



UKRAINE

TECHNICAL ASSISTANCE REPORT—PUBLIC FINANCIAL MANAGEMENT OVERVIEW

February 2016

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PUBLIC FINANCIAL MANAGEMENT OVERVIEW

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ACRONYMS AND ABBREVIATIONS

ACU	Accounting Chamber of Ukraine
AFS	Annual Financial Statements
BCU	Budget Code of Ukraine 2011
CoM	Council of Ministers
EU	European Union
FAD	Fiscal Affairs Department
IFMIS	Integrated Financial Management Information System
IPSAS	International Public Sector Accounting Standards
KSU	Key Spending Unit
LG	Local Government
LM	Line Ministry
MEFP	Memorandum of Economic and Financial Policies
MoEDT	Ministry of Economic Development and Trade
MoF	Ministry of Finance
MTBF	Medium-term budget framework
NBU	National Bank of Ukraine
PIFC	Public Internal Financial Control
PBB	Performance Based Budgeting
PFM	Public Financial Management
PFMP	World Bank Public Finance Modernization Project
SFI	State Financial Inspectorate
STU	State Treasury of Ukraine
TA	Technical Assistance
TSA	Treasury Single Account
UAH	Ukrainian Hyrvnia
VR	Verkhovna Rada (Parliament)

PREFACE

At the request of the Ukrainian Ministry of Finance, a technical assistance mission visited Kiev during July 15-29, 2014. The purpose of the mission was to: (i) review the overall status of public financial management; (ii) provide recommendations on urgent measures in the areas of cash management, expenditure controls, and fiscal oversight of SOEs; (iii) outline a strategy for medium-term PFM reforms; and (iv) carry out preliminary analysis for a Fiscal Safeguards Assessment. The mission met with: Mr. Lisoenko (Deputy Minister of Finance) and senior staff in the Ministry of Finance; Mr. Udovychenko, Deputy Governor of the National Bank of Ukraine, Mr. Dniprov, Deputy Minister of Education and Science; Mr. Myroniuk, Deputy Head of the State Property Fund; Ms. Shamrai, Head of Consolidated Accounts in the State Treasury; Mr. Pylypenko, General Comptroller of the Accounting Chamber of Ukraine and their officials. The mission also met with Mr. Kramarenko, Deputy Head of the Kiev City State Administration and his officials; Mr. Konovets, Deputy Chairman of the Board of Naftogas, and with representatives of the State Financial Inspection. In addition, the mission met with representatives of the World Bank and the European Commission.

The mission would like to express its sincere appreciation for the excellent support given by all these staff during the mission. The mission is also extremely grateful for the excellent support given to the team by staff at the IMF office, in particular, to Mr. Shpak for his truly excellent support, and to Ms. Mendelenko, Ms. Rubashova, and Ms Shulga for their excellent interpretation and translation efforts over the course of the mission.

EXECUTIVE SUMMARY

This report has been compiled against a backdrop of political uncertainty and heightened security concerns. Public financial management (PFM) reforms may not be to the forefront of government priorities at present but severe budgetary pressures need to be addressed and measures adopted to help implement sustainable fiscal policy. The report focuses on immediate PFM reforms needs that help alleviate immediate budget pressures, and also identifies medium-term reforms to address long-standing weaknesses in PFM systems.

Budget Planning

Reforms to the budget planning process need to be cognizant of the two immediate determinants of reform, namely: the authorities' IMF supported economic program and the EU-Ukraine Association Agreement. Essentially, these proscribe the need for an expenditure based fiscal consolidation program and a medium-term budget planning process.

FAD's previous recommendations on developing a medium-term budget framework have not been implemented to date. In the current environment, full implementation may not be immediately possible but specific measures should be taken to introduce realism and a medium-term outlook to support consolidation and ensure other PFM reforms are successful.

There is a need to introduce medium-term expenditure ceilings on Key Spending Units (KSU), binding for the first year and indicative for the following two together with the introduction of forward budget estimates. Budget projections should also reflect the measures being proposed under the IMF supported program and that spending units take these into account when preparing their budget proposals to prevent future accumulation of arrears.

Plans to prioritize reforms to the existing performance budgeting system should not be considered in the short-term given existing resource constraints. Over the medium-term the legal framework will need to be revised to integrate the MTBF with the budget process.

Developing a cash management strategy

The government's banking arrangements including the presence of a treasury single account (TSA) largely meet international good practice, but there are some areas that could be improved to maximize the efficiency of cash management operations.

All cash balances of general government including the social funds and balances being held in foreign exchange accounts in the National Bank Of Ukraine (NBU) and the commercial banks should be made available for liquidity management purposes, although some safeguards need to be put in place to ensure that general government entities have access to their own resources when they need them to meet their own obligations. Foreign exchange and Hyrvina bank accounts in the commercial banks should be reviewed with a view to closure and balances in foreign exchange accounts in the NBU should be used for liquidity management purposes.

Before this can be fully achieved cash planning will need to be considerably strengthened. The existing cash planning system is extremely short-term and is not conducive to efficient liquidity management. Capacity should be developed by establishing a cash planning unit in the MoF supported by a high level cash management committee to ensure that information needed to produce accurate and timely cash plans is made available from all relevant stakeholders.

To reduce volatility of cash balances and to better integrate cash and debt management operations the Debt and International Financial Policy Department should be given responsibility for managing the end of day balances on the TSA.

Budget Execution and Internal Control

Existing practices of releasing cash in the absence of an appropriation through the issuance of loans from the TSA and allowing KSUs to borrow to fund capital expenditures in excess of budget appropriations breach fundamental principles of PFM and should be discontinued.

The accumulation of substantial payment arrears also point to weaknesses in existing budget execution and control processes. Commitment controls need to be introduced earlier in the expenditure cycle to prevent accumulation of arrears and support cash management.

Existing rigidities in budget execution make it difficult for program managers to manage threats to their service delivery programs. This could be alleviated by offering KSUs greater flexibility in transferring their budget within certain economic categories. Protected and unprotected expenditures should be abolished as part of a move to introduce greater realism in budget planning and provide adequate resources for all appropriated expenditures.

An extensive control framework of ex-ante and ex-post controls exists, although efforts are in train to further increase ex ante control with little perceptible added value. Initiatives by institutions such as the Accounting Chamber of Ukraine to expand their mandate to include ex-ante controls should be resisted to prevent conflict between their role as an independent assessor and acting as a participant in operational decisions and policy implementation.

The focus should be on ongoing efforts to roll out the internal audit function to all budget entities and putting measures in place to make managers responsible for the internal control processes in their own ministries. Greater budget flexibility and more relaxed external controls should be granted to KSUs once they have demonstrated that they have adequate control processes in place. However, these changes should be pursued in the medium term.

Accounting and Fiscal Reporting

Extensive cash based reports on the execution of the budget are produced and published but the government's ambition to transition to an accrual based system by the beginning of 2015 will be hampered by weaknesses in current systems including accounting systems; the existing focus on cash based reporting and lack of accountancy capacity.

Progress towards an accrual based framework will require the acquisition of IT systems to support the implementation, as existing systems are inadequate. Even if such systems are put in place relatively quickly, experience teaches that completion of a major reform such as this may take years, and the first step should be the preparation of a realistic implementation plan.

One area that should be explored is the expansion of the coverage of fiscal reporting to cover the wider public sector. State-Owned Enterprises and other public entities outside of general government are major sources of fiscal risk and existing reporting structures do not adequately capture their activities. Obtaining full coverage of reporting of the public sector poses significant challenges in the face of disparate reporting and accounting standards and will require a phased approach before consolidated reporting is achievable.

Management and oversight of state assets

The existing portfolio of state assets is a source of significant value and also of fiscal risk. Government ownership of these assets brings with it a number of conflicting objectives including the desire to maximize value of the portfolio, regulate the industries in which they are present, and implement social policy through the medium of these assets.

The state asset ownership and management framework is decentralized, fragmented, and includes numerous conflicting roles and responsibilities at different levels of government. The legal framework surrounding ownership is also complex, often contradictory and is likely hampering efforts to increase transparency, put in place a coherent management framework and unblock the stalled privatization program.

Three areas should be prioritized to manage the portfolio of state assets and unlock potential value and identify and mitigate the associated fiscal risks: the legal framework, the ownership structure, and transparency policies. Many of these reforms will take a number of years to complete and a phased approach is appropriate. The emphasis in the short-term should be on putting the institutional structures in place to enable: the identification of the size of the consolidated portfolio; the fiscal risks emanating from the sector; and the implementation of a transparency policy with the objective of disseminating details of the value and size of the portfolio to the wider public and potential investors.

To do so, will require the establishment of a unit in the ministry of finance to; determine and manage the risks associated with the portfolio; oversee all financial flows; and establish the portfolio's value. This should be accompanied by publication of an annual report on the portfolio of state assets to include details of potential values. Over the medium-term a review of the legal framework surrounding management and oversight should be carried out and a more ambitious management structure should be considered to consolidate responsibility for active ownership, financial control and privatizations within a single arms length entity.

Table 1 is a list of summary recommendations and proposals for follow up technical assistance to help implement the PFM reforms being proposed in the report.

Table 1. Ukraine: Summary of Recommendation and Action Plan

Rec No.	Action	Short-term	Medium-Term	Responsibility	TA needs
Budget Planning					
2.1	2015 Budget projections to include MTFE and expenditure ceiling for KSUs			MoF	
2.2	Issue new budget instructions to KSUs			MoF	
2.3	Coordinate budget projections with structural reform and rationalization plans			MoF and KSUs	FAD STX
2.4	PFM action plan to center budget preparation reforms on developing MTBF			MoF and donors	
2.5	Revise the Budget Code to provide a legal backing for the MTBF reform			MoF, COM, VR	FAD STX ²
Cash Management Strategy					
3.1	Survey central government commercial bank accounts and rationalize			STU	
3.2	Eliminate foreign currency accounts of spending units in the commercial banks			STU and MoF	FAD STX
3.3	Put in place formal arrangements to borrow balances of Social Security Funds			STU, MoF, SSF	FAD STX
3.4	Review foreign currency accounts in the NBU with a view to rationalization			MoF	FAD STX
3.5	Identify impact of lack of liquidity on LGs ability provide legally mandated services.			MoF, STU	
3.6	Establish a cash planning unit in the Ministry of Finance or STU.			MoF, STU	FAD STX
3.7	Reduce volatility of TSA through alignment of major receipts and expenditures			MoF Budget Dept	
3.8	Debt Department responsible for managing the balance on the TSA			MoF, STU	FAD STX and HQ
Budget Execution and Internal Control					
4.1	Introduce commitment controls to the budget execution framework for 2015			STU	FAD STX
4.2	Develop an arrears clearance strategy			MoF	FAD STX
4.3	Eliminate distinction between protected and unprotected items in 2016 budget			MoF	
4.4	Produce a strategy for expanding the functionality of STU IT systems			STU and donors	FAD STX
4.5	Provide managers with greater flexibility in budget execution control rules			CoM and MoF	

Table 1. Ukraine: Summary of Recommendation and Action Plan (Concluded)

4.6	Limit mandate of the ACU to ex post audit			CoM and VR	
4.7	Amend BCU allowing ACU explain budget to CoM and Budget Committee			CoM and VR	FAD STX and HQ
4.8	Continue the roll-out of internal audit and make managers accountable			MoF and SFI	Other Donors
4.9	Grant freedom from ex ante-controls once certification is achieved			MoF and SFI	Other donors
Fiscal Reporting					
5.1	Develop implementation plan to achieve compliance with accrual accounting standards			STU	FAD STX
5.2	Include SOEs in the annual financial statements as a separate sector			STU	FAD STX
5.3	Prepare consolidated public sector reporting (likely to take at least 5 years)			STU	FAD STX
State Assets					
6.1	Establish unit in the MoF to manage financial aspects of SOE's			MOF	FAD STX
6.2	Separate commercial and non-market based assets and report on cost of subsidies			MOF	FAD STX
6.3	Decree identifying value maximization as sole objective for commercial assets			MOF	
6.4	Carry out a stock-take of consolidated portfolio of state-assets			MOF	FAD STX
6.5	Publish an annual review of state assets in English on the government web site			MOF and CoM	FAD STX
6.6	Review group to conduct a review of legal framework for SOE management			Multiple	
6.7	Consolidate ownership within MoF and prepare long-term ownership plan			CoM, MoF	HQ mission

I. INTRODUCTION

1. **This report has been compiled against a backdrop of political uncertainty and heightened security concerns in the eastern part of the country.** Public financial

management (PFM) reforms may not be to the forefront of government priorities in this environment but severe budgetary pressures need to be addressed and putting in place measures to help implement sustainable fiscal policy will be an important part of any return to normalcy. The report focuses on PFM reforms that need to be addressed to help alleviate immediate budget pressures, and also identifies more medium-term reforms to address long-standing weaknesses in Ukraine's PFM systems. The immediate areas of concern include:

- **Cash Management:** Government cash balances in the Treasury Single Account are precarious. A cash management strategy that enables the authorities to continue to provide essential government services in a fiscally sustainable manner and ensures that cash resources are available to meet ongoing obligations needs to be put in place.
- **Expenditure Controls:** Expenditure controls need to be strengthened to guard against further accumulation of payment arrears at different levels of government as fiscal consolidation starts to pressurize budgets.
- **Fiscal Reporting:** Existing reporting capacity needs to be strengthened with a view to improving the timeliness, accuracy, and coverage of reporting such that fiscal reports provide a complete overview of government operations at different levels of the general government and the wider public sector. There is also a need to improve oversight of the wider public sector and state owned enterprises in particular.

2. **Once the immediate fiscal situation has been stabilized, Ukraine's progress in budget formulation should be reviewed and a robust medium-term budget framework (MTBF) should be put in place.** Many of the existing problems in budget execution and cash management have stemmed from lack of realism in the budget planning process.

3. **In addition, there is a need to improve monitoring and oversight of state assets.**

The existing fragmented ownership, management, and monitoring framework has contributed to the lack of transparency as to the activities of the wider public sector and the lack of understanding as to the size of the fiscal risks and value of the existing state asset portfolio.

4. **The remainder of the report is structured as follow:** Chapter II reviews progress in reforming budget planning processes; Chapter III advises on a strategy to strengthen cash management practices; Chapter IV examines budget execution and internal control; Chapter V reviews accounting and fiscal reporting; Chapter VI examines the reforms needed to manage state assets professionally; and finally Chapter VII examines supporting reforms to ensure the successful implementation of the PFM reform program.

II. BUDGET PREPARATION

A. Background and Context

5. **There are currently two main determinants of reform in budget preparation—the authorities’ economic program supported by the IMF¹ and the EU-Ukraine Association Agreement.²** The authorities have committed to:

- achieving a gradual expenditure-based fiscal consolidation over the medium term, as stated in their Memorandum of Economic and Financial Policies (MEFP) under the IMF-supported program; and
- exchanging information, experience, best practice and take other actions with the EU in the area of budget policy, including on developing a medium-term budget forecast/planning system under the EU-Ukraine Association Agreement.

Therefore, budget preparation reforms should be focused on areas that support the fiscal consolidation effort and the introduction of a medium-term policy orientation of the budget to ensure that this effort is sustained.

6. **Budget preparation has been subject to review by two FAD missions in 2011 and 2012.** The missions recommended a wide range of measures to improve budget preparation in the context of developing a medium-term budget framework (MTBF).³ Progress in implementing the recommended measures has been limited. Table 2 summarizes key recommendations and provides information on the status of their implementation.

7. **While previously recommended measures remain valid, full implementation may not be feasible in the short term, due to the tense economic, political, and security situation.⁴** However, some immediate steps are needed to support the authorities’ fiscal consolidation efforts, and reforms in other areas of fiscal management such as expenditure control and cash management. Reforms in these areas will not bring about the desired outcomes without the creation of a stable and credible budget preparation process. Aside from these immediate concerns, reform plans to strengthen budget preparation in the medium-term are also important, in order to create a sense of direction for existing rather sketchy reform initiatives. This section, therefore, focuses on short-term measures in budget preparation, but

¹ <http://www.imf.org/external/pubs/cat/longres.aspx?sk=41516.0>.

² http://eeas.europa.eu/ukraine/assoagreement/assoagreement-2013_en.htm.

³ See *Developing Medium-Term Budgeting* (Cangiano et al., 2011) and *Strengthening the Medium-Term Budget Framework* (Ljungman et al., 2012).

⁴ Some recommended actions, such as defining fiscal objectives and introducing in-year macroeconomic forecasting updates, are implemented in the context of the IMF-supported program, although not formally incorporated in the legal framework and the budget process.

makes also recommendations for prioritizing the medium-term reform agenda in this area, referring to previous FAD advice on introducing an MTBF, as needed.

Table 2. Ukraine: Key Recommendations of the 2011/2012 FAD Missions

Recommended Measures	Status of Implementation
Set three-year aggregate expenditure ceilings, first year being legally binding, second and third year subject to technical revisions in the following year.	Introduced formally, but not used for the outer two years
Define the ceiling as covering aggregate primary expenditure of the state budget, including special funds plus the expenditure of the social fund, net of intergovernmental transfers.	Covers only current expenditure
Amend the Budget Code to require the proposal of aggregate expenditure ceilings.	Not implemented
Introduce a prioritization phase in the spring, allocating expenditure between main policy areas and key spending units.	Not implemented
Amend the Budget Code to require that the Cabinet of Ministers present to parliament a Fiscal Strategy Document in May (replacing the Budget Declaration).	Not implemented
Introduce a requirement in the Budget Code that a budget margin—defined as the difference between the aggregate ceiling and projected expenditure subject to the ceiling—should be at least 2 percent of total expenditure for the upcoming year and 3 percent for the second and third years.	Not implemented
Introduce into the Budget Code a provision that subject Special Funds to the aggregate ceiling on expenditure.	Not implemented
Require a parliamentary approval in the spring of the three-year ceilings and the allocation between main policy areas.	Not implemented
Amend the Budget Code to require that the annual report include a follow-up on the medium-term budget framework.	Not implemented
Introduce a mandatory macroeconomic forecasting update in mid-August.	Not implemented
Make public the Ministry of Economy forecasts together with that of the NBU, and publish the previous year's macroeconomic forecast together with the actual outturn.	MoEDT publishes a consensus forecast
Introduce a 3-year average overall balance objective	Not implemented

B. Immediate Measures

8. **The most urgent immediate measure is to fully incorporate the recently updated fiscal objectives and policies, as agreed under the IMF-supported program, within the internal budget process.** These reflect a revised macroeconomic framework to account for the most recent developments, and require actions for the revision of the current budget and the preparation of the 2015 budget.

