Problems and Prospects of Departmental Financial Statements*

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I. Introduction

In November 2002, the Fiscal System Council established a Subcommittee on Governmental Accounting to plot a future course for governmental accounting in Japan. This Subcommittee carried out comprehensive studies on the significance and objectives of governmental accounting as well as on the basic ideas underlying financial reports, and compiled the results of its studies in June 2003 as *Basic Ideas on Governmental Accounting.* In response to a recommendation made in this *Basic Ideas on Governmental Accounting*, that "With focus on each ministry and agency (hereinafter referred to as 'Department'), the basic unit of the administration and budget execution as well as the subject entity for administrative evaluation, the Financial Statements that contain information on flow and stock should be prepared by Department, and accountability and greater administrative efficiency should be sought," the Fiscal System Council drafted its *Standard for Departmental Financial Statements* in June 2004. Since then, the Departments have prepared Departmental Financial Statements in accordance with the *Standard for Departmental Financial Statements*, including balance sheets as well as operating expense statements in which the general accounts and special accounts under their purview were consolidated in FY2002 settlement of accounts. In addition, Government Financial Statements consolidating these documents have been prepared since FY2003 settlement of accounts. Efforts to enhance governmental accounting in Japan at the Department level have thus been concentrated on the preparation of the Departmental Financial Statements through the preparation of Japanese Government Balance Sheets (tentative draft) since FY1998 and financial statements of special accounts since FY1999.

Despite the fact that addressing issues facing the existing governmental accounting system underlies the preparation of the Departmental Financial Statements, these efforts are predicated on maintaining the existing system, as those at the Department level have been so far. Therefore, no legal position or usage for the Departmental Financial Statements has been clarified[1], and this has given rise to concern that these documents will simply continue to be prepared but not be used much, as seen with those prepared heretofore. In view of Japan's severe fiscal circumstances, efforts to improve governmental accounting should be directed at improving the efficiency of administrative and fiscal activities. To that end, consideration should be given to drastically reforming subsystems

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1) The requirements for preparing Departmental Financial Statements have been stipulated in Cabinet guidelines and have not been enshrined into law (Cabinet Office [2004] p. 6).

comprising governmental accounting systems, such as the budget system, account settlement system, and audit system. This paper will discuss issues involving the Departmental Financial Statements and explore solutions to address them, taking into consideration fundamental reforms to the existing governmental accounting system (N.B.: the views expressed in this paper are the personal views of the author and do not reflect the official views of the Board of Audit, where the author works).

II. Present Issues Involving Departmental Financial Statements

The Departments prepare financial statements to provide financial information that helps ensure accountability for the fiscal condition of each Department and contributes to more efficient and appropriate budget execution.[2] Nevertheless, the following limitations call into question the ability of the current Departmental Financial Statements to address the issues[3] confronting the current governmental accounting system.

1. Limitations due to Utilization Methods

To prepare Departmental Financial Statements that address the issues facing the current governmental accounting system, it is critical to identify needed information and define how to utilize it specifically, and then to develop a governmental accounting standard and establish a system to obtain and use the necessary financial information with a view to carry out fundamental reforms to the existing governmental accounting system. However, the *Standard for Departmental Financial Statements* which serves as a governmental accounting standard for the Departmental Financial Statements, applies the ideas and methods of corporate accounting to the figures from revenue-expenditure final accounts calculated under the existing system without specifying necessary financial information. In addition, with the precise methods for using this financial information still unclear, it is only natural that no system for utilizing this information has yet been developed. As just described, priority has been given to ease of preparation and to preparation itself in the Departmental Financial Statements, presuming maintenance of the existing governmental accounting system, and, the topsy-turvy approach of considering specific methods for utilizing information only after the preparation of the Statements[4] has substantially limited these methods.

2. Limitations due to Preparation Standard

The Departments prepare their Financial Statements after the end of each fiscal year in accordance with the *Standard for Departmental Financial Statements* by making necessary revisions, e.g., distinguishing between current expenditures and capital expenditures based on figures in the revenue-expenditure final accounts (prepared using cash-basis/single-entry bookkeeping), writing off depreciation and reserving allowances. In other words, unlike Independent Administrative Institutions and National University Corporations to which corporate accounting rules are applicable in principle, the Departments continue to employ cash-basis/single-entry bookkeeping, and they have not introduced accrual basis/double-entry bookkeeping for day-to-day entries from the beginning of the fiscal year. Therefore, since the revenue-expenditure final accounts that provide the basic figures are usually prepared in September of the following fiscal year, the Departments begin preparing their documents from this point. In addition, the Departmental Financial Statements should be released immediately following submission of the revenue-expenditure final accounts to the Diet. However, as, revenue-expenditure final accounts have been submitted on or around November 20 of the following

2) Ministry of Finance, Fiscal System Council (2004), p. ii.
3) With regard to issues facing the present governmental accounting system, see AZUMA (2005), pp. 77-81.
4) Ministry of Finance, Fiscal System Council (2003), pp. 20-21.

fiscal year at the request of the Upper House since the FY2003 account settlement, the Financial Statements are published sometime thereafter[5]. As it shows, accountability for financial status of the fiscal year is not implemented in a timely manner because of significant delay in preparation and submission of the documents. In addition, since changes in the middle of the fiscal year, such as those to the mid-term settlements, are not allowed, financial information cannot be provided in a timely manner during the process of budget execution for the fiscal year.

