Governance and Public Management Series

Public Sector Accounting and Auditing in Europe

The Challenge of Harmonization

Isabel Brusca, Eugenio Caperchione, Sandra Cohen and Francesca Manes Rossi

"This collective book provides a systematic overview of trajectories in public accounting and auditing across Europe. However important this achievement is in itself, the value of this work also goes beyond it. It is testimony to some of the constitutive traits of public administration in Europe: the heterogeneity of national responses in the face of 'global' public management pressures, or in the softer form of 'international standards'; the enduring influence of diverse administrative traditions; the variety of solutions that national and local governments are attempting to improve public management. Scholars and practitioners alike will benefit from this up-to-date review of public accounting systems across Europe."

– Edoardo Ongaro, Professor of International Public Services Management,
Northumbria University, Newcastle, UK, and President of EGPA,
European Group for Public Administration

"This book is ambitious since it covers budgeting, accounting and auditing. It is also a wide book since it covers fourteen countries and their three levels of government. Finally, it is a profound book since it covers an essential financial cycle that is necessary to define responsibilities and accountabilities. For reasons of comparison, learning, and transfer of good practices Europe needs harmonization of its financial systems. This excellent book contributes to this essential agenda."

– Geert Bouckaert, KU Leuven Governance Institute, and President of IIAS,
International Institute of Administrative Sciences

"An international harmonization is still to be reached – but remains an unavoidable challenge, an essential matter for accountability. This book, with its fully updated picture on 14 European countries, offers the reader a clear insight into the most recent developments and the right ways to promote a really functional harmonization."

– Philippe Adhémar, Chair of Accounting Standards,
Centre for Financial Professions, Paris, France,
and formerly IPSAS Board Chair

"By framing the case studies of 14 countries into a cohesive analysis, the authors have managed to provide a picture of public accounting practices in Europe. They have also reaffirmed that public accounting systems in Europe are greatly heterogeneous, so that the challenge of harmonization cannot be overstated."

– Martine Blockx, Partner at EY

"This book enables the reader to better understand the accounting and auditing systems of the Public Sector by country, offering a comparison that can be used by managers and professionals interested in working to improve the harmonization, transparency, accountability and efficiency of our European Public Sector."

– Claudio Mariani, Partner of KPMG Spa, Italy –
Head of the Healthcare and Public Sector

IIAS Series: Governance and Public Management

International Institute of Administrative Sciences (IIAS) – *Improving Administrative Sciences Worldwide*

The International Institute of Administrative Sciences (IIAS) is an NGO with scientific purpose established in 1930 whose seat is still in Brussels. The Institute is a worldwide platform providing a space for exchanges that promote knowledge and practices to improve the organization and operation of Public Administration and to ensure that public agencies will be in a position to better respond to the current and future expectations and needs of society. It provides thus a forum where practical experiences and theoretical analyses of experts (academics and practitioners) in public administration worldwide and from all cultures are presented and discussed.

To cover the diversity of its members, the IIAS has set up four sub-entities:
– The EGPA (European Group for Public Administration)
– The IASIA (International Association of Schools and Institutes of Administration)
– The LAGPA (Latin American Group for Public Administration)
– The AGPA (Asian Group for Public Administration)

Website: http://www.iias-iisa.org

Governance and Public Management Series

The *Governance and Public Management* series, published in conjunction with the International Institute of Administrative Sciences (IIAS), brings the best research in public administration and management to a global audience. Encouraging a diversity of approach and perspective, the series reflects the Institute's conviction for a neutral and objective voice, grounded in the exigency of fact. How is governance conducted *now*? How could it be done better? What defines the law of administration and the management of public affairs, and can their implementation be enhanced? Such questions lie behind the Institute's core value of *accountability*: those who exercise authority must account for its use – to those on whose behalf they act.

Titles in the series include:

Paul Joyce, John Bryson and Marc Holzer (*editors*)
DEVELOPMENTS IN STRATEGIC AND PUBLIC MANAGEMENT
Studies in the US and Europe

Leo Huberts
THE INTEGRITY OF GOVERNANCE
What It Is, What We Know, What Is Done and Where to Go

Taco Brandsen, Willem Trommel and Bram Verschuere (*editors*)
MANUFACTURING CIVIL SOCIETY
Principles, Practices and Effects

Pekka Valkama, Stephen J. Bailey and Ari-Veikko Anttiroiko (*editors*)
ORGANIZATIONAL INNOVATION IN PUBLIC SERVICES
Forms and Governance

Victor Bekkers, Jurian Edelenbos, Bram Steijn (*editors*)
INNOVATION IN THE PUBLIC SECTOR
Linking Capacity and Leadership

Michiel S. De Vries
THE IMPORTANCE OF NEGLECT IN POLICY-MAKING

Michiel S. De Vries and P.S. Reddy, M. Shamsul Haque (*editors*)
IMPROVING LOCAL GOVERNMENT
Outcomes of Comparative Research

Michiel S. De Vries and Pan Suk Kim (*editors*)
VALUE AND VIRTUE IN PUBLIC ADMINISTRATION
A Comparative Perspective

Wouter Van Dooren and Steven Van de Walle (*editors*)
PERFORMANCE INFORMATION IN THE PUBLIC SECTOR

Per Lægreid and Koen Verhoest (*editors*)
GOVERNANCE OF PUBLIC SECTOR ORGANIZATIONS
Proliferation, Autonomy and Performance

Eberhard Bohne
THE WORLD TRADE ORGANIZATION
Institutional Development and Reform

Governance and Public Management Series
Series Standing Order ISBN 978–0–230–50655–8 (hardback)
978–0–230–50656–5 (paperback)

You can receive future titles in this series as they are published by placing a standing order. Please contact your bookseller or, in case of difficulty, write to us at the address below with your name and address, the title of the series and one of the ISBNs quoted above.

Customer Services Department, Macmillan Distribution Ltd, Houndmills, Basingstoke, Hampshire RG21 6XS, England

Public Sector Accounting and Auditing in Europe

The Challenge of Harmonization

Edited by

Isabel Brusca
University of Zaragoza, Spain

Eugenio Caperchione
Modena and Reggio Emilia University, Italy

Sandra Cohen
Athens University of Economics and Business, Greece

Francesca Manes Rossi
University of Salerno, Italy

palgrave
macmillan

First published 2015 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN: 978–1–137–46133–9

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

Public sector accounting and auditing in Europe : the challenge of harmonization / [edited by] Isabel Brusca [and others].
pages cm.—(Governance and public management)
ISBN 978–1–137–46133–9 (hardback)
1. Finance, Public – Europe – Accounting. 2. Finance, Public – Europe – Auditing. I. Brusca, Isabel.

HJ9924.P83 2015
657'.8350094—dc23 2015001287

*This book is dedicated to all students, scholars,
public servants and practitioners who devote their interest
and passion to studying public sector financial management and
accounting and making them work in favour of
better public sector governance.*

Contents

List of Illustrations

Figures

Tables

Foreword

After the last decade of the 20th century and the first decade of the 21st century this is again a time where major changes in public sector accounting seem to be around the corner. Triggered by the sovereign debt crisis, an increased need for fiscal surveillance by the European Commission and the obviously crucial role of governmental accounting as a provider of complete and reliable input data for the macro-systems ESA and GFS, the European Commission put forward a project to introduce harmonized accrual accounting systems at all levels of government in the member states. This European Public Sector Accounting Standards (EPSAS) project – even if it is not implemented as planned – will put pressure on the governments of those member states that still have cash based or modified cash based accounting systems to shift them to an accruals base. Thus, we might see accrual governmental accounting systems in place in all, or almost all, EU member states during the third decade of the 21st century.

In a situation like this, comprehensive information on accounting practices and reform projects are indispensable for those who are concerned with reform – both government practitioners and professional accountants. Moreover, from a scientific point of view, an update of earlier transnational studies on governmental accounting reforms is urgently needed.