9. **As a first step, the authorities have prepared and submitted to parliament a supplementary budget for 2014.** The main focus of the supplementary budget is on cutting spending—including freezing wages and pensions; limiting new hiring; and cutting spending on goods and services as well as transfers to SOEs and investment projects—while targeting social assistance to the most vulnerable, and providing additional funds for defense in relation to the intensification of the conflict in the East. It is important that the supplementary budget is adopted as a matter of priority regardless of the fluid political situation.⁵ This should be immediately followed by government's resolution and detailed instruction of the MoF to key spending units (KSUs)⁶ on the implementation of the revised budget to ensure that the expenditure measures are effectively implemented and do not lead to the accumulation of expenditure arrears (see the discussion on commitment controls in Chapter IV).

10. **In relation to the above, and following the established budget procedure, the government should also adopt a resolution on approving projections for the 2015 budget.** Two new elements could be included in this resolution: (i) a medium-term macro-fiscal framework (MTFF) consistent with the macro-fiscal framework in the MEFP; and (ii) three-year aggregate expenditure ceilings for KSUs. A possible format and content of a medium-term macro-fiscal framework, as part of a broader Fiscal Strategy Document is presented in Table 4. The expenditure ceilings should: (i) cover all primary expenditure; (ii) be an integral part of the macro-fiscal framework; and (iii) be binding for 2015 and indicative for 2016 and 2017.

11. **In implementing the government resolution, the MoF needs to issue a new budget instruction for the preparation of the 2015 budget.** The instruction sent to line ministries and other spending units in early July needs to be abolished, because it does not reflect the recently updated macroeconomic and macrofiscal framework as well as the impact of the expenditure measures included in the 2014 draft supplementary budget.

12. **Given the increased fiscal pressure and reduced fiscal buffers, the MoF should ensure that the expenditure ceilings are effectively enforced.** In practice, it means that

⁵ The prime minister resigned on July 24, 2014 after the collapse of the ruling coalition in parliament, paving the way for early parliamentary elections this fall.

⁶ These include ministries, agencies and other spending units that constitute a main unit of appropriation, according to the Budget Code.

budget submissions of spending units should be made strictly within the released ceilings. Therefore, the current practice of directly or indirectly (through preparing an addendum to the budget submission with unfunded activities) avoiding the expenditure ceilings should be eliminated, and possible changes should be considered only within the agreed fiscal envelop. Despite overall uncertainties and possible future changes, the indicative ceilings for the outer two years will provide KSUs with a point of reference for their expenditure in the medium term, and for potential cost-efficiency gains in their respective sectors.

13. **These new elements in the budget process require a new approach to the upcoming discussions between the MoF and KSUs on the 2015 budget and their three-year expenditure plans.** Instead of the traditional bargaining for additional resources for the next fiscal year, the discussions should focus on reforms to underpin the achievement of the medium-term expenditure ceilings. The forward estimates in budget submissions should identify the impact of changes in current policies, as defined in the supplementary budget, on future years and the cost-efficiency gains of new policies. To this end, the work on the 2015 budget and beyond should be closely coordinated with the comprehensive plan for structural reforms and rationalization of expenditure in key sectors. The authorities intend to prepare the plan by end-September building on the recommendations of recent FAD mission⁷ and in consultation with the World Bank. Box 1 is an illustration of the direction of the key reform efforts expected to be implemented in the education sector.

Box 1. Education Reform

The education system is overstaffed and oversupplied with buildings in spite of a declining student population. There is potential for large cost-efficiency gains in the sector. Reform options include: increasing the teaching load of public school teachers; aligning class and school sizes with average European levels; reducing excessive staffing on the basis of performance reviews; and means-testing of free services provided to students while protecting vulnerable groups.

14. **Finally, in the short run the reform agenda in the budget preparation area needs to be prioritized.** The MoF is currently preparing a draft action plan for PFM reforms that includes a number of measures to improve budget preparation.⁸ The budget preparation measures focus predominantly on further developing program and performance budgeting (PPB). Important measures for strengthening the policy context and medium-term orientation of the budget are included under the umbrella of the PPB reform.

15. **Under current circumstances, the prioritization of the strengthening of PPB may not be wise.** International experience indicates that efforts to develop a comprehensive PPB system are extremely resource and time consuming. In an environment where heavy work

⁷ See Options for Short-Term Expenditure Rationalization (Coady et al., 2014).

⁸ This is still a work in progress.

pressures are likely to persist due to the current economic and financial crisis and the need to support fiscal consolidation, the prioritization of PBB in the short-term may unduly divert key staff from more urgent tasks. Countries that faced financial distress, such as Greece and Cyprus, phased out PBB reforms until later stage when the objectives of fiscal consolidation are broadly achieved. A similar approach would be appropriate in Ukraine and need to be further coordinated with the MTBF implementation strategy, as further discussed in the next subsection.

16. **Therefore, a less complex, more practical, and better prioritized approach is recommended.** It should be centered on the development of an MTBF. The rationale is that one of the main objectives of the authorities in the fiscal policy area, as stated in their MEFP, is to achieve an expenditure-based fiscal consolidation over the medium term. The MTBF would be a key instrument in helping to achieve this objective.

Short-term (0-6 months)

Recommendation 2.1:⁹ Adopt a government resolution on preparing budget projections for 2015, including: (i) an MTFF for 2015-17; and expenditure ceiling for KSUs (binding for 2015, and indicative for 2016 and 2017).

Recommendation 2.2: In relation to the above, issue new budget instructions to KSUs to identify in their budget submissions the impact of changes in current policies, as defined in the supplementary budget, on future years and the cost-efficiency gains of new policies.

Recommendation 2.3: Ensure the work on 2015–17 budget projections is closely coordinated with the comprehensive plan for structural reforms and rationalization of expenditure in key sectors planned to be prepared by end-September.

Recommendation 2.4: Amend the existing PFM action plan to center budget preparation reforms on introducing an MTBF.

C. Introducing an MTBF

Current situation

17. **Article 21 of the Budget Code of Ukraine (BCU) provides the legal basis for developing budget forecasts for the two budget periods following the planned one.** The code stipulates that the medium-term budget forecasts should be prepared on the base of a

⁹ Following the mission, the authorities advised that government resolution 404 had been adopted on August 27, 2014 on forecasts of economic and social development of Ukraine that are generally consistent with the forecasts under the IMF-supported program, and that these had been used for developing a draft budget for 2015. According to the authorities, these actions had broadly addressed recommendation 2.1, and recommendation 2.2.

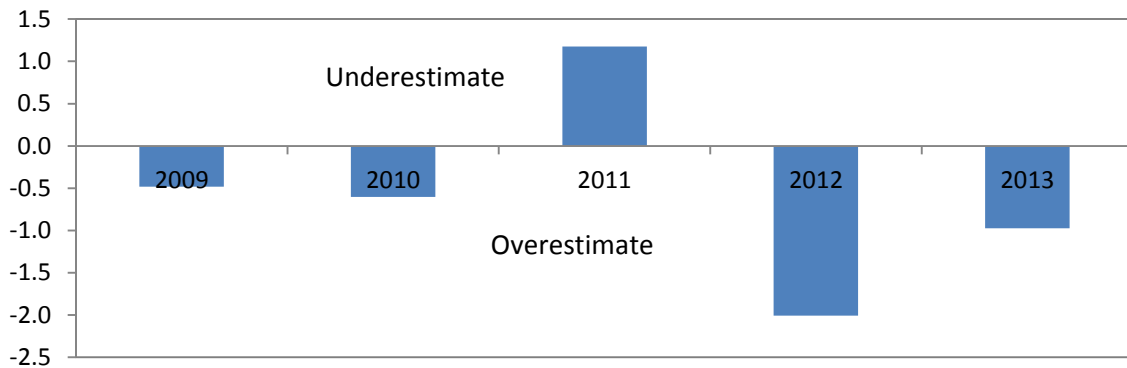
macroeconomic framework, explicitly identifying indicators such as nominal and real GDP, consumer price indices and producer price indices, annual average official exchange rate of the hryvnia and the official year-end exchange rate, enterprises' profits, payroll, unemployment level, exports and imports of goods. The code also appropriately defines the main actors in this exercise in the face of the MoF, MoEDT, and the NBU.

18. **However, this provision of the code has been enforced only once when projections for 2013 and 2014 were prepared during the 2012 budget preparation process.** No medium-term budget projections have been approved by the government since 2012, allegedly because of the absence of an agreed and adopted medium-term macroeconomic framework. At the same time, as required by the MoF, the KSUs continue to prepare their budget submissions for three years. However, under the circumstances, this has been only a formal requirement with no material impact on the annual budget process.

19. **According to Article 21 of the BCU, the projections for the outer two years should be approved by government, after the approval by parliament of the annual budget law.** The idea seems to be that the macroeconomic and macro-fiscal projections could change as a result of the parliamentary deliberation on the annual budget that would lead to changes in the medium-term budget projections. Therefore, regardless of the soundness of the changes in the macroeconomic framework, the government should feel compelled to revise the medium-term fiscal projection to reflect these changes. Indeed, the government's resolution on budget projections for 2013 and 2014 were approved subsequent to the approval of the Law on the State Budget for 2012.

20. **There are significant problems with the existing approach to preparing the MTBF.** In particular, it fragments the budget process, undermines the credibility of both the annual budget and medium-term budget projections and undermines the top-down process in which the projections set the framework within which budget decisions are then taken. In addition, it increases the possibility of political interference in the macro forecasting process. This, among other factors, explains the significant forecasting errors in the macroeconomic and fiscal projections for 2012-13 that reflected in significant deviation between the planned and actual fiscal balance, as illustrated in Figure 1.

Figure 1. Ukraine: Balance Forecast Deviation
(Percent of GDP, Actual - Forecast)



21. **Despite the absence of a good track record to build upon, the implementation of the recommended short-term measures could provide a solid base for the start of the MTBF exercise.** To this end, this section further elaborates on: (i) the status of important preconditions for the successful implementation of an MTBF; (ii) actions needed to adopt a medium-term fiscal framework (MTFF) and use it as a foundation of the MTBF; and (iii) implementation strategy for introducing an MTBF.

Preconditions for a successful MTBF

22. **There are four main preconditions for the successful implementation of an MTBF.** These include: (i) a credible and predictable annual budget; (ii) accurate medium-term macroeconomic projections; (iii) established fiscal objectives and rules; and (iv) a comprehensive, unified, top-down budget process. As indicated in Table 3, these preconditions remain to be met. The forecasting errors in both macroeconomic projections and fiscal aggregates are still significant and undermine the credibility of the annual budget. There are no well established fiscal objectives or rules to anchor fiscal policies, and expenditure ceilings are limited in coverage and not binding.

23. **The IMF-supported program provides a framework to meet these preconditions in the short run.** The program includes macroeconomic and fiscal projections subject to regular reviews. It is important that these are fully incorporated in the internal macroeconomic and macro-fiscal forecasting process. The program also provides fiscal objectives and targets to anchor fiscal policies, and to introduce binding expenditure ceilings with the 2015 budget. As discussed in the previous subsection, the specific actions required include the adoption of a supplementary budget for 2015, and adoption of a new government resolution and new budget instruction of the MoF on the preparation of the 2015 budget.

Table 3. Ukraine: Preconditions for Successful Implementation of a MTBF

Precondition	Current Status	Required Action
Credible Annual Budget	Forecasting error for revenue, expenditure, and the fiscal balance remains significant, and was further adversely affected by the ongoing economic and financial crisis	<i>In the short run:</i> Fully align the annual budget projections, including for 2014 and 2015, with the fiscal projections under the IMF-supported program
Accurate medium-term macroeconomic framework	Forecasting error for GDP remains significant was further adversely affected by the ongoing economic and financial crisis, and it is not insulated from political interference	<i>In the short run:</i> Fully align the existing macro projections with the macroeconomic framework agreed under the IMF-supported program. <i>In the mid-term:</i> Ensure independent oversight of the fiscal forecasting process
Established fiscal objectives and rules	A debt rule setting a debt-to-GDP ratio of 60 percent is included in the existing Budget Code, and specific fiscal targets are defined in the annual budget guidelines, but they are not effectively used as an anchor of fiscal policies in the mid-term	<i>In the short run:</i> Define fiscal objectives and targets in line with the IMF-supported program. <i>In the mid-term:</i> Consider introducing fiscal rules through the Budget Code and enforce them following the expiration of the IMF-supported program. Technical assistance to design the rules may be required
Comprehensive, unified, top-down budget process	MoF releases expenditure ceilings but they are limited in coverage only to current expenditure and are not binding	<i>In the short run:</i> Approve with the 2015 MTFE binding expenditure ceilings covering all expenditures for 2015 and indicative expenditure ceilings for 2016 and 2017

24. **Looking forward, steps need to be undertaken to insulate the macro forecasting process from political interference.** This could be achieved through independent oversight of the fiscal forecasting process. To this end different options could be explored, including: (i) establishing a fiscal council following relevant experiences in the EU member countries (not necessarily appropriate at the moment but could be considered in the future); (ii) publishing the model used to make forecasts (possibly in the context of the preparation and approval of the Fiscal Strategy Document as further discussed in the report) to allow other stakeholders (banks, think tanks etc.) to review methodologies; and (iii) publishing comparisons of government forecast to those of other independent forecasts (IMF, EC).

Medium-term fiscal framework

25. **The MTFF is the foundation for developing a sound MTBF.** The MTFF can be defined as a rolling plan that establishes integrated multi-year policy-based limits or targets for key fiscal aggregates—debt, financing, primary balance, revenues, and expenditures—consistent with and supportive of the overall macroeconomic framework. As such, it is a critical tool in strategic fiscal management, and provides the foundation for the resource allocation facet of budget preparation under an MTBF.
26. **The Budget Policy Guidelines issued by government usually in April do not include an MTFF.**¹⁰ The guidelines are focused on the upcoming fiscal year, and provide only information on key macroeconomic assumptions such as GDP growth and inflation, and broad fiscal targets such as budget deficit and debt-to-GDP ratio.
27. **In order to strengthen the strategic and policy orientation of the budget the Budget Policy Guidelines need to be replaced by a Fiscal Strategy Document.** Such a recommendation was made by the 2012 FAD mission, but no steps had been made for its implementation. The Fiscal Strategy Document should include in contrast to the current guidelines: (i) an MTFF; and (ii) aggregate expenditure ceilings for KSUs. A possible outline for a Fiscal Strategy Document for 2015 to incorporate an MTFF, and the current status of information sources for its preparation is presented in Table 4.
28. **As shown in Table 4, a significant part of the information for the preparation of the Fiscal Strategy Document is available.** Therefore, a first Fiscal Strategy Document could be prepared in the context of the recommended government resolution on the 2015 budget. In addition to the Fiscal Strategy Document, the government should also approve expenditure ceilings by KSUs. The design and implementation of the expenditure ceilings is discussed in detail in the 2012 FAD report, and could be referred to as needed.

¹⁰ The Budget Policy Guidelines for 2015 was approved by government on April 16, 2014.

