

The convergence of governmental and non-profit sector accounting in transition countries: the case of Croatia¹

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Abstract

This paper provides a perspective on the development of governmental and non-profit sector accounting in Croatia. Precisely, in considering the adequacy of Croatian non-profit sector accounting and financial reporting model, this paper uses qualitative analysis to evaluate the appropriateness of former and existing accounting regulation and financial reporting framework with respect to user needs, as well as to compare the degree of non-profit sector accounting and financial reporting system reform changes to the development of the governmental accounting and financial reporting system.

By emphasizing the challenges of accrual accounting in governmental and non-profit sector in developed countries, our study implies that following the international trend of accruals affirmation and implementation, financial reporting reforms in Croatia have so far resulted in implementing quality solutions that represent a good basis for further adjustment and development of non-profit sector accounting system, and are driven toward full accruals or somewhat modified accrual basis implementation. We find that since 2008 Croatia has made a significant step towards the convergence of governmental and non-governmental organizations' accounting systems and towards harmonizing their financial reporting systems, which prior to 2008 diverged greatly. Such a chosen reform path enables the set up of a consistent and modern non-profit sector accounting system.

Key words: convergence of accounting and financial reporting systems, government sector, non-profit sector, regulatory framework, Croatia

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1. INTRODUCTION

Internationally, the not-for-profit regulatory space is rapidly changing. Poor quality financial reporting by not-for-profits has long been recognised as a major regulatory issue, since it not only jeopardizes the financial health of not-for-profits but poses a high risk to the public's trust in the sector (Cordery and Baskerville, 2007; Leslie, 2009). The production of high quality financial information necessitates the establishment of a regulatory system and accounting regime that recognises the unique needs of the not-for-profit sector and its stakeholders and provides guidance that aids the preparation of clear, understandable and comparable not-for-profit financial reports (van Staden and Heslop, 2009). The establishment of integrated systems of regulation for not-for-profits will facilitate the preparation of meaningful and transparent financial reports, assisting in the achievement of not-for-profit organizational financial health and developing stakeholders' trust in the sector.

Challenges such as the adoption of IFRS highlight existing not-for-profit financial reporting challenges. Different regulatory systems and processes that jurisdictions adopt to develop not-for-profit accounting regimes are being compared. Irvine and Ryan (2010) find that the adoption of IFRS is particularly challenging in nations where accounting regulatory arrangements or regulations are ambiguous. Thus, the global adoption of IFRS is increasingly impacting the not-for-profit sector as jurisdictions grapple with its implications. The mentioned study examines and compares the different regulatory systems and processes that jurisdictions with a similar common law charity tradition adopt to provide appropriate accounting regulation and guidance for their not-for-profit sectors. England and Wales regulatory model (integrated model of not-for-profit regulation), with a single national regulator is pointed out to be recognised as the leader in the field. The not-for-profit accounting standard setting regime in Canada is undergoing a period of change and uncertainty, facing a number of challenges, including the adoption of IFRS, while seeking to promote a consultative style of standard setting. These changes have the potential to redefine existing relationships between the Canada Revenue Agency and accounting standard setters. In the US, the not-for-profit regulatory arena, while occupied by several regulatory organizations, is centrally dominated by the Internal Revenue Service. The FASB operates independently, even though the need for a more integrated system of not-for-profit regulation has been recognized. As for the Australian regulatory space is concerned, the Australian government is still deliberating about whether it will establish an independent not-for-profit regulatory body. In New Zealand, the regulatory space is currently complex and congested. While there is a national charity regulator, there is little co-operation between that regulator and the accounting standard setters.

The not-for-profit regulatory space change is also fostered by the international trend of financial reporting systems convergence. The need for high quality global standards to enhance sound and consistent financial reporting, and the fact that the inefficiency and ineffectiveness of public sector in its actions, extended to a belief that public and private sectors did not have to be managed in fundamentally different ways, fostered the already started harmonization of national and international public sector accounting systems and their convergence towards the private sector financial reporting standards, and accrual implementation in governmental accounting and financial reporting (Roje and Vašiček, 2008). As a result, 31 accrual International Public Sector Reporting Standards (IPSAS) emerged, out of which 28 are based on International Financial Reporting Standards (IFRSs). Some countries base national public sector (governmental) accounting standards on IPSASs, keeping their own national sovereignty, others prepare IPSASs compliant financial statements, while some intend to change to accruals and consult IPSASs (Roje, Vašiček, and Hladika, 2009). In addition, different authors have provided an array of reasons for