3. Limitations due to Budget System/Account Settlement System

The smallest unit for expenditure budgets voted in the Diet under the current system is the "item", and the Public Finance Law requires that budget items be classified by objective. At present, though, items are not necessarily grouped by policy; expenditures connected with a single policy may be split among multiple items, while expenditures tied to multiple policies are often included under a single item. In addition, when allocating expenditure budgets to each Department once the budgets are approved, the Cabinet classifies the items into "sub-items" that are then categorized by expenditure. The revenue-expenditure final accounts on which the Departmental Financial Statements are based are thus also not grouped by policy. As a consequence of being derived from revenue-expenditure final accounts figures not grouped by policy, the Departmental Financial Statements merely provide financial information on costs by expenditure (personnel costs, administrative costs, etc.) and cannot provide financial information on costs by policy. The Departments provide administrative services (output) in order to achieve certain policy objectives (outcome), but because outcome/output performance information is not given in the present budget documents or account settlement statements, the efficiency (output/input) and cost-effectiveness (outcome/input) of administrative services could not be assessed even if policy-specific cost information were to be provided through the Departmental Financial Statements.

4. Limitations due to Internal Control

As the Departmental Financial Statements are prepared based on the figures in the revenue-expenditure final accounts, the national property book, the state commodity management book and others, the credibility of the Financial Statements depends heavily on the effectiveness of internal control put in place to ensure adequate preparation of these settlements statements and asset books, etc. Internal control at individual Departments under the present governmental accounting system is grounded in a check-and-balance[6] approach manifested in the separation of accounting institutions and internal audits, but this structure operates under the following limitations.

(a) The effectiveness of the check-and-balance approach is limited by the fact that, though accounting duties may be segregated at the accounting organization level, at the assistant level a single person is often concurrently responsible for multiple duties, especially at smaller government offices[7].

(b) The effectiveness of internal audits can be diminished when, for example, internal audit organizations are not structurally independent from accounting organizations or when no audit manuals/audit reports are prepared[8].

(c) Accounting irregularities at the Departments occur not only within accounting organizations but also within project implementation divisions not covered under the check-and-balance

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5) The Departmental Financial Statements for the FY2003 settlement of accounts were published in April 2005. The Departmental Financial Statements for the FY2004 settlement of accounts have not yet been published as of January 31, 2006.
6) Accountancy law in principle forbids assignment of concurrent responsibility for revenue authorization and cash collection(Article 8), obligation and obligation authorization (Article 13.5), and expenditure authorization and cash payment (Article 26) to the same official.
7) Board of Audit (2004b), pp. 114-127.
8) Board of Audit (2002), pp. 756-833.

structure; a check-and-balance structure encompassing only accounting organizations is thus limited in effectiveness[9]. When accounting irregularities occur, the non-compliance of accounting procedures with financial accounting laws and regulations is compounded by the failure to prepare adequate financial reports due to the misappropriation of cash and other assets as well as the emergence of off-book assets and liabilities.

(d) The current laws and regulations only require that the book prices of national property be updated every five years[10] and that commodities and books be audited once each fiscal year and whenever the state commodity management officer is replaced[11]; physical inventory procedures are thus not necessarily carried out at the end of each fiscal year to confirm the substantiality and completeness of assets.

Because the adequacy of figures in the revenue-expenditure final accounts, the national property book, the state commodity management book and others is not ensured through internal control, the Departmental Financial Statements based on these figures cannot offer highly credible financial information.

5. Limitations due to Audit System

With the Departmental Financial Statements prepared based on figures from the revenue-expenditure final accounts, the national property book, the state commodity management book, and other statements, the credibility of the Departmental Financial Statements is also dependent on external audits conducted to ensure the adequacy of the settlement of accounts, asset books, and so on. Under the present governmental accounting system, external audits of individual Departments are fundamentally conducted by the Board of Audit. However, since the Board of Audit confirms the amounts of settled accounts only by reconciling figures from statements submitted by revenue collectors, disbursing officials, and other officials against those from statements submitted by the Bank of Japan, the adequacy of revenue-expenditure final accounts is not assured. The Board of Audit also does not conduct audits for the purpose of assuring the adequacy of the national property book, the state commodity management book, and the state credits management book[12]. Furthermore, despite the fact that the Departmental Financial Statements are based on the figures from the revenue-expenditure final accounts prepared using a cash-basis/single-entry system, these statements also incorporate subjective decisions by the Departments on such matters as the transfer of valuation reserves such as allowance for bad debt, the transfer of liability allowance such as reserves for retirement allowances, and posting of depreciation for national property and commodities. Yet, the Board of Audit does not presently conduct audits to assure the adequacy of the Departmental Financial Statements. Given that the Board of Audit does not assure the adequacy of the Statements, the Departmental Financial Statements cannot provide highly credible financial information.

III. Prospect for New Departmental Financial Statements

Although the Departmental Financial Statements have been introduced to address issues

9) Board of Audit (2004c), pp. 177-183.
10) National Property Law Implementation Ordinance, Article 23.
11) State Commodity Management Law Implementation Ordinance, Article 44.1.
12) The "Comprehensive Statement on Change in National Property and Present Amount," the "Comprehensive Report on Change in Commodities and Present Amount," and the "Comprehensive Report on the Present Amount of State Credits" are prepared each fiscal year on the basis of these asset books and submitted to the Diet. However, the Board of Audit does not conduct audits of these financial reports to assure their adequacy.

facing the current governmental accounting system, these Statements are still subject to the problems discussed in section II because they are premised on maintenance of the present system, as efforts at the Department level were. Presuming an across-the-board review of the Departmental Financial Statements at present, this section will look at measures to resolve the issues discussed in II above while giving due consideration to fundamental reforms of the present governmental accounting system.

1. Utilization Methods

To actually utilize the financial information provided in the Departmental Financial Statements, the financial information needed to resolve the issues confronting the present governmental accounting system must first be specified and methods for utilizing that information must be clearly set out. This will make it possible to develop a governmental accounting standard and to establish a system that can obtain the needed financial information and utilize them, including a possibility to carry out fundamental reform of the current system. The following are examples of specific methods for utilizing the financial information provided in the Departmental Financial Statements[13).

