

Changing Accounting System: Challenges for the Public Sector Auditors

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Abstract

Changing global environment has urged for public sector reforms towards efficiency and competitiveness. Among others is the shifting of accounting system from cash-based to accrual-based accounting in the government which was seen as crucial in the public sector reforms. In that light, this paper reviews the developments that has taken place in the Malaysian public sector accounting and discuss the changing of accounting system for the public sector auditors from the National Auditing Department (NAD). Implications of accrual accounting system on NAD and government's organizations as well as suggestions to implement accrual accounting system are also discussed. This paper addresses the need for government, NAD and audit profession to have concerted efforts in the implementation of appropriate accrual accounting system for the public sectors. These efforts could speed up achievement of best Malaysian governmental accounting system which assists in best evaluation and decision making, attributes of public sector reforms.

Introduction

Public sector reform towards enhanced efficiency, effectiveness and accountability of public service delivery has been global phenomena nowadays. Norman (1995) wrote that governmental accounting has taken vital role in the reform. Accounting plays an important role as the means to measure and documents achievement, and the language of accountancy is negotiated to assume similar role in public service organization (Lapsley, 1999). Significant accounting reforms had been taken place in many countries in tandem with the public sector reforms (Guthrie, 1999). Parts of the changes include moving from traditional cash accounting to the business model of accrual accounting.

Pollitt and Bouckaert (2004, Table 4.3, p. 71) reports a pattern of budgetary reform which begins with a traditional cash based accounting system followed by a shift to the double entry bookkeeping with elements of cost analysis, modified cash or modified accrual basis, and later the application and development of full accrual accounts which emphasized on information related to performance. Baker & Rennie (2006) have classified the government accounting systems range from cash to accrual accounting that shown in Figure 1. This spectrum consists

of four points including cash, modified cash, modified accrual, and full accrual accounting.

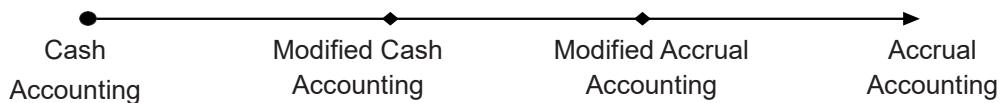


Figure 1: Accounting System Spectrum, adapted from Baker and Rennie (2006)

Cash accounting system has been predominantly applied in the public sector in the past. However, lots of changes or reforms happened in the public sector that urges the change towards the adoption of accrual accounting internationally. The definition of accrual accounting forwarded by the International Public Sector Accounting Standard (IPSAS) is that transactions and/or business events are recognized when they take place, regardless of cash involvement. This means that transactions and business events be recorded and recognized in the period which it occurs and reported in the financial period pertaining to that period although cash have been (or will be) considered during the previous period (or future period).

The shift towards comprehensive public accrual accounting started in the late 1980's, with New Zealand being the first sovereign nation to adopt public sector accrual accounting (Pallot & Ball, 1997). Funnel and Cooper (1999) wrote that Australia has also been among the first few countries to assume the accrual accounting techniques for its public sector. The United Kingdom's public sector fully implemented accrual accounting in 1998/99 (Henly et al, 1986) although NHS Trusts have started applying accrual accounting methodologies in 1992. In 2004, a third of the member counties of Organisational for Economics Co-Operation and Development (OECD) had adopted accrual accounting for reporting (Blondal, 2004).

The introduction and acceptance of accrual accounting and financial reporting in the public sectors of many countries throughout the world does not come easy. There have been a voluminous debate in support and against the accrual basis either wholly or as part. The implementation of accrual accounting is undeniable will also affect the audit practices of the NAD and external auditor profession in Malaysia. This paper records the account of accrual accounting adoption for the public sector in Malaysia and challenges the auditing profession faced.

Development of Governmental Accounting in Malaysia

During the years before Programme Performance Budgeting System (PPBS) was introduced in 1969, Malaysia adopted a line item budget or Traditional Budgeting System (TBS) that focusing on inputs or objects of expenditure. The system emphasized 'control, conformity with rules, and the legality of expenditure' (Dean, 1989). TBS basically focuses on extrapolating past spending levels into the next year and incrementing the level for inflation on new programmes or projects (Abdul Rauf et al., 2003). PPBS started 1969 with the objectives

of supporting the government officials and administrator to plan based on the most efficient and economical ways of achieving objectives of government programmes and to establish priorities in budgeting for competing programmes (Dean, 1989). The success of PPBS was however hindered by incompatibilities between accounting and budgeting systems, difficulties in determining programme structures and performance measurement, low management commitment as well as unskilled human resources (Dean, 1989).

In 1990, the Malaysian Budgeting System (MBS) also known as the Modified Budgeting System was introduced through Treasury Circular No. 11 and implemented in phases to cover all government ministries and departments by 1995. The MBS mandated that programme evaluations be conducted on a particular programme component at least once in a period of five years. The objective of MBS is to improve allocation of resources to government programmes and strengthen mechanism for the accountability of controlling officers and programme managers.

Government of Malaysia later introduced Micro Accounting System (MAS) in 1992 which adds more information than those produced through MBS- cash based accounting system. The MAS is similar to activity-based-costing which its objective to determine the cost of outputs produced by Government departments. Thus, in calculating total cost of an output, identification of all the resources used to produce the particular output is necessary which then the activity costs be determined and the cost of output be consolidated.

Standard Accounting System for Government Agencies (SAGA) was introduced and launched in 1996. This was computerized accounting package that introduced for the statutory body in Malaysia based on accrual accounting basis. The main purpose of SAGA is to ensure that the accounts of the Statutory Bodies are being updated daily and submitted in time for auditing purposes. (Abdul Rauf et al., 2003). The systems enable the local authorities, statutory bodies and public enterprises to use accrual basis to prepare their accounts.

The government of Malaysia is also considering introducing the accrual basis to account for the federal and state government activities. In view of the increasing adoption of accrual accounting basis in the public sector in the world and the advantages of accrual accounting, the government accounts will have to be compelled by circumstances to implement accrual basis. We will examine the advantages and disadvantages for the adoption of the accrual accounting basis in the public sector in the next sessions.

Opportunities and Challenges of the Accrual Accounting in the Public Sector

The adoption of accrual accounting and financial reporting in the public sector offers many advantages. First, it is argued that the adoption of accrual accounting will enhance transparency, both internally and externally in the public sector (Boxall, 1998). Mellor (1996) argued that the use of accrual basis gives a complete picture of the government's financial position, disclosed

the impact of policy over the long term, focuses attention on the management of total resources and obligations, and increases integrity of financial reporting. Accrual accounting provides a more comprehensive accountability framework than the cash basis. For example, New Zealand has gone further than any other nations in devising systems of measuring compliance and monitoring accountability when it adopted the accrual basis. The output based management and budgeting under the accrual system can provide comprehensive information and effective performance measurement that lead to accountability of management within government agencies over their actions and decisions (Ball et al, 1999).

Accrual accounting also provides more information to managers, the Parliament and the public, hence increasing the quality of overall decision making. Full cost information that captured under the accrual basis supports more effective decision making for the government. The management accounting purpose of accruals accounting is supported by Robinson (1998) who argues that the need for information on the full cost provided by accruals accounting serves the purposes of performance monitoring. Accrual accounting allows for more effective and efficient use of resources, especially regarding capital assets. It allows for a distinction to be made between capital and operating expenditures. Accrual accounting can match the cost of the asset to the benefits being received and forces the government to keep detailed asset registries (Pallot & Ball, 1997). It enables the government to match real economic costs with the outputs being achieved and leads to better evaluation of performance (Evans, 1995).

The accrual basis allows the comparison from year to year and with the private sector. By using accrual accounting for financial reporting purposes, the government can compare itself against the private sector for performance measurement and outsourcing purposes (Pallot & Ball, 1996). This comparison leads to greater efficiency because it gives the government a credible alternative service delivery mechanism (Carlin, 2005) through outsourcing to private sectors if the private sector can perform the task more efficiently. Lastly, accrual accounting establishes effective performance measurements for the government agencies. Accrual accounting allows for the analysis of overall goals, objectives and costs of service. The ability to analyze the outcomes of various departments, projects and initiatives will lead to increased accountability over the quality, quantity and cost of inputs being used (Pallot & Ball, 1996). Information generated from accrual basis is important in assisting government and other users to assess the financial condition and performance of government.

While much of the literature suggests benefits that can be attached to accrual accounting, its adoption as a basis of accounting also has some drawbacks. First, it introduces more subjectivity into the accounts. Although its subjectivity is not boundless because of the audit function and accounting standards, it can be misused to distort accounting information rather than provide a fairer picture. As a result, this may undermine the objectivity of financial statements. Many authors argued that accrual basis may distort the objectives of financial reporting for the public sector in which it could cause poor decisions in resource allocation and investment rather than improving the accuracy and usefulness of cost estimates (Carlin, 2005).

Accrual accounting practices in public sector demand higher administrative and accounting costs. The adoption and implementation of an accounting system across the public sector requires significant effort and resources. The public sector has to increase the number of financial managers qualified as accountants, and to provide more financial management and accounting training to the existing staff (Hepworth, 2003). These would obviously add to the administrative cost for the public sector.

Hepworth (2003) had set out some preconditions to implement the accrual accounting. The following preconditions may serve the guidelines for Malaysia public sector to implement the accrual accounting:-

- Consultation and acceptance are necessary to implement the system. The employees and management must be willing to recognize and accept the benefits that changes will bring about and prepare culturally for changes;
- The reforms require increase number of finance managers who may be a qualified accountant to be employed;
- Cooperation by accountancy body in the development of accounting standards and involve in the application of this standards;
- A comprehensive training for line managements to understand the accrual accounting are essential;
- There must be no system corruption and the rules specified in the system must be fully complied;
- The reform need widespread support across the government bodies as it would take times to introduce and implement the system;
- IT capacity must be able to support and respond the new requirements that introduced by the accrual system;
- A comprehensive and annual independent audit of the accounts is essential and cannot be compromised; and
- The introduction of accrual accounting and budgeting should be seen as part of the wide ranging process of reform.

In addition, Lüder's contingency model had been used to explain why changes in governmental accounting take place (Lüder, 1992). The model suggests that accounting innovation can be traced to stimuli such as politicians, administrators and the public that can affect the attitudes and behaviour of users and producers of accounting information. The model also identified the stimuli for change in Lüder (1994) such as fiscal stress, financial scandal or some dominant doctrine. Implementation barriers for governmental accounting include the legal system, the size of jurisdiction and availability of qualified staff.

Saleh (2007a) in their study on the perceptions of the government's accountants and auditors, policy makers and other professional accountant in terms of the factors that have contributed to the development of the Malaysian governmental accounting, found that:

- Financial crisis did not result any changes in the development of accrual;
- The Treasury, including the Accountant General's Department (AGD), played major roles to initiate the changes in the development of governmental accounting in Malaysia;
- AGD should be the standard setter as the accrual accounting would require a different set of accounting standards than the current Treasury Instructions and Circulars;
- Changing the legal requirements would not be a great obstacle to change the accounting system;
- International pressures and professionalism were not perceived to be major factors in the development of Malaysian governmental accounting; and
- Accrual accounting is seen to be relevant to governmental accounting but indicate that the possibility of adopting accrual accounting in Malaysian governmental accounting in the very near future.

The study of these factors is important as it would indicate whether the Malaysian government should implement the accrual accounting practice. These findings can be served as guidelines for government before implementing the system.

Challenges to the National Audit Department

According to Article 106 of the Federal Constitution, the Auditor General has the powers and duties to audit and report on the accounts of the Federal and States. The NAD of Malaysia is entrusted to ensure the existence of accountability in the administration and management of public funds through the audit of accounts and activities of the government agencies. The change of the accounting system to accrual accounting would result in the reform of the NAD and impact on their audit scope.

The scope of audit, audit procedures and audit objectives would be changed after the implementation of the accrual accounting. The accounting standard that used by the government agencies would be quite similar to the private sectors after the change. In fact, the government intends to use fair value concept to reflect the true situation of the government agencies (National Audit Department, 2006). Hence, NAD auditors must also understand fully the new requirements of IFRS in the process of auditing (National Audit Department, 2007a). Therefore, a detailed audit plan and substantive audit evidences may be required especially in the first time adoption of the accrual accounting in the financial statements.

Moreover, additional audit objectives should be developed for the accrual accounting system such as evaluation of a new computer system installed, existence of the assets, the right and obligation for the liabilities, the certification of memorandum trading accounts or a provision of stock certification (Jones & Bates, 1990). In short, the NAD officers should gain an in-depth knowledge on the accrual accounting system in order to develop the suitable audit objectives, audit procedures and audit programme.

In view that accrual accounting establishes effective performance measurements for the government agencies, the NAD should devise a new audit programme and audit plans to analyze and identify the key features of the new performance measurement and the new benchmarks for performance in the organizations, programmes and projects that to be examined (Sherer & Turley, 1991). During the Symposium of Auditing Management in Water Industry 2009, the Audit General proposed that the investment and expenditure on the water industry should be incurred on the basis of value for money and avoids any unnecessary wastage in view of the increasing cost incurred by the government and limited budget (National Audit Department, 2009). Value of money is achieved when a public body carries out its duties to high standards at low costs (Henley et al., 1986). Hence, the audit should focus on the value for money in the Malaysian public sectors that had been practiced by other jurisdictions.

Another issue on which the NAD should focus is assets and liabilities valuation. Moving to full accrual accounting means that each government department has to identify and value its assets and liabilities and bring them into a balance sheet. To ensure that all properties of the Malaysian mission offices are properly maintained, the NAD needs to carry out yearly physical inspections of all buildings and facilities that require structural, electrical and mechanical maintenance (National Audit department, 2009).

To move towards the accrual accounting system, the accounting and management information system may need to be changed. The accounting system has to be specially tested by the NAD. This involves the auditor in reviewing the general and application control of the system to ensure that the new systems maintain the integrity and security of the information. The NAD may need to consider the controls over the data centre and network operations, access security, data capture control and output controls. The auditor would need to assess his evaluation of internal controls on the new system (Jones & Bates, 1990). Auditors can use the Computer Assisted Audit Techniques and Tools (CAATTs) to facilitate the implementation of the audit procedures. The audit techniques include auditing around the computer, auditing through the computer and auditing with the computer (National Audit Department, 2006).

Furthermore, auditors need to acknowledge changes after the implementation of accrual system in reaching their conclusions and arriving audit opinion. Such considerations will help them to exercise audit judgment as well as avoid poor outcome result from the risks not carefully assessed and insufficient planning. The NAD should take initiative to develop good practice guides and produce wider range of reports and advice. In addition, they should encourage consultation by establishing new forms of accounts or reports. They can also play a role as a consultant. They can provide recommendations in his arrangements, provide specific advices

to agencies that seek for assistances and promote the formation of management structures dedicated to improved performance (Jones & Bates, 1990). They have part to play a wider role in the implementation process.

Challenges to the Auditing Profession

In Malaysia, external auditor is not appointed by the government to audit the accounts. This scenario is different from other jurisdictions. In the UK, the Local Government Finance Act 1982 gives the Audit Commission the duty to appoint the external auditor to each local authority (Jones & Pendlebury, 2000). Saleh (2006) indicates that the Malaysian professional accounting bodies have not showed interest in the development of governmental accounting. Professional bodies only dealt with accounting in the private sector. Lüder (1992) had indicated that the professional bodies are in favour of applying the private-sector accounting treatment in the public sector. When the central government in the UK introduced accrual accounting in 2000, one of the major costs is the increased cost of employing professional accountant (Connolly & Hyndman, 2005) because government has only few qualified accountant due to the simplicity of the cash accounting system implemented in the past. Therefore, there will be higher demand for the professional accountants in the Malaysia public sector if accrual system is implemented.

One of the advantages to adopt accrual accounting in the public sector that we highlighted above is it enhances transparency and accountability in the public sector. In the UK public sector, the appointment of external auditor aims to increase the effectiveness of audit, particularly in the pursuit of value for money. In the UK public sector, an external audit is intended first to provide an assurance as to the reliability of the published accounts. Second, it intended to provide further assurance as to the regularity of the underlying transactions. Third, it aims to provide an assessment of the efficiency and effectiveness in the central and local government sectors (Henly et al. 1993). Thus, external auditor is able to provide these assurances and assessments from the standpoint from outside party as they are independent and impartial in the public view.

The developments of the public sector accounting will influence the audit objectives, approach, methods and techniques that adopted in the NAD. The NAD would not have many resources or expert to develop the new audit approaches and programmes that tailor to the accrual accounting. Working with the external auditors would resolve this issue. External auditor with wider experience, of course, will familiar in auditing the accounts that adopt accrual principle. The external auditors have a part to play in the wider education process. Advice and assistance by the auditor will often be needed in implementing accrual system, without compromising audit independence and reporting freedoms (Sherer & Turley, 1991). During the Seminar on Internal Audit, the Auditor General viewed that the internal auditor and external auditor can collaborate with each others. As external auditor focus on the sampling method that do not

cover all the aspects in the public sector, the internal auditor can help the external auditor to communicate any internal control deficiencies or material misstatements to relevant person in charged in the public sectors. This would help the government to resolve weaknesses that highlighted in the audit report (National Audit Department, 2007b). Hence, collaboration with the government internal auditors is important to audit the public sector accounts.

Conclusion

Countries around the globe have increasingly in support for and adopted full accrual accounting for their public sector for the prevailing advantages accounted by developed countries pioneered the accrual basis. Without exclusion, Malaysia government had pulled all resources and effort to move forward with accrual accounting. Various researches have suggested that adoption of accrual accounting can lead to the accountability and transparency in the accounts. Moreover, the full cost information allows for a better decision making and better measurement on the government agencies performance. However, its adoption as a basis of accounting also has some drawbacks such as the subjectivity of the accounting information and the increasing cost of moving to the new system. Accrual accounting would be successfully implemented should a whole series of preconditions be made available. Hence, a comprehensive review and survey to explore the factors that influence the implementation of the accrual system in Malaysia is necessary.

Public sector accounting evolution would undoubtedly influence the NAD. Changes in accounting system may affect audit objectives and audit scope. The new government initiatives require audit to emphasize more on the performance measurement, fair valuation of assets and the information technology audit. To support the newly evolved functions, additional training is vital for the NAD staffs to update their skill and knowledge on the accrual accounting, government initiatives and the relevant audit approach. External auditor is proven to have the ability to support the process of implementation of efficient accounting system in the public sector and effective public sector administration (Abu Hasan, 2010). Effective external audit in the public sector would further enhance the credibility and transparency of the financial reporting which have been accounted in the public sector of other jurisdictions. In view of the advantages derived from accrual accounting system, the government, NAD and audit profession should make concerted efforts to support the implementation of appropriate accrual accounting system for the public sectors.

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