implementing accruals in general government and in government entities' financial reporting as well as in budgeting. However, a very important one, according to the existing literature, is the fact that accruals enable "the whole of accounts" that assures gathering full information on assets, liabilities, revenues and expenses of an entity, and the sector as a whole (Pallot, 1992). Unlike the experiences in the private sector, that is unique and consistent in accrual accounting basis appliance, the same basis is unevenly applied in public sector accounting worldwide. Even more, different accounting basis as gradual transitions from cash accounting to accrual accounting, have been implemented in public sector financial reporting in different countries, depending on the level of national accounting systems development. International research has shown that developed countries have made a significant progress regarding the implementation of the accruals in public sector. Some of them have already implemented accrual accounting basis in budgeting and reporting at the consolidated State level. In these countries (e.g. New Zealand, Australia, Canada, United Kingdom), it was the introduction of private sector management techniques into the public sector that has led to the full adoption of the accrual basis in reporting and budgeting (Roje, 2007). Having also taken into account transition countries' experiences, study by Roje (2007) concludes that it is especially in Anglo-Saxon countries where the accrual criterion predominates in public sector accounting, while Continental European countries are still in the process of converting to accrual accounting for both reporting and budgeting. Typically, the latter countries (and more precisely transition countries) have so far adopted modified cash or modified accrual systems instead of full accrual systems. The data on countries in transition (e.g. Poland, Slovakia, Check Republic, Romania, and Croatia) in Roje (2007) points out several discrepancies among the countries as for the process of adopting more complex accounting basis is concerned. In addition, Roje, Vašiček, and Hladika (2009) draw to the conclusion that the transformation phase towards adopting accruals in governmental accounting and reporting in majority of transitions countries has been characterized by accounting basis inconsistency. Consequently, it slows down the process of compliance with the majority of accrual IPSASs. Yet, limited attention has been paid in the academic literature to the relationship between governmental accounting regulation and non-profit sector accounting regulation. This paper aims to address that gap, providing a perspective of developments in the accounting/financial reporting regulation in the governmental and not-for-profit sector and the divergence between /convergence of the two systems in Croatia.

From the beginning of 1994 until the end of 2007, non-profit organizations in the Republic of Croatia had been applying the accounting system governed by the Decree on Accounting for Non-profit Organizations.² In spite of numerous essential and formal drawbacks, this system withstood the various criticisms within the professional society for couple of years. In practice, different professional, but unofficial accounting and reporting solutions were used as substitutes for the inconsistent legislative provisions in regards to the charts of accounts, recognition of financial reporting elements, and in regards to the content of financial statements likewise. Such solutions were also accepted by the external data users, including the supervisory and statistics state bodies. Meanwhile, governmental and business accounting systems have been updated on several occasions. Most of the changes were introduced within the context of adjusting our legislative regulations to the *Acquis Communautaire*³. This

² Official Gazette 112/93. *The Decree on Accounting for Non-profit Organizations* is a free translation of the authors, since all the acts, decrees, policies, etc. in Croatia are officially published only in Croatian. The original document is titled "Uredba o računovodstvu neprofitnih organizacija" (Narodne novine, 112/1993). As shown later in the third section of the paper, the Decree published in 1993 was amended in 2008, due to the changes made in accounting for non-profit organizations.

³ The Community *acquis*.

context represented an adequate moment for the systematic and professional standardization of the accounting system for non-profit organizations.

The paper comprises of two main parts: (a) the analysis of Croatian governmental and non-profit sector accounting system development, and the divergence between the two, and (b) the discussion of non-profit sector accounting and financial reporting changes in progress that have partly resulted in bridging governmental and non-profit sector accounting. The next section of the paper addresses the conceptual definition of non – profit organizations in Croatia. The last section concludes and highlights the possibilities for future research.

2. CONCEPTUAL DEFINITION OF NON – PROFIT ORGANIZATIONS IN CROATIA

There are different definitions of a non-profit organization depending on the different aspects such as legal, financial and economic aspect in particular. However, the term *non-profit organization* is not explicitly defined within the existing legal documents of the Republic of Croatia. In addition, the Constitution of the Republic of Croatia proclaims the freedom of association as one of the fundamental political rights (Article 43.). Namely, “Everyone shall be guaranteed the right to freedom of association for the purposes of protection of their interests or promotion of their social, economic, political, national, cultural and other beliefs (convictions) and objectives. For this purpose, everyone may freely form trade unions and other associations, join or leave them, in conformity with the law. The exercise of this right shall be restricted by the prohibition of any violent threat to the democratic constitutional order and independence, unity and territorial integrity of the Republic of Croatia.”

Even though, there is no legal definition of a non-profit organization, it is possible to point out certain legal characteristics of non-profit organizations. These are as following:

- The non-profit organization as a type of legal entity exists and operates for other reasons than generating profit. Thus, the emphasis is not on avoiding generating the profit (in a sense of accumulating net income surplus), but on the presence of a prevailing public benefit.
- The non-profit organization is prohibited from distributing the earned profit to the third parties that could, due to their position, influence the work of the organization in order to achieve personal gains.
- The characteristics of a non-profit organization do not necessarily depend on its legal form, i.e. the purpose of setting up the organization and the activities which the organization performs are considered crucial/ important, rather than the character of organization’s legal identity.

The most common definition of a non-profit organization refers to the one in relation to its founder. According to Anthony and Young (1988, p. 49), “a *non-profit organization* is an organization whose objective is something else rather than earning the profit for its owner. Its main *purpose* usually includes providing services.” Such a definition stresses the basic difference between profit and non-profit organizations.

Non-profit organizations are, above all, oriented towards achieving better conditions for providing services based on available resources. The relations with the service users are achieved without direct market links. Non-profit organizations are not financed through the sales of goods or services on the market but are, usually/typically, financed from other sources (various subsidy means, grants, alms, contributions, membership fees etc). Due to the nature of their activities, measuring the expenses and benefits, as well as expressing provided benefits in money terms is quite difficult.

In accordance with the manner of their financing, and thus financial reporting, non-profit

organizations in Croatia are divided into two main categories:

- Governmental non-profit organizations or public non-profit organizations and
- Non-governmental or private non-profit organizations.

If the activity of a non-profit organization is funded and financially supported by the state, then it is performed in compliance with the state policy and is financed, directly or indirectly, out of the fiscal and parafiscal state revenues. Such non-profit organizations form part of the national public sector, i.e. the general state sector. Namely, the public sector is determined according to the methodology of the International Monetary Fund, the United Nations System of National Accounts and the European System of National Accounts.

The structure of non-governmental non-profit organizations is mostly founded on voluntary basis (they are made up of a group of citizens that have voluntarily joined in order to carry out certain activities). They are mostly financed through donations, grants, membership contributions and other similar specific forms of financing that are, as a rule, based on voluntary and humane grounds.

In order for the non-profit organizations to achieve an optimal level in performing set goals and tasks, it is necessary to establish an adequate accounting information system as a support in a process of managing the non-profit organizations. Accounting for the non-profit organizations, besides all the similarities, might contain significant/distinctive/meaningful differences in relation to business accounting. Those differences might arise/result from:

- the absence of earning the profit as a motive,
- the existence of legal requirements, i.e. constrains to gathering and spending resources,
- responsibilities consigned to public authorities in managing the resources,
- possible use of fund accounting,
- possible modified accruals' appliance, etc.

On the other hand, the fact that the main objective of performing the activities is not driven by profit gathering enables the accounting systems of private and governmental non-profit organizations to share many common features.

As other transition countries, Croatia has in the last two decades, prompted the development of civil society, and non-profit organizations as its institutional components. Thus, in the Republic of Croatia, as in other countries, non-profit sector refers to numerous associations and their federations, foundations, institutions, political parties, chambers, trade unions, religious and other communities, volunteer fire companies, humanitarian organizations, car clubs and other legal entities whose main objective is not the acquisition of the profit. Such organizations do not distribute their surplus funds to owners or shareholders, but instead use them to help pursue their goals. According to various data sources, there are about 40,000 registered non-profit organizations in the Republic of Croatia. Since the non – profit organizations in Croatia refer to a legally heterogeneous group with a different territorial scope of activities there is no single registry that would fully cover and account for the non-profit sector as a whole. Also, it has been rather hard to capture a comprehensive picture of economic and financial importance of non-profit organizations in Croatia. This is mostly due to the lack of unique requirements for all non-profit organizations as for the financial reporting is concerned. Precisely, the accounting regulations make a distinction between organizations that are required to keep double-entry book keeping system and apply the external financial reporting from those who, because of their financial marginality (meaning that their total asset or annual revenue has not exceeded the value of 100,000.00 HRK⁴ (ca. EUR 13,000.00) consequently over a three year period), regulate their accounting system according to their internal laws. According to the available data, in 2009,

⁴ HRK is the official Croatian currency.

approximately 20% of all registered non-profit organizations prepared their financial reports for the external users and submitted those to the authorities. This refers to a total of 8.340 entities, with a total asset value of 48,6 billion HRK (ca. EUR 6,7 billion), composed of non financial assets (37,1%) and financial assets (62,9%).

3. CROATIAN GOVERNMENTAL AND NON-PROFIT SECTOR ACCOUNTING SYSTEM DEVELOPMENT - THE DIVERGENCE BETWEEN THE TWO

3.1. The development of governmental accounting in Croatia

Croatian national government accounting system had historically been influenced by the cameral accounting theory. Since it had been developed to monitor and control the balance between planned and actual amounts of all state revenues (cash inflows) and expenditures (cash outflows) for a certain period, single entry cash transactions had been a sufficient solution. In addition, being a Continental European country, its budgetary system has in fact influenced the accounting system. Consequently, the governmental accounting information system's structure and contents has been viewed more in function of State's budget goal achievements and less in function of achieving greater management efficiencies and hence better outcomes (Roje, Vašiček, D., and Vašiček, V., 2008). In an economic system in which the government controlled all major sectors of the economy, formulated all decisions about use of the resources and about the distribution of income, and regulated production, distribution, prices, etc., governmental accounting happened to serve the prior purpose of monitoring and controlling the budgeting processes. Therefore, governmental accounting happened to be more in function of national accounts, and statistics information systems were given priority with respect to accounting information systems and financial reporting.

Since 1991, when Croatia gained independence, a new public expenditures' financing model was established and accounting and financial reporting systems were changed. The governmental accounting reform started in 2001 and ever since Croatia has been trying to follow the international developments towards the introduction of accrual accounting within the national government sector. The later regards the implementation of modified accrual accounting as a gradual transition from cash basis to full accruals. As emphasised, in the year of 2002, new governmental accounting system was established in Croatia. Since governmental activities have been financed through the Budget, the legislative frame regarding governmental accounting development was determined by the Budget Act⁵ and other additional set of regulations.⁶ Those additional regulations, decrees, instructions, policies, define and analyze certain parts of the main Act more precisely and thus enable faster and easier qualitative adoption of regulated solutions.⁷

⁵ *The Budget Act* is a free translation of the authors, since all the acts, decrees, policies, etc. in Croatia are officially published only in Croatian. The original document is titled " Zakon o proračunu " (Narodne novine, 87/2008). Since governmental activities have been financed through the Budget, the legislative framework regarding governmental accounting development was determined by The Budget act and supplemental set of regulations, all published in Croatian Official Gazette. The regulations (decrees, instructions, policies), define and analyze certain parts of The Budget Act more precisely and thus enable faster and easier qualitative adoption of regulated solutions.

⁶ Pravilnik o proračunskom računovodstvu i računskom planu (Nar. nov. br. 27/2005.), Pravilnik o financijskom izvještavanju u proračunskom računovodstvu (Nar. nov. br. 27/2005.), Pravilnik o utvrđivanju korisnika proračuna i o vođenju registra (Nar. nov. br. 80/2004.).

⁷ All regulations enacted are published in Croatian Official Gazette.

According to the stated regulations, there are several distinguished qualitative features of the existing Croatian governmental accounting system that need to be understood and these are as follows.⁸

- all general government entities (central and local government and their component entities) are obligated by the law to apply governmental accounting and financial reporting model.⁹ The fact that all entities within general government are obligated to do so, assures complete accounting and reporting on general government activities;
- unified chart of accounts and consistent appliance of rules for recording cash transactions and economic events are regulated by the law as well. This assures standardized information base for conducting additional data analysis when needed;
- as regards information on budget (budget planning and budget execution), accounting and financial reporting, the appliance of organizational, economic, functional, location and program classifications of the budget is obligatory;
- existing accounting information system of a general government has been regulated to be based on modified accrual accounting basis and the historic cost principles regarding balance sheet items, as a gradual transition towards accruals implementation and compliance towards the IPSASs. Generally, modifications of accrual accounting basis vary. This allows governments that have not yet applied full accrual basis to model their own accounting system by adjusting it according to their particularities (e.g. with respect to quality of an existing accounting system, the willingness and qualifications of the public sector accounting staff, taking into account the priorities in conducting reforms, the level of political will to introduce changes, international requirements and level of necessity to complete the reform etc.). Even though actual amounts and financial statements are prepared on modified accrual accounting basis, budget amounts are still prepared on cash basis. However, we find this consistent with the international trend that reform of implementing accrual accounting for financial reporting comes first and budgeting follows;
- the most important features of Croatian governmental financial reporting model based on modified accrual accounting basis (on a path towards full accruals adoption) are as follows:¹⁰
 - ✓ revenues are generally recognized on cash basis with only certain revenues recorded on accrual basis;
 - ✓ regular expenditures and liabilities are recognized on accrual basis;
 - ✓ expenditures regarding the fixed assets supply are not capitalized but rather treated as an expense in full when obtained. This further implies that assets are not being depreciated yearly based on the estimated assets usage period;
- consistent appliance of internationally recognized and comparable analytical framework of financial and statistics reporting has resulted in establishing contextual and functional linkage concerning financial and statistics reporting. Precisely, one of the reasons for

⁸ Adopted and adapted from Vašiček V. (2004), «Stanje i pravci razvoja računovodstva proračuna» (engl. Possible courses for government accounting system development), XXXIX simpozij HZRFD (Croatian Association of Accountants and Financial Experts), Financijski i računovodstveni aspekti korporativnog upravljanja u profitnim i neprofitnim subjektima, Pula, Croatia.

⁹The term „component entities“ refers to departments, boards, agencies, commissions etc.

¹⁰ More detailed in Grupa autora (redakcija Vašiček, D.), 2003 „Primjena računskog plana proračuna, 2003/2004“, HZRIF, Zagreb, pp. 118-120.

directing accounting information system reform towards accruals implementation is the fact that Government Finance Statistics (GFS 2001) are accrual based;

- obligation to make periodical and annual financial reports; obligation for consolidated semi annual and annual settlement of budget accounts of the Republic of Croatia.

There may be various reasons for such a high degree of governmental accounting normativism. Firstly, Croatian independence was declared in 1991 and the planned economy was changed to the market-driven one. Secondly, there has been high degree of public finances' centralization, public expenditures' have been financed through central Budget, and there has been an obligation to consolidate reporting on public expenditures. Also, as a part of the inevitable process of adjusting its system towards the one of the EU, Croatia has had to take into account different international institutions' requirements. The situation of a strong money focus in the budget, combined with a strong law tradition, helps to explain why Croatia, as it is the case with other Continental European countries, had been reluctant to replace their financial accounts (focusing on revenues as cash receipts and expenses as cash payments) with performance accounts (full accrual accounts - focusing on revenues earned /realized and expenditures incurred).

In addition to the aforementioned qualitative features of existing Croatian government accounting system, national public sector accounting standards have not been developed. This is mainly due to the fact that accounting framework in Croatia has been set up as a law – based system. Despite the non-existence of national public sector accounting standards, the appliance of IPSASs has not been enacted as obligatory, though the implementation of certain accounting solutions defined by IPSASs has been recommended by the aforementioned Croatian regulations.

3.2. Development of the financial reporting system for non – profit organizations (from 1994 to 2008)

A separate accounting system for non-profit organizations in the Republic of Croatia was established at the end of 1993 and was to be applied/ effective from January 1, 1994. In the first year of its implementation, this system encompassed all non-profit organizations, meaning both, the governmental non-profit organizations (budget users) and other (private) non-profit subjects, regardless of the difference among them in terms of the process of their establishment and their sources of financing.

One year later, in 1995, budgetary accounting was singled out as an individual system from the universal accounting system for non-profit organizations.¹¹ All budgetary organizations that were financed out of the state budget or out of the budget of local and self-government authorities were obliged to implement the budgetary accounting system. The other non-profit organizations i.e. those that were financed mainly through other means (means provided by the founders, membership contributions, non-budget funds, donations, grants, sponsorships and the like) were obliged to conduct their accounting in line with the accounting system for non-profit organizations. After the budgetary organizations were excluded from the accounting of non-profit organizations, the necessary adjustments were not made within the accounting of non-profit organizations.

The identifiable feature of accounting for non-profit organization was fund accounting and the modified accrual as an accounting concept that determines the criteria for accounting

¹¹ Since governmental activities are financed through budget execution, governmental accounting is sometimes in Croatian literature referred to as „budgetary“ accounting. If so, the term budgetary accounting does not address accounting for the budget only but also it addresses the financial reporting for governmental entities that are also financed through the budget.

recognition of economic events regardless of when cash transactions occurred. In a process of choosing the accounting model, certain superficial and inconsistent global experiences were followed; the model of fund accounting was set up. Such a model of fund accounting was developed in the United States of America, specifically for the needs of reporting for supported units, mostly on the state level. The implementation of such a system in Croatia, without significant adjustments, was unsuitable in its mere beginning. Therefore, based on the different types and number of funds the model had to be modified and adjusted to suit Croatian non-profit organizations' specific features.

Discrepancies in the accounting for non-profit organizations, lack of accounting information and the demand of non-profit organizations for certain additional information, led towards the inconsistency in applying the economic classification of revenues and expenses (structure of the chart of accounts), and consequently had influence on the content of certain positions in the financial statements. Moreover, the analysis of financial statements' content showed certain inconsistencies of the financial statements' elements with the content of books kept according to the prescribed valuation methods. Normatively, the enforced valuation method was the accounting concept of modified accruals, but in practise it actually resulted in de facto cash basis concept appliance, e.g. recognition of revenues was conditioned by the collection of revenues within the period or 20 days upon the end of the accounting period. Accordingly, the recognition of costs that were not paid within the reporting period or upon 20 days following the last day of the reporting period, did not form part of the annual expenses. In the situation of no liquidity at all, as well as in other similar situations, significant unpaid amounts were not recognized or reported as expenses within the period in which they occurred.¹²

Due to the fact that it had not been systematically and expertly founded and pursued in practice, such accounting system was abolished by the end of 2007.

4. ON THE PATH OF BRIDGING GOVERNMENTAL AND NON-PROFIT SECTOR ACCOUNTING IN CROATIA: NON-PROFIT SECTOR ACCOUNTING AND FINANCIAL REPORTING CHANGES SINCE 2008

4.1. Non – profit accounting: considered reform paths

When forming the funds in non-profit organizations' accounting system, certain ongoing dilemmas regarding the classification of activities and funding sources tended to rise. The accounting system did not comply with the need of non - profit organizations for some other set of information/data, as evidenced from the analysis of the chart of accounts' structure and certain financial statements items. These facts were the reasons for commencing a radical reform of the non-profit sector accounting and financial reporting system.

Two possible paths of changes were possible: to focus on restructuring or abandoning fund accounting system, or to focus on changing the choice of accounting basis. Either path taken would result in the change in the form and the contents of financial statements and in the application of systematic classification which would necessarily require changes in the contents of the chart of accounts, and further adjustments of the records in main and supplemental ledgers. Thus, in the context of the non-profit accounting system reform, the following changes were taken into account:

- a) reorganizing the fund accounting system,

¹² For more details about the assessment of the accounting system for non-profit organizations 2004-2007, please see Vasicek V. and Vasicek D. (2007), „Stanje i potreba razvoja računovodstva neprofitnih organizacija“, *Riznica* (8/9)

- b) changes in the choice of accounting concepts,
- c) changes in the form and contents of financial statements,
- d) harmonizing data records in main and supplemental books of accounts, and
- e) changes within the chart of accounts.

The arguments in favour of the reorganization or abolition of fund accounting model as an inappropriate accounting system for the non-profit organizations, were largely pointed out in practise. Most of the non-profit organizations had had only the Fund of regular activities as the open-type fund where all the accounting for the resources for financing the activities for which the organization was funded, was conducted. "The fund is defined as a fiscal and accounting entity with a balance of equilibrium as the difference between cash and other assets denominated in values, and associated liabilities, which was separated with the intention of holding for a specific activity or to achieve certain objectives in accordance with the specific regulations, restrictions or limitations."¹³ Such a definition pointed out the criteria of opening the funds. The number and types of funds had not been limited. For each asset acquired from particular source of financing a new fund could have been opened that would serve for recording for agreed asset usage/spending. Often, the limitations regarding the means of asset usage, set by the source of financing the asset, had required monitoring for such assets through a special fund. The aforementioned, led to the conclusion that the activities and sources of financing of the non-profit organizations had differed across different groups of the non-profit organizations. Therefore, setting up a single and unitary fund accounting model would have not met their specific information needs. Also, specificities in accounting recognition of individual groups of non-profit organizations had required a separate approach to each group and individual concrete solutions within the fund accounting system.