(1) Utilization for Fiscal Discipline

In Japan's FY2005 general account, 34.39 trillion yen, or 41.8% of revenues, is expected to be procured through government bonds, and the amount of government bonds issued is expected to exceed 538 trillion yen at the end of FY2005 because of years of dependence on government bonds for fiscal management. Should this fiscal situation persist, flexible administration of public finance to cope with changes in socioeconomic circumstances – e.g., maturation of the economic structure and the onset of declining and rapidly aging population – will become difficult, thus making it all the more important to work toward more sound fiscal administration. To that end, the finances of the country as a whole must be controlled by imposing fiscal discipline for a medium to long term at the macro level and measuring performance against it each fiscal year.

Fiscal discipline has yet to be imposed by legislation in Japan, but the basic guideline for public finance administration aims to achieve a surplus in the primary balance of national and local governments in the early 2010s[14). The primary balance represents a fiscal balance that deducts expenditures excluding principal and interest payment related to past debts from revenues from taxes and others excluding borrowings. When revenues and expenditures balance out, revenues from government bonds will be allocated only to redemption of the national debt and interest payment and thus the debt balance will increase by only the amount of interest. Since the primary balance is calculated on a cash basis and thus cannot be differentiated between current balance (expenses and costs) and capital balance (assets and liabilities), it only provides financial information on the sustainability of public finance and cannot offer financial information on the equity of inter-generational burdens.

In this case, the financial information provided in the Departmental Financial Statements could be utilized to control public finance for the entire country by imposing medium to long-term fiscal discipline at the macro level and measuring performance against it each fiscal year. Because in this case both the current revenues and expenditures, and the assets and liabilities, of the country will

13) Providing financial information needed to ensure accountability and providing financial information needed for efficient administrative/financial activities can be regarded as the principal objectives of financial reports in governmental accounting. The details of system design will depend on which is given greater priority and, in view of Japan's challenging fiscal situation, this paper places emphasis on the latter as a concrete method for utilizing the Departmental Financial Statements. An examination of governmental accounting system reform in the developed countries of Europe and America reveals that reforms in France (since the FY2006 budget) and the US have stressed the former, while reforms in Australia, Canada, New Zealand and the UK have emphasized the latter.

14) Cabinet Office (2005b), p. 11

be needed as financial information pertaining to the sustainability of public finance and the equity of intergenerational burdens, the Ministry of Finance needs to prepare Japanese Government Financial Statements that consolidate the Financial Statements from every Department[15].

(2) Utilization for Departmental Financial Goals

Since responsibility for budget execution ultimately resides in individual Departments, sound financial administration necessitates control of the administrative management by Department from a financial perspective by translating the medium to long-term fiscal discipline at the macro level into single-year financial goals at the Department level and measuring their performance against these goals every fiscal year. When setting single-year financial goals at the Department level, it is important to categorize expenditures into discretionary spending and mandatory spending. This is because the Departments can control their discretionary spending through administrative management, but they cannot do so for mandatory spending since mandatory spending is required by law[16].

Basic Guideline for Preliminary Budget Request is issued every fiscal year in Japan as a standard for Department budget requests. The Guideline requires expenditures to be divided between "expenditures related public investment" and "other expenditures," and the latter to be further divided into mandatory spending and discretionary spending with the across-the-board standard for estimation by specifying the ratios to the initial budget amounts of the previous fiscal year[17]. In the end, though, the Basic Guideline serves only as the standard for Departments to submit their preliminary budget requests. It does not specify financial goals for budget execution.

In this case, the financial information provided in the Departmental Financial Statements could be utilized to control the administrative management of each Department from a financial perspective by setting single-year financial goals at the Department level and measuring their performance against the goals every fiscal year. In this instance, the Departments would need to prepare segment information on discretionary spending because the breakdown of discretionary spending, including personnel costs, will be needed as financial information[18].

(3) Utilization for Financial Goals for Implementing Agencies

Each Department comprises organizations engaged in policy planning and those engaged in policy implementation, and the latter execute the vast majority of budgets. For the sake of sound financial management, the administrative management of implementing agencies must be controlled from a financial perspective by translating single-year financial goals at the Department level into single-year financial goals at the implementing agency level and measuring their performances

15) Canada, Australia, New Zealand and the UK are among those countries utilizing or planning to utilize financial information provided by financial statements to impose medium- to long-term fiscal discipline at the macro level. In the UK, for instance, the Blair administration has advocated limiting government loans to investment expenditures (i.e., ensuring that the current balance does not fall into deficit) and maintaining net debt in the public sector below 40% of GDP as goals for medium- to long-term fiscal discipline at the macro level in line with The Code for Fiscal Stability (1998). To obtain financial information on this fiscal discipline, HM Treasury prepares consolidated financial statements for the public sector as a whole that encompass both the central government (departments, etc.) and local governments (Whole of Government Accounts; WGA) applying accounting standards in accordance with Article 9.1 of the Government Resources and Accounts Act 2000 (Cabinet Office (2000a) sec. 9). Preparation of FY2003-04 consolidated financial statements for the central government as a whole is now underway, with preparation of the WGA expected to begin in FY2006-07.

16) Included within mandatory spending are social insurance benefits, debt servicing costs, local allocation tax grants, local government treasury charges, and contributions to international organizations. In Japan, personnel costs are included in mandatory spending, while in the developed countries of Europe and America they are included in discretionary spending.

17) Cabinet Office (2005c), pp. 1-3

18) New Zealand and the UK are among those countries utilizing financial information provided by financial reports to set financial goals at the department level. In the UK, for example, multiple fiscal-year budgets of three-year terms have been adopted at departments since the FY1999-2000 budget, and the FY2005-06 to FY2007-08 budgets are currently being prepared using the 2004 Spending Review. The 2004 Spending Review sets out Efficiency Targets common to all departments based upon agreements between HM Treasury and these departments, and departments are required to reduce their management costs by 2.5% within discretionary spending (HM Treasury (2004b), pp. 13-26). After each fiscal year, departments must prepare Departmental Reports analyzing their success in achieving the efficiency targets by comparing these targets with their actual performance.

against the goals each fiscal year.