This is what the present volume provides: case studies of 14 countries (13 of them member states of the European Union (EU)) on current practice in accounting and auditing at all levels of government. Moreover, in the first and the last chapters the authors discuss standard setting in public sector accounting, with special reference to the EPSAS project, and provide an empirically substantiated comparison of national reform endeavours, respectively.

The editors have to be congratulated on their initiative in putting this book together. It is timely and relevant for government officials, professional accountants and scholars.

Klaus Lüder
Emeritus Professor of Public Sector Financial Management
and Business Administration
German University of Administrative Sciences Speyer

Preface

During the last 20 years the accounting systems of all levels of government in Europe have undergone substantial changes mainly inspired by the New Public Financial Management. The process of public sector accounting modernization has been recently intensified by the demands imposed by several stakeholders for the disclosure of high quality – and relevant to decision making – financial information to be used for transparency and accountability purposes. The financial crisis in Europe and the development of the International Public Sector Accounting Standards (IPSAS) have contributed to placing the necessity for improvements in governmental accounting high on the priority list of the EU policy agenda. The European Union has recently decided to develop a set of accounting standards that would build upon IPSAS and at the same time satisfy the EU's policy objectives. This set of standards is called the European Public Sector Accounting Standards (EPSAS). However, the accounting systems used in the public sector across Europe are not homogeneous. On the contrary, they are made up of a pluralistic mosaic of not only the different accounting bases (e.g. cash, modified cash, accrual accounting) adopted by the European countries but also the heterogeneous systems applied by the different levels of government within a given country. While the horizontal and vertical differentiations of governmental accounting systems in Europe are a fact, there is no repository for gathering and analysing this information in a systematic way. Moreover, the substantial accounting and budgeting changes that have taken place over the last 20 years have not always been communicated in a timely fashion beyond country boundaries.

This book is an answer to this shortcoming. It is the co-operative work of 25 reputable researchers who discuss in detail the governmental accounting status quo in their home countries. It is an initiative of the Chairs of the XII Permanent Study Group of the European Group of Public Administration (EGPA) and many of the contributors to this book are members of the group. This is an important advantage in achieving a uniform structure of the country studies, as the authors are familiar with the accounting systems of the countries and are experts in public sector accounting and financial management. In the majority of cases the chapter authors are natives, which not only facilitates access to documents and legislation usually written in local languages but also safeguards the relevance of the text within the country context. The book analyses in a concise, thorough and comprehensive way the public sector accounting, budgeting and auditing systems at all levels of government in 14 European countries. The analysis is followed by a synthesis in which the main similarities and differences between the governmental accounting systems are discussed. The book therefore sheds a light on the challenges that are likely to be faced by European countries moving towards an adoption of public sector accounting international standards like IPSAS, EPSAS or any other system that may emerge.

The book is structured as follows.

In the introduction potential challenges are discussed by *Eugenio Caperchione*, from Modena and Reggio Emilia University, mainly through a theoretically informed lens. The first challenge is international harmonization in the context of governmental accounting in Europe forming a multifaceted mosaic within and among countries. The second challenge is the choice and implementation of international standards and whether IPSAS or EPSAS provide answers to the harmonization puzzle.

The country chapters then follow, in which material from the 14 countries under study is presented uniformly. For each level of government (central, regional and local) an analysis of budgeting, accounting, financial reporting and auditing issues is performed in a concise way. Each chapter concludes with an assessment by the authors of the readiness for change in the country towards a set of public sector international accounting standards (e.g. IPSAS/EPSAS). The assessment identifies major differences, convergence areas, technical facilitators and hurdles to imminent change.

Iris Rauskala, from Zurich University of Applied Sciences, and *Iris Saliterer*, from Alpen-Adria Universität Klagenfurt, present an overview of the developments and status quo of public sector budgeting, accounting and auditing in Austria. In the Austrian context, the focus is on the comprehensive budgeting and accounting reform at the central level, which introduced accrual budgeting and accounting in an attempt to approach the IPSAS. The reform, which took its full effect in 2013, serves as a reference model and reform driver with regard to the intended harmonization of budgeting, accounting and reporting standards for all government levels.

Johan Christiaens and *Simon Neyt*, from Ghent University, analyse the public accounting system and audit in Belgium. Recent reforms are leading all Belgian government levels towards accrual accounting, inspired by European System of National and Regional Accounts (ESA) regulations and business sector standards but with very little attention on IPSAS. Differences in the mind-sets of these government levels have produced a landscape of diversified public sector accounting systems with some pioneers and some who are still lagging behind.

Caroline Aggestam Pontoppidan, from Copenhagen Business School, offers an up-to-date summary description of public sector accounting in Denmark. While the focus is on accounting, the chapter also addresses public sector budgeting and auditing practices. The chapter concludes with a current analysis of the main challenges for Denmark if the country were to adopt IPSAS.

Lasse Oulasvirta, from the University of Tampere, describes public sector financial accounting and auditing in Finland. The accounting institutions in both central and local governments have been based on a national model of the revenue and expense-led approach in contrast to the asset and liability-led approach. The chosen approach is deeply rooted as, so far, it has been able to resist international standards based on unfamiliar approaches and frameworks. The auditing guarantees an annual audit of all public sector entities.

Marine Portal, from the University of Poitiers, deals with the radical changes in budgeting, financial accounting and auditing which 2006 reforms introduced in the French public sector. The chapter discusses the main novelties of this reform, which are: the new set of standards with a conceptual framework based on public and private international standards; the new budgetary presentation due to a new organization of public policies; and the new set of financial statements subject to a new financial audit. Additionally, special attention is given to local or regional specificities. The chapter concludes with the rules and practices that detail the main challenges for public accounting in France that relate mainly to recognition and measurement issues.

Thomas Müller-Marqués Berger and *Jens Heiling*, from Ernst & Young GmbH, provide brief assessments of public sector budgeting, accounting/financial reporting and auditing in Germany. The situation in Germany can be described as many and various, mainly due to the federal government structure. The chapter also goes into the latest reform movements and describes the challenges public administrations are currently facing.

Sandra Cohen, from Athens University of Economics and Business, presents the characteristics of accounting, budgeting and auditing in Greece. Greece constitutes an interesting case where central government, regions and municipalities apply completely different accounting systems, such as, modified-cash accounting, cash accounting and accrual accounting. Several changes to financial management and budgeting procedures have been initiated recently in Greece as part of the structural reforms imposed by the Troika. Within this context, various challenges and impediments regarding consolidation and transition to IPSAS or EPSAS emerge.

Francesca Manes Rossi, from the University of Salerno, analyses the public sector accounting and audit systems in Italy. The harmonization law under trial (mandatory application starts in 2015) is considered as the basis for discussion. The new set of accounting and auditing rules has mainly focused on achieving a harmonization between public entities in Italy and is inspired by the need to keep public expenditure under control, while improving the efficiency and effectiveness of the whole public sector. The rules for public sector accounting combine the traditional budgetary culture with accrual, but the application of international standards seems to be far off.

Tjerk Budding, from VU University Amsterdam, and *Frans van Schaik*, from the University of Amsterdam and Deloitte, analyse public sector budgeting, accounting and auditing in the Netherlands. Their analysis shows that Dutch central government entities use a variety of reporting methods, from a modified cash basis in the ministries, to an accrual basis in non-departmental public bodies. Dutch local government entities use a modified accrual basis, but IPSAS have not yet played a role in their regulation. However, although governments at all levels in the Netherlands are technically able to make the transition (having sufficient IT systems and staff capacity), there seems to be little willingness to adopt accrual accounting according to IPSAS.