There were no doubts regarding the need to change the cash accounting concept. Information gaps and limitations that resulted from applying the cash basis reflected in the lack of quality of external financial reports that were often made for the purpose of meeting legal obligations only. In addition the international trend of accrual accounting affirmation and implementation also influenced the start up of the non-profit sector financial reporting change and the decision to start implementing full or somewhat modified accrual accounting. Deciding to change to accruals further implied the implementation of internationally comparable and relevant classification for the presentation of the financial statements elements.

4.2. Core propositions of the reformed accounting and financial reporting system

Starting from January 1, 2008, the full accrual basis has been introduced and applied in accounting for non-profit organizations, for the recognition of business transactions and events, i.e. the recognition of revenues and expenses.

The new draft of the Accounting Act¹⁴ was the formal legal framework that led to significant changes in the existing system of accounting and financial reporting for the non-profit organizations. The religious communities, political parties, trade unions and other non-profit organizations obliged to pursue the provisions of the Act, were defined/identified/determined by the Government of the Republic of Croatia. The accounting for non-profit organizations

¹³ „Codification of Governmental Accounting and Financial Reporting Standards”, GASB, Norwalk, 1990., str. 45.

¹⁴ Official Gazette No. 109/2007, Article 2, Paragraph 5. *The Accounting Act* is a free translation of the authors, since all the acts, decrees, etc. in Croatia are officially published only in Croatian. The original document is titled “*Zakon o računovodstvu*“ (Narodne novine, 109/2007).

was further enforced by the Decree on Accounting for Non-profit Organizations¹⁵ that was brought with the purpose of: defining book keeping documents and account books (financial records), organizing the book keeping, providing information on (listing, specifying) the assets and liabilities, defining principles for the recognition of assets, liabilities, organization's own resources, revenues and expenses, the implementation of the accounting plan and its contents, financial reporting, and other issues related to the accounting of non-profit organizations.

The entities that are obliged to comply with the requirements of the new Decree on Accounting for Non-profit Organizations refer mostly to non-governmental non-profit organizations i.e. associations and alliances, funds, foundations, institutions, political parties, chambers, unions, religious and other communities, to all other legal entities whose primary aim is not to generate the profit, and to those that are, due to certain specific regulations, classified as non-profit organizations. Thus, the Decree has never referred to the State Budget, the budgets of local and regional self-government units, budget and extra-budgetary users defined by the Budget Act¹⁶ and affirmed in the Register of State Budget Users. Namely, due to the similarities in the nature of their activities and the manner they were founded in, it is often quite hard to make distinction between the governmental (budget) and nongovernmental (extra-budgetary) non-profit organizations. In order to achieve a clear distinction between the organizations, the Budget Act, and the Policy on defining budget users and managing the Register of state budget users¹⁷ have set forth the criteria for the recognition of budget users, having emphasized the founders and/or ownership rights and the percentage of having overall expenses financed from state or local budgets (50% and above).

The distinction of the two groups is considered rather important since they ought to conform to different accounting systems. Governmental non-profit organizations (budget and extra-budgetary users) included in the Register of state budget users, are obliged to implement governmental (budget) accounting, whilst all other non-profit organizations (non-governmental) are obliged to apply the non-profit accounting system. However, *small* non-profit organizations are exempted from full implementation of accounting principles and financial reporting according to the Decree. Specifically, according to Article 71 of the Decree, a non-profit organization with an asset value or annual revenue less than HRK 100,000 (ca. EUR 13,000) in continuity over the last three years, is not legally obliged to complete and turn in financial statements, as well as to implement the double-entry book keeping and the chart of accounts according to the provisions prescribed by the Decree.

In addition, the Decree on Accounting for Non-profit Organizations does not stipulate the possibility to apply fund accounting. This further implies that the non-profit organization is obliged to manage the accounting (book keeping) within one main account, as unitary for all events that occur. Yet, the non-profit organizations remain enabled to decide about setting up

¹⁵ Official Gazette No. 10/2008. *The Decree on Accounting for Non-profit Organizations* is a free translation of the authors, since all the acts, decrees, policies, etc. in Croatia are officially published only in Croatian. The original document is titled "Uredba o računovodstvu neprofitnih organizacija" (Narodne novine, 10/2008).

¹⁶ *The Budget Act* is a free translation of the authors, since all the acts, decrees, policies, etc. in Croatia are officially published only in Croatian. The original document is titled "Zakon o proračunu" (Narodne novine, 87/2008).

Since governmental activities have been financed through the Budget, the legislative framework regarding governmental accounting development was determined by The Budget act and supplemental set of regulations, all published in Croatian Official Gazette. The regulations (decrees, instructions, policies), define and analyze certain parts of The Budget Act more precisely and thus enable faster and easier qualitative adoption of regulated solutions.

¹⁷ *The Policy on defining budget users and managing the Register of state budget users* is a free translation of the authors, since all the acts, decrees, policies, etc. in Croatia are officially published only in Croatian. The original document is titled "Pravilnik o utvrđivanju korisnika proračuna i vođenju Registra korisnika proračuna" (Narodne novine, 80/2004).

a system of fund accounting and adjust it to their internal needs.

The Decree does not point out the accounting basis as a fundamental precondition and the start-up criteria for reporting on business transactions and events. However, as aforementioned, the full accrual basis has been introduced and applied for the recognition of business transactions and events, i.e. the recognition of revenues and expenses, implicitly confirming the accruals as a compulsory accounting basis.

The data obtained from the accrual basis financial statements is more complete, integral and thorough, when compared to the data presented in modified cash or accrual basis financial statements. The application of accrual basis ensures recording data on business transactions and events that are expected to have effect in consequent accounting periods. Such data can be found useful to financial statement users when assessing (a) future trends towards the increase or decrease of resources that are at the non-profit organization's disposal, (b) the ability of the organization to fulfil the tasks for which it has been established, and (c) management performance and the degree of its responsibility for the use of the entrusted resources.

To summarize, the new system is characterized by the following elements:

- accrual accounting implementation (with a few simplifications and departures from the full accrual implementation),
- the abolishment of the obligatory fund accounting appliance,
- the enforcement of the international economic classifications enforced a new, more detailed (four – digit) chart of accounts,
- the establishment of the new system of financial reporting,
- the set up of the non-profit organizations' Register as a complete record of entities obliged to financial reporting,
- the fact that small non-profit organization (the organizations with an asset value or annual revenue less than HRK 100,000 (ca. EUR 13,000)) in continuity over the last three years, is not legally obliged to complete and turn in financial statements, as well as to implement the double-entry book keeping.¹⁸

The most significant features of today's system of accounting concepts are related to the following:

- Capitalization of the acquisition costs and accounting for the depreciation of a non-financial long-term asset

Recognition of assets is primarily based on either the historical cost (value) of the asset or on the estimated value. Hence, assets are capitalized and initially valued according to the amounts spent on their acquisition, unless the cost of acquisition cannot be established, in which case the estimated value is used to account for the assets. This means that the system introduces the calculation of depreciation as proportional costs of its use over time, and abandons the former system of recognizing the total expense at the moment of its acquisition. The regulatory framework also prescribes the compulsory revalorization (in conditions of inflation when the increase rate, measured by the coefficient of the price quoted by industrial product manufacturers for three previous years, is above 30%) in which the effects of valorisation are assigned to own resources (capital).

¹⁸ For more details on small non-profit organizations please see: Vašiček.V. and Vasecek, D.: Reforma računovodstva neprofitnih organizacija –konvergencija izvještajnih sustava javnog i neprofitnog sektora“, Zbornik referata II.Konferencije „Hrvatski javni sektor“, Opatija, HZRIF, 2008.; Vašiček V. et al. (ur. Vašiček, D.): Računovodstvo neprofitnih organizacija s primjenom kontnog plana i poreznih propisa, HZRIF, Zagreb, 2009.

- Recognition of revenues

As for recognizing revenues, the categories of reciprocal and non-reciprocal income are introduced and defined. The difference among two groups of revenues is identified, as follows:

- ✓ reciprocal income i.e. counter-service income from delivering goods, providing service or other income that assumes invoicing and
- ✓ non- reciprocal income as particular sources for non-profit organization's financing such as membership fees, donations, and other similar incomes.

Reciprocal incomes, as incomes based on the delivery of goods or services, are recognized in the relevant accounting period under the condition that they are measured regardless the moment of their collection. If so, income is recognized when occurred in relation to the moment of delivery under the general conditions of measurement and reliability for income collection. On the other hand, non-reciprocal incomes, as incomes that are not realized from direct delivery of goods or services (donations, membership fees, contributions and similar income) are recognized in the relevant reporting period under the condition that they are available i.e. that they will be collected before the financial statements for the relevant period are presented. The matching principle is a culmination of accrual accounting and the revenue recognition principle. According to the principle, expenses are recognized when obligations are (1) incurred, and (2) offset against recognized revenues, which were generated from those expenses (related on the cause-and-effect basis), no matter when cash is paid out. The matching principle allows better evaluation of actual profitability and performance (shows how much was spent to earn revenue), and reduces noise from timing mismatch between when costs are incurred and when revenue is realized.

- Recognition of expenses

Unlike the practice of the abolished fund accounting system, where expenses were recognized in correlation with the moment of payment, the new accounting and financial reporting system is completely based on accrual basis, i.e. the expenses are recognized regardless of when the payment occurs. In this sense, the regulation framework stipulates the following:

- ✓ expenses are recognized in the corresponding reporting period regardless of the moment when payment occurs,
- ✓ short-term non-financial assets' acquisition costs are recognized when actual expense occurs, i.e. moment of sale,
- ✓ long-term assets' acquisition costs are capitalized, whereas expenditures are recognized during assets' useful life,
- ✓ acquisition costs of a long-term non-financial tangible assets whose historical cost per unit are under HRK 3,500 (ca. EUR 500) can be written off on a one-time basis.

- Classifications and accounting plans

The new non-profit regulation framework also covers the new approach to classifications and introduces a new, more comprehensive and systematic chart of accounts. The new accounting plan for non-profit organizations defines numerical labels and descriptions for individual accounts that are to be used by non-profit organizations in their bookkeeping records of assets, liabilities and organizations' own resources as well as when recognizing revenues and expenses. The new classification system enables the comparability of the data on non-profit organizations with the data on governmental non-profit organizations (budget users), and it is based on the application of the international economic classification of assets, liabilities,

revenues and expenses as defined by GFS 2001¹⁹.

Accounts are classified into four categories: classes, groups, subgroups and sections. Hence, the new system of four-digit compulsory accounts has been introduced. Sections, as the fourth account level within the accounting plan can further be subdivided into analytical and sub-analytical accounts according to the needs of a particular organization. The classification of sections within the accounting plan is still carried out according to the decimal system.

Revenues are classified according to the following groups of accounts: income from sales of goods and services, income from membership fees and contributions, income under special regulations, income from assets, incomes from donations, and other incomes.

Expenses are classified according to the following groups of accounts: compensation of employees, material expenses, depreciation expenses, financial expenses, donations and other expenses.

- Financial reporting

The system of financial reporting is based on standardized forms and scopes of financial statements. Basic financial statements include: the balance sheet, profit and loss account and notes accompanying the financial statements. All financial statements are completed for a business year which is in alignment with the calendar year whereas only the profit and loss accounts are prepared for accounting period during the year and this is on six-month basis from January 1st to June 30th. All financial statements give a clear picture of the financial position and the performance of the non-profit legal entity. As stated, only those non-profit organizations whose value of assets or whose total revenues consequently over the last three years exceeded HRK 100,000 (ca EUR 13,000) are obliged to submit their financial statements to the Ministry of Finance and the State Audit Office. According to the 2008 and 2009 data, only 8.340 entities or 20% of the total number of registered non-profit organizations referred to non-profit organizations whose value of assets or whose total revenues in the former three years were more than HRK 100,000 (ca EUR 13,000).²⁰

5. CONCLUSION

This paper uses qualitative analysis of former and existing accounting regulation and financial reporting framework to compare the degree of non-profit sector accounting and financial reporting system reform changes to the development of the governmental accounting and financial reporting system.

The efficiency of non-profit organizations in achieving their objectives and carrying out their tasks are directly linked to good governance practice. To insure the information base needed to support the management, the establishment of appropriate accounting and information system and management control is inevitable. The reform of accounting and reporting systems in Croatia has been directed towards abolishing fund accounting practice and has been driven by the change of the accounting basis choice. This has resulted in changing the form and contents of financial statements and in applying the systematic classification that requires changes within the contents of the chart of accounts and records of compliance with primary and supplemental ledgers. Moreover, we deem this is to be further regulated by the international requirements for the application of relevant classification systems of international financial and statistical reporting.

¹⁹ IMF, A Manual of Governmental Finance Statistic, 2001

²⁰ According to the research of economic and financial position of non-profit organizations for 2008 and 2009, 8,340 entities submitted their financial statements. For more, see D.Vašiček/D.Kovačić: *Prikaz i analiza rezultata poslovanja neprofitnih organizacija u Republici Hrvatskoj*, Riznica br.10, HZRIF, 2010, p.15

The implementation of accruals accounting has enabled the achievement of the optimal degree of governmental and private non-profit organizations' harmonization. This further suggests that it is justified and reasonable, for all non-profit organization groups, to apply the same rules of measurement and evaluation, and recognition of revenues and expenses, as well as the internationally comparable and acceptable economic classification of revenues and expenses.

By following the international trend of affirmation and implementation of the accrual accounting concept, the reform direction of non-profit organizations external financial reporting change was to adopt a complete or slightly adapted accrual accounting concept, i.e. direct or indirect application of IAS/IFRS. We find this to be a significant step towards the convergence of governmental and non-governmental organizations' accounting systems and towards harmonizing their financial reporting systems, which prior to 2008 diverged greatly. Precisely, (a) ever since 2001, when governmental accounting reform started, Croatia has been trying to follow the international developments towards the introduction of accrual accounting within the national government sector. Therefore, shortly after the reform commenced modified accrual accounting as a gradual transition from cash basis to accruals was implemented.; (b) Accounting in Croatian non-profit organizations has ever since 1994 been a topic of debate in the accounting profession who has questioned its usefulness, particularly in the standard-setting process, so that, both, fund accounting and modified accrual system (which in practise resulted in de facto cash accounting) were eventually abolished due to the fact that they had not been systematically and expertly founded and conducted.; (c) Even though governmental accounting and private sector accounting systems have been gradually over years upgraded and adjusted to user needs, the accounting reform for non-profit organizations was conducted radically in 2008 when the change from de facto cash accounting to full accruals was enforced, having decreased significantly the divergence between governmental and non-governmental organizations' accounting systems. Such a chosen reform path enables the set up of a consistent and modern non-profit sector accounting system.

The quantitative analysis of the outcomes of new non-profit organizations' accounting regulation and financial reporting framework, in organizations' practice is, however, left for our future research.

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