As part of the central government reform carried out in Japan in January 2001, implementing agencies were created within the Departments to assume primary responsibility for policy implementation[19). To improve the efficiency of operations and to increase the independence of implementing agencies, the heads of Departments are required to delegate the authority over affairs falling under the purview of the respective implementing agencies to the heads of those agencies, develop and announce implementation standards for the delegated affairs, establish goals for the agencies, and evaluate their performance against these goals and announce the result[20). To ensure effective goal management, quantitative indicators and numerical goals must be established in advance to measure the agencies' achievement against them, and post-implementation comparisons must be made between actual performance and goals. At present, however, only part or none of the necessary quantitative indicators and target figures has been established for some implementing agencies[21). In addition, despite the fact that improved efficiency can be reflected in the reduction of cost to provide administrative services, no implementing agency has laid down numerical goals using financial indicators.

In this case, the financial information provided in the Departmental Financial Statements could be utilized to control the administrative management of implementing agencies from a financial perspective by setting out single-year financial goals at the agency level and measuring their performance against those goals every fiscal year. As a cost breakdown of discretionary spending including personnel cost would be needed as financial information in this case, each Department would need to prepare segment information by implementing agency[22).

(4) Utilization for Policy Evaluation

The policy structure of each Department comprises policies (narrowly defined) → programs → projects when viewed as the relationship of objective → means. Here, (1) a policy (narrowly defined) is a basic goal to resolve a specific administrative issue, (2) a program is a concrete goal to achieve the policy (narrowly defined) and a coherent group of organizational government activities, and (3) a project is a concrete policy means to carry out the program and represents an individual government activity[23). The policy structure of the government where mostly a single national policy (narrowly defined) encompasses multiple programs and a single program encompasses multiple projects is a three-tiered pyramid. Consequently, more of the budget must be allocated to more efficient (output/input) or more cost-effective (outcome/input) policy means under rigorously set financial goals to ensure sound financial management while maintaining the levels of output and outcome.

As part of central government reform in January 2001, a policy evaluation system was introduced for active review of policies in light of effectiveness and post-implementation changes in

19) As of January 31, 2006, eight implementing agencies (Defense Facilities Administration Agency, Public Security Intelligence Agency, National Tax Agency, Social Insurance Agency, Japan Patent Office, Japan Meteorological Agency, Japan Coast Guard, and Maritime Accident Inquiry Agency) have been established in six ministries.

20) Basic Law on Central Government Reform, Article 16.6

21) Ministry of Internal Affairs and Communications, Administrative Evaluation Bureau (2004), p. 6

22) Australia, Canada, New Zealand, and the UK are among those countries utilizing financial information provided by financial reports to set financial goals at the implementing agency level. In the UK, for example, agencies responsible for policy implementation (Executive Agencies) were created in all departments in 1988, and each Executive Agency concludes a Framework Document with the competent minister every three to five years setting out the establishment purposes and policy objectives of the Executive Agency. These Executive Agencies prepare Corporate Plans for three- to five- year terms for setting out managemental objectives and strategies. Executive Agencies also prepare one- to three-year Business Plans each fiscal year for achieving the policy objectives in line with their strategies, and these Plans spell out the administrative services to be provided as well as performance targets and efficiency targets. These efficiency targets ordinarily are the same as those of the departments to which they belong, and management costs within discretionary spending are to be reduced by 2.5% for each fiscal year covered in the 2004 Spending Review. After each fiscal year, every Executive Agency prepares an Annual Report and Accounts in accordance with Article 7 of the Government Resources and Accounts Act 2000 in which it analyzes their success in achieving the efficiency targets by comparing these targets with their actual performance.

23) Inter-ministerial Liaison Council on Policy Evaluation (2005), pp. 1-2

socioeconomic circumstances. A law governing policy evaluation by administrative organizations was then implemented in April 2002 to increase the effectiveness of policy evaluation. Under this law, the Departments are required to assess the effects of the policies under their purview in a timely fashion, make evaluations from the perspectives of necessity, efficiency, and effectiveness accordingly, and appropriately reflect these evaluation results in the policies. It is important that these evaluation results be reflected in budgets for policy evaluation to function effectively and, to that end, policy structures must be matched with budget structures and the cost of each policy must be calculated. However, policy-specific costs are not available in the current revenue-expenditure final accounts because expenditure budgets are prepared on a cash basis and not necessarily classified by policy.

In this case, each Department could utilize the financial information provided in the Departmental Financial Statements to allocate more budget to more efficient or cost-effective policy means. Because the full cost by policy is needed as financial information and the level of their achievements in output/outcome performance targets for each policy is needed as performance information in this case, the Departments will need to introduce performance budgets that link evaluations with budgets[24) 25)].

(5) Utilization for Incentives for Efficient Budget Execution

Under the current budget system, surpluses in final accounts for revenue-expenditure are carried over as revenues for the following fiscal year[26)]. Hence, even if a discrepancy arises between the estimated and executed budget amounts for a special account overseen by a single Department, since the unused amount stemming from the unexecuted portion of the budget will be allocated to the Department's budget for the following fiscal year, this will work as an incentive to keep the budget rather than to execute it fully as estimated. In general accounts covering general revenues and expenditures of all Departments, on the other hand, the portion of the budget saved by Departments through improved administrative management or the distribution of budgets to more efficient or cost-effective policy means is not carried over to the following fiscal year; this gives Departments the incentive to expend the budget rather than keep it. The Departments must therefore be given incentives to achieve policy objectives while executing their budgets efficiently.

The Japanese Diet has discussed a substantial amount of unused budget and surpluses in special accounts (e.g., the special account for reinforcement of agricultural management base) and the disparity between estimated and executed budgets in special accounts (e.g., the special account for promotion of power resources), and passed resolutions demanding inquiries into settlements[27)] and requesting the Board of Audit to investigate these special accounts. There have also been situations found in expenditure in general account where the spending rate for discretionary spending sharply rises or the ratio of unused fund declines, or the number of contracts signed for purchases of goods and

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24) Allocating budgets to more highly efficient and more highly cost-effective policy means is dependent on being able to calculate the cause-effect relationship between output and outcome, and the relationship between input and output or that between input and outcome, quantitatively. Because these relationships could not be ascertained even with the introduction of a performance budget for some policies under the purview of departments, program evaluation must be carried out separately for such policies. It is essential to develop a logic model when evaluating programs, and the introduction of a performance budget will facilitate development of this logic model.

25) Australia, Canada, New Zealand and the UK are among those countries utilizing the financial information provided by financial reports to evaluate policies from the perspectives of efficiency and cost-effectiveness. In the UK, for instance, the Spending Review carried out every other year since 1998 contain Public Service Agreements between HM Treasury and departments and present Aims, Objectives, and Performance Targets for the next three fiscal years (HM Treasury (2004c)). To achieve these Objectives, departments prepare one- to three-year Business Plans each fiscal year setting out the administrative services to be provided and output targets. After each fiscal year, departments also prepare Autumn Performance Reports and Departmental Reports that analyze their success in achieving performance/output targets by comparing these targets with their actual performance as well as the costs of providing administrative services.

26) Public Finance Law, Article 41

27) House of Councilors, Committee of Public Accounts (2005), pp. 1-3

facility maintenance sees a considerable increase at the end of a fiscal year[28).

In this case, the financial information provided in the Departmental Financial Statements could be utilized to offer the Departments incentives to achieve policy objectives while efficiently executing budgets. For this purpose, special accounts need to be integrated as far as possible into the general account with the aim of sharing financial resources between the general and special accounts. For personnel costs and other discretionary spending, it would also be necessary to (1) impose capital cost on net assets[29)], (2) apply accounting for the impairment of assets to fixed assets, and (3) allow all or part of unused budget to be freely carried over to the following fiscal year. Because the breakdowns of assets, liabilities and costs related to discretionary spending are needed as financial information to realize the above (1) and (2), and the unused amount in discretionary spending is needed as financial information for (3), the Departments will need to prepare segment-specific information on discretionary spending[30)].

(6) Utilization for Market Testing

The Departments provide the public with administrative services to achieve policy objectives, but this is implemented actually by the following entities; (1) internal divisions of each Department, (2) implementing agencies of each Department, (3) local branch offices of each Department, (4) government-financed corporations, (5) local governments, and (6) private enterprises, and so on. However, some of the administrative services implemented by the public sector ((1)-(5)) may also be provided by private enterprises, including job placement services for job seekers and the collection of social insurance premiums. Therefore, the implementing entities providing the administrative services overlapping with those provided by private enterprises should be reviewed to ensure more efficient budget execution.

There is a need in Japan to develop a system for introducing market testing on a full-scale basis to improve the efficiency of administrative services[31)]. Market testing is a system whereby the public and private sectors will participate in competitive biddings under transparent, neutral and fair competition conditions for the services that are currently provided by the public sector, and a bidder who will be able to provide better services in terms of price and quality will provide the services. For the market testing system to function effectively, performance information on the quantity, quality and timing of the administrative services implemented by the public sector needs to be clarified and the costs for providing these services also needs to be figured out by the same accounting standard as those applied at private enterprises. Because such performance information is not presently available in final account statements and the accounting is still cash based and on a single-entry basis, the costs of providing administrative services cannot be calculated.

In this case, the financial information provided in the Departmental Financial Statements

28) Board of Audit (2004a), pp. 1200-1245

29) In the developed countries of Europe and America, capital costs are calculated by multiplying the net assets of departments by a certain rate; departments post these capital costs as cost in their financial reports or pay the amount of the capital costs into the national treasury. If a financial objective of reducing costs for discretionary spending by a certain rate is established, even only posting these capital costs as cost in their financial reports encourages reviews of assets held as a means of reducing costs and promotes the sell-off of unnecessary assets.

30) Australia, New Zealand, and the UK are among those countries that impose capital costs or apply accounting for the impairment of assets to give departments incentives to pursue efficient budget execution. In these countries, the unused amounts in discretionary spending may be fully and freely carried over to the following fiscal year. In the UK, for example, accrual-basis accounting was introduced at departments with the FY1999-2000 settlement of accounts. Departments calculate the cost of capital charge every fiscal year by multiplying net assets on their balance sheets by a predetermined rate (3.5% at present), and list this figure as a cost in Schedule 2: Operating Cost Statement of the Resource Accounts, prepared in accordance with Article 5.1 of the Government Resources and Accounts Act 2000. This cost of capital charge is only listed as a cost and is not paid into the national treasury (HM Treasury (2005), chap. 4). Should fixed assets no longer serve their initial objectives or become idle and thereby hamper the ability to provide service, departments reduce the balance sheet values of these fixed assets to their recoverable values and list this impairment amount as a cost in their operating cost statements (HM Treasury (2005), chap. 5). Departments may fully and freely carry over unused amounts in discretionary spending to the next fiscal year.

31) Cabinet Office (2005b), p. 7

could be utilized to find the costs of providing administrative services needed for the implementation of market testing. The Departments would need, in this case, to report performance information on the quantity, quality and timing of key administrative services provided in a fiscal year in their final accounts statements. Because financial information is needed on the full cost per administrative service, the Departments would need to introduce Activity-Based Costing[32][33] and prepare segment-specific information by project[34].

2. Governmental Accounting Standard

(1) System

If specific methods for utilizing the financial information provided in the Departmental Financial Statements can be identified as in the previous section III-1, it becomes essential to introduce corporate accounting methods such as accrual-basis accounting, double-entry bookkeeping, and cost accounting into governmental accounting to obtain the necessary financial information. Accordingly, the Generally Accepted Accounting Principles (GAAP)[35] applicable to the financial reports of private enterprises should serve as a foundation for governmental accounting standard. This would make it possible to (1) differentiate balances into current balances (expenses and costs) and capital balances (assets and liabilities) (2) execute budgets while monitoring financial information, (3) prepare credible financial reports coordinated with bookkeeping system, (4) consolidate the Statements with those of Independent Administrative Institutions, National University Corporations, and other organizations to which GAAP are applicable as a rule, and (5) obtain financial information comparable to that of private enterprises.

Nevertheless, the administrative activities of the Departments have special features not found at private enterprises, including (1) the pursuit of policy objectives rather than profits, (2) financial resources stemming not from compensation for the services provided but from compulsorily collected taxation, (3) the provision of administrative services through administrative organizations rather than market organizations, (4) budget control approved in advance by the Diet, and (5) the need to comply with financial accounting and other relevant laws and regulations. As GAAP do not include standards covering these unique characteristics, supplementary or new standards must be added to deal with them[36].

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32) Activity-Based Costing is a method for assigning personnel costs, property costs and other costs to the costs of individual activities in line with work time, area, and other resource drivers, and for calculating costs per activity unit or for operations overall, after the operations in question have been subdivided into individual activities.

33) Departments ascertain the full costs of the operations in question using Activity-Based Costing, etc. in case of implementing market testing (Cabinet Office (2005a), p. 16).

34) Australia, New Zealand, the UK and the US are among those countries implementing market testing, and these countries have all introduced Activity-Based Costing. In the UK, for example, the Blair administration has mandated that departments consider systems for efficiently providing better quality administrative services over a five-year period from 2000 (Better Quality Services [BQS] review) in accordance with the Modernizing Government policy established in 1999. This BQS review is intended to examine the necessity of all administrative services being provided by departments as well as determine the best implementing entity in terms of cost and quality. Ultimately, one of five options must be selected: (1) abolition, (2) internal restructuring, (3) market testing, (4) privatization, and (5) outsourcing. If market testing or outsourcing is selected, competitive bidding must be carried out (Cabinet Office (2000b), pp. 1-2). Activity-Based Costing has now been introduced in some departments (Departments for Environment, Food and Rural Affairs, National Police Agency, etc.) to determine the full costs of providing administrative services.

35) In Japan, GAAP represent a comprehensive accounting system made up of (1) standards set out by the Business Accounting Council, (2) practical guidelines set out by the Japanese Institute of Certified Public Accountants, and (3) de facto corporate accounting practices not set out in writing, with the "Corporate Accounting Rules" (Business Accounting Council, latest revision: April 1982) at the top.

36) Australia, New Zealand and the UK are among those countries that supplement or add standards based on GAAP suited to the peculiar nature of accounting in the public sector (e.g., budget controls) in developing governmental accounting standards applicable to the financial reports of departments. In the UK, for instance, HM Treasury stipulates the format and content of department Resource Accounts in compliance as far as possible with GAAP applicable to the financial reports of private enterprises, in accordance with Article 5.3 of the Government Resources and Accounts Act 2000. In keeping with the provisions of this Article, HM Treasury has issued the Government Financial Reporting Manual (FReM) to serve as governmental accounting standards applicable to the financial reports of departments. The UK's GAAP comprises, among others, the Financial Reporting Standard and the Statement of Standard Accounting Practice developed by the Accounting Standards Board. The FReM basically incorporates all or part of the standards comprising GAAP but sets out supplementary and new accounting principles and procedures suited to the special characteristics of the public sector (e.g., budget control by Parliament) (HM Treasury (2005), chap. 2).

(2) Establishing Organizations

The governmental accounting standards based on GAAP currently in place at the national level are (1) the Independent Administrative Institution Accounting Standard prepared in February 2000 by the Study Group of Independent Administrative Institution Accounting Standard of the Ministry of Internal Affairs and Communications[37], (2) the Guidelines on Administrative Cost Calculation Statement Preparation at Special Corporations prepared in June 2001 by the Fiscal System Council of the Ministry of Finance, and (3) the National University Corporation Accounting Standards prepared in March 2003 by the Ministry of Education, Culture, Sports, Science and Technology's Review Board of National University Corporation Accounting Standards. These governmental accounting standards overlap in certain areas with those of GAAP while stipulating different accounting procedures for the same transactions in others, reflecting differences in organizations establishing the standards. To streamline the standards and ensure comparability of financial information between the Departments and government-financed corporations, the organizations which have established these standards so far need to be abolished or unified to establish a new organization, and these current standards also need to be abolished or unified to create a new governmental accounting structure, taking an opportunity to develop governmental accounting standard applicable to the Departmental Financial Statements.

3. Budget System/Accounts Settlement System

Once specific methods for utilizing the financial information provided in the Departmental Financial Statements have been identified as in the previous section III-1, it is essential to introduce a performance budget that links evaluations with budgets to obtain and utilize the needed information. Expenditure budgets must be divided between current budgets and capital budgets in this case. Here, current budgets mean the costs of providing administrative services for a certain fiscal year, while capital budgets mean capitalized expenditures for providing administrative services in the subsequent fiscal years. Therefore, current budgets are prepared on an accrual basis while capital budgets are prepared on a cash basis.