Susana Jorge, from the University of Coimbra, describes the system of public sector accounting and auditing in Portugal. Given that a new accounting and reporting system is being developed and is expected to be implemented within three years, the description focuses on the system presently in practice while pointing to the main changes to be brought about by the new one, which approaches international standards. In Portugal, as in other continental European countries, both current and future systems of public sector accounting and reporting, combine financial accrual-based accounting with budgetary traditional cash-based accounting.

Isabel Brusca, from the University of Zaragoza, *Vicente Montesinos*, from the University of Valencia, and *José Manuel Vela*, from the Polytechnic University of Valencia, analyse public sector accounting and audit systems in Spain. Recent accounting reforms have tried to approach international standards and the main driver has been the traditional convergence between public and private accounting systems. Spain is a clear example of a country that adopts public sector accounting following business sector standards while combining them with the traditional budgetary culture of public management.

Torbjörn Tagesson, from Linköping University, and *Giuseppe Grossi*, from Kristianstad University, describe the regulation of budgeting, accounting and auditing in the public sector in Sweden, a country with a long tradition of accrual accounting with a revenue-expense approach based on historical cost accounting. Even if accounting standards for the public sector in Sweden are comparatively close to international standards, some fundamental differences remain. These differences are not a coincidence, but exist because the Swedish standard-setters have come to different conclusions from those of the International Public Sector Accounting Standards Board (IPSASB).

Sandro Fuchs, *Andreas Bergmann*, *Iris Rauskala* and *Anna Schmitt*, from Zurich University of Applied Sciences, analyse the public budgeting, accounting and auditing system in Switzerland. Due to the federal structure of Switzerland and the high degree of legal and financial autonomy at all three governmental levels, budgeting and accounting practices not only differ vertically, namely between governmental levels, but also horizontally within the same level of government. However, strong efforts with respect to the harmonization of public budgeting and accounting can be observed. All entities on all three levels are on accrual budgeting and accounting but, despite formal harmonization, differences in the recognition and measurement of transactions remain significant.

Rowan Jones, from the University of Birmingham, and *Josette Caruana*, from the University of Malta, present the characteristics of accounting, budgeting and auditing in the United Kingdom. The Treasury dominates the budgeting and accounting of central government, with its powers also being felt at local government level. Accounting is governed by various sets of standards but they all refer to International Financial Reporting Standards (IFRS), as adapted for the public sector, with significant encroachment on national accounting rules. Auditing at both levels of government is the responsibility of bodies independent of the Treasury. Full accrual accounting and budgeting are practiced, but some challenges are still acknowledged.

In the last chapter co-editors *Isabel Brusca*, *Eugenio Caperchione*, *Sandra Cohen* and *Francesca Manes Rossi* compare public sector budgeting, accounting and auditing systems of the three levels of government in the 14 European countries covered in the book. Their analysis reveals that budgeting and accounting systems show a significant heterogeneity between countries for all government levels and that there is also a lack of harmonization among different government levels within countries. In most countries, accounting standards are different for central, regional and local governments. Furthermore, although in all the countries analysed there are provisions for both internal and external audits, auditing in the public sector displays a heterogeneous panorama. The chapter concludes with a view of the readiness for change to IPSAS or EPSAS in the countries analysed, showing important differences in the challenges and efforts necessary to move in that direction.

Notes on Contributors

Editors

Isabel Brusca is a professor in the Department of Accounting and Finance at the University of Zaragoza. She teaches and researches in public administration accounting, management and audit.

Eugenio Caperchione is Professor of Accounting at the Department of Economics "Marco Biagi", University of Modena and Reggio Emilia, where he teaches and researches in public management and public sector accounting.

Sandra Cohen is Associate Professor of Accounting in the Department of Business Administration at Athens University of Economics and Business. Her research interests lie in the fields of public sector accounting, management accounting and intellectual capital.

Francesca Manes Rossi is Associate Professor of Accounting in the Management and Information Technology Department at Salerno University, where she teaches and conducts research on public accounting and management.

Contributors

Caroline Aggestam Pontoppidan is an associate professor at the Copenhagen Business School, Department of Accounting and Auditing. She is an experienced educator and researcher specializing in International Public Sector Accounting Standards (IPSAS) and other international accounting issues.

Andreas Bergmann is a Professor and Director of the Institute of Public Management at Zurich University of Applied Sciences. He is a Chair of the IPSAS Board and has been an advisor to public financial management reforms in several countries and various international organizations.

Tjerk Budding is Senior Lecturer in Public Sector Accounting at VU University, The Netherlands. His research focuses on public sector management and financial accounting.

Josette Caruana is Lecturer in Accounting at the University of Malta, Malta, where she teaches and researches in Public Sector Accounting.

Johan Christiaens is Professor of Public Sector Accounting at Ghent University, Belgium. His focus is on financial accounting and reporting in governments and non-profit organizations.

Sandro Fuchs is an associate at the Institute of Public Management at Zürich University of Applied Science. He teaches and researches in the field of public financial management, public finance, public governance, internal control and risk management.

Giuseppe Grossi is Professor of Public Management and Accounting and Leader of the Research Environment on Governance, Regulation, Internationalisation and Performance (GRIP) at Kristianstad University, Sweden, where he teaches and researches accounting, public management and governance.

Jens Heiling belongs to the technical staff in the Professional Practice Group of Ernst & Young GmbH, Germany. His focus is on public sector accounting and IPSAS. He is one of the editors of Ernst & Young's quarterly newsletter "IPSAS Outlook".

Rowan Jones is Emeritus Professor of Public Sector Accounting, University of Birmingham, UK. He has a long experience in teaching and researching in public sector accounting, being author of several articles and books on the matter.

Susana Jorge is an assistant professor in the Faculty of Economics, University of Coimbra, Portugal. She teaches and researches in public sector accounting and management, and is affiliated with the Research Centre in Political Science (CICP), University of Minho, Portugal.

Vicente Montesinos is Professor of Accounting and Finance at the University of Valencia, Spain. He chaired the Spanish Academic Accounting Association and is a regular consultant for public administrations.

Thomas Müller-Marqués Berger is Ernst & Young's Global Head of International Public Sector Accounting and since 2012 he is Assurance Leader Government and Public Sector for EMEIA (Europe, Middle East, India and Africa) within Ernst & Young. He is a former member of the IPSAS Board and since 2012 he is Chairman of the Public Sector Committee of FEE (Federation of European Accountants).

Simon Neyt is a staff assistant in Ernst & Young's public sector and an assistant in their Accounting Research Public Sector (ARPS) UGent. He is involved in public and non-profit sector projects and service lines.

Lasse Oulasvirta is Professor of Public Sector Financial Management and Accounting in the School of Management, University of Tampere, Finland. His teaching and research have mainly consisted of public sector economy and budgeting, financial and management accounting, auditing and evaluation.

Marine Portal is an associate professor, IAE, Poitiers University, France where she teaches and researches, mainly in public accounting.

Iris Rauskala is a Senior Research Associate and Head of the Public Financial Management Unit at the Institute of Public Management at Zürich University of Applied Science. She has experience in applied research and project work in the field of public financial management, especially financial accounting and budgeting.

Iris Saliterer is a senior assistant professor at the Alpen-Adria Universität Klagenfurt, Austria, with a focus on empirical studies and comparative analyses of international and national trajectories of public management reforms within different policy fields, (public) performance measurement and new public financial management.

Anna Schmitt is a research assistant at the Institute of Public Management at Zürich University of Applied Science. She researches in the field of public financial management, especially public governance and business law.

Torbjörn Tagesson is Professor of Accounting at Linköping University and the Executive Director of the Swedish Council for Municipal Accounting. He received his PhD in Business Administration in 2002 and is the author of several books and articles on accounting, auditing and public administration.