Table 4. Ukraine: Possible Outline for Fiscal Strategy Document

Topic	Status and Sources of Information
A. Macroeconomic Section	
Brief narrative on recent developments and challenges; <ul style="list-style-type: none"> • set out targets and major policies; • note on the Government's recent track record of achieving objectives or forecast errors 	Done partially in the Budget Policy Guidelines <ul style="list-style-type: none"> • more needed on economic policies; • need track record section and explanation of deviations
Table with projections for the key indicators in the real, external, monetary sectors	Derive from the MEFP
Note on the major forecast risks, and results of sensitivity of key economic variables to changes in assumptions (e.g., oil prices, European economic outlook, tourism arrivals)	Prepare on the base of the MEFP and the macroeconomic forecasts of the MoEDT
Brief write-up of the "optimistic" and "pessimistic" scenarios	Use the MEFP and further consult with staff under the IMF-supported program
Note on the internal consistency of the macroeconomic framework, (attesting to coordinated monetary and fiscal policies, and realism of and consistency of projections)	Use the MEFP and further consult with the IMF staff
B. Fiscal Section	
Narrative on recent developments with focus on track record of having achieved or not major policy objectives and targets	This should be prepared by the Budget Department of the MoF
Statement on fiscal sustainability being key to macro-stability; lead in to setting out complete set of fiscal targets (including debt and primary balance ratios), and also: <ul style="list-style-type: none"> • size of government (i.e., for total domestic revenue (tax plus non-tax), and the desired medium-term structure of revenues (tax vs. non-tax; taxes on incomes vs. taxes on consumption, etc.) • for capital investment to GDP • for the Government's wage bill • other key fiscal targets 	Ditto. Done only partially in the Budget Policy Guidelines. Need to be extended for: the key fiscal aggregates beyond the upcoming fiscal year; the intended path of total revenue and its structure (targets for the various aggregated revenue ratios and sub-aggregates); and targets for key recurrent spending components e.g. Wage bill
Tables and write-up on the results of the baseline projections (focus on main fiscal aggregates)	Use the MEFP and further consult with the IMF staff
Note and table on the magnitude of the gaps with respect to the targets	This should be prepared by the Budget Department to show the magnitude of the gap between what the government intended to collect and spend and the actual figures for the last three years
Main elements of fiscal strategy: <ul style="list-style-type: none"> • decisions (& the motivation) on relative contributions of revenue and expenditure measures to "close the gaps" and timeframe for implementation • details on each of the specific revenue or expenditure measures and impact they will have on taxpayers, ministries, public servants, or the public 	Derive from the MEFP and the draft supplementary budget for 2014
Annotated charts juxtaposing for the major fiscal aggregates, the baseline and the active scenario values, and with brief notes to direct the reader's attention	May be introduced from 2016

Table 4. Ukraine: Possible Outline for Fiscal Strategy Document (Concluded)

Topic	Status of Sources of Information
Note on what this means for: <ul style="list-style-type: none"> • the overall resource envelope (i.e., total expenditures) • Statutory expenditures (e.g. social programs, pensions) • Capital expenditure (total) • Interest payments • Wage bill • Non-wage primary recurrent expenditure (Total Goods and Services plus Transfers and Subsidies) - areas of focus in Budget allocation process) 	Ditto
Tables, charts and write-ups of the "active" scenario	Derive from the MEFP. The fiscal tables (output of the policy scenario in the MTFF) represent the synthesis of the upstream budget preparation work
C. Fiscal Risks	
Assessment of macroeconomic risks	Need to include discussion of the sensitivity of fiscal forecasts to major macroeconomic assumptions. Derive from the MEFP and the risk statement prepared by the MoEDT
Assessment of specific risks, including attendant claims on the contingency fund; asset and liability management; state guarantees; and PPPs	MoF and MoEDT. Done only partially. Need to be extended to other specific fiscal risks
Assessment of political and security risks	Derive from the risk statement prepared by the MoEDT
Assessment of risks associated with public enterprises	As a minimum, all transfers between the government and public corporations should be disclosed. This would also involve brief account of the results of the work of the State Property Fund and sectoral ministries
Assessment of fiscal risks associated with local governments	Information on the financial condition and performance of local governments, including of communal enterprises. May require input from MoRD, the Association of Ukrainian Cities, and selected municipalities (e.g., Kiev municipality)
Fiscal risks related to pensions or other demographic factors	This would require input from the Pension Fund

Implementation strategy

29. **The introduction of an MTBF has three main objectives: strengthening a sustainable macro-fiscal development, promoting more effective allocation of resources, and encouraging more efficient use of resources.** *First*, as discussed in the previous subsection, strengthening the sustainability of public finance on a macro level can be achieved with an MTFF. To this end, the MTFF is the foundation for the development of a full-fledged MTBF. *Second*, an MTBF supports the more effective allocation of resources with a more comprehensive budget process. The medium-term perspective of budget allocations would help identify fiscal problems

the KSUs face at an early stage and set policy earlier than it can be done in the context of the standard annual budget process. *Third*, a well-functioning MTBF can promote more effective use of resources by creating more stable and predictable conditions under which KSUs can plan their expenditures. An MTBF with sectoral ceilings offers greater predictability to KSUs as to the extent of resources available to them, thereby supporting multiyear planning.

30. **Under the circumstances, it is clear that all the main objectives of the MTBF cannot be achieved at once.** Therefore, a phased approach to the introduction of the MTBF should be adopted. In the short term, including in the context of the 2015 budget, the focus should be predominantly on the first objective: strengthening the sustainability of public finance on a macro level, while the ongoing work on developing a performance management framework under the PPB reform to support achieving the other two objectives may need to be phased in. Certain design features of an MTBF, such as special treatment of expenditure items, budget margins, carryover rules, and mechanisms for accountability, will need further technical discussions and regulatory support, and may also need a bit more time to be introduced (see 2011/2012 FAD reports and Table 5).

31. **The preparation of an MTFF as a key element of a broader Fiscal Strategy Document would be an appropriate starting point.** At the same time, the need of short-term expenditure rationalization requires the release of binding ceilings for 2015, and indicative ceilings for 2016 and 2017 to ensure that the expenditure measures are effectively enforced. The following implementation strategy should be considered:

- Adopt in the context of the preparation of the 2015 budget an MTFF and expenditure ceilings for 2015-17, as an initial step and foundation of the MTBF. The MTFF should be based on the fiscal objectives defined in the MEFP;
- Update the MTFF in early 2015 in the context of the preparation of the Fiscal Strategy Document, and release expenditure ceilings for line ministries to guide their budget submissions for 2016-18;
- Integrate the development of the MTBF in the budget calendar starting with the preparation of the 2017 budget; and
- Develop the design features of the MTBF, as recommended in the 2011 and 2012 FAD reports and further discussed in this section, in order to introduce a full-fledged MTBF with the 2018 budget.

Table 5. Ukraine: Design Features of an MTBF

Design Feature	Recommended Treatment
Budget Preparation	
Aggregate expenditure ceiling	Implement an aggregate ceiling for 3 years and make them binding when the fiscal position stabilizes
Expenditure ceilings by KSUs	Implement comprehensive ceilings covering all primary expenditures which are binding for the first year and indicative for the outer two years
Special treatment of expenditure items mitigating uncertainty	Limited budget items for special treatment should be identified and allocation mechanism defined
Budget Process	
Incorporate a strategic budget phase	Start the budget calendar with the issuance of a Fiscal Strategy Document and KSU expenditure ceilings in April
Macroeconomic framework	Integrate it with the preparation of the Fiscal Strategy Document
Budget Execution	
Tight and regular controls	Focus on ceilings and shift away from line-items
Regular updates of medium-term expenditure projections	Mid-year update or two times a year
Budget margin	Analyze circumstances during the initial phase based on which rules for size, level of budget, and use of the margin should be established
Carryover rules	Analyze carefully concerning adverse effects
Multiyear expenditure commitments	Establish commitment registration system for non-capital expenditure
Reporting and Accountability	
Reporting on the achievement of the ceilings in budget execution	Prepare an annual report on ceilings displaying any deviations between multiyear plans and expenditure outcomes
Mechanisms for accountability	Analyze experience in the initial phase and decide on appropriate mechanisms

32. **The introduction of the MTBF will have a significant impact on the overall PFM reform agenda.** Table 5 summarizes key design features of an MTBF and recommendations for their possible treatment made in the FAD 2011/2012 and this report. The introduction of the MTBF, therefore, should be closely coordinated with other relevant PFM reforms, including in the areas of budget execution, accounting and reporting.

33. **Finally, the MTBF process will need to be further institutionalized.** This would require changes to the BCU in order to provide a legal backing for the MTBF reform. A number of

specific required changes with focus on the Fiscal Strategy Document and expenditure ceilings are listed in Table 2. The introduction of an MTBF may also require further strengthening the macro-fiscal forecasting capacity of the MoF.

Recommendation

Medium term (6 months to 2 years)

Recommendation 2.5: Revise the Budget Code to provide a legal backing for the MTBF reform.

III. DEVELOPING A CASH MANAGEMENT STRATEGY

A. Overview and Context

34. **The commonly observed objective of government cash management is that cash should be available at the right time to meet the government's obligations as they fall due, but this is proving difficult to achieve in the current environment.** Access to capital markets is limited and the continuing disturbances in the East make it difficult to predict the timing and scale of revenues and expenditures in the short to medium term.

35. **While acknowledging these constraints, steps can be taken that would serve to improve the predictability and availability of cash to support the government's ongoing operations.** There are a number of areas where the cash management system can be further strengthened to achieve better outcomes. These include strengthening government banking arrangements, albeit from a strong base, improving cash planning, which is currently quite weak, and integrating cash and debt management operations to maximize efficiency of management of the government's financial resources.

B. Government Banking Arrangements

36. **The government's banking arrangements largely line up with good international practice but some changes to the structure of government accounts would improve the efficiency of cash management operations.** The Treasury Single Account (TSA) structure in the NBU is comprehensive covering all of general government and the social funds and is tightly controlled by the State Treasury of Ukraine (STU) in accordance with the provisions of the BCU.¹¹

37. **The sweeping arrangements for TSA balances work well, although it is unclear as to the purpose of one NBU account in the STU's chart of accounts.** This seems to indicate that

¹¹ Article 43 of the 2010 Budget Code.

the STU has accounts outside the TSA in the NBU.¹² However, the vast majority of sub-accounts of general government budget entities established in the TSA are swept into a consolidated account so that they can be used in managing the overall liquidity of the general government. However, these sweeping arrangements are not carried out for all entities.

Management of social and pension fund balances

38. **Some earmarking of balances held on sub-accounts in the TSA is currently practiced.** These mainly relate to the unified social fund balances. These funds are not swept into the consolidated TSA although they contain substantial balances that could be used for government liquidity management purposes (as at June 1, 2014 the balances was UAH 6.6 billion or US\$ 553 million) provided there are strict rules on reallocation to the social funds as and when they are needed (this will also require strong cash flow planning to ensure funds are available in the consolidated TSA).

39. **The mission is led to understand that the government is not legally entitled to borrow these funds for liquidity management purposes and therefore their balances tend to lie idle unremunerated in the TSA.** It is also possible that some of central government commercial bank deposits identified in the monetary survey (see paragraph 39) may be the result of the social funds seeking to earn a return on their cash balances.¹³ If this is the case, one option could be to enter into contracts with the social and pension funds that allow for their surplus funds to be lent to the STU for cash management purposes in return for an agreed rate of interest. Obviously, formal rules would need to be developed requiring the STU to return the funds as required by the social funds to meet their obligations. This will also require detailed cash plans (see cash planning section below) to be prepared by the social funds identifying when their contributions and obligations will be collected/dispensed so that the treasury can ensure resources are available to repay the social funds.

Commercial bank accounts of central government entities

40. **There is evidence in the monetary survey that some central government deposits are leaking into the commercial banks, despite assurance that this is not the case.** While the amounts are not very large, relatively speaking, averaging around UAH 4 billion (US\$341

¹² Account 1122- Titled "Other STU accounts with NBU" contained balances of just under UAH 16 billion (US\$ 1.3 billion) as at June 10, 2014. The mission was unable to determine the purpose of this account. It may relate to foreign exchange accounts described below, but the balance does not fully correspond with data received from the Treasury on foreign exchange balances on the same date.

¹³ Despite repeated requests, the mission was unable to confirm whether the social funds or the pension fund had accounts in the commercial banks. As the pension fund is borrows money regularly from the STU to finance its ongoing obligations, it is unlikely that significant balances are held on account at present but this may change as measures to reform the pension system to make it fiscally sustainable kick in.

million)¹⁴ between June 2013-May 2014 (see Table 1), it does indicate that there may not be full transparency of the accounts under the control of government agencies in the commercial banks. The STU indicated that these amounts may relate to foreign exchange accounts held by spending units in the commercial banks, as the TSA is a domestic currency system and KSUs need foreign currency accounts for their spending operations. However, this does not fully explain the amounts on deposit. As at April 1, 2014, balances of foreign currency accounts in commercial banks amounted to UAH 1 billion (US 85 million)¹⁵ while balances in the commercial banks amounted to UAH 3.6 billion (US\$ 306 million) as at the end of March 2014 (Table 6).

41. **Even if foreign currency accounts make up the bulk of the funds on deposit, it is unclear why KSUs should need foreign currency accounts in the commercial banks.** It should be possible for the STU to purchase foreign currency on behalf of KSUs where needed and deduct the equivalent amount in UAH from their accounts in the TSA. This would be far more efficient and negate the need for these accounts however small they appear at present.

Table 6. Ukraine: General Government Deposits in Commercial Banks, June 13–May 14, 2014

	June	July	August	September	October	November	December	January	February	March	April	May
Central Government	4,420	4,878	4,413	4,504	5,058	4,552	2,761	2,843	3,505	3,560	3,645	3,248
Local Government	1,064	1,034	1,001	1,061	1,147	1,064	189	195	157	169	145	199
Total	5,484	5,912	5,414	5,565	6,206	5,615	2,950	3,038	3,661	3,729	3,790	3,447

Source: NBU Monetary Statistics

42. **However, it also appears that the STU may also have some cash in the commercial accounts.** The chart of accounts in the STU would also indicate that as at June 10, 2014 account number 1222 contained balances of UAH 1.4 billion (US\$ 123 million) in cash accounts in the commercial banks, while account number 1224 also appears to have balances of UAH 527 billion (US\$62) million in the commercial banks.¹⁶ To ensure that all budgetary funds are available for liquidity management purposes, the STU should conduct a review of its accounts with a view to consolidating remaining government accounts in the TSA.

¹⁴ Source NBU Monetary Statistics -

http://www.bank.gov.ua/control/en/publish/category;jsessionid=1AE064CAB4A3FBB3A0A1256E5F524213?cat_id=8782107

¹⁵ Source: State Treasury.

¹⁶ A/C 1222 is described as Treasury of Ukraine other account in Banks, while account 1224 is described as accounts of institutions and organizations that are financed from the state budget in the banks. STU number 326 as of August 11, 2008.

Foreign currency accounts in the NBU

43. **The current practice of “ring-fencing” foreign currency denominated deposits in the NBU should be reviewed to improve daily liquidity management needs.** Large foreign currency denominated cash balances being held on deposit in the NBU, are earmarked to pay off foreign currency obligations and in particular foreign currency denominated debt repayments. While understanding that there is a reluctance to convert foreign exchange balances to UAH when there are large foreign currency obligations on the horizon (as at end June 2014 foreign currency deposits were sufficient to finance two month’s worth of foreign currency debt redemptions), it would appear to make little sense for these funds to be lying idle (earning no interest in the NBU) while cash rationing takes place during budget execution. It would be more sensible to sell the foreign exchange to the NBU who could include them as part of their reserves and use at least a part to contribute to government liquidity management. These foreign currency balances would provide a substantial boost to resources available for liquidity management purposes.

44. **Any move to convert foreign exchange balances would need to be accompanied by significant strengthening of existing cash forecasting capacity.** Accurate cash planning would be needed to ensure that sufficient resources would be available in UAH to repurchase the foreign exchange when required to meet upcoming foreign currency denominated debt redemptions and the foreign currency obligations (see Section C). It will also require close communication with NBU to ensure that they are aware of all upcoming requests for purchase of foreign currency to finance these obligations.

Local Government accounts in the TSA

45. **The shortage of liquidity in the TSA is causing difficulties for Local Governments (LG), as their accounts are, for the most part maintained in the TSA.** In addition to budget transfers from central government, LG’s are also required to deposit their own revenues (OR) in accounts in the TSA. These funds are being used by the ST to finance ongoing liquidity needs in the consolidated account which conceptually is not problematic provided the funds are made available to the LGs when they need to meet their own obligations. However, the STU is frequently, especially in the current environment, unable to reimburse the LGs when they seek to use the funds to pay their obligations financed from their own revenues.

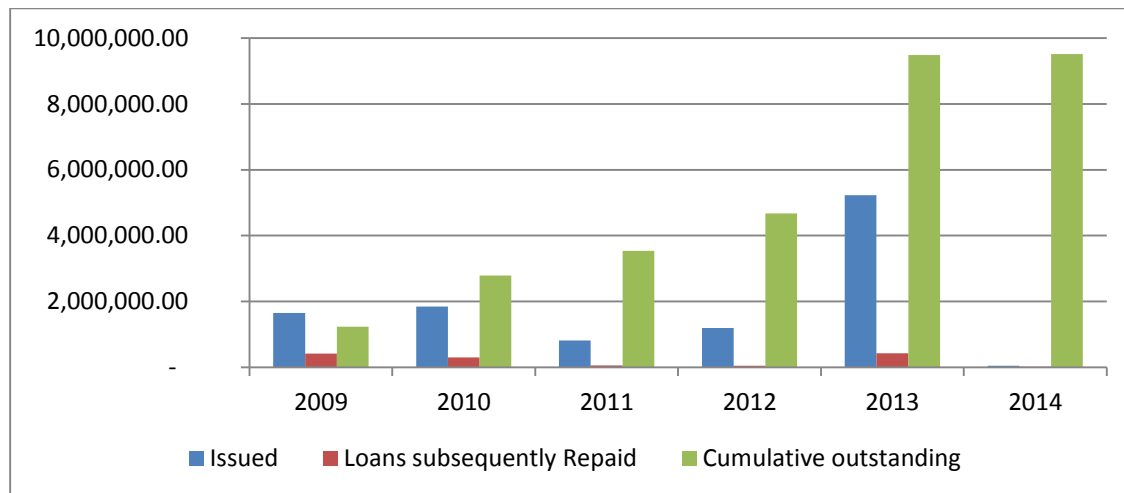
46. **The lack of availability of LGs OR impacts in two ways:** (i) it limits their incentives of LGs to collect OR; and (ii) reduces their ability to plan and execute their budgets based on their own forecasts also contributing to arrears accumulation. The requirement for the STU to pay protected expenditures is the main cause of this problem, as the lack of realism witnessed in the budget planning stage squeezes out any non-priority expenditures including those financed by OR of the LGs. Better cash planning and commitment control (see Section C) could also help to

alleviate this problem and ensure that resources are available to meet obligations of all levels of government, when they are needed.

47. **LGs have in the past been offered access to short and medium-term loans from the STU to cover any shortfalls in their budgets.** These loans have traditionally been offered to offset shortfalls caused by lack of realism in budgets and the problem of underfunded responsibilities devolved to LG and financed by central government transfers. There are two types of such loans: short-term loans that must be repaid within the fiscal year; and medium-term loans that may be outstanding past the end of the year. In the case of short-term loans the ST can and does deduct outstanding balances from their share of revenue to ensure they are repaid, but MT loans have largely tended to accumulate especially over the last few years (see Figure 2) to a situation where there are currently approximately UAH 9.5 billion (US\$ 810 million or 0.6 Percent of GDP) outstanding as at mid-2014.

48. **The loans are frequently granted to compensate for underfunding of legally mandated devolved competencies reliant on central government transfers.** The increasing balance is symptomatic of the level of central government underfunding of LG activities.

Figure 2. Ukraine: Medium-term Loans Outstanding from Short-term to Local Governments 2009–June 2014 (UAH '000s)



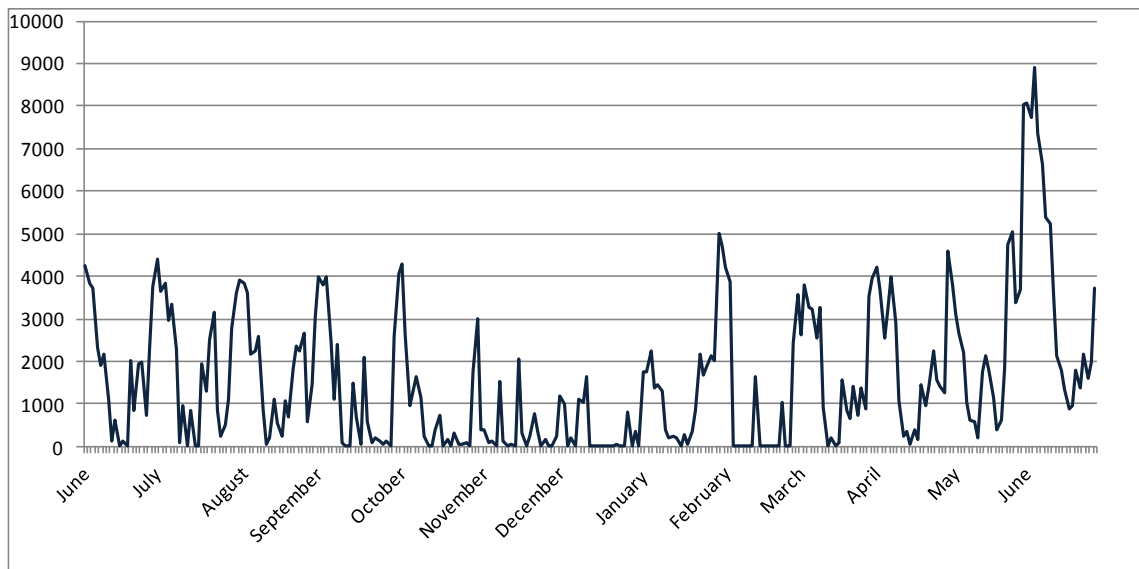
49. **It is significant that the level of issuance and repayment has dropped significantly in 2014 following rapid accumulation in 2013.** This is probably due to the lack of resources available to the STU to grant such loans, given the current liquidity constraints and the inability of the LGs to repay the loans, but it does not mean that the underfunding problem has been solved. This situation is likely to lead to a rapid accumulation of arrears if LGs cannot access funding and unless the grants to LGs are urgently reviewed to ensure that funding is commensurate with the expected level of service delivery in areas of responsibility devolved to LGs.

Reducing volatility in government balances

50. **Government cash balances on the TSA are volatile.** Balances frequently approach or reach zero in the middle of the month when many expenditures fall due. Revenues on the other hand are largely received at the end of the month (see Figure 3). This mismatch in the timing of receipts and payments could, over time, be reduced by seeking to better align revenue and expenditure patterns by ensuring that large ticket items (such as wage payments) are aligned with large revenue receipts.

51. **Aligning expenditure and revenue items will take time.** This cannot happen overnight but should be considered as part of a medium-term strategy to reduce the level of volatility on the TSA. This would also help the NBU in managing liquidity in the system as the smaller the volatility of government balances on the TSA the less intervention the NBU has to make in the markets to sterilize government activity in the market.

Figure 3. Ukraine: Daily Consolidated TSA Balance, June 2013—June 2014 (UAH million)



Recommendations

Short term (1-6 months)

Recommendation 3.1: The STU should survey all central government agencies to determine whether they have commercial bank accounts and act to rationalize them if it is found that they exist to manage own source revenues or other funds. The STU should also review its own accounts to determine whether they are required.

Recommendation 3.2: Eliminate foreign currency accounts of spending units in the commercial banks. The STU should be tasked with purchasing foreign currency on behalf of spending units to

finance any foreign currency obligations that they may have and credit the UAH equivalent against their UAH accounts in the TSA.

Medium term (6 months to 2 years)

Recommendation 3.3: Once cash planning capacity has been strengthened the STU should put in place formal arrangements to borrow the balances of the Social Security Funds in the TSA for liquidity management purposes. This would require formal agreements for making funds available as required by the social funds and the development of detailed cash plans both for the state budget and the social funds.

Recommendation 3.4: The MoF and STU should review the practice of maintaining large balances in foreign currency accounts in the NBU to finance future debt redemptions. Foreign exchange receipts, including drawdowns of debt, should be automatically converted to UAH and placed on the TSA to be used for cash management purposes. This policy should only be enacted once adequate cash forecasting capacity has been developed and in conjunction with a formalized process to inform the NBU of upcoming foreign exchange purchase requirements of the government so that the NBU can be in a position to provide the foreign exchange when required.

Recommendation 3.5: The MoF should identify the extent to which lack of liquidity in the STU and subsequent inability to provide loans to LGs will impact on LGs ability provide legally mandated services. Prevention of a rapid accumulation of arrears will require a review of services provided by LGs funded by transfers from central government to ensure the level of services match the available resource envelopes (i.e., available transfers).

C. Cash Planning

52. **Cash forecasting in Ukraine is relatively unsophisticated and focuses on very short-term immediate cash needs.** At present, the STU produces a weekly forecast of cash balances for the following month. This is used by the State Budget Department and the Debt and International Financial Policy Department in planning budget execution and debt issuance strategies. Monthly financial plans of line ministries are also produced at the beginning of the budget year once the budget is approved but they are not updated over the course of the year. There is no unit responsible for the production and updating of longer-term forecasts.

53. **Building reliable cash flow forecasts is a prerequisite for any successful cash management strategy.** The forecast period should extend for at least six months, although should ideally be at least twelve months (some governments, e.g., France, project daily flows for the period of one year ahead). This relates to the time period within which offsetting action may usefully be taken to provide financing for periods where shortages of cash are experienced. This can take the form of adjustment to a bond issuance program or by the issue of T-bills for short-

term liquidity management purposes. The design of an effective forecasting and monitoring capability should be built around the following elements:

- A database of actual daily cash flows, as a means of identifying patterns for monitoring. Actual cash flows should be closely tracked against departments' profiles and major divergences investigated, as part of improving the forecasting processes.
- Information flow to the cash managers from revenue and spending units. The preparation of short-term cash flow forecasts cannot effectively be done only at the centre, i.e., ignoring the knowledge of those budget agencies that are closer to the interface between government and other sectors. Budget agencies are also best placed to supply information when actual flows are diverging from the budget.
- A network of contacts, voice and electronic, with the main spending and revenue departments, to be used both to develop forecasts and monitor current flows.

54. **In an ideal world, efficient cash management systems enable daily forecasts of cash flows across the TSA, together with the monitoring of actual changes close to real time.**

There is no simple technical short cut that facilitates this. In general, it has been found that econometric techniques are not useful for daily or monthly projections—their main role is to help forecast annual or quarterly aggregates, which are used to act as a constraint or quota.

Daily/monthly cash flow forecasts are built up from a mixture of knowledge about specific flows, historical experience of patterns, information feeding in from spending and revenue agencies, and judgments about the impact of any recent changes in policy or application of administrative rules. There is often a difference between the compilation of "above the line" (i.e., revenue and expenditure) forecasts, which may fall to those monitoring budget execution or receipts, and those "below the line" (debt and other financial transactions), where the cash and debt managers take responsibility.

55. **Typically, country experience dictates starting with rough monthly projections and gradually building up these rough projections towards weekly and finally daily forecasts.**

This type of process does not need sophisticated modeling techniques. The patterns in cash flows can be examined, e.g., by plotting individual time series on a year-over-year basis to reveal annual seasonality. Many government expenditure and receipt data, and movements of cash balances, may exhibit strong and predictable seasonal variations. Equally important is to:

- Identify the key people at the working level in the selected revenue and spending departments, who will be able to supply the relevant information.
- Set up formal requirements to ensure that profiles are supplied and updated.
- Back the latter by informal arrangements, whereby the cash managers are given early notice of any major changes. These changes need to be communicated not only in

advance of the day being studied but also on the day itself, to ensure that any offsetting action can be taken, whether by the cash managers or the NBU.

56. **The focus should be on those sums that are large in size, most variable and most unpredictable.** In the U.K., for example, more detailed information is collected from just 15 departments who together account for over 80 percent of government spending.

57. **In addition to supplying training to agencies to produce accurate and updated forecasts, the MoF should build capacity to construct and analyze cash flow plans.** Whilst technical assistance can help to set up the modeling and provide initial training within the MoF, STU, and the spending and revenue agencies, ongoing efforts to analyze the forecasts and improve accuracy require continuous effort and coordination across government. A cash management team of at least six full-time staff would be needed to ensure that cash planning and active cash management could be performed effectively.

58. **The location of a cash management unit needs careful consideration.** At present, as indicated above, the STU produces very short term cash forecasts and in theory could be mandated to produce longer-dated forecasts over a six-month to one year period that can be used by all of the key stakeholders including the Budget Department and importantly, the Debt and International Financial Policy Department (see next section) to inform both funding and budget execution planning decisions throughout the fiscal year. However, the STU may not have the information networks needed to receive detailed data from line ministries and revenue collection agencies on the evolution of their cash receipts and expenditures over the course of the year. Therefore, it may make some sense to establish a cash planning unit in the MoF where such information can be requested and a cash planning network more easily be developed. The decision as to the appropriate organization should be dependent on the capacity of the agency to develop such a network.

Recommendations

Short term (1-6 months)

Recommendation 3.6: Establish a cash planning unit in the MoF or the STU to produce detailed cash plans to be used by key stakeholders including the STU, Budget Department, and the Debt and International Financial Policy Department.

Medium term (6 months to 2 years)

Recommendation 3.7: Reduce volatility of TSA balances through alignment of dates for major receipts and expenditures.

D. Integration with Debt Management

59. **Debt management operations are currently not coordinated with cash needs.**

The borrowing plan for the year, which understandably is updated regularly in the current environment, focuses on the redemption schedule of existing debt rather than on the funding needs of the government. This is not unusual. Government cash management and debt management objectives often appear to conflict. Cash managers seek to ensure that funds are available to finance day to day operations at the lowest possible cost to government, while debt managers are concerned that government borrowing plans be orderly and that they fulfill their annual borrowing plan as mandated by government. However, in periods of liquidity shortage (and generally), it is important that debt issuance is coordinated with the cash needs of the government.

60. **In many countries debt instruments with short maturities such as short-term T-bills are usually connected with cash management operations while those with longer maturities are reserved for debt management operations.**

The existing T-bill issuance program is not fully coordinated with the cash flow profile of government operations. This is largely due to the absence of accurate cash plans far enough into the future that will allow the debt managers to identify design an issuance program for short-term debt that will match the profile of government cash needs.

61. **Management of government resources is currently fragmented with the MoF and the ST, both having different and possibly conflicting objectives as debt manager and cash manager respectively.**

Many advanced countries have a single integrated manager of government financial resources to manage borrowing and short-term investment needs of the government. In many advanced countries, this task has been given to the debt manager (e.g., France, Ireland, UK, Sweden). Integrating cash and debt management operations increases the likelihood that issuance and investment strategies are consistent.

62. **A resolution issued by the CoM permits the STU to purchase T-bills to invest idle government balances but this is not optimal in managing the government's financial resources.**¹⁷

It does not make sense that one arm of the government issues T-bills and another purchases them as an investment instrument, given the transaction costs involved.

63. **A more rational approach would be to give responsibility for managing the balance on the TSA account to a single manager, in this case the debt manager.**

The debt manager could then be made responsible for ensuring that T-Bill issuance plans reflect the cash needs of the government and that they are adjusted to optimize the level of cash balances on the TSA. This would obviate the need for the cash manger to consider purchasing government securities

¹⁷ COM Resolution 65 of 2011, Article 12 of the 2010 Budget code also provides for surplus balances to be invested in government securities.

to invest surplus balances. The debt manager would be made responsible for ensuring that a minimal balance is maintained at all times on the account allowing the STU to carry out its payment and allocation function.

64. **While the idea of an active cash manager may seem slightly irrelevant in a period where ongoing cash rationing is present, there are benefits to adopting this policy sooner rather than later.** In addition to tasking the debt manager with ensuring that the T-bill issuance strategy is consistent with cash needs, it will also incentivize the manager to seek better and longer dated information on the cash position. It will, however, need a commitment to improve the quality and horizon of existing cash forecasts and access to the STU system to monitor the level of cash balances on the system on a daily basis.

Recommendations

Medium term (6 months to 2 years)

Recommendation 3.8: Integrate cash and debt management by making the Debt and International Financial Policy Department responsible for managing balances on the TSA.

IV. BUDGET EXECUTION AND INTERNAL CONTROL

A. Budget Execution

Current situation

65. **The State Treasury of Ukraine (STU) is responsible for overseeing budget execution.** STU is an independent body but operates within the administration of the MoF. The STU performs budget execution transaction services on behalf of budget spending units. It undertakes budget execution control during these transactions and produces reports on budget execution. STU has a head office in Kiev, 27 main departments in each of the 24 regions (plus Kyiv, Sevastopol, and Crimea), and 633 local administrative centers with 16,000 staff in total.

66. **The STU's bespoke information technology system called E-KAZNA supports its operations.** This system was developed with assistance from the World Bank and implemented with assistance of the IMF. In the past there were separate systems for revenue and expenditure but these have recently been combined into a "unified" system. The software is operated on a de-concentrated basis by STU offices at all three levels, with data transferred between the databases of the district and the regional offices and between regional offices and the central database in the STU head office. Major revenue and spending agencies each have their own separate accounting software to support their operations. These systems are not directly connected to the E-KAZNA system. In the past this has required that all transactions be initiated and recorded at a STU site but manual systems of data interchange between STU and its clients have begun to be introduced.

67. **STU has a direct connection to the payments system managed by the NBU.** Access to the interbank clearing system has enabled the STU to undertake electronic transactions for both revenue collection and processing of payments. As a result, almost all revenues are collected via transfer of funds from commercial banks—acting as collection agents—and almost all payments are made by electronic funds transfer (96 percent).

68. **The Budget is classified according to administrative unit, program, and economic classification.** A functional classification is used in budget preparation and reporting but is not used for budget execution control. The economic classification specified is quite detailed, equivalent to a 4-digit GFS economic classification (but not fully compliant with GFSM 2001). As an example, the approved budget for a program within a spending unit has an economic line item for “purchase of electricity,” which is a sub-set of “utilities,” which as sub-set of “goods and services.” Budget execution is controlled at this level of detail, where agencies cannot spend more, for example, on purchase of electricity than specified in their allocated budget.

69. **Virement controls limit the movement in the structure of the approved budget.** Agencies may request approval for transferring the approved budget between economic categories of expenditure and between programs. The MoF must approve any transfer between the recurrent (operating) economic categories of expenditure and the CoM, and the Budget Committee of the Rada must approve proposed transfer of appropriation between programs and/or movement between development and operating classifications within a program. Adjustments of the budget between spending units requires changes to the annual budget law as these represent changes to the appropriations. The Budget Department is responsible for administering virement and informs STU of approved adjustments.

70. **Once the budget is approved, the approved budget is allocated according to a monthly breakdown of planned budget execution.** In accordance with Article 23 of the BCU, at the start of the year, agencies provide a proposal for the timing of their expenditures based on the expected timing of their expenditure obligations (known as a “Rozpys”). For agencies participating in program budgeting, these plans must be consistent with the approved program “passport” that elaborates a range of details regarding the purpose of the program as well detailed expenditure plans. On a monthly basis, the STU releases budget allotments to enable expenditures according to these Rozpys plans. Where agencies have administrative sub-units (such as Oblasts), these entities provide STU with a proposed allotment of their released budget amount between their sub-units.

71. **There are “protected” items identified in the budget that receive special treatment in the process of budget release.** Protected categories, specified in Article 55 of the BCU include salaries, payroll, utilities, debt servicing, transfers to households, transfers to local government, purchase of medicines, and tertiary education. Protected items are released by the STU on a monthly basis according to the Rozpys. The release of unprotected items are not automatically released according to the Rozpys but rather the release of allotment for these

items is more closely subjected to the short term availability of liquidity in the TSA. Allocation for unprotected items is released on weekly basis.

72. **There is a distinction in the budget between the General Fund and Special Funds and this distinction impacts on budget execution.** The General fund budget consists of all revenues used to fund budgeted expenditures of general government agencies that have not been earmarked to a special fund budget line. Special funds include revenues that are earmarked for a specific purpose, including some own-source revenues, donor funded activities and certain borrowings. For these special funds, there is a direct link between the value of revenue and the value of expenditure—where expenditure generally cannot exceed the revenue and expenditure is directed to a specific activity. The allotment of the approved budget for Special Funds thus depends on the actual timing of the revenue received.

73. **A form of budget obligation control exists, where agencies are required to record in the STU system the value of the invoices they have received in executing the budget.** Procedures exist for electronic transmission of data regarding these obligations from spending agencies to the STU. The STU performs budget control on these obligations and will not record any commitment in excess of the allocated budget.

74. **Expenditures are initiated by the STU and controlled against the approved budget.** Spending units initiate expenditures by taking the required paperwork to a Treasury office. The Treasury office checks the validity of the documents, ensure the relevant authority has approved them, confirm that the expense is properly classified, and the amount of proposed expenditure is within the approved budget. Where an obligation is recorded in the Treasury system, the expense is controlled and recorded against the relevant commitment.

Issues to be addressed

75. **The manner in which financing is controlled against the budget is a key weakness of the current budget execution process.** CoM Resolution 404 appears to explicitly allow borrowing by agencies to fund capital expenditure in excess of budget appropriations. In addition, the practice of Treasury lending to sub-national governments involves release of cash from the central budget to the local budget in the absence of an appropriation. In simple terms, all cash flows out of the funds of the National Government should be covered by an appropriation and the fact that there is a TSA does not obviate this requirement. These practices, of releasing cash in the absence of an appropriation, breach fundamental principles of sound public financial management i.e., that funds should only be spent if approved in the budget. This principle is also embedded in the Constitution of Ukraine.

76. **Weaknesses in the operation of the STU are highlighted by payment arrears accruing during the current period of unplanned fiscal imbalance.** In response to low balances in the TSA, the STU is not paying all of the invoices presented by spending agencies for payment. As at June 2014, arrears totaled 4.18Bn UAH (0.3 percent of GDP). These arrears

represent the value of invoices recorded in the STU system as obligation but have not been paid. The composition of the arrears is set out in Table 7. This amount includes only arrears in the unprotected expenditure and thus potentially underestimates the true value of arrears as anecdotal evidence suggests the possibility that there are unpaid invoices for protected items that are not recorded in the STU system. Total arrears, including unpaid VAT refunds, is 7.8Bn UAH.

77. **A core function of the STU is to ensure sufficient cash to pay the expenditures approved in the budget.** Over the long term, the key component of the solution to this problem is ensuring that that the expenditure side of the budget is realistic having regard to accurate revenue forecasts (see Chapter III). A further solution to the problem of payment arrears is to enhance cash management practices, the primary purpose of which is to ensure sufficient liquidity so that all payment obligations can be met (see Chapter III). Nonetheless, the current crisis also points to the need for the government to have greater capacity to manage the rate at which it is incurring expenditure obligations during the year.

Table 7. Ukraine: Accumulated Payment Arrears at June 28, 2014
(mln. UAH)

State Budget	1,715.7
General fund	378.1
Special fund	1,337.6
Local budgets	2,430.9
General fund	941.7
Special fund	1,489.2
Social Welfare Funds	34.2
Employment fund	31.7
Industrial accident and occupational disease social insurance fund	2.1
Temporary disability social insurance fund	0.4
Total Payment Arrears	4,180.8

Source: MoF

78. **The current allotment process is not effective in restraining the rate at which expenditure obligations are incurred.** During the current crisis, the government has been issuing internal directives to reduce expenditure by eliminating certain types of purchases as well as not paying the invoices received for purchase of unprotected items. However, a more robust systematic approach is required for managing budget execution to avoid incurring arrears during times of poor liquidity in the TSA.

79. **Commitment control should be introduced to support effective budget execution control and cash management operations.** A "commitment" is a decision made by a program manager to ear-mark certain budget funds for a specific purpose. For example, if a manager

issues a purchase requisition to commence the procurement of blankets for a hospital, this action represents a commitment of budget funds. Once this commitment is entered, it flags an intention that an obligation will soon exist for this specific purpose. Many modern Treasury systems support the recording of commitments at the time they are incurred. Many IFMIS systems with purchasing modules automatically record a commitment when the system-generated purchase requisition is prepared. As some payment types are regular and obligatory in nature—such as salaries paid to permanent staff—a commitment should be automatically registered when funds are allocated for this purpose.

80. **The current budget execution process includes recording of obligations but these are normally recorded after contracts are signed or goods purchased.** Therefore they come too late in the budget process to be used for controlling expenditures and preventing the incurrence of arrears resulting from insufficient appropriations to cover committed expenditures. Agencies are already required to record their accounts payable as soon as invoices are received, meaning that there is information currently available on obligations (although outside the STU system). A practical solution to introducing commitment control is to require that, instead of obligation being recorded when the legal obligation arises, that this be converted into a commitment recording process, where the spending agency records the obligation/commitment in the treasury system at the stage just prior to commencement of procurement.

81. **Commitment control improves budget execution control and helps to avoid expenditure arrears during a time of poor liquidity.**¹⁸ Having information regarding commitments assists in cash forecasting as it is a source of intelligence regarding the timing of future expenditures. Recording of commitments is also a potential budget execution control mechanism as commitments can be controlled against budget allocations. With commitments being recorded and controlled against the budget, managing the release of budget allocation will control the incurrence of liabilities. In this way, where there is a forecast cash shortfall, restricting allocations will constrain the value of the commitments agencies can enter and thus also restricts the incurring of obligations. Using such controls enables the rate of spending to be managed without incurring arrears.

82. **Irrespective of the processes put in place to prevent future arrears, a strategy may be needed to deal with the existing stock of arrears, if they cannot be repaid from existing budget appropriations for individual budget agencies.**¹⁹ The following key factors should guide an arrears clearance strategy:

¹⁸ IMF Technical Note 09/04 [Commitment Control](#) by Dimitar Radev and Pokar Khemani outlines the benefits and technical features of sound commitment control.

¹⁹ See: IMF Technical Note 14/03 *Prevention and Management of Government Expenditure Arrears* by Suzanne Flynn and Mario Pessoa.

- *Comprehensiveness.* The arrears clearance strategy should apply to all outstanding payments incurred by all parts of the public sector, whether in the central government, sub-national governments, or state-owned enterprises.
- *Transparency.* The clearance of arrears should proceed according to a public timetable, and criteria for prioritizing clearance should be transparently stated and adhered to.
- *Credibility.* To demonstrate commitment to addressing the root causes of the problem, the strategy should include measures to avoid the accumulation of new arrears, and ministries or agencies that fail to implement these measures should be penalized appropriately.
- *Realism.* The government's annual budget and medium-term fiscal projections should make adequate provision for the cash cost of arrears clearance.
- *Verification.* Arrears should be verified to ensure that only valid claims are cleared.

83. **The distinction between protected and unprotected items is not appropriate in the medium term.** Once fiscal stability is restored, advanced cash management tools are implemented, and commitment controls introduced, it should be possible to avoid cash rationing. The current process of deliberately holding back payment of "unprotected" items undermines the whole system of public finance as it impacts on the revenues of private sector suppliers, inflates the costs of government purchasing, and is encouraging local government and semi-autonomous agencies (such as universities) to seek approval to establish their own STU operations. As soon as possible, the Government should formally eliminate the distinction between protected and unprotected items and commit to executing payment for all items included in the budget in a timely manner.

84. **Seeking to control expenditure at a highly detailed level (by program and detailed economic classification) creates severe rigidity in budget execution.** In budget planning, it cannot be expected that any agency can predict with precise detail the exact amounts that will be spent on individual economic line items. It is inevitable that the context in which the budget is executed will change, often due to external factors, and managers must have flexibility to respond. Evidence provided by spending units is that the lack of flexibility in the budget execution regime in Ukraine prevents managers from responding to opportunities and threats in managing service delivery programs and contributes to the incurring of payment arrears.

85. **Most developed countries, including within the region, have moved towards budget execution regimes that provide greater flexibility in budget execution.** There are two ways in which this can be done. One way is to give spending agencies flexibility to transfer their budget between economic categories without needing higher-level approval. This authority is often restricted, for example by placing a limit on the size of the total value of such transfers and/or by restricting transfers in or out of some major categories (often these restrictions are on salaries).

86. **Another alternative is to record transactions at the detailed level of the CoA but roll-up the value of these to be controlled against a higher level in the CoA.** For example, rather than controlling expenditure on “purchase of gas,” all utility purchases could be automatically added together by the STU system (“rolled up”) and controlled against the total budget for “utilities.” Schedule 3 of the annual budget law includes such summary level detail for each of the general fund (as shown in Table 8) and the special fund programs. This would be an appropriate level at which to control budget execution.

87. **Future enhancement of Treasury operations is dependent on the capacities of its IT system.** As part of current Public Finance Modernization Project (PFMP), supported by the World Bank, the Government has been pursuing the purchase of an Integrated Financial Management Information System (IFMIS). This IFMIS system is intended to be a web-based solution that supports a broader range of transactions and services within the STU as well as supporting budget preparation, debt management, procurement, donor assistance management, and human resource management. However, following successive unsuccessful procurement actions and the pending completion of the PFMP, it is possible that the FMIS will not be acquired as planned. The inability to acquire a functioning IFMIS poses a substantial barrier to future reform of public financial management and is particularly damaging to the future enhancements to the efficiency of the STU.

Table 8. Ukraine: Outline of Schedule 3 of Budget Law 2013

Department/Program	General Fund				
	Total	Consumption Expenditures	Of which		Development Expenditures
			Salaries	Utilities	
	-	-	-	-	-
TOTAL	-	-	-	-	-
Ministry	-	-	-	-	-
Department	-	-	-	-	-
Program	-	-	-	-	-

88. **The government should work closely with its development partners to determine an appropriate strategy for acquiring a more advanced STU system as soon as practical.** In terms of STU operations, the objective should be to have a robust system that is available to both STU and spending units, supports online transactions through the interbank clearing system, enables automatic reconciliation of accounts, supports appropriate internal controls, has robust security and audit functions, has a general ledger that supports accounting and reporting in accordance with accounting policy and interfaces with other financial management systems. There are available off-the-shelf IFMIS packages that include these features in their core financial management modules and also have available budget preparation, procurement, debt management, payroll, and human resources modules. While expanding the functionality of the existing STU is technically feasible, acquiring an off-the-shelf IFMIS package may be less

complicated and potentially a more efficient way to quickly acquire the functionality required whilst also supporting other key PFM functions.

Recommendations

Short term (1-6 months)

Recommendation 4.1: The STU should introduce commitment controls to the budget execution framework for 2015, requiring that a commitment be recorded in the STU system at the point at which procurement commences. Use control over commitments as a last resort should cash management processes fail to provide liquidity in the TSA.

Recommendation 4.2: The MoF should consider developing an arrears clearance strategy directed at clearing all arrears in a timeframe consistent with IMF program and developed having regard to the principles outlined in IMF TNM 14/03 if existing arrears cannot be cleared utilizing existing appropriations of budget users.

Medium term (6 months to 2 years)

Recommendation 4.3: Eliminate the distinction between protected and unprotected items from the 2016 budget onwards and commit to making all payment of items included in the budget within 30 days of being due.

Recommendation 4.4: In cooperation with development partners, produce a strategy for expanding the functionality of the systems available to STU for supporting the internal control, accounting, and reporting functions of budgetary agencies and the STU.

Recommendation 4.5: Provide managers with greater flexibility in budget execution control rules by controlling the budget by program and summary level economic classification (as per Schedule 3 of the 2013 budget law).

B. Internal Control and External and Internal Audit

89. **The financial control framework in Ukraine is extensive.** The control framework comprises ex ante controls by the STU, ex ante and ex post controls by the State Financial Inspection Service (SFI), and extensive ex post control and audit of the State Budget of Ukraine by the Accounting Chamber (ACU) and Internal Auditors in Budgetary Institutions as well the internal control framework that exist in each institution.

Accounting Chamber (External Audit)

90. **The Accounting Chamber of Ukraine (ACU) is the Ukraine's external audit institution and reports directly to the Verkhovna Rada.** It is established by Section 98 of the Constitution of Ukraine to undertake "control over the receipt of finances to the State Budget of

Ukraine and their use on behalf of the Verkhovna Rada of Ukraine.” Recent constitutional amendments have clarified that the ACU has a broad role in auditing both the revenue and expenditure sides of the budget—addressing previous uncertainty about the ACUs scope to audit revenue collection.

91. **The ACU is governed by a Chamber comprising a Chairman, two deputies, a Secretary and Chief Controllers.** The members of the Chamber are elected by a majority secret vote of the Verkhovna Rada and they have a seven-year term.

92. **The ACU performs its role by undertaking ex post audit of the execution of the budget.** An audit plan is independently developed each year by the ACU. Members of the Verkhovna Rada may request a specific audit to take place (if endorsed by at least 150 members) but such requests have been rare. The ACU performs compliance audits but its broad mandate and goal of engaging “on all issues concerning effective and transparency in management of budget resources” has allowed it to undertake broader examinations of program effectiveness and efficiency. The ACU provides reports on its audit findings, including audit recommendations to the Verkhovna Rada and often directly to the COM and the President as well as issuing information bulletins for the benefit of budgetary institutions. In addition, the ACU provides an audit opinion on the Annual Report on Compliance with the Budget Law (the annual financial statements) published by the STU as well as quarterly reports on debt revenue and expenditure developments as required under Article 110 of the Budget Code and Article 27 of the Law on the Accounting Chamber. **The ACU has been seeking to improve the effectiveness of its operations.** ACU is a member of EUROSAI and INTOSAI, and with assistance of these bodies and international development partners, including the German and UK supreme audit institutions; it is working toward full implementation of INTOSAI standards.

93. **The ACU has prepared a new draft of its legislative framework.** The draft provisions seek to protect the ACU from impositions on its independence through inadequate funding. At present the ACU budget is prepared in the same manner as any other budgetary institution—through the budget process coordinated by the MoF. The ACU is seeking to avoid this budget process by presenting its budget proposal directly to the Verkhovna Rada each year. In addition, the ACU is seeking to gain a clear mandate to undertake ex ante control activities where it perceives there is risk to the budget—for example, to verify the validity of revenue administration rulings before they are issued. The ACU would also like to formalise its role in providing the Verkhovna Rada with advice on macrofiscal forecasting during the budget process. However, these proposals are expected to be quite controversial.

94. **While it is important that the ACU be free from interference through inadequate funding, completely avoiding the budget preparation process is not an ideal solution.** The problem with avoiding the early stages of the budget process is that it provides a large unknown externally determined hole in the draft budget—making it more difficult for the government to formulate aggregate fiscal strategy. It would be better to seek the required independence mandating that the ACU submit a draft budget in the usual way but have the legal right to

provide a brief to the CoM, Budget Committee, and the Verkhovna Rada to justify its budget request. This would make any changes to the budget submission made by MoF highly transparent.

95. **Any move by ACU to engage in ex ante control and policy development functions might undermine its independence.** If ACU gets engaged in advising the Verkhovna Rada on fiscal policy during the budget preparation processes, competing with MoF and Ministry of Economy and trade on issues such as economic forecasting, it loses its ability to be an independent and objective surveyor of the processes. In addition, the assessment of fiscal policy requires very different skills to those of a traditional auditor. Similarly, the ACU needs to be seen to be independent and objective in auditing the validity of administrative decisions made by government and may lose this if it starts to engage in the making of such decisions. The ACU has a key role to play in enhancing transparency and accountability and may lose this capacity if it becomes part of the government policymaking and administration apparatus.

96. **The ACU is concerned about the implications of the 2014 Supplementary Budget Law, as this is understood to place a limit on external audit activities during the remainder of this year.** The Government should not seek to limit the powers and actions of the ACU through legislative instrument, as this will inevitably raise the issue of violation of the Constitutional mandate of the ACU. It is also poor public financial management practice to allow a period where there is less accountability for effective execution of the budget. The ACU should be seen as a source of advice to the CoM on effective internal control systems and independently verifying the effective implementation of such controls.

Financial Inspection service

97. **The State Financial Inspection of Ukraine (SFI) is an executive body that undertakes ex post review and audit of budget execution.** The SFI's executive authority is directed and coordinated by the Cabinet of Ministers of Ukraine through the Minister of Finance. Key appointments to the SFI are appointed and dismissed by the CoM on the basis of proposals of the Minister of Finance. The SFI reports to the Verkhovna Rada, the CoM, and the MoF on the outcomes of their activities assessing budget units compliance with the budget law. The SFI has a central office with 390 staff and regional offices with a combined staff of over 6,000.

98. **SFI undertakes both inspection and auditing activities.** The inspection function is a process of ex post fiscal control, where the SFI checks the compliance of certain transactions after they are processed. Where non-compliance is observed, the SFI seeks to identify who was responsible for violations and imposes administrative sanctions, makes referrals to law enforcement agencies (and the prosecutor if appropriate) and directs actions to redress non-compliance. Through such action, SFI is not seeking to identify or address any systematic weaknesses in the internal control environment that contributed to the violation but rather identify and address the specific act of non-compliance. The SFI estimates that these control activities add significant value to the budget with a return to the state budget misappropriated

funds and implementation of the agreements in the amount of 370 million. UAH since the beginning of 2014.

99. **The financial auditing activities of the SFI are essentially performance-type audits.**

These audits seek to identify areas of ineffective and inefficient use of public funds in the implementation of budget programs. Unlike the inspection actions, the audit findings do not seek to apportion responsibility and the findings and recommendations are non-binding.

100. **The scope of the SFI activities has recently been expanded to include ex ante control.** Resolution 214 of the COM has provided SFI a mandate to undertake operational audits of the 36 largest SOEs. These will essentially involve SFI having a presence in these SOE and undertaking selective ex ante control over certain operations of these SOEs. The intention of this action is to avoid violations within SOEs and is particularly focused on areas, such as procurement, where previous audits have identified instances of non-compliance. A risk based approach is to be taken, with the initial intention to undertake ex-ante control over purchases of goods with a value of more than 300,000 UAH and any procurement of works with a value of more than 1 million UAH. In addition to these SOE focused actions, SFI was tasked with conducting a one-off audit of all of the payments of all budgetary institutions recorded as being in arrears in the Treasury system.

101. **Since 2005 SFI has embarked on a reform program directed at introducing an internal audit function in all budgetary institutions.** SFI has been receiving substantial assistance from international development partners in progressing these reforms. Legislation has been passed, regulations issued and substantial training delivered, and 75 ministries and central executive bodies now have IA units in place. In addition, internal audit units have been formed in all regional administrations.²⁰ The objective is to roll out the IA function, starting from the central agencies, then the oblasts and then the other local bodies.