To introduce performance budgets, current budgets must (1) classify budget amounts (costs) by policy in budget statements, (2) establish numerical goals by program using outcome performance indicators in budget statements, (3) set numerical goals by project using output performance indicators in budget statements, (4) compare settlement amounts (costs) with budget amounts (costs) by policy in statements of account settlement, (5) compare actual and target figures for outcome performance by program in settlement statements and report these evaluation results, and (6) compare the actual and target figures for output performance by project in settlement statements and report these evaluation results. Although introducing such performance budgets for all current budgets would be best, initially personnel costs and other discretionary spending could be covered and the scope could be gradually expanded to mandatory spending[38].

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37) The Study Group of Independent Administrative Institution Accounting Standard and the Fiscal System Council issued revised versions in March 2003 and June 2005 accompanying the transformation of special corporations into Independent Administrative Institutions.

38) Australia, France (since its FY2006 budget), New Zealand, the UK and the US are among those countries that classify budget amounts and settlement amounts by policy. In the UK, for example, the expenditure budgets of departments are divided into Resource Budgets and Capital Budgets. Resource Budgets are further divided into Requests for Resources, and budget amounts have been listed on an accrual basis since the FY2001-02 budget. In accordance with Article 5.1 of the Government Resources and Accounts Act 2000, departments after each fiscal year prepare Resource Accounts in which they compare settlement amounts with budget amounts by policy using Schedule 1: Summary of Resource Outturn, and list the costs of providing administrative services by policy objective using Schedule 5: Resources by Departmental Aim and Objectives.

4. Internal Control

Once specific methods for utilizing the financial information provided in the Departmental Financial Statements have been identified as in the previous section III-1, it is essential to establish internal control for obtaining credible financial information. In this case, compliance with the COSO Framework, the global standard for both private enterprises and the public sector in western countries, is important. The COSO Framework defines "internal control as a process implemented by all organizations and constituent members of an entity to ensure rationally that operational management is being implemented efficiently and effectively, that credible financial reports are being prepared, and that relevant laws and regulations are being observed." Internal control thus comprises (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring. Incorporating these constituent elements into the operational management process to function as one will enable the above three objectives to be achieved[39].

Each department is expected to establish and implement concrete internal control procedures in accordance with the COSO Framework reflecting their surrounding environments and characteristics of their policies under their purview. Internal control for financial reports requires (1) identifying the cycles of transactions related to quantitatively and qualitatively important accounts in statements, (2) identifying risks of possible inadequate financial reports being submitted in these transaction cycles from the perspectives of accuracy, substantiality and completeness, (3) evaluating the effectiveness of existing control activities put in place to prevent these risks, (4) newly establishing necessary control activities in areas needing improvement, and (5) confirming how control activities are being actually carried out. Because the Departments are responsible for developing and enforcing effective internal controls, it is also reasonable that each Department prepares internal control reports that evaluate the effectiveness of internal control for financial reports and includes these reports, together with the Departmental Financial Statements, in settlement statements[40].

5. Audit System

(1) Financial Audits

If specific methods for utilizing the financial information in the Departmental Financial Statements can be identified as in the previous section III-1, it is essential to introduce new financial audits by the Board of Audit for obtaining credible financial information. In this case, it is also important not only to assure adequacy of the financial statements themselves but also to verify the effectiveness of budget controls at each Department and compliance with financial accounting and other relevant laws and regulations[41]. In addition, as mentioned in the above III-1-(4), the condition

39) COSO (1992). The concept of internal control in Japan's "Audit Standards" (latest revision: January 2002, Business Accounting Council) is also based on the COSO Framework. COSO prepared a report in 2004 on Enterprise Risk Management (ERM) that positioned internal control as a constituent element of ERM (COSO (2004)).

40) The UK and the US are among those countries using the COSO Framework as a basis for establishing and implementing internal control at departments. In the UK, for example, departments establish and implement effective internal control in accordance with the Dear Accounting Officer (DAO) letter sent by HM Treasury in 2000(DAO (GEN) 13/00), each fiscal year preparing a Statement on Internal Control that evaluates the effectiveness of internal control, posting this in their Resource Accounts together with their financial statements, and submitting these documents to the House of Commons. HM Treasury in 2001 prepared guidance offering commentary on strategic frameworks for risk management with the aim of qualitatively improving internal control in departments, revising the same in 2004. In the revised edition HM Treasury offered the COSO Framework as an example of specific internal control standards with which departments should comply (HM Treasury (2004a), chap. 1).

41) Australia, New Zealand and the UK are among those countries where the Supreme Audit Institution carries out audits of the financial statements of individual departments to assure their credibility, the effectiveness of budget control, and compliance with financial accounting and other relevant laws and regulations by departments. In the UK, for example, the Comptroller and Auditor-General conducts audits of the financial statements of individual departments as prescribed in Article 6.1 of the Government Resources and Accounts (GRA) Act 2000. These audit reports present views on (1) whether the financial statements show the operational costs and financial situation of the department truly and fairly and whether they have been prepared appropriately in accordance with the GRA Act and the instructions of HM Treasury based on this Act, and (2) whether all key revenues and expenditures are assigned to objectives authorized by the Parliament, and whether the financial transactions of the department are being processed in compliance with relevant laws and regulations. The Comptroller and Auditor-General also reviews Statement on Internal Control in the course of department financial audits as required in agreements with HM Treasury. Audit reports only report cases in which items requested by HM Treasury

to evaluate policies in terms of efficiency and cost-effectiveness and allocate budgets in accordance with these results is to be able to quantitatively estimate the cause and effect relationship between output and outcome as well as the relationships between input and output or between input and outcome. Given the need to enhance the credibility of not only financial information on inputs (costs) but also performance information on output and outcome, it may be also reasonable to conduct audits on performance information in performance reports to verify its adequacy[42].

(2) Structure of Government Auditing Standard

To ensure the credibility of financial audits and clarify the scope of responsibility of the Board of Audit, it is essential to develop a government auditing standard applicable to financial audits. As mentioned in III-2 and III-4 above, if assuming that a governmental accounting standard is developed based on the GAAP and internal control is developed based on the COSO Framework, the Generally Accepted Auditing Standards (GAAS)[43], which are employed in audits of the financial statements of private enterprises, will be the basis of the government auditing standard. This will enable financial audits to be carried out using risk approach[44], which is the global standard.

The administrative activities of the Departments are distinct in certain ways from those of private enterprises; the former are subject to budget controls approved in advance by Diet and must comply with financial accounting and other relevant laws and regulations. As the GAAS do not address these features, supplementary or new standards must be added to deal with these features[45].

(3) Establishing Organizations of Government Auditing Standard

The government auditing standards presently in place at the national level are the Standard for Audits by Accounting Auditors of Independent Administrative Organizations[46] developed in March 2001 by the Ministry of Internal Affairs and Communications' Study Group on Independent Administrative Organization Accounting Standard, and the Standard for Audits by Accounting Auditors of National University Corporations developed in March 2004 by the Ministry of Education,

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have not been satisfactorily disclosed, in which certain expressions might lead to misinterpretations, or in which there are contradictions in the information obtained in the course of conducting financial audits. The audit report by the Comptroller and Auditor-General will be posted alongside the financial statements in question as well as Statement on Internal Control in the Resource Accounts for each department in accordance with Article 6.4 of the GRA Act; these documents are then submitted by HM Treasury to the House of Commons by January 31 of the following fiscal year.

42) New Zealand and the UK are among those countries where the Supreme Audit Institution carries out audits of performance information included in the performance reports of departments and verifies their adequacy. In the UK, for example, departments after each fiscal year prepare Autumn Performance Reports and Departmental Reports that analyze their sucess in achieving performance/output targets set out in the Public Service Agreement (PSA) and the Business Plan by comparing these targets with their actual performance. At the request of the government following the Sherman Report in 2002, the Comptroller and Auditor-General has been conducting audits at least once each PSA period to verify the performance data collection systems developed by departments. More specifically, these audits verify (1) whether or not departments have developed performance data collection systems for ascertaining the actual figures for outcome performance targets, (2) whether departments are implementing risk management to ensure the credibility of the performance data, and (3) whether departments have established adequate control procedures for preparing performance reports. The Comptroller and Anditor-General compiles the results of the audits of department performance data collection systems into a single comprehensive report and submits this to the Parliament separately from department Autumn Performance Reports and Departmental Reports (National Audit Office (2005)).

43) GAAS in Japan's case are a comprehensive audit system comprising the Business Accounting Council's "Audit Standards" (last revised: January 2002) and the practical guidelines from the Japanese Institute of Certified Public Accountants that manifest these.

44) Risk approach is a method for evaluating the inherent risk and control risk of an auditee corporation and for prioritizing the use of audit personnel and time toward areas in which there is a higher likelihood of uncovering important falsifications.

45) Australia, New Zealand, the UK and the US are among those countries that supplement and add standards suited to the unique characteristics of the public sector (e.g., budget controls) when developing GAAS-based government auditing standards to be applied to the financial audits of departments. In the UK, for example, financial audits of departments are conducted in accordance with the GAAS established by the Auditing Practices Board (APB) in line with decisions handed down by the Comptroller and Anditor-General. The APB has developed APB Ethical Standards for Audits and Statements of Auditing Standards (SAS) to serve as GAAS, and in 2001 offered a revised version of Practice Note 10 as guidance to be applied to the financial audits in the public sector. This revised version described supplemental audit procedures to be followed when applying SAS (originally applicable to financial statements audits at private enterprises) to the public sector and set out new additional audit procedures for budget execution to ensure compliance with the Appropriation Act, financial accounting and other relevant laws and regulations (Auditing Practices Board (2001)).

46) The Study Group of Independent Administrative Institution Accounting Standard and the Fiscal System Council issued a revised edition in July 2003 accompanying the transformation of special corporations into Independent Administrative Institutions.

Culture, Sports, Science and Technology's Review Board of National University Corporation Accounting Standards. These standards overlap in certain areas with GAAS while mentioning audits of economy and efficiency that do not fall within the scope of financial audits. To streamline these standards and clearly distinguish between financial audits and performance audits, the organizations that have developed these standards need to be abolished or unified to establish a new organization, and these current standards also need to be abolished or unified to create a new government auditing structure, taking an opportunity to develop a government auditing standard applicable to the Departmental Financial Statements.

IV. Conclusion

Given Japan's severe fiscal situation, the time has apparently come for a transition from preparing financial reports without using much of the information in the reports by applying some approaches of corporate accounting to utilizing the information for administrative management. To that end, the first crucial steps are to identify the financial information which is needed to carry out efficient administrative and fiscal activities, but not available under the present governmental accounting system, and to determine specifically how to use the information. This would make it possible to develop a governmental accounting standard and establish a system that can obtain the necessary financial information and utilize them, including a possibility to carry out fundamental reforms of the present system. As the administrative and fiscal activities of each Department could not be evaluated simply with financial information in such a case, the key question in designing the system will be how to link financial information with performance information for greater use.

Australia, New Zealand, the UK and other developed Western countries base their governmental accounting standards on the GAAP, applicable to the financial reports of private enterprises. Because the internationalization of GAAP has led to the application of international accounting standards to public accounting in these countries[47)], the internationalization of governmental accounting standards themselves can also be expected. Since financial information for administrative management cannot be provided qualitatively or in a timely fashion under the current method of settlement adjustment for the Departmental Financial Statements, Japan, too, should consider developing a governmental accounting standard based on the GAAP as part of the trend toward the internationalization of governmental accounting standards.

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