Frans van Schaik is Deloitte's Global Leader Public Sector Accounting and Auditing and Professor of Management Accounting at the University of Amsterdam. He served on the IPSAS Board and is an advisor in IPSAS implementation to national governments around the world.

José Manuel Vela is Professor of Accounting and Finance at the University of Valencia (Spain) and an economist. He has been involved in several research projects, especially connected with governmental accounting reforms and its comparative analysis in the international field.

1
Standard Setting in the Public Sector: State of the Art

Eugenio Caperchione

1.1 Introduction

Public sector accounting has been the object of great renewal, in many a country, for more than 20 years. Although quite often this change is referred to as a trend, a uniform and consistent movement towards a common goal, it has to be recognized that most reforms have been largely a product of individual countries, both in the decision on scope and timing and in implementation choices. The design may have been nearly the same in different countries, but not its actual development. Unsurprisingly, the persistence of national traditions on the one side (Kvaal and Nobes, 2012) and the relevance of public sector accounting to the national sovereignty on the other, have played a significant role, so that the features of many reforms remain country specific.

Consequently, this book's first objective is to give an account of public sector accounting reforms in a panel of European countries. A thorough empirical analysis will allow us to understand the commonalities and differences of reforms that are all placed under a New Public Management (NPM) umbrella (Caperchione, 2006).

The 14 countries we have chosen to this aim are different in size, administrative framework, accounting tradition, legal system, geographical area, and degree of accounting innovation. All, except Switzerland, are EU members.

Thus, the following chapters present the budgeting, accounting, financial reporting and auditing systems in place in each country at each government level; while the last chapter synthetizes the findings and gives an account of similarities and differences.

As it will become clear, the latter are still quite relevant, so that the request to strive for an increased harmonization of accounting systems is increasingly supported. An international harmonization of public sector accounting, it is claimed, should produce a number of benefits, and appears as an unavoidable challenge.

We come to our second objective: clarifying what accounting harmonization is, whether it really deserves to be achieved, how this can happen, what we can expect from it. Since harmonization has many facets, we discuss them all in the next paragraph.

Having data based on 14 countries also helps us to check the degree of vertical harmonization existing in each country, as well as the distance between them. A tool to reduce this distance, and to enhance comparability among financial reports, may be the adoption of widely accepted standards.

This book's third objective is therefore to discuss international accounting standards. In order to do this, each country chapter reports on whether and to what extent public sector accounting follows any set of international standards, or if it still refers to national standards.

This updated picture of public sector accounting and auditing in a large group of European countries gives us relevant information on the need and room for harmonization policies, on the choices made as far as accounting standards are concerned, and on possible attitudes towards the future adoption of newly established standards (such as the, so-called, European Public Sector Accounting Standards (EPSAS)).

Having set these aims, this chapter deals with theoretical questions on the above mentioned items – while the last one will present a number of open issues.

1.2 First challenge: international harmonization

Accounting harmonization is currently an important issue, in both the private and public sectors.

According to Nobes (1991: 70) it is "a process of increasing the compatibility of accounting practices by setting bounds to their degree of variation".

Thus, harmonized accounting systems should be largely homogeneous, under a number of relevant aspects, such as underlying assumptions, list, format and content of documents, evaluation principles and measurement bases among others.

Historically, concerns for country-based harmonization appeared largely before requests for international harmonization – and are continuing to play a significant role in the decisions of many key actors (Nobes, 2013).

If we focus on the public sector, a country-based harmonization can be pursued between the accounting systems used at different government levels in a single country (vertical harmonization) or between a country's private and public accounting systems: public administrations, private companies, associations and non-profit organizations should all have similar or "harmonized" accounts (horizontal harmonization).

The differences between government budgeting, national accounting and the accounting discipline have also been considered, which might also deserve some reconciliation within countries (Jones, 2003).

Eventually, a demand for a harmonization between countries (or international harmonization) emerged. As Lüder and Kampmann (1993: 63) suggested, this demand was originally due to a number of specific events, like the growth of international capital markets or the increasing role of international organizations in granting loans to national governments and public institutions. At the same time, harmonization gained support as a tool to enhance government accountability, to make life easier for parties interested in reading and comparing financial reports and in evaluating the different governments' performance, and for transparency.

Some doubts about the usefulness of international harmonization have nevertheless been raised by scholars. Among them, Nobes (1988: 204) suggested that while "for commercial accounting there are obvious beneficiaries of harmonization", this would not be the case for public sector accounting: individuals rarely "lend internationally to governments". There are, we could add, institutional investors operating internationally, but these can receive tailored information from governments asking for financial assistance.

There is also a feasibility issue to consider: countries hardly ever start from the same point; accountants have different backgrounds and qualifications; the amount of investment needed to harmonize can be enormous. All this meant letting go of any prospect of a worldwide harmonization, and suggesting the pursuance of some sort of "regional" international harmonization in homogeneous clusters of countries (Monsen, 1994).

This sort of circumscribed harmonization could be quite interesting for the member states of the European Union that have agreed to coordinate their economies in many respects; comparing budgets, financial reports and performance measures should then be common practice, both for governments and citizens.

Additionally, as Lüder and Kampmann (1993: 74–78) noticed, harmonizing at EU level would allow for the production of good quality data to be used with a view to assessing each country's compliance with the parameters established in European treaties.

This same position has been quite recently taken by the EU Commission (2013: 5), which believes that the statistical data needed for the compilation of macroeconomic statistics on government (art. 338 of the Treaty on the Functioning of the European Union) "would be considerably improved if all government entities used harmonised accounting standards".

The Commission (ibid.) suggests that "harmonised standards for public sector accounting would enhance transparency, comparability and cost efficiency".

The variety of accounting systems throughout the EU is seen as an obstacle to fiscal transparency and surveillance and, ultimately, as a threat to an acceptable European governance. The financial crisis, the Commission adds (ibid.), "underlines the importance of timely and reliable financial and fiscal data, and evidences the consequences of insufficiently complete and comparable financial reporting in the public sector".

International harmonization, we can conclude, has many supporters, and raises big expectations. Whether these can really be met is debatable, however. The evidence collected by this book's authors, and presented in the following chapters, suggests many governments are reluctant to strive for this Europe-wide harmonization. Despite some formal backing, governments mainly work inside their country to achieve internal vertical or horizontal harmonization.

This is no surprise. Public sector accounting is one aspect of a country's sovereignty, which cannot be disposed of without very compelling reasons. A testimony of this can be found in the recent creation of a number of national standard setters (such as the Conseil suisse de présentation des comptes publics, the French Conseil de normalisation des comptes publics, or the German Gremium zur Standardisierung des staatlichen Rechnungswesens, all established in the period 2008–2009).

The creation of these bodies, and the missions officially attributed to them, confirm that the main orientation of standard setters continues to be national; when a reference is made to the international perspective and to the production of international standards, this is more to influence them than to get inspiration from them or to work towards an agreed upon harmonization (Caperchione and Mori, 2013: 326).

The most convinced supporters of harmonization are other parties, who are more genuinely linked to an international dimension. The major auditing firms, investment funds, consulting teams, as well as the international standard setters, are all in favour of whatever action may lead to a convergence of accounting systems. As Christensen (2005) suggests, these players promote and back accounting reforms and, in so doing, use private sector accounting as the substantial benchmark for the public sector.

Some academics, such as Budäus et al. (2013), are also quite clear in expressing their agreement for a profound change of governmental accounting and believe harmonization is a must. This enthusiasm, however, is not shared by many.

If this is the landscape in which the issue has to be dealt with, there probably are some suggestions for the prospective promoters of a successful harmonization.

A first obvious recommendation would be not to forget the, already mentioned, relevance of public sector accounting to a country's sovereignty.