102. **Ukraine is at an important cross road in the development of its control regime.** On the one hand, it has been progressing towards the international norms (such as the EU Public Internal Financial Control (PIFC) regime) which seek to strengthen management control and accountability within agencies. Internal audit and accrual accounting are key elements of this reform. At the same time, the recent efforts by the ACU to engage in ex ante control and the expanded scope of the SFI to undertake ex ante control runs contrary to good practice. It is understandable that increased control is sought during the current period of military conflict and

²⁰. Regulations and resolutions passed include: CoM Resolution 1001 of 28.09.2011 approving the formation of internal audit units in ministries and other central executive bodies and their territorial bodies and public institutions subordinated to the ministries and other central executive bodies. MoF Order 995 of 14.09.2012 approving guidelines on the organization of internal control; MoF order 1217 of 29.09.2011 approving the Code of Ethics of internal audit units, MoF Order 347 of 27.03.2014 approving internal audit performance reporting requirements and MoF Order 794 of 31.07.2014 approving the procedure for the State Financial Inspection of Ukraine's control of internal audit.

associated fiscal challenges. However, international experience suggests that seeking to strengthen the internal control framework within budgetary institutions— where managers are given greater flexibility but in an environment of robust transparency and accountability—is the best solution to promoting good public financial management outcomes. Ukraine has made large strides in this direction and should not lose its way by reverting to the command and control systems of the past.

103. **The key elements of a strong modern internal control regime are:**

- (i) Enhanced flexibility for managers in executing their budgets.
- (ii) A shift away from control over inputs toward attainment of outcomes. This should be reflected in both the budget process and reporting regime.
- (iii) A clear legal requirement for the senior managers in budgetary institutions to establish a sound internal control regime, including functioning internal audit, separation of duties, delegation of authorities, and risk based controls.
- (iv) Strengthened reporting regime, requiring agencies to produce a publicly released annual report with Annual Financial Statements (AFS) produced according to accounting standards as well as reporting on the outputs produced, efficiency indicators and reporting on outcomes achieved from use of public resources.
- (v) External audit of the annual reports of all agencies, including an audit opinion (according to INTOSAI standards)

104. **The transition towards more decentralized control can be managed in a structured manner.** Some countries have established a formal certification process, where greater flexibility in budget execution and freedom from ex-ante controls is given only once strong internal control regimes are in place in that agency, as proven by achieving unqualified external audit by the ACU of that agencies AFS.

Recommendations

Short term (1-6 months)

Recommendation 4.6: Do not expand the mandate of the ACU to include engagement in ex-ante controls and/or administrative decisions or policy making activities. The focus of the ACU should be on performing independent ex-post audit activities consistent with INTOSAI standards.

Medium term (6 months to 2 years)

Recommendation 4.7: Amend the Budget Code that provides a mechanism for ACU to place a submission explaining their original budget request before the CoM and the Budget Committee of the Verkhovna Rada at the time that the budget is being considered.

Recommendation 4.8: Continue the roll-out of internal audit, with the objective of having a functioning IA in all national, oblast level spending units by end of 2015 and make managers accountable for results. The staff and resources of the SFI should be shifted into budgetary institutions to support strengthening the internal control regime within these agencies.

Recommendation 4.9: Introduce a certification regime, where freedom from all ex-ante controls and greater flexibility in budget execution (more relaxed virement rules) is granted once unqualified external audit of AFS is achieved by an individual agency.

V. ACCOUNTING AND FISCAL REPORTING

A. Accounting and Financial Reporting at General Government Level

105. **The STU produces monthly and quarterly budget execution reports and an annual report on enforcement of the Budget.** These reports are each submitted to the Verkhovna Rada, the President of Ukraine, the COM, the Accounting Chamber, and the MoF and all are published on the STU website. There is no distinction between annual budget execution reporting and financial reporting as there is a single report that serves both purposes. The content of the annual budget execution reports includes:

- a report on financial position (balance sheet) of the State Budget of Ukraine;
- a statement of financial result of the State Budget execution;
- cash flow statement;
- execution of the State Budget of Ukraine;
- budget arrears;
- usage of the reserve fund;
- public debt and government guaranteed debt status;
- issuance, balances and payments relating to execution of government guarantees;
- explanation of progress in achieving the targets of the State Budget of Ukraine and local budgets for the reporting period, including indicators by the key spending units within the budget programs; and
- information on compliance with the articles of the Law on the State Budget of Ukraine.

To supplement the quarterly and annual general budget execution reports, the revenue administration agency submits to the Verkhova Rada, the COM, and the MoF a report on tax expenditures, tax write-offs, and data on revenue agreed to be deferred or paid by installment.

106. **The STU produces all budget execution reports on a timely basis in accordance with the timeframes specified in the Budget Code.** Annual reports are produced by April 1 each year, quarterly reports within 35 days of the end of the period, and monthly reports within 15

days of the end of the month. All are submitted to the Accounting Chamber with the quarterly and annual reports being subject to a published audit opinion.

107. **There is a close relationship between the accounting functions of the STU and budgetary institutions.**²¹ Treasury undertakes reporting for State and sub-national government both separately and on a consolidated basis. While the STU is responsible for preparing budget execution reports, it relies on receiving data, such as the stock of accounts payable, from the budgetary institutions to perform this task. The STU has the authority to agree to the appointment or dismissal of the Chief Accountant of each budgetary agency and issues instructions to agencies regarding accounting and reporting.

108. **The STU and individual budgetary institutions undertake accounting and reporting separately but in collaboration with each other.** This is a parallel system in the sense that individual agencies are responsible for undertaking their own accounting, on their own systems, rather than through a centralized general ledger. However, the STU performs transactions on behalf of budgetary institutions and accounts for these transactions within the Treasury system and the same classification system is used for the common elements of the chart of accounts. Due to the fact that each agency has a separate accounting system and does not have direct access to the STU system, there is much manual interchange of data to enable reconciliation and reporting.

109. **Different accounting policies are followed in the various types of government entities.** Accounting is performed on a cash basis by the STU, on a modified cash basis by budgetary institutions and on an accrual basis by the social funds and SOEs. A key difference between the accounting policy of the STU and budgetary institutions is that the STU records cash expenditures while budgetary institutions record accounts payable.

B. Transition to Accrual Accounting

110. **The government has committed to transition to accrual accounting.** With the assistance of the World Bank, 19 new public sector accounting standards have been developed and adopted based on the International Public Sector Accounting Standards (IPSAS) accrual standards.²² A COM resolution will see these accounting standards adopted from January 1, 2015, with 2015 annual financial statements produced on the basis of these accrual standards.

²¹ In accordance with the BCU, "budgetary institutions" means government bodies, local self-governments and duly established organizations of local governments fully financed from the corresponding state or local budget. Budgetary institutions are non-profitable.

²² Public Sector Accounting System Modernization Strategy for the Years 2007-2015" (Resolution by the Cabinet of Ministers of Ukraine #34 dated January 16, 2007), and the "Strategy of Applying International Financial Reporting Standards in Ukraine" (Decree by the Cabinet of Ministers of Ukraine #911-p dated October 24, 2007) were approved.

111. **Despite the requirements of the CoM resolution, it is not realistic that accrual accounting will be fully adopted during 2015.** Ukraine certainly has achieved great progress in implementing many of the requirements for transition to accrual accounting. Indeed, the current reporting regime includes some of the elements required in an accrual regime, including reporting of the stock of certain financial assets and liabilities, including arrears. However, having regard to the good practice guidance on transition to accrual accounting, remaining weakness will hinder progress toward full accrual accounting, including:

- Weaknesses in the accounting systems;
- The budget execution focus of reporting;
- Lack of capacity for accounting for the use of assets, liabilities and inventories; and
- Lack of coverage of all controlled entities in the accounts.

112. **At the time that the decision was made to transition to accrual accounting (as early as 2007), there was an expectation that a new IFMIS system would be in place to facilitate appropriated accounting reforms.** As it has transpired, this new IFMIS system is not yet procured. Despite ongoing enhancements to the current system in place in the STU, there remain significant weaknesses in its capacity to support accrual accounting. The current Treasury system is designed to track movement in cash deposit accounts and to control and control and report against cash based budget appropriations. This system does not support transactions in nonfinancial assets, nor does it record non-cash balances such as accounts payable or receivable.

113. **Currently, the STU supports reporting of some accrual data, such as accounts payable, by requiring that these be recorded in the systems maintained by budgetary institutions.** There are two key issues with this approach. The first is that there are many different accounting systems in place in key spending agencies (40 different systems were in place last time this was assessed by the STU). As the complexity of the types of information grows with the introduction of accrual accounting, and the business processes associated with accounting for these transactions are introduced, the existence of many different accounting systems will become a problem. The second issue is that, if the STU is to consolidate and report on the accrual data residing in budgetary institutions, it must have new systems for gathering and consolidating this data.

114. **There are two solutions available to address the accounting systems requirements for accrual accounting.** The first is to put in place a common accounting package in budgetary institutions and then develop a data warehouse and consolidation tool for compiling reports. The second is to introduce an IFMIS system that supports accounting and reporting requirements of the STU and the budgetary institutions using a common platform. The second approach is more desirable as it avoids the difficulties of managing data interchange and supports budget control and reporting through a common system.

115. **The move to accrual accounting will create perceptions of a disconnect between the Budget and the annual financial statements.** The budget will continue to be prepared on a cash basis. At the moment, there is a direct point of comparison between the cash-based budget and the cash-based annual financial statements (AFS). While accrual accounting standards support the production of a cash flow statement, it is the operating statement that contains the main indicators of financial performance in the accrual AFS. In countries that have introduced accrual accounting but retained a cash based budget, building an understanding among key budget stakeholders on the relevance and relationship between accrual indicators in the AFS as compared to the cash-based budget has proven a major challenge. One way to address this is to have a separate budget outcomes statement published within the AFS. Changes will need to be made to the budget code to make clear the distinction between the AFS and the budget outcomes report.

116. **Perhaps the greatest challenge for all governments in transitioning to accrual accounting is the need to account for movements in the balance of their assets and liabilities that do not result from transactions.** Accounting for movements in the value of physical assets requires maintaining a database of assets and tracking movements in the value of the stock of assets that result both from transactions (purchase and sale of assets) as well market driven changes as well as depreciation. Similarly, changes in the stock of financial liabilities can occur both due to transactions as well as market movement and exogenous changes (such as an increase in a defined-benefit pension liability when there is a change in life expectancy). Keeping track of the changes in the value of the stock of assets and liabilities requires a whole new set of business processes, data requirements, expertise and systems—many of which are not already be in place within Ukraine’s budgetary institutions.

117. **Many countries in the transition to accrual accounting sequence the introduction of accounting for assets and liabilities.** The IMF technical note on introduction of accrual accounting²³ suggest, that given the complexities involved in identification and valuation of nonfinancial assets, it may be expedient to initially focus the implementation effort on financial assets and liabilities, and continue to account for nonfinancial assets on a cash basis. Even within financial assets and liabilities, it may be possible to phase the implementation so that items such as accounts payable, accounts receivable, and debts are incorporated first, while the more complex valuation issues are addressed at a later stage.

Recommendation

Short-term (0-6 months)

Recommendation 5.1: An implementation plan should be developed by STU for achieving compliance with the accrual accounting standards to be introduced from 2015.

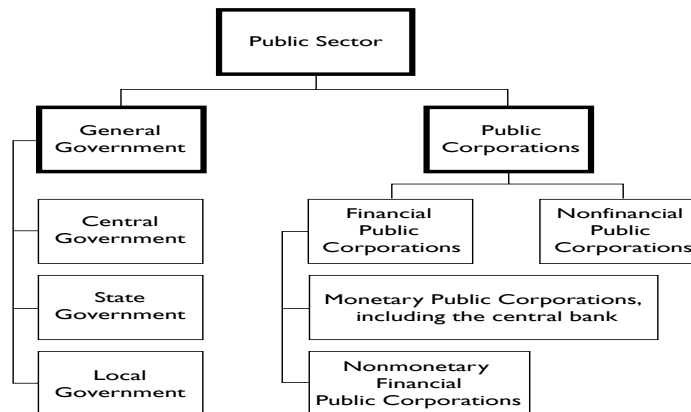
²³ IMF TNM 09/02 *Transition to Accrual Accounting* by Abdul Khan and Stephen Mayes.

C. Expanding Reporting Coverage to the Wider Public Sector

118. **The expanded coverage of accounts is one area where compliance with IPSAS is desirable but not achievable in the short term.** IPSAS requires consolidated reporting on the financials of all of the entities under the control of the government. According to the definition of control, the State-Owned Enterprises and non-budgetary operations of the social welfare funds would need to be included in the consolidated financial reports. From a fiscal management perspective, including these entities in the accounts would be highly desirable, as these entities are in practice instruments for the delivery of public policy, many are recipients of significant government support, and their funding (guarantees and subsidized market activities) are sources of significant fiscal risk.

119. **Attaining coverage of SOEs in financial statements poses significant challenges.** A financial reporting regime would need to be established where SOEs report to the STU according to an accounting policy and classification scheme consistent with that used by the national government. Achieving compliance with such a reporting regime may pose challenges for the SOEs and for the STU in enforcing compliance. This reporting regime would need to include highly accurate reporting of all flows between the SOEs and the Government, including all subsidies as well as transactions where government agencies are the counterpart. This information is required to undertake a consolidation of the account to avoid double counting of revenues and expenditures.

Figure 4. GFS Classification of Public Sector



120. **Reporting on the SOE would not require them using the treasury system or requiring that STU have access to all their transaction data.** One method for gathering data for reporting on SOEs is to require periodic provision of aggregated accounting data by SOEs to the STU based on a common chart of accounts. This chart of accounts for SOE reporting should initially be at a high level (low level of detail), to support reporting on key aggregates equivalent to the major categories as contained in the operating statement, cash flow statement and balance sheet of the national government. The STU's consolidation of whole-of-government

reporting will require that SOEs also provide the STU with precise data on the transactions of the SOE to which a budgetary agency is the counterpart. At least initially, it can be expected that some SOEs will not be able to provide this data, due to weaknesses in their systems, inconsistent accounting policies or incomplete data sets.²⁴ The STU would need to work with each SOE, and the relevant line Ministry that oversees the SOE, to develop a program of reform and capacity building to enable each SOE to provide such data. It is a reasonable objective to include data of the SOEs separately in the AFS for 2016 and on a consolidated basis from 2018.

121. Compliance with IPSAS implies exclusion of sub-national government from the accounts. According to the control criteria for coverage of IPSAS reporting, local governments would not be included with the reporting entity. This is because sub-national governments are not under the control of the national government. However sub-national government in Ukraine (as elsewhere) are at the heart of the delivery of many functions of government and their finances impact and reflect the overall fiscal policy of the nation. It is for this reason, that sub-national governments are included as part of the general government sector of GFS (see Figure 4). It is highly desirable that sub-national governments continue to be included within the coverage of consolidated AFS.

122. Given the challenges that remain in implementing accrual accounting standards, a comprehensive implementation plan should be developed (see Box 2 for an illustrative guide). By necessity this may involve a period of transition to full compliance with some of the standards. The IMF's technical note on the transition to accrual accounting contains illustrative guidance on the sequencing of accrual accounting reform, which could be a useful reference in developing such an implementation plan. As outlined above, significant progress has already been made, but significant weaknesses exist and should be addressed in a sequenced manner.

²⁴ To the extent that the international accounting standards being duly followed by SOEs are inconsistent with IPSAS, these will need to be accommodated and noted in the government's consolidated AFS.

Box 2. Illustrative Guidance on Sequencing Accrual Accounting Reforms

Stage one implementation (Years 1–3)

- General ledger—management of the government’s central financial data repository, including COA, ledger structure, and journal structure
- Purchasing—management of the full procurement cycle, including commitment management
- Payments and accounts payable—management of all supplier and grantee payments, including management of accounts payable (arrears)
- Revenue—management of all invoicing and related processes (excluding taxation revenue—this will be managed by the central tax agency)
- Receipts and accounts receivable—management of receipts and receivables functions (excluding taxation revenue—this will be managed by the central tax agency)
- Banking management—including management of banking deposits, bank transfers, bank accounts, and bank reconciliation
- Cash management—including management of cash budgeting, cash forecasting, cash accounting, and cash reporting
- Fund management—including accounting for and reporting all transactions and balances of trust accounts, extra-budgetary accounts, special accounts, hypothecated funds, etc
- Data collection and consolidation—including automated elimination of intrasector transactions and balances. Note that data collection may not be required if the accounting function is centralized
- Financial reporting—including production of full range of management reports, GAAP financial reports, *GFSM 2001* reports, SNA reports, ESA reports, etc.
- Management of estimates, projections and budgets (if the government has decided that these should be integrated with the accounting functions)

Stage two implementation (Years 3–4)

- Investment management (if applicable)
- Debt management (if applicable)

Stage three implementation (Years 3–10)

- Fixed asset management—including registration, revaluation, depreciation management, maintenance, etc.
- Inventory management (if applicable) —including recording, valuation, stocktaking etc

Source: IMF TNM 09/02 *Transition to Accrual Accounting* by Abdul Khan and Stephen Mayes.

Recommendations

Medium term (6 months to 2 years)

Recommendation 5.2: The STU should include the Public Non-Financial Corporations sector (SOEs) in the annual financial statements both as a separate sector (from 2016) and also on a consolidated basis (from 2018) onwards. A reporting format and a suitable common chart of accounts should be developed and trialed during 2015 for introduction for data gathering in 2016.

Long term (2 years plus)

Recommendation 5.3: In the long term, consolidated reporting by the STU should be done on a whole-of-government (GFS Public Sector) basis showing each of the budgetary central government, the SOE sector, the off-budgetary agencies and the sub-national governments both separately as well as on a consolidated basis. This implies continuing to report sub-national sector separately and on a consolidated basis—including after the accrual standards are adopted despite this not being required by IPSAS.

VI. MANAGEMENT AND OVERSIGHT OF STATE ASSETS

A. Background

123. **The Ukrainian government is the owner of a large portfolio of commercial assets including, public-owned entities, banks and real estate (“public assets”), as well as being the largest employer within the commercial sector.** The portfolio of public assets includes almost 20 thousand entities of which more than 5,600 are owned at the central government level and more than 13,800 at sub-national level.²⁵ Two of the largest banks in Ukraine, the State Export-Import Bank of Ukraine (Ukreximbank) and the State Oschadnyi Bank (Savings Bank), are fully state-owned.

124. **The real estate component is potentially the most valuable part of the portfolio, as well as well as the least transparent.** The government owns a significant portfolio of commercial real estate at central government level, and possibly even more at sub-national level. However, there is currently no information available as to the size and value of this portfolio. This would require a stocktaking effort using the recently installed electronic State Land Cadaster, as well as information from the State Register of Property Rights to Real Estate, held by the State Register Service of Ukraine at the Ministry of Justice.

125. **The portfolio of public assets is a source of significant value.**²⁶ In the absence of publically available information, using financial assets and non-financial assets as a proxy gives some indication of the size of the portfolio of public assets.²⁷ Together, they represent some 60 percent of GDP or USD 72 billion, of which financial assets represent some 18 percent of GDP or USD 22 billion, including shares in corporate assets and banks. Nonfinancial assets represent

²⁵ State Statistical Council.

²⁶ IMF WP/00/180: the Cost of Government and the Misuse of Public Assets, Tanzi and Prakash, 2000.

²⁷ IMF WP13/95: Another Look at Government’s Balance Sheet: The Role of Non-Financial Assets, 2013.

some 42 percent of GDP or USD 50 billion, comprising mostly structures such as roads and real estate.²⁸

126. **Public assets continue to have a negative fiscal impact.** The net cost to the state in 2013 amounted to 1.8 percent of GDP, of which contribution from state assets to the budget through dividends was around 0.2 percent of GDP while fiscal support through transfers of budgetary resources amounted to 2 percent of GDP.²⁹ In addition, the crisis has further expanded the public sector through nationalization and state recapitalization of banks, with an additional supplementary budget of 1 percent in case additional capital will be needed for the banks.³⁰ At the same time privatization receipts have stalled, representing less than 0.2 percent of GDP in 2013.³¹ Issuance of public guarantees for state enterprise debt amounted to 8.4 percent of GDP, as of May 2014, of which around 77 percent of these guarantees are foreign exchange denominated bearing significant exchange rate risk.³²

127. **Energy subsidies in Ukraine, on-and off-budget, amounted to more than 7.5 percent of GDP in 2012.** Ukraine is one of the most energy intensive countries in Europe, with use of energy per unit of GDP 10 times above the OECD average and with extremely low prices on sales of gas to households and district heating companies, which strongly contributed to large cash deficits for Naftogaz (see Box 3) and inability to pay for imported gas. By end-March 2014, Naftogaz had built up arrears of about USD2.2 billion, or 1.5 percent of GDP to Gazprom and significantly depleted its stored gas reserves.³³

²⁸ Source: IMF Government Financial Statistics 2012.

²⁹ Source: MoF.

³⁰ IMF Country Report 14/106.

³¹ Source: IMF/ State Property Fund.

³² Source: MoF.

³³ Source: IMF Country Report 14/106.

Box 3. Naftogaz – An Example

Naftogaz is a government owned, vertically integrated oil and gas company. It is the largest company in Ukraine and of utmost strategic importance to the country from an economic, political, and even security perspective. The company is charged with a wide array of conflicting objectives, functions and reporting lines. It is nominally a commercial company however, without legal title to the assets it is set to operate, which remains in the direct ownership of the State. Historically, it has appointed government officials to its board, while the management reports directly to the COM and the Ministry Energy on both regulatory and operational issues.

Naftogaz related subsidies to households through underpriced household gas and heating costs almost 5 percent of GDP per annum. The domestic business model of Naftogaz is entirely dependent on substantial government subsidies throughout its entire value chain. This system of subsidies increasingly weighs on government finances, sustains energy over-consumption, dampens investment in delivery systems, and undermines incentives for domestic production. In the presence of budgetary constraints untargeted implicit gas subsidies also divert resources away from other social and infrastructure spending.^{1/}

Naftogaz is constantly being monitored by local and international institutions including national law enforcement agencies, IFIs, and the European Commission. As an example, a state audit report in 2009 concluded that its operations were non-transparent, and that information on its financial performance and foreign trade activities was contradictory and confusing. Despite low financial sustainability and solvency depending on foreign credits, the supervising ministry, the Ministry of Energy, lacks the analytical capacity and the specific mandate to perform any real oversight and control function over the company's activities. At the same time, the internal audit committee is denied access to financial information, despite misappropriations of UAH 6 billion from the company's budget, significant growth in wage arrears and bad loans, as well as large amounts from the company's budget that are earmarked for "sponsorship and charity."^{2/}

The latest available audited financial statements of Naftogaz are from 2011.

To address the main challenges, the government has begun to establish fair tariffs and started an unbundling process, to ensure long-term sustainability and protect business value. This in accordance with the EU Third Energy Package that includes ownership unbundling, stipulating the separation of companies' generation and sale operations from their transmission networks, splitting Naftogaz into its four separate business areas, Exploration, Transportation, Storage and Wholesale Distribution.

The government is considering a partial privatization of some of the assets, transportation, and storage. However, the value and strategic importance of some of these assets are linked to geopolitical issues, such as the potential construction of a fourth pipeline connection between Russian and Western Europe - the South Stream, which could be seen as diverting gas transported through Ukraine, and thereby potentially lower the value of the assets and a potential privatization.

1/ IMF WP/12/247: Ukraine Gas Pricing Policy, 2012.

2/ Accounting Chamber of Ukraine: audit of "Naftogaz Ukrainy," 2001.

128. **Despite several government efforts to reform state ownership over the years, major challenges remain.** Significant efforts and analysis has also been made by IFIs, including the IMF,³⁴ The World Bank,³⁵ the IFC³⁶ which are basically concurrent in their conclusions about the main issues facing the management of public assets. These include the need to:

- update and modernize the legal framework;
- separate policy and commercial objectives;
- introduce clear financial objectives and a transparent reporting process; and
- consolidate ownership management within an independent vehicle.

129. **The absence of these factors undermines efficiency and service delivery, impacts on the fiscal position, and opens the door to corruption and vested interests.** This chapter does not seek to duplicate previous efforts, but rather to analyze from a financial perspective how maximize the value of the portfolio and minimize risk, as well as improve the credibility and attractiveness of the portfolio to all stakeholders, including international investors.

B. Examining the Portfolio of State Assets from a Market Perspective

130. **There is a need to clearly separate commercial objectives and non-market objectives, as well as commercial assets and non-market assets.** Commercial assets work under market conditions, with a profit and value maximization objective. Non-market assets do not and are mostly designed to carry out a publically funded policy objective.

131. **Government ownership of commercial assets brings with it a number of conflicting roles and objectives that can serve to reduce the value of the assets under its control.** The objective of the government, as owner of a commercial asset is to maximize value by constantly improving operational efficiency, optimizing the capital structure and developing the business to eliminate competition. The objective of the government as regulatory institution is that of a referee, independent from any of the participants aiming to reduce monopoly profits and inefficiency, lowering the prices for end-users, and increasing investments and productivity, by encouraging competition in the sector. These roles are inherently conflicting. This has a cost to the government and to the wider economy. To compensate for this, three components of public

³⁴ IMF Country Report No. 07/47, IMF Policy Discussion Paper, "Privatization in Ukraine: Challenges of Assessment and Coverage of Fund Conditionality." PDP/02/7.

³⁵ The World Bank: "Study on Management of State-Owned Enterprises in Ukraine", 2002; the "Analysis of Performance of State-Owned Enterprises," 2007; Ukraine System of Financial Oversight and Governance of state assets, 2011; Toolkit for Improving state assets Corporate Governance, 2010.

³⁶ IFC: Corporate governance practices in Ukraine, 2008.

ownership of commercial assets are required to actively develop the assets, while still being controlled within the government sphere:

- **Political insulation** – to ensure a level-playing field and avoid market distortions in markets where state-owned commercial assets and private sector companies compete, the legal and regulatory framework for state-owned assets should include a clear separation between the government’s ownership management function and other policy functions, in particular with regards to market regulation. To begin with a clear separation between commercial and non-market assets is required. In order to fulfill its core objective of maximizing value, commercial assets require a distinct management structure from those of non-market assets. This has led most governments in market economies to set up independent vehicles for the sole purpose of managing the ownership of its commercial assets, enabling the recruitment and concentration of relevant capacity to maximize the value of the portfolio. In financially more developed countries such as Singapore, Finland, Spain, Portugal, Abu Dhabi, and Malaysia etc., this has resulted in the establishment of a ring-fenced holding company, at arm’s-length distance from short-term political influence.
- **Clear objective** – implementing and clearly communicating value maximization, as the sole objective for the portfolio is a prerequisite to enable each individual company to be clearly focused and align the interests of the board, management, and all employees with that of the owner. A clear objective is also fundamental for transparency and oversight, as well the introduction of relevant incentives. Commercial assets charged with also carrying out a policy objective, should clearly describe, publish and quantify the cost of this policy (whether in the form of subsidies or otherwise). The company should not be part of the policy decision making process.
- **Transparency** – is the most effective tool to measure and assign responsibility and accountability for development of operational efficiency, capital structure and a competitive business model, with the objective of maximizing value. Transparency and disclosure requirements are essential components of any modern corporate governance framework and support efforts to improve the quality and effectiveness of oversight. These include the application of international standards for accounting and financial reporting, as well as being subject to an annual external audit. All of these expose performance to greater public scrutiny, which in turn provides a strong incentive to improve management, monitoring, and to execute ownership rights more effectively. The reporting requirements of a public asset should at least be equivalent to private sector requirements. Flows between government and the SoE should also be transparent, including funding for any “community service obligations.”

C. Types of Ownership Management Systems

132. **The two different systems for managing public assets are the decentralized and the consolidated model.** Efforts in recent years to improve management of public assets were largely triggered by deregulation and the effects of technological advances and an increasingly global economy. The trend is clearly moving from the decentralized model, towards a separation of ownership and regulation into a consolidated model, as recommended by the OECD Guidelines on Corporate Governance of SOEs.³⁷

The decentralized model

The unitary approach

133. **Planned and developed economies prior to liberalization practiced a decentralized structure of managing ownership rights of commercial assets, similar to that in Ukraine.** The regulatory function and the ownership management were indistinguishable, and handled within the same ministry, without any specific capacity to manage ownership issues from a financial perspective, as regulatory and ownership objectives were largely the same.

134. **Many sectors were liberalized in OECD countries due to the effects of technological development, especially in network industries and an increasingly globalized world economy.** Technological developments such as the Internet, mobile telephony and logistics swiftly made most business models obsolete, requiring greater operational efficiency and optimal capital structure. To further develop, business required substantial investment that could benefit from private sector participation. International investors and capital markets providing either debt or equity investments required a modernization of governance, transparency, and the legal framework of state assets. The risk connected with managing public assets increased, as did the need for capacity building from the government, as an owner.

135. **With liberalization came the need to separate commercial objectives from policy objectives.** Policy and commercial objectives are in direct conflict, such as when a government has to make choice between maximizing the number of employees and salary levels, or maximizing profits and the value of the company. This conflict often results in the government abdicating from its role as an owner, for tactical political reasons as well as lack of capacity, leaving the actual control of the company completely in the hands of the management or other vested interests. This opens up to opportunities for rent seeking behavior and corruption.

³⁷ OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2005.

The dual governance approach

136. **Splitting the roles and introducing a partnering ministry such as the Ministry of Finance to perform the monitoring role was a slightly modified approach that helped adopt a single objective and enabled a greater oversight and transparency.** However, the dual command structure has a built-in organizational conflict whereby the different objectives of the two organizations, while improving the internal efficiency of the government, leave a crucial gap in the management capacity towards the asset, limiting the ability to align the interest of the company with that of the owner. The model prevails in a number of OECD countries, including Greece, Italy, Mexico, and Turkey.³⁸

The consolidated model

137. **The last decade has seen more and more governments merging the exercising of ownership rights with that of financial monitoring into one single ownership management entity, as recommended by the OECD.**³⁹ Such a consolidated vehicle was either set up as a government entity or as an independent ring-fenced holding company at arm's length distance from the government—a National Wealth Fund ('NWF').

The government entity approach

138. **The consolidated model significantly improved the government's potential capacity to match the company management in the development of the asset.** The government entity approach often meant a dedicated unit was set up within the MoF, such as in France, Sweden, or the UK, or as a special unit reporting directly to the Prime Minister's office such as in Finland and China. The aim of maximizing value, required financial and industrial expertise and the capacity to understand international capital markets and investors.

139. **However, the capacity of a civil servant to assume full commercial responsibility for managing commercial assets was rather restricted, as was the capacity to pay market rates for the relevant expertise.** This constrained capacity development. In addition, a focus on value maximization does not always combine well with the wider spectrum of political concerns, and this has led to countries such as Finland following Singapore's lead in creating a ring-fenced vehicle at arm's-length from the political arena.

The National Wealth Fund approach

140. **Vesting state-owned commercial assets in an independent ring fenced holding company at arm's length from short-term political interference, has strategic, financial,**

³⁸ Corporate Governance of state assets: A Survey of OECD Countries, 2005.

³⁹ OECD Guidelines on Corporate Governance of state assets, 2005.

and economic benefits. Within a corporate environment assets can be considered as a whole from the point of view of operating income and liabilities. With a strategy for dealing with loss-making assets, priorities for improvement and opportunities for raising finance and choosing the optimal time for disposals can be made and allowing policy to be considered from the point of view of the overall impact on the economy.

141. **The most successful example of a NWF is probably Temasek in Singapore, formally incorporated in 1974 (Box 4).**⁴⁰ Other Asian NWFs can be found in Malaysia, Abu Dhabi, China, and Korea. In Europe, Spain, and Portugal among others has used this model, especially as an efficient vehicle for privatizations.

142. **The economic benefits of consolidating all commercial assets in a single company stem from a fully integrated business plan for the entire portfolio, without constraints on necessary actions to maximize value.** This has important scale effects and enables the portfolio to be developed and privatized more efficiently.

Box 4. Temasek of Singapore

Temasek is wholly owned by the government and reporting directly to the prime minister's office. Its investment theme centers on transforming the local economy and growing the middle-income population.

Temasek's portfolio covers a broad spectrum of industries including: financial services, media and telecom, technology, transportation, industrials, consumer, real estate, energy and resources, as well as life sciences.

As an active owner in the region, it has increased its assets under management from S\$354 million at inception to S\$223 billion in 2013, with a shareholder return of around 17 percent compounded annually.

Temasek also enjoys an overall corporate credit rating of "Aaa" by Moody's and "AAA" by Standard & Poor's.

Source: Temasek

D. The Existing Framework for Managing State Assets in Ukraine

143. **The basic legal framework for management of state assets is provided for in the Commercial Code of Ukraine ("CCU"),⁴¹ along with the Law on the Management of State**

⁴⁰ Wicaksono; Corporate Governance of State Assets: Investment Holding Structure in Singapore etc. 2009.

⁴¹ The Commercial Code of Ukraine, 2004, (also called, the Economic Code of Ukraine, 2004).

Objects (“State Property Law”).⁴² The framework also includes resolutions of the Council of Ministers of Ukraine (“CoM,” or “Council of Ministers”)⁴³ regulations, procedures, and rules issued by the Ministry of Economy, Ministry of Finance, the State Property Fund (SPF) and the various line ministries. This complex web of overlapping and sometimes contradictory legislation contributes to the absence of clarity and visibility and can act to create opportunities for vested interests and corruption.

144. **Government bodies managing or monitoring state assets (“Governing Body”) can be divided in two broad categories; those with responsibility for directly managing assets, and those with responsibility for monitoring and oversight of assets.** Governing bodies directly managing state assets include the CoM, the line ministries, and other agencies, as well as the SPF, MoF, Ministry of Economy, and the Ministry of Industrial Policy. Governing bodies coordinating the monitoring and oversight include the CoM, SPF, the Corporate Rights Agency, the MoF, Ministry of Economy, and the State Fiscal Service. The highly decentralized system of governance with such wide range of governing bodies, in different and often overlapping and sometimes contradicting responsibility creates an overwhelming governance vacuum.

145. **The authority of the CoM with regards to state assets is governed in the Constitution and several laws including the CCU, the State Property Law, and the Law on the Cabinet of Ministers.** The State Property Law lists and authorizes the other state bodies and their responsibilities with regards to state assets, without distinguishing between commercial and regulatory responsibilities, commercial and policy objectives. In addition, there are special laws for certain sectors such as railways and utilities, as well as specific assets such pipelines, seaports, and inter-city road infrastructure.

146. **There are two types of legal entities for state assets: unitary enterprises, and joint-stock companies.** Unitary enterprises are not subject to many corporate legal requirements applicable to the private sector, with regards to governance, transparency or auditing, and are governed at the discretion of the relevant governing body. These enterprises can be divided into two types, the “Kazenni” and the commercial entity. The Kazenni is a special purpose entity with policy objectives fully controlled by the government and given the “operational management rights” to manage a specific asset without full ownership operate under close state direction. The Commercial Entity is a “for-profit” legal entity with “business management rights” that involve certain broader responsibilities to manage a specific property of the government, but similarly without legal ownership of the assets.

⁴² The Law of Ukraine on Management of State-owned Objects, 2006, also referred to as the Law of Ukraine on Management of State-Property.

⁴³ Sometimes also referred to as the Cabinet of Ministers.

147. **Unitary enterprises cannot be privatized in their current legal form, without substantial changes to the legal framework, due to the lack of an appropriate corporate governance structure and proper title over its assets.** “Joint-stock companies” are commercial companies that can issue shares and are subject to the same general corporate legal framework, applicable to privately owned companies, unless wholly government-owned when specific rules, regulations and laws may apply.⁴⁴ Joint-stock companies also do not have legal title to the assets they operate, such as in the case of Naftogaz. In reality, the fact that most of the actual physical assets are directly owned by the state and not by the legal entity assigned to manage it leaves the care for these physical assets at risk of neglect and managed for short-term cash needs rather than value generation. The regulatory function is combined with that of manager, with neither function incentivized to care for the asset.

Political insulation

148. **The unitary enterprise is not required to have a board of directors, independent directors, a supervisory board or other corporate governance bodies such as an annual general meeting, and is, in principle, governed by a single civil servant within its governing body.** In practice, this means that the civil servant makes every important business and operational decision and is fully involved in day-to-day business. This results in the absence of political insulation and separation between policy and commercial objectives.

149. **Managers of unitary enterprises are meant to be selected on a competitive basis by the governing body, with competitive remuneration as an important instrument to attract professional people.** However, according to a recent study the government does not seem to have been effective in attracting top candidates, despite legislation to grant adequate remuneration packages. Nor does the evaluation system applied to monitor their performance seem to have had much impact on company performance or management turnover.⁴⁵

Governing bodies

The State Property Fund

150. **The State Property Fund (‘SPF’) was established as the agency for privatization of state assets and is given an annual target for privatization proceeds by the CoM.** The SPF does not have the capacity to formulate a coherent portfolio strategy for management and subsequent privatization of its assets to maximize proceeds, nor does it have the relevant financial data available on the consolidated portfolio. Instead the CoM decides on the required annual privatization proceeds from a political and budgetary perspective, without the capacity to

⁴⁴ Commercial Code of Ukraine (CCU).

⁴⁵ World Bank: Ukraine System of Financial Oversight and Governance of State Assets, 2011.

undertake a proper analysis to determine what is realistically achievable or strategically desirable. Furthermore, the SPF does not have the mandate or resources to hire professional advisers from the private sector supporting the sales process, further adding to its disadvantage as a government body active in the commercial sector.

151. **The selection of assets to be privatized to meet targeted privatization proceeds is left to the discretion of the governing body.** This can and does lead to the less attractive assets being put forward for sale with a preference to maintain the more valuable assets. Without the financial or operational capacity to restructure the assets, or choose the optimal time for disposals the process is giving undue advantage to the buyer. Assets not sold within a certain agreed period must then either be transferred back to the line ministry or subjected to 'fire sales'. This results in the SPF acting as liquidator with assets often being treated as distressed. This approach opens up the potential of collusion between buyers and the transfer of state assets to the private sector at private below actual market value.

Ministry of Economic Development and Trade

152. **The MoEDT is responsible for evaluating the governing bodies and "the efficiency of state property management."**⁴⁶ The methodology is closer to compliance with central planning than either oversight or management of an asset and its actual performance in a market economy. As an example it sets requirements and criteria on how to evaluate the efficiency of governing bodies' ability to implement their financial plans, with a scoring system with three broad categories; positive, satisfactory, or negative.

153. **The MoEDT is also responsible for reviewing the governing bodies and their evaluation of the managers of state entities.** The manager of a state entity is evaluated by its governing body. This evaluation is reviewed by the MoEDT, who also establishes the methodology. However, the review work is carried out without any validation or audit to ensure the accuracy of reported results. According to a recent study, the evaluation does not seem to have an effect on either remuneration or performance. Nor do underperformers seem to be replaced.⁴⁷ The MoEDT is also the owner of 48 state entities, which constitutes an apparent conflict of interest.

Ministry of Finance

154. **The MoF is solely authorized to monitor the fiscal impact of state assets.** It does not have a direct oversight function or responsibility to evaluate individual assets. Nor does the government have the transparency capacity to evaluate the consolidated portfolio with regard to financial performance or fiscal risk. The State Financial Inspection unit has recently been given

⁴⁶ The Property Law of Ukraine.

⁴⁷ World Bank: Ukraine System of Financial Oversight and Governance of State Assets, 2011.

the mandate to perform direct operational audit (ex ante control) over selected activities in the 36 largest SOEs (see Chapter IV).

155. **The MoF oversees compliance of governing bodies with meeting dividend targets.** These targets are based on political and budgetary requirements defined as a percentage of the planned net profit in the Financial Plan, which gives both the manager of each entity as well as the governing body the incentive to minimize profits. This politicized objective takes precedence over any financial objective to maximize the value of the portfolio.

The Accounting Chamber

156. **The Accounting Chamber audits state assets use of budgetary resources.** It does not attest to the reliability of financial statements. It may however conduct reviews of a state asset's use of budget funds.⁴⁸

The need to introduce a clear financial objective

157. **In the absence of a clear objective, financial indicators established by the MoEDT, are limited to monitoring the state assets from a fiscal and compliance perspective.** The reality is that performance management will only become meaningful when a clear financial objective has been established such as value maximization, harmonizing with the established practice in the private sector. The inherent conflict of interest between regulatory, political, and ownership issues with regards to the state asset portfolio, is not addressed within the government from either a policy, organizational, or practical perspective.

Transparency considerations

158. **The Constitution, the Law on Information, and the Law on Access to Public information, establishes the basic framework for public access to information.** Information is generally classified either as open or limited access. Information determined to be of limited access is further designated as confidential or of significant national importance (state secret), which is subsequently governed by the Law on State Secrets.

159. **Governing bodies primarily exercise their state assets oversight function through the approval of financial plans and formal comparison of actual versus budgeted performance.** There is little emphasis on transparency in current oversight and monitoring processes. This is mainly due to the governance objective being limited to and focused on the compliance with legal requirements, policy issues, and financial plans. Mixing conflicting objectives does not allow operational efficiency to be measured or benchmarking with similar

⁴⁸ The Law on Accounting Chamber.

operations internationally, preventing the government from understanding the true effectiveness of its operations, as well as the fiscal risk with its ownership.

The privatization process

160. **Ukraine began implementing a privatization program in 1992 with the objectives of increasing the private sector's share of the economy, generating foreign direct investment and contributing funds to the State Budget.** From 1992 to June 30, 2009, Ukraine raised more than UAH 40 billion in privatization receipts, divesting more than 120 thousand assets, including around 28 thousand assets from central government and more than 90 thousand from local government. Attracting foreign direct investments has proven to be a challenge and since 2009 privatizations has largely stalled.

E. Managing State Assets - The Way Forward

161. **To improve the value and attractiveness of the Portfolio towards the entire spectra of investors and stakeholders, including international investors, and minimize fiscal risk, it will be important to strengthen three main areas:**

- Legal Structure
- Ownership Management
- Transparency Policies

Legal reform

162. **Reforming the legal structure governing state assets should aim to reduce and eliminate overlapping structures and conflicting objectives, creating clear dissemination of responsibility and accountability unified under the single objective of value maximization.** Delegating responsibility and accountability to the boards of directors best capable of managing assets and simultaneously vesting the ownership responsibility with a consolidated ownership vehicle and thereby building the professional capacity capable to manage and develop the portfolio from an ownership perspective.

163. **In practice this would require a comprehensive reform to a number of existing laws and subsidiary regulations, including specifically the Code and Property Law.** This in turn would require other legislation to be brought in line with these amendments. Legal reforms should aim to eliminate differences in the legal framework between state assets and those applicable to private sector equivalents. However, this might also require a reform of corporate laws applicable to the private sector to ensure good international practice, is observed with the objective of improving the governance and management structure in the entire economy.

Ownership rights management

164. **The centralized ownership models that have been developed in other countries and that are described above are not feasible to introduce at the present time given the political and fiscal constraints that the government is currently facing.** However, a centralized ownership model with a clear mandate to maximize value of the state asset portfolio should be the ultimate objective when the necessary prerequisites are in place including a complete overhaul of the legal framework, the governance, accounting and reporting structures surrounding the state asset portfolio.

165. **However, there is clearly a need to move towards a consolidated model of ownership, as recommended by the OECD and demonstrated by successive governments.** The actual vehicle can take a number of shapes dependent on political will and ambition. The main purpose is to institutionalize political insulation and allow capacity to be developed to help maximize value and minimize fiscal risks.

166. **The appropriate short-term solution is to build up capacity to manage the fiscal risks associated with the consolidated portfolio and centralize the oversight function, through establishment of a dedicated unit within the MoF.** The unit's primary objective in the short term would be to address the need for transparent and comprehensive assessments of financial plans and to identify and propose measures to mitigate fiscal risks. This initial step would require preparation and publication of a consolidated annual report for the portfolio of state assets acting in effect much like a virtual holding company.

167. **Separation of commercial and non-market assets will be essential in attempting to apply a value maximization objective for the portfolio of commercial assets.** Clearly defining remaining subsidies or policy objectives and quantifying, and transparently identifying them is the first step towards transforming each asset to a solely commercial basis.⁴⁹ All policy costs when identified and quantified should be procured under competitive tender by either the entity or by a central procurement authority within the government or the relevant line ministry. Ultimately the entity should be relieved from dealing with policy issues and focus solely on its core business.

168. **In the medium term, once the necessary prerequisites are in place, it would be desirable to gain full ownership control of all state assets by merging the SPF and the MoF's oversight unit.** The objective would be to consolidate full responsibility for active ownership, financial control, and privatizations through an independent division within the CoM

⁴⁹ Companies can be run on a commercial basis (e.g., subsidies to railway companies to allow pensioners to travel free or at a reduced rate on the rail system) even when being granted subsidies by the government as long as there is transparent and formalized understanding as to the nature and cost of the subsidy necessary to meet the social policy objective.

or the MoF. Such a move would considerably improve the credibility of the state as an owner towards all stakeholders, including international investors. This unit would have the sole responsibility for any privatization and would be held accountable for ensuring the selection and preparation of assets prior to sale to maximize shareholder value.

169. **When sufficient capacity is developed and when the political environment is conducive, the Ownership Management Unit could be converted into an independent, properly ring-fenced holding company.** This would place it at arm's-length from the government, reporting directly to the CoM.

Transparency policy

170. **Transparency policy should ensure that all stakeholders including international investors understand the nature and the status of the assets held and managed by the state.** The quality and reliability of information has to be regarded as credible for any marketable initiative to be viable, including the retention of any independent auditing and valuation of the assets.

171. **In the short term, the objective should be to identify the financial position of the consolidated portfolio of state-assets. This can be achieved quickly through:**

- *The compilation and publication of an Annual Review of the state asset portfolio* - This aggregate compilation by sector, including the real estate assets, similar to the Lithuanian and Latvian Annual Reviews would be published in English and available on the government's website.⁵⁰ With the proper resources in place this annual review can be compiled and published within six months from commencement.
- *Simultaneously, establishing a single and comprehensive database of all state assets* - This should include real estate, enabling independent valuations of each asset, establishing relevant dividend policy, as well as overall risk management.
- *Implementing a new comprehensive Transparency Policy* – This should oblige the government to publish a consolidated Annual Report of all state assets, audited by an internationally recognized auditing firm. This report should consolidate the annual reports of individual state assets. Each Annual Report would therefore provide a fair picture of the development of the Portfolio and each major holding, its business activities, position and result in accordance with laws and usual practice, including description of its business, risks and risk management, major investments, R&D, the work of the board and its composition during the year, compensation to leading executives and description of the incentive program etc. such as

⁵⁰ Lithuanian Annual Review: <http://www.lrv.lt/bylos/Naujienos/VVI2010EN.pdf>.

that of Solidium in Finland.⁵¹ Subsidies directly attributable to state assets resulting from a requirement to charge non-market prices should be separately identified.

172. **Reporting polices should be analogous to those of a publically listed vehicle and regular communications to the public should be issued in the form of published annual consolidated reports and quarterly portfolio reviews.** The operational objectives of each corporate asset should be published in the annular report of each respective holding together with financial targets and operational goals, to ensure that the invested capital is managed to the benefit of the shareholders and within the limits of the core business.

173. **The boards of the state-owned commercial assets should be made responsible for compliance with accounting and reporting standards.** Larger holding or holdings of strategic importance should, in addition to current accounting legislation and generally-accepted accounting principles, also comply with international practice of listed companies.⁵² State-owned companies should also be required to submit their reports in an appropriate format to the MoF to enable consolidated reporting of the SOE sector and consolidation in public sector reports as required by international accounting standards.

174. **The large state assets should be required to publish their annual reports and financial statements audited by a reputable company, in Ukrainian and in English.** The ownership vehicle should also have a dedicated website in English, as well as in Ukrainian publishing its annual report and audited financial statement, as well as quarterly financial data aiming for the best international practice. This requirement should apply for all state-owned companies with annual turnover in excess of UAH 50 million.

175. **To assess the potential value of state-owned real estate, a stock take should be performed and all information consolidated in a database ensuring harmonization and transparency of data.** Increased transparency will allow the government to proceed with more professional management through the accurate definition of different sectors/sub-sectors of assets. Real estate information should be published in the annual report of the ownership vehicle, including periodic external valuations by independent appraisers.

⁵¹ Solidium Annual Report: <http://www.e-julkaisu.fi/solidium/annualreport-2013/>.

⁵² The listing rules requirements stipulated of the Warsaw Stock Exchange would be a good benchmark.

Recommendations

Short term (1–6 months)

Recommendation 6.1: Establish a unit within the MoF with the sole responsibility for managing the consolidated fiscal risk related to state assets, including value, dividend, and cost of subsidies and policy objectives.

Recommendation 6.2: Separate commercial and non-market based assets and transparently report on the cost of subsidies and policy based interventions in commercial assets.

Recommendation 6.3: Issue a government decree identifying value maximization as the sole objective for commercial assets.

Recommendation 6.4: Carry out a stock-take of consolidated portfolio of state-assets, including value, yield and risk, and establish a single and comprehensive database of all state assets, including the real estate, enabling independent valuations of each asset, establishing relevant dividend policy, as well as overall risk management.

Recommendation 6.5: Publish an annual review of state assets in English on the government web site.

Medium term (6 months to 2 years):

Recommendation 6.6: Appoint a government review group, consisting of public and private sector experts to conduct a legal review that will assess the reforms needed to:

- Streamline the legal structure governing the portfolio of public assets, to eliminate overlapping structures and conflicting objectives unified under the single objective of value maximization.
- Harmonize the legal framework and eliminate differences between what is applicable to state assets and private sector equivalents in order to attract even international investors.

Recommendation 6.7: Consolidate the ownership function within the MoF as an intermediate measure to gain control of state assets, including:

- Merging the SPF and the MoF SOE financial management unit to consolidate full responsibility for active ownership, financial control, and privatizations.
- Appointing a sub-group under the government review group, consisting of predominantly private sector experts to conduct a study of the optimal route for implementing an independent, arms-length ownership vehicle for state assets.

VII. OTHER SUPPORTING PFM REFORMS

A. The Legal Framework

176. **The BCU, the primary legislation supporting the budget process will need to be reviewed in light of the changes being proposed in this report.** A number of reforms in budget planning, and execution will necessitate amendments to the legislation to allow them to come into effect. While not exhaustive, Table 9 outlines some of the changes that may need to be considered in various sections of the BCU.

177. **In addition, other legislation and secondary regulations and resolutions may also need to be reviewed to ensure that they are in conformity with the provisions of the amended BCU.** New regulations may also be needed to introduce more stringent medium-term budget planning provisions in the BCU and to implement fiscal rules and new budget execution controls.

Table 9. Ukraine: Potential Changes Needed to BCU to Support PFM Reforms

Required Changes	Article(s) in Code	Rationale
Inclusion of new or amended Definitions	Article 2	New definitions need to be included such as a definition of a MTBF
Abolishment of general and special categories of expenditure	Article 57	To reduce the current practice of earmarking revenues the current categorization of general and special budgets needs to be removed with all revenues treated equally as sources of funding for all budgetary expenditures
Strengthening provisions surrounding the MTBF	Article 21	Existing provisions need to be strengthened to include the need for aggregate and sectoral expenditure ceilings
Amending the Budget calendar	Articles 33-38	The budget calendar needs to be revised to support the alignment of the MTBF and the annual budget
Strengthening and introducing commitment controls earlier in the expenditure cycle	Article 46	The article needs to explicitly require commitments to be verified against budget appropriations prior to entry into contractual obligations
Virement provisions	Articles 43 and 47	The articles need to be redrafted to reduce the level of control and allow greater flexibility for KSU's in the execution of their budgets
Protected expenditures	Article 55	Remove the concept of protected expenditures as a move towards developing a realistic budget that ensures there is adequate fiscal space to meet all expenditures approved in the budget
Internal Financial Control	Articles 26, 113-118,	Provide a mechanism for relaxing external controls for those agencies that meet required standards of internal control and reporting.
Reporting	Chapter 10	Require production of annual reports by every major budgetary institution, including AFS and report on outcomes.
Accrual Accounting	Chapter 10	Provide guidance on the distinction between budget execution reporting and accrual AFS.
Fiscal Responsibility provisions and introduction of fiscal rules	New	Need to insert new fiscal responsibility provisions (fiscal Council?) and provisions for the establishment and implementation of fiscal rules

B. Reviewing Organizational Responsibilities

178. **The changes proposed in the other sections of the report will also necessitate a review of existing organizational responsibilities.** In particular, the responsibilities of the MoF may need to be substantially broadened to include a greater oversight role for management of SOE's through the establishment of the SOE oversight unit mentioned in Chapter V. In addition, there new responsibilities for managing the cash balance on the TSA will also require the creation of a cash planning unit in the Debt and International Financial Policy Department with new staff and broadening the responsibilities of the Directorate to manage the end of day balance on the TSA.