Cashflows from Investing Activities	**0**
Net Borrowing Requirement	**0**
Cashflows from Financing Activities:	
Sale of Treasury Bills	0
Sale of Treasury Notes	0
Sale of Treasury Bonds	0
Sale of Foreign Securities	0
Net Cashflows from Financing Activities	0
Net Movement in Cash Held	**0**
Opening Cash Balance	0
Closing Cash Balance	0

Chapter 8

Finacial Impact of the Commission´s Recommendations

The financial impact of the Commission's recommendations are discussed in this chapter. The recommendations are four-fold.

First, reporting various transactions on a net basis will end. This means that various tax expenditures that have been reported as negative Treasury revenue will be reported as expenditures. Similarly, various revenue that has been reported as negative expenditures will be reported as Treasury revenue.

Second, the new comprehensive definition of government entities will result in various entities being included in the system of financial reporting for the first time.

Third, various entities that have been reported in Group B will be moved to Group A for reporting purposes.

Fourth, the Budget will be on accrual-basis as well as showing cash movements. This means that all obligations entered into during a given year will be treated as expenditure.

The impact of the Commission's recommendations on reported expenditure and revenue can be divided into two parts. First, the impact of the changes in definition and classification of entities, revenue and expenditure. Second, the impact of moving from cash-basis to accrual-basis.

The greatest financial impact is due to reporting various tax expenditures, which are not linked to the taxpayer´s liability for the respective tax, as expenditure rather than as negative Treasury revenue. This means that the children's benefit and mortgage interest benefit will be treated as expenditures like other entitlement programs. The reporting for other tax expenditures, which are directly linked to the taxpayer's liability for the respective tax, such as the personal allowance, will not be changed. Membership fees in the Church of Iceland, which are collected with the individual income tax, will no longer be reported as a negative Treasury revenue item. They will be reported on the expenditure side as transfer payments to the Church. Various other revenue that has been treated as negative expenditure will be treated as Treasury revenue. Compulsory fees will be treated as operating revenue while non-

compulsory revenue will continue to be treated as negative expenditure. Examples of compulsory fees are fees for issuing passports and driver's licenses. Examples of non-compulsory fees are the sale of publications by the Bureau of Statistics and the sale of maps by the Geodetic Survey. Finally, various revenue that has been reported as proprietary revenue of Group B entities will be reported as Treasury revenue. Examples include license fees to the Icelandic Broadcasting Service and various harbor fees.

The following table summarizes the financial impact of the above recommendations for fiscal year 1992.

Impact of New Definitions and Classifications (FY1992)

millions of krona

1.	**New Classifications within Group A**		11.493
	Children's benefits as expenditure	4.410	
	Mortgage interest benefits as expenditure	2.800	
	Church of Iceland membership fees as expenditure	1.100	
	User fees as treasury revenue	3.183	
2.	**Group B proprietary revenue as treasury revenue**	2.250	
3.	**New Group A entities**		3.092
4.	**Total (1+2+3)**		**16.835**

It should be reiterated that the changes in reported revenue and expenditure are due only to reclassification. It does not represent changes in the level of taxation or the financial position of the Treasury. Reported revenue and expenditure as a proportion of GDP will, however, increase. Reported tax receipts, as a proportion of GDP, will increase from 24,5% to 27,3% and reported total revenue, as a proportion of GDP, will increase from 26,5% to 30,7%. These changes will make the figures more comparable to those reported for other countries.

The lost tax claims write-offs will also be treated as expenditure instead of as negative revenue. This increases both reported revenue and expenditure by a corresponding amount. These write-offs have been very irregular in recent years and no attempt is made to estimate their impact on reported revenue and expenditure.

The impact of moving from cash-basis to accrual-basis impacts both the revenue side and the expenditure side of the Budget. This means that all obligations entered into during a given year are reported during that year, irrespective of when they result in actual cash outlays or cash receipts. Previously, they had not been reported until the actual cash changed hands. The changes involve primarily pension obligations and cost-sharing projects with local governments.

The following table shows the financial impact of moving from cash-basis to accrual-basis for FY1992:.

Impact of Moving from Cash-Basis to Accrual-Basis FY1992

(millions of kronur)	Revenue	Expenditure	Difference
1. Cash-Basis	103.447	110.608	7.161
2. Accrual-Basis	106.039	116.631	10.592
3. Difference (2-1)	**2.592**	**6.023**	**3.431**

The above table shows that assessed revenues are 2.592 million krónur higher than collected revenue in FY1992. Expenses incurred are 6.023 million krónur in excess of expenses paid in FY1992. This does not represent increased government activity but more comprehensive reporting of government activity.

Finally, the following table summarizes the total impact on reported revenue and expenditure of the Commission´s recommendations for FY1992.

Total Impact of Commission´s Recommendations FY1992

(millions of krónur)	Revenue	Expenses	Difference
1. Classification of Transactions........	11.493	11.493	0
2. Group B Proprietary Revenue.......	2.250	2.250	0
3. Definition of Entities	3.092	3.092	0
4. Accrual-Basis Obligations	2.592	6.028	-3.431
5. Cash-Basis	103.447	110.608	-7.161
5. Total	**122.874**	**133.466**	**-10.592**

Chapter 9

Financial Reporting for Group B and Group C Entities

Group B non-financial public enterprises and Group C lending institutions should be reported in the Budget and the Financial Statements. Group B non-financial public enterprises operate in a market environment and derive their revenue primarily from the sale of goods and services to individuals and private sector companies. Some of these enterprises enjoy a monopoly position while others operate in a competitive environment. The tariffs of these enterprises are generally set to cover all costs. Group C lending institutions extend credit to non-Group A entities. These institutions operate on the capital markets where they derive most of their disposable funds.The financial plans of Group B and Group C entities will be presented in the Budget each year so that the *Althingi* will be able to review them. The financial statements of these entities will be published in the government's Financial Statements. The Treasury's guarantee of the obligations of government entities varies according to their legal form. The Treasury unconditionally guarantees the obligations of Group B non-financial public enterprises and, for the most part, Group C lending institutions as well. The Treasury also unconditionally guarantees the obligations of most Group D financial institutions. The Treasury is unconditionally liable for the obligations of various joint-ownership companies except where specifically stated otherwise in legislation. The government's liability for the obligations of entities incorporated as limited liability companies is, however, limited to its shareholding in the respective company. The legal form of an enterprise is thus an important determinant for what group it belongs to. If a Group B or Group C entity is incorporated, then it moves to Group E.

9.1 Financial Reporting for Group B and Group C Entities.

The *Althingi´s* discussion of the operations and finances of Group B and Group C entities is often unclear. Group B entities are presently reported in the Budget. The *Althingi* limits its discussion, however, to a relatively few enterprises and often more in the context of the Credit Budget than the Budget. These entities are required to

submit their financial statements in standard form to the State Accounting Office for publication in the government's Financial Statements. Group C entities are not reported in the Budget, but are discussed by the *Althingi* in the context of the Credit Budget where they are granted borrowing authority. The financial statements of Group C entities have not been published in the government's Financial Statements.

The *Althingi* should discuss the operations and finances of Group B and Group C entities in a more systematic manner than is presently the case. Their financial plans should be presented in the Budget and discussed along with other elements of the Budget. Those elements of their finances requiring parliamentary action, including levels of dividends, investment, borrowing and lending, will be shown in Article 3 and Article 4 of the Budget. A summary table of their finances will be presented in a supplement to the Budget.

Financial statements of Group B and Group C entities should be included in the government's Financial Statements. It is, however, recommended that these enterprises no longer be required to present their financial statements in standard form to the State Accounting Office. This will save considerable time and effort for many enterprises. Despite the government's ownership interest, the operations and finances of Group B non-financial public enterprises and Group C lending institutions are most often similar to that of their private sector counterparts. These enterprises should therefore conduct their financial reporting in line with the accepted practice in their respective industries. It is also important that their presentation in the Budget and the Financial Statements be in line with private sector practice. This forms the basis for comparing the performance of Group B and Group C entities to their private sector counterparts.

Corporate financial statements generally present an operating statement, balance sheet and statement of cashflows together with explanatory notes. The main goal of corporate financial statements is to provide information on the company's operating and financial performance and changes in its financial position. The financial statements are mainly concerned with recording past activity and not forecasting future performance.

The balance sheet shows a company's assets and whether they were financed by debt or equity. The statement also contains information on the cash position of the company and its ability to pay its obligations in the short term.

The operating statement aims to give a fair view of the company's operations and financial performance. Revenue is reported when it accrues, not when it is actually received. Similarly, expenses are reported when they incur, not when they are actually paid.

Private sector financial reporting in Iceland employs two types of financial flow

statements. Both types aim to show the profit or loss from operations, investments in long-term assets and whether they were financed by debt or equity. One statement focuses on changes in working capital while the other focuses on changes in cash on hand.

It should be reiterated that Group B non-financial public enterprises and Group C lending institutions will employ the financial reporting practice of their respective industries. In a supplement to the Budget, a summary financial plan will be presented for each Group B and Group C entity. The format of these plans will vary and is based on the practices in the entity's respective industry. In all cases, the cash-flows of Group B and Group C entities will be presented with their pension obligation treated as an expense as they are incurred.

Finally, it should be noted that the new system of financial reporting for the Treasury (Group A) means that there is a direct link between the balance sheet of the Treasury (Group A) and those of Group B and Group C entities. The Treasury's holdings in non-Group A entities will be treated as an asset in the Treasury's Financial Statements, as discussed in Chapter 6. All decisions made by the *Althingi* regarding the finances of Group B and Group C entities will have a direct impact on the finances of the Treasury (Group A). This should form the basis for a more focused discussion in the *Althingi* of their operations and finances.

Chapter 10

Legislative Changes

Many of the Commission´s recommendations can be implemented without legislative action. Some of the Commission's recommendations, however, require legislative changes. The Commission believes that a comprehensive new Financial Reporting Act should be enacted. Other legislation needs to be reviewed and changed so as to make it compatible with the provisions of the new Act. In addition, new regulations and manuals need to be issued.

10.1 Legal Basis for Financial Reporting

The present legal basis for the government's system of financial reporting is the Financial Reporting Act of 1966, as amended in 1982 and 1985. The form and content of this legislation is out of date in many respects. The Act deals very precisely with certain issues while not discussing others at all. The Act is clearly set in the manual bookkeeping environment of the 1960s. Accounting principles have also developed greatly over this time. New legislation on private sector accounting has also been enacted. There should be uniformity between that private sector Act and the government's Financial Reporting Act to the extent possible.

The Commission recommends that the government's financial reporting framework be formalized on three levels: by legislation, by regulations and by a manual. Each serves a different purposes:

Legislation. The overall framework for the government's system of financial reporting should be formalized in legislation. This should encompass general principles and rules for definition and classification of entities and transactions.

Regulation. Regulations issued on the basis of the Act will provide more detailed rules for the definition and classification of entities and transactions.. The objective is to make the government's system of financial reporting more dynamic so that it can be adjusted to changing circumstances, within the overall framework set by the Act.

Manual. The manual will set forth the rules contained in the legislation and the regulations together with further discussion, explanations and examples. The manual will be continually updated.

10.2 Other Legislative Matters.

The Commission recommends that the overall framework for the government's system of financial reporting be enacted into law. Two special issues need to be considered as well: the supplementary budgets and the status of non-profit institutions.

Supplementary Budgets. The Commission recommends that the Budget should be reported on accrual-basis while also providing information on cash-basis. The supplementary budgets are presently reported on cash-basis. It is important to report supplementary budgets on accrual-basis in order to ensure uniformity with the Budget. The very purpose of supplemental budgets needs to be defined more clearly in legislation.

Non-Profit Institutions. The Commission recommends that non-profit institutions that are majority funded by the Treasury have their financial statements published with the government's Financial Statements. This is to show their use of financial resources and how their operations compare with government agencies. The government needs legislative authority to demand these financial statements. Appropriations to these institutions should be made conditional on the return of their financial statements.

In addition to the Financial Reporting Act, various other laws contain related provisions. It is essential that these provisions be reviewed and adjusted so as to make them compatible with the new Financial Reporting Act. These provisions can be divided into the following three groups.

Provisions regarding borrowing and guarantees. The Economic Management Act of 1979 contains provisions regarding the Credit Budget and related matters. The Commission recommends that the Credit Budget be incorporated into the Budget and that the necessary legal provisions be incorporated into the Financial Reporting Act. Related provisions of other legislation need to be adjusted as well. The Treasury and Government Enterprises Borrowing Act of 1974 also contains provisions that appear appropriate for incorporating into the new Financial Reporting Act. Provisions of the Debt Management Agency Act of 1991 need to be reviewed and adjusted as well.

Provisions in Agencies' Enabling Legislation. There are examples of provisions in agencie´s enabling legislation dictating where they should be grouped for reporting purposes. For example, the Real Property Valuation Agency´s enabling legislation states that it a Group B entity. The Commission recommends that entities be divided into Group A-E in line with the nature of their operations and that general

rules be set in this regard. It is necessary to search for all provisions that may be incompatible with this recommendation and adjust them accordingly. There are also examples of entities that belong to Group A due to the nature of their operations, but are classified in Group B because they enjoy independent borrowing authority. Provisions such as these need to be adjusted as well.

Out of Date Legislation. There are examples of various entities which are not operational, but still have their enabling legislation in effect. Such legislation should be repealed.