A second point concerns the very nature of harmonization, which should be much more a matter of convergence, to be obtained over time, than the search for uniformity (Lüder, 2014: 424–425). The latter, consisting of "the imposition of a more rigid and narrow set of rules", could rather be called standardization (Nobes, 1991: 70). As Adam et al. (2014: 146) clearly point out, standardization can hardly be seen as a realistic prospect for EU member countries, which will quite probably wish to keep a significant autonomy and are therefore unlikely to accept a situation in which all accounting rules would be unified with no room left for options.

We then have to consider that the various kinds of harmonization do not always work in the same direction; if a country is requiring public sector accounting to move towards the same country's private sector accounting, this may be to the detriment of an external harmonization. Similarly, the satisfaction of specific information needs at local level, where many decisions are taken, can hinder the move towards a common international framework. This makes it necessary that any harmonization action clarify and balance its objectives and priorities.

Finally, the process is important. As things stand, harmonization requires that governments arrive at a truly agreed upon proposal. At European level, this is more likely to happen not only if the different voices can be heard, but also if the proposal concentrates on what is really needed.

1.3 Second challenge: choice and implementation of international accounting standards

Most recent interventions on governmental accounting systems have been driven by the move to accrual. This is an apparent trend, which has significantly influenced many a legislation, as can be seen extensively in the following chapters.

The reasons behind this move, and its outcomes, have been largely discussed in the scientific community. Lüder was a pioneer in this debate, suggesting the public sector should adopt "an approach somewhere between traditional public sector cash-based accounting and business accounting, but closer to the latter" (1988: 100) and promoting pilot studies in German local administrations. Other scholars have also supported the diffusion of accrual, while some voices have underlined a number of possible shortcomings to this move (e.g. Ellwood and Newberry, 2007; Lapsley et al., 2009; Hyndman and Connolly, 2011), so the debate is still open.

The adoption of accrual, a system intrinsically characterized by the existence of possible alternative criteria in evaluating assets, liabilities, revenues and expenses, requires the introduction of a set of accounting standards. These can reduce the subjectivity and discretionary power of preparers of financial statements and limit the possibility of adopting window dressing policies.

Accounting standards, generally made up of a conceptual framework and book-keeping and measurement standards, have been quite frequently derived from business accounting – although the need remains to set specific standards whenever public sector specificities have to be tackled.

Depending on the relevant country's legal system and accounting tradition, the production of national standards has followed different paths, as has their enforcement (Caperchione, 2000).

Similarly to what has happened in the private sector, the awareness of these common and often overlapping developments was at the basis of many proposals for a set of international accounting standards, which could also serve as a tool for international harmonization (Benito et al., 2007: 298).

The key player in this regard has been – and still is – the International Public Sector Accounting Standards Board (IPSASB), which started in 1986 as the Public Sector Committee of the International Federation of Accountants (IFAC) and in 2004 became an independent standard setting board supported by IFAC. Aimed at enhancing "the quality, consistency, and transparency of public sector financial reporting worldwide", the IPSASB has produced 38 International Public Sector Accounting Standards so far. All this work has attempted to achieve the least possible distance from the private sector standards developed by the International Accounting Standards Board, so that the two sets are highly homogeneous, although distinct.

Due to their origin, International Public Sector Accounting Standards (IPSAS) are normally not compulsory. The Board extensively promotes and encourages their adoption, which mainly means reporting according to the standards. A growing number of supranational organizations are adopting IPSAS, as are a growing number of countries, especially developing ones. While the IPSASB proudly reports this increasing success (IPSASB, 2014), attention should be paid to the fact that, as is the case for businesses, what at first sight looks like an adoption of a set of standards may actually be a less binding referral to them (Zeff and Nobes, 2010).

Moreover, many Organization for Economic Co-operation and Development (OECD) countries seem unwilling to move to IPSAS, despite the margins left for adaptation. This is also apparent in many of the countries analysed in this book, which surely adds to the divergence of their accounting systems.

This persisting divergence is currently being challenged at European level, since it is seen as a great obstacle to an effective functioning of the European Union. The poor quality of some countries' reporting has been claimed to have played a significant role in delaying a complete awareness of the size and impact of the financial crisis. So the request for a change in accounting is encouraged, which should allow for the collection of trustworthy data on which to base the checks on a country's compliance with agreed parameters.

A first step in this direction has been the, so-called, Six-Pack, a legislative package adopted by the Council of the European Union on 8 November 2011, within which is the Council Directive on requirements for budgetary frameworks of the member states, whose article 16 (3) led the Commission to carry out an assessment of the suitability of IPSAS for EU member states by the end of 2012.

To this aim, a public consultation was launched in February 2012 by Eurostat, which received 68 submissions from a variety of stakeholder groups and individuals (Eurostat, 2012). According to the EU Commission (2013: 8) "the overall conclusion is twofold. On the one hand, it seems clear that IPSAS cannot easily be implemented in EU Member States as it stands currently (sic). On the other hand, the IPSAS standards represent an indisputable reference for potential EU harmonised public sector accounts". The Commission also believes that "most stakeholders agree that IPSAS would be suitable as a reference framework for the future development of a set of European Public Sector Accounting Standards".

These conclusions are debatable, not least due to the very low number of responses and their poor statistical significance. The multifaceted reality of the, then, 27 countries was difficult to capture in 68 papers (of which a dozen were from outside Europe, ten from private individuals, and only six countries with three or more submissions) submitted to a non-compulsory consultation.

Nevertheless, Eurostat has subsequently taken the initiative, starting an ambitious programme aimed at developing and gradually introducing EPSAS in member states.

The whole design of EPSAS, truly a work in progress, will not be presented here: public presentations, official and unofficial websites, and briefing papers such as FEE (2014) allow any interested party to follow the project's objectives and ongoing development.

We can, however, report that an intense debate about EPSAS is taking place among both academics and practitioners.

What is remarkable is that most positions are either very favourable to EPSAS and to the change they can bring at European level (e.g. Budäus, 2013: 98–100) or, more frequently, quite sceptical about their real usefulness and applicability.

Lüder (2014: 420–421) discards the expectation that EPSAS would actually allow for uniform reporting in the Eurozone countries, let alone in the EU-28. The EPSAS will inevitably be a result of a political compromise, and will consequently leave the room open for alternative treatments and measurement options – to the detriment of their overall coherence and comparability.

Jones and Caruana (2014: 268) do not believe that "EPSAS transformed from IPSAS" can really provide the information needed for budgetary surveillance. IPSAS, they say, have nothing to do with budgeting; their link to business accounting standards makes it difficult to allow a significant link to the current European System of National and Regional Accounts (the so called ESA 2010); they are "inextricable from an independent audit providing an opinion on the fairness of the resultant financial statements, based on a set of auditing standards" – about which "the EPSAS proposal is silent".

The cost of the whole transition to EPSAS is worrying many parties who are analysing the required steps.

The Bundesrechnungshof (German Federal Court of Audit) expects huge costs to German public administrations. The first adoption of EPSAS would require extensive use of consulting, education and IT services, whose costs could be much higher than foreseen, because of a potential demand–supply mismatch (2014: 14).

Lüder (2014: 423) adds to the implementation costs those needed for the subsequent necessary follow-up to any change in standards and interpretations, and those for the implementation of new standards.

The report recently presented by PwC (2014) cannot fully remove these worries, both for the too many assumptions it is (maybe inevitably) based on, which may undermine the significance of the calculations, and for the fact that a consulting firm could obviously be regarded as a party interested in developing of a new area of business (Bundesrechnungshof, 2014: 8; 14).

The accounting discipline, on its side, sheds additional light on what a set of international standards could really provide. Nobes (2013) provides evidence that despite a (claimed) wide adoption of International Financial Reporting Standards (IFRS), divergences remain in place, due to policy options, enforcement practices and language issues. Clarke and Dean (2007) observe that private companies' compliance with the accounting standards does not immediately lead to financial statements actually disclosing those companies' wealth and financial progress; they also believe that misleading financial statements are more the result of compliance with the accounting rules with the best of intentions, than of a deviation from them with the intent to mislead.

We should not expect, consequently, that EPSAS will necessarily ensure transparency, or avoid malpractice. Thus, in order not to misjudge what EPSAS can really offer, it is probably necessary to dispose of rhetoric, and redesign the whole process, leaving more room for suggestions coming from the field and limiting change to what is really essential.

A reasonable path should then consist of a critical analysis of potential benefits and expected costs, an evaluation of alternative solutions and a careful management of the change process.

We have already dealt with costs, we can only add here that costs are certain – although not easily quantifiable – while the benefits may be uncertain. A thorough examination of possible alternatives is asked for by many parties.

The Financial Reporting Advisory Board of the UK Treasury considers that "Eurostat's central aim of improving macro-level statistical reporting by ensuring the application of accrual accounting standards at the micro-level could be met by other more proportionate approaches. This could include requiring Member States to introduce a recognised suite of internationally accepted accruals-based accounting standards (be that IPSAS or IFRS) throughout the general government sector by a set date with an understanding that the individual context of Member States will lead to a need for some local adaptation or interpretation" (FRAB, 2014: par. 6).

The Bundesrechnungshof (2014: 14) shares this view and suggests looking for less far-reaching reforms in order to improve the quality and comparability of data.

A real alternative, according to Lüder (2014: 419; 424), could consist of choosing the IMF's GFS and the Government Finance Statistics Manual as the basis for harmonizing public sector accounting in Europe. GFS, he believes, have been developed for the public sector: they facilitate matching with national accounts; they offer a consistent and quite stable framework; they widely limit accounting options, so favouring a higher quality and comparability (about this alternative, and its application in Australia, see also Barton, 2011).

Finally, as to the change process, it should be managed with great caution, taking into account the very diverse starting points of the relevant administrations. These are also given a specific paragraph in every country chapter in this book. Since EPSAS (and IPSAS) are on offer for countries to harmonize, it is probably useful to evaluate whether countries could really move to either of them easily, or that, at the very least, they could comply if necessary.

The authors of the country chapters have thus been asked not only to report on whether IPSAS, IFRS or national standards are in place, but also to give their estimate of the readiness for a (further) change, and of the initiatives needed in order to succeed in this task.

1.4 Conclusion

We have seen throughout this chapter public administrations are facing two important and interconnected challenges, namely reducing the distance between their accounting systems and choosing an appropriate set of standards to achieve this aim.

In this respect there are many open issues: the willingness to adopt international standards is not spread equally, and is sometimes quite limited; there is more than one set of standards available; and a general consensus on which set would best fit the needs of EU member states is still missing.

The debate will probably last for a long time, and will allow for the refinement of the proposed solutions; but none of them, we believe, will prove satisfactory, if a wholly uniform system is designed which overlooks the importance of good management at a decentralized level. Practitioners, scholars and legislators ought to pursue an apparently more modest, but probably more effective, convergence on the essential points, if they really wish to contribute to harmonization.

References

B. Adam, M. Fudalla and K. Lüder (2014), "Positionspapier 'European Public Sector Accounting Standards' (EPSAS): Möglichkeiten und Grenzen der Harmonisierung des öffentlichen Rechnungswesens in der Europäischen Union", *der gemeindehaushalt*, 115 (7), 145–147.

A. Barton (2011), "Why Governments Should Use the Government Finance Statistics Accounting System", *Abacus*, 47 (4), 411–445.

B. Benito, I. Brusca and V. Montesinos (2007), "The Harmonization of Government Financial Information Systems: The Role of the IPSASs", *International Review of Administrative Sciences*, 73 (2), 293–317.

D. Budäus (2013), "Institutionelle Transparenz als wesentliches Element einer demokratisch legitimierten öffentlichen Ressourcensteuerung", in W. Wallmann, K. Nowak, P. Mühlhausen, K-H. Steingässer (Hrsg.), *Moderne Finanzkontrolle und öffentliche Rechnungslegung, Denkschrift anlässlich der Verabschiedung von Herrn Prof. Dr. Manfred Eibelshäuser aus dem Amt des Präsidenten des Hessischen Rechnungshofs*. Köln: Luchterhand Verlag, 81–100.

D. Budäus, A. Burth and D. Hilgers (2013), "Ist eine Harmonisierung des europäischen Haushaltsrechts sinnvoll?", *HaushaltsZeitung*, 2, 11–14.

Bundesrechnungshof (2014), *Bericht nach § 88 Abs. 2 BHO über die angestrebte Umsetzung harmonisierter Rechnungsführungsgrundsätze für den öffentlichen Sektor (EPSAS) in den Mitgliedstaaten der Europäischen Union*, Bonn 13 February 2014.

E. Caperchione (2000), "Trends and Open Issues in Governmental Accounting Systems: Some Elements of Comparison", in E. Caperchione and R. Mussari (eds), *Comparative Issues in Local Government Accounting*. Boston: Kluwer Academic Publishers.

E. Caperchione (2006), *The New Public Management. A Perspective for Finance Practitioners*. Brussels: FEE.

E. Caperchione and E. Mori (2013), "L'harmonisation comptable des administrations publiques: une analyse comparée internationale", *Politiques et Management Public*, 30 (3), Juillet–Septembre, 315–328.

M. Christensen (2005), "The 'Third Hand': Private Sector Consultants in Public Sector Accounting Change", *European Accounting Review*, 14 (3), 447–474.

F. Clarke and G. Dean (2007), *Indecent Disclosure. Gilding the Corporate Lily*. Melbourne: Cambridge University Press.

S. Ellwood and S. Newberry (2007), "Public Sector Accrual Accounting: Institutionalising Neo-liberal Principles?", *Accounting, Auditing and Accountability Journal*, 20 (4), 549–573.

EU Commission (2011), *Council Directive 2011/85/EU on Requirements for Budgetary Frameworks of the Member States*.

EU Commission (2013), *COM (2013) 114 Final, Report from the Commission to the Council and the European Parliament. Towards Implementing Harmonised Public Sector Accounting Standards in Member States. The Suitability of IPSAS for the Member States*. Brussels.

Eurostat (2012), *Public Consultation – Assessment of the Suitability of the International Public Sector Accounting Standards for the Member States, Summary of Responses*. Luxembourg.

FEE – Fédération des Experts Comptables Européens (2014), *Briefing Paper on EPSAS*.

FRAB (2014), *Financial Reporting Advisory Board Paper. Secretariat Paper. European Public Sector Accounting Standards – Update on Recent Developments*, 3 April.

N. Hyndman and C. Connolly (2011), "Accruals Accounting in the Public Sector: A Road not Always Taken", *Management Accounting Research*, 22 (1), 36–45.

International Public Sector Accounting Standards Board (IPSASB) (2014), *International Public Sector Accounting Standards Board Fact Sheet*, April.

R. Jones (2003), "Measuring and Reporting the Nation's Finances: Statistics and Accounting", *Public Money and Management*, 23 (1), 21–28.

R. Jones and J. Caruana (2014), "A Perspective on the Proposal for European Public Sector Accounting Standards, in the Context of Accruals in UK Government Accounting", *Accounting, Economics and Law*, 4 (3), 265–282.

E. Kvaal and C. Nobes (2012), "IFRS Policy Changes and the Continuation of National Patterns of IFRS Practice", *European Accounting Review*, 21 (2), 343–371.

I. Lapsley, R. Mussari and G. Paulsson (2009), "On the Adoption of Accrual Accounting in the Public Sector: A Self-evident and Problematic Reform", *European Accounting Review*, 18 (4), 719–723.

K. Lüder (1988), "Governmental Accounting in West European Countries: With Special Reference to the Federal Republic of Germany", in J.L. Chan and R.H. Jones (eds), *Governmental Accounting and Auditing*. Routledge, London: International Comparisons, 82–104.

K. Lüder (2014), "Harmonisierung des öffentlichen Rechnungswesens in der EU mittels internationaler Standards? Einige Anmerkungen zur Diskussion von EPSAS", in Hessischer Rechnungshof (Hrsg.), *Entwicklung der öffentlichen Rechnungslegung in Europa – European Public Sector Accounting Standards (EPSAS)*. Wiesbaden: Kommunal- und Schul-Verlag, 415–427.

K. Lüder and B. Kampmann (1993), *Harmonisierung des öffentlichen Rechnungswesens in der Europäischen Gemeinschaft*. Speyer: Speyerer Forschungsberichte, nr. 125, Forschungsinstitut.

N. Monsen (1994), "Regional Accounting Harmonization. A Case for Regional Accounting Standards", in E. Buschor and K. Schedler (eds), *Perspectives on Performance Measurement and Public Sector Accounting*. Bern: Paul Haupt.

C. Nobes (1988), "An Historical-Comparative Perspective of Governmental Accounting", in J.L. Chan and R.H. Jones (eds), *Governmental Accounting and Auditing*. Routledge, London: International Comparisons.

C. Nobes (1991), "Harmonization of Financial Reporting", in C. Nobes and R. Parker (eds), *Comparative International Accounting*, third ed. New York: Prentice Hall, 70–91.

C. Nobes (2013), "The Continued Survival of International Differences under IFRS", *Accounting and Business Research*, 43 (2), 83–111.

PwC (2014), Collection of Information Related to the Potential Impact, Including Costs, of Implementing Accrual Accounting in the Public Sector and Technical Analysis of the Suitability of Individual IPSAS Standards 2013/S 107-182395, downloadable at http://ec.europa.eu/eurostat/documents/1015035/4261806/EPSAS-study-final-PwC-report.pdf, last download 23 January 2015.

S. Zeff and C. Nobes (2010), "Commentary: Has Australia (or Any Other Jurisdiction), 'Adopted' IFRS?", *Australian Accounting Review*, 20 (2), 178–184.

Useful sites

http://ec.europa.eu/eurostat/web/government-finance-statistics/government-accounting

http://www.epsas.eu/de/

2

Public Sector Accounting and Auditing in Austria

Iris Rauskala and Iris Saliterer

2.1 Introduction

Austria is a federal republic that consists of nine states (*Länder*) and 2,354 (in 2013) local governments, which are organized upon the principle of local self-administration. The combination of a federal principle and the principle of local self-administration accounts for the organizational complexity of Austrian public administration. Legislation is divided between central and federal governments, while executive functions are split even further between all three levels of government. The strong legalistic tradition and the federal principle also impact the development and implementation of budgeting and accounting reforms at all levels. Mutual legislative participation of federal and state governments makes far-reaching reforms in general a very complex and prolonged process (Meyer and Hammerschmid, 2005).

2.2 Public sector accounting standards in Austria

2.2.1 Framework of public sector accounting

According to the legal traditions of the Austrian state, governmental budgeting and accounting standards are laid down in laws, regulations and directives. Therefore, in most cases budgeting and accounting reforms make legal amendments necessary.

In the years 2007–2013 the central government implemented a comprehensive budgeting and accounting reform (see Section 2.3). The reform involved amendments of the constitution on the one hand, where the core pillars and main principles (outcome/performance orientation with explicit integration of gender equality, efficiency, transparency, true and fair view) of the reform were laid down; and, on the other hand, comprehensive revisions of Federal Budget Law (*Bundeshaushaltsgesetz, BHG*) through the introduction of two detailed reform bills, which were unanimously approved by Parliament in 2007 and 2009. Based on the BHG, a number of regulations were issued by the Ministry of Finance (MoF) with the consent of the

Court of Audit (CoA) (e.g. Federal Budget Regulations, Chart of Accounts Regulations, Opening Balance Regulations), or by the CoA itself where it had responsibility (e.g. Accounting Regulations). Some of these regulations were further operationalized through directives, which included detailed explanations regarding the origin and implementation of different accounting standards.

As the nine federal states are autonomous in regulating their own and their local governments' budgeting and accounting systems a high diversity of budgeting and accounting approaches can be observed. The legal budgeting and accounting frameworks for the three layers of government can therefore be regarded as highly complex. Apart from primarily reporting-oriented harmonization elements laid down in the *Voranschlags und Rechnungsabschlussverordnung* (VRV, see Sections 2.2.2 and 2.2.4), up until then no general accounting plan or conceptual framework for public sector entities at all levels had existed.

The VRV includes the charts of (economic) accounts (which are very similar at central, state and local government levels) and a detailed functional chart for regional and local governments to ensure the comparability of their reports. In the course of the reform at central level, the chart of accounts only needed minor adaptations as it included most of the accounts necessary for accrual accounting elements since the 1980s. At central level this was laid down in the Chart of Accounts Regulation (and not in the VRV) and served as a basis for the different financial statements. Here, a revised internal accounting manual is in the preparation stage. For all levels there is a direct link between each account and its respective position in the required financial statements.

2.2.2 Financial statements, consolidation, measurement and recognition standards

Even though no general accounting plan exists, some crucial harmonization elements have been established in a *Voranschlags und Rechnungsabschlussverordnung* (*VRV*), issued by the Ministry of Finance (MoF) together with the Court of Audit (CoA), the last amended regulation being the VRV 1997. The power of the central level to issue this regulation (VRV) is laid down in the constitution (§ 16 (1) Finanz-Verfassungsgesetz). The consensus that the central level has the power to issue a regulation which defines the compulsory structure of the budget and the financial statement for harmonization purposes (VRV) was reached in 1949. Nevertheless, amendments to the VRV have always relied on a broad consensus, as a gentlemen's agreement was reached in the 1970s, which made the unanimous approval of all members of the VRV Committee (*VRV Komitee*) necessary. This committee consists of representatives from central, regional and local government levels, as well as the Austrian Court of Audit. Local governments are represented by the Associations of Towns and Municipalities.

The VRV has the aim of ensuring the comparability of budgets and financial statements from regional and local governments and defines their compulsory structure, their content and their measurement bases. Budgets have to be cash/obligation based and take the form of line-item budgets, being comprised of strict and detailed functional categories directly integrated with the relevant economic accounts. This results in budgets with the same structure/format for each regional and local government. Accordingly, federal states and local governments have to publish closing accounts, which have to be cash and commitment (receivables and payables) based (see Lüder, 2002 or Anessi Pessina and Steccolini, 2008 for an explanation) and take the form of budgetary accounting (execution) statements.

Moreover, as laid down in the VRV, a large number of compulsory notes, which include additional information (e.g. financial liabilities, transfer payments), have to be enclosed. At the regional and local levels a balance sheet is only requested for specific types of public enterprise, which are not regulated in detail. Most states and some local governments enclose a financial position or a financial performance statement but, due to the high diversity of accounting standards applied by the states, the statements cannot be compared.

According to the VRV, budgeting by regional and local governments has to be on a (modified) cash basis with the consequence that financial reporting does not play a significant role as the information provided is not considered relevant within decision-making processes. Due to the focus on statements based on modified cash the elaboration of consolidated statements on the basis of financial accounting is not required.

However, due to the comprehensive budgeting and accounting reforms at central level, the picture is changing, as the reform is now also having an impact on the other two governmental layers. The reform shows a strong orientation towards International Public Sector Accounting Standards (IPSAS) and is described in detail in the next section as it comprises crucial elements (e.g. accounting principles, compulsory elements of financial statements, measurement and recognition standards, standards for the consolidated statements) with regard to the intended harmonization of budgeting, accounting and reporting standards for all levels. In this context, a new VRV is in negotiation, which uses the legal reform framework of the central level as a reference model.

2.2.3 Links between the budget and financial accounting

Since 2013 budgeting and accounting at central level has been accruals-based, which, on a double-entry bookkeeping basis, also allows for the integration of budgetary (execution) accounting. At regional and local government levels the dominant form of public sector accounting in Austria is still the, so-called, cameralistic one (*Kameralistik*). From a technical view, cameralistic accounting is based on single-entry bookkeeping, keeping and presenting the operating account in the same format as, and alongside, the budget (Jones and Pendlebury, 2000: 158). In its classic form, it includes only cash transactions but it is being developed constantly and in the Austrian context it can be classified as modified cash based. It highlights the central role of the budget in a public sector context, arguing that the most important role of accounting is to record and control the execution of the budget approved by the politicians. In the 1980s the central level (followed by some regional governments) introduced an accounting system that included a shift from cameralistic accounting, while not losing its strength mentioned above, which can be described as a "budget execution stage-oriented double-entry-based system" allowing for the parallel recognition of accrual and cost accounting elements. Local governments from one state have applied a modified version of accrual accounting since the 1950s, while local governments in other federal states apply extended forms of cameralistics or elements of accrual accounting. Although the accounting landscape at state and local government levels in Austria is characterized by a high diversity of accounting techniques, they all maintain a strong link between the budgeting and accounting systems.

2.3 Central government

According to the BHG, public sector budgeting and accounting regulations are applicable to all entities that belong to the core sector of government. Moreover, legal entities managed by central government entities, or by persons appointed for this purpose by central government entities (e.g. the central accounting agency), also have to apply these regulations (BHG 2013 and the Accounting Regulation RLV 2013). However, government entities with their own legal personality or institutions with partial legal independence are excluded from the scope of this law (e.g. the public universities). Legally independent business entities that are managed or controlled by the federal government and apply the Austrian Commercial Code (*Unternehmensgesetzbuch, UGB*) are also excluded from this regulation (e.g. Austrian Federal Forests). The UGB includes the national accounting standards for the business sector, which are not always in line with IPSAS.

The central level strived towards implementing accrual budgeting and accounting as a central part of a comprehensive budgeting and management reform starting with pilot projects in 1999. Implementation of the current budgeting and accounting reform started in 2007 and took full effect in 2013. The first stage of the reform, which took effect in 2009, introduced a four-year medium-term expenditure framework with binding ceilings accompanied by budget strategy reports and a new reserves regime. The second stage, starting in 2013, introduced a revised, simplified and outcome-oriented budget structure based on functions (pyramid structure: five rubrics,[1] 32 functional chapters around 70 global budgets) and organizational responsibilities (224 first-order detailed budgets and 141 second-order detailed budgets, administrative units). This step represents a shift from detailed line-item budgeting and is closely linked to the implementation of a lump-sum budgeting approach, which is informed by performance information. As a counterbalance to the increased flexibility and managerial freedom, the ministries and administrative units have to conform to specified accountability and transparency requirements, for example, reporting outputs and outcomes, managing their budget within agreed ceilings, and preparing their budgets and accounts on an accrual basis (Seiwald, 2013). The introduction of this last represents a major element of the second reform stage. The accrual accounting reform is IPSAS-oriented, and aims to provide a true and fair view of public finances. According to Austria's legalistic tradition, IPSAS are not applied directly, but are implemented through national law and respective regulations and directives. In fact, the introduction of IPSAS is not a copy and paste approach, since there are a number of adaptations in respect of national characteristics and public sector accounting traditions and specialities (Steger, 2012). With regard to the aim of this contribution, the next section mainly considers the aforementioned aspects.

2.3.1 Budgeting

With the reform, budgeting is now accruals-based, as it comprises financial performance and cash flow statements following the logic of the new budget structure (each detailed budget has its own set of financial statements). Therefore both perspectives – use of cash for macroeconomic control and budget execution, and use of resources for management decisions – are available for steering the budget (Steger, 2010).

In this regard, the structure of the operating and cash flow statements replaces the structure of the old budgetary accounting regime. This allows a comparison of budgeted and actual amounts, which is in line with IPSAS 24 and also ensures budget execution control. A statement of financial position is not part of the budgeting process.

With its comprehensive budgeting and accounting reforms, Austria is part of the group of countries that have set in place accrual accounting which, on a double-entry bookkeeping basis, also allows for the integration of budgetary (execution) accounting. Within the latter, different budget stages or transactions defined in the BHG 2013 are recognized: (1) pending liabilities, (2) receivables and liabilities and (3) payments. According to the BHG, transactions are recognized as pending liabilities, where allocations have been noted or reserved but no liability has been established yet, and allocations for which no receivable has been established yet. The first two mentioned transaction types are not shown in the cash flow statement, which takes the form of a budget execution statement, but offer important information for the reserves regime. The (budgetary) cash flow statement results from the cash and obligation based system, which is integrated in, or run parallel to, the accrual accounting cycle (Nasi and Steccolini, 2008; Anessi Pessina and Steccolini, 2007). The accounting standards, which are applicable to the latter, are described in the next section.

2.3.2 Accounting

Assets: presentation, measurement, recognition and valuation criteria

The BHG differentiates between long-term (current) and short-term (non-current) assets. Long-term assets comprise the minimum categorization of immaterial assets, property, plant and equipment, securities, investment in associates and long-term receivables. Short-term assets comprise the minimum categorization of short-term receivables, inventories and cash. Besides these differentiations, a general definition of the term asset is missing. However, as the reform is IPSAS-oriented, the application of the respective asset definition is likely. Nevertheless, there is no differentiation between assets generating future economic returns and assets generating service potential, as IPSAS 16 has not been applied. In this context, the Ministry of Finance stated that the recognition and valuation of an asset does not imply that it is for sale or that it is held for economic benefit (Gschiel and Seiwald, 2014). Assets are mainly held for the public good, thus the main interest is the generation of service potential. This understanding also affects the valuation criteria applied to the valuation of different asset categories.

The central government recognizes an asset according to the principle of economic control (§ 50 BHV 2013). Economic control is given where the central government uses an asset and takes the risk of its loss as if it was the owner of the asset, irrespective of the ownership according to civil law. The following measurement bases are applied:

- Cost/acquisition cost or cost of purchase/construction cost.
- Cost less any accumulated depreciation.
- Fair value.

With regard to the measurement of long-term assets after recognition, only the cost model may be applied, except for inventories. Moreover, intangible assets are only recognized and valuated if they are purchased. IPSAS 31, which allows for the recognition of construction costs under specific circumstances, is therefore not applied. Heritage assets (tangible and intangible) have to be recorded, but they need not be valuated (option), thus no depreciation is applied to these assets. In case they are not valuated, they are only recorded in the notes. Buildings form an exception to this rule, as they have to be both recognized and valuated.

In November 2013, an opening balance sheet for the central government following the new accounting regulations was made publicly available. Due to the lack of standards for the preparation of an opening balance sheet for units already in existence, a pragmatic approach was applied. Although mainly IPSAS-oriented, some specific regulations and directives were necessary to safeguard balanced costs and benefits (e.g. limitation of costly external expertise for valuation aspects).

Liabilities: presentation, recognition and measurement

The legislation, as well as the opening balance sheet for the year 2013, differentiates between the following categories of liabilities, which are in line with IPSAS 1 with regard to current and non-current liabilities:

- Long-term liabilities: long-term financial liabilities, long-term debt, long-term provisions.
- Short-term liabilities: short-term financial liabilities, short-term debt, short-term provisions.

There are detailed definitions for liabilities, debts and provisions. These definitions and recognitions are in line with IPSAS, but are regulated in greater detail because of the specific statistical requirements and the information needs of different stakeholders. Provisions for pensions are only included in the notes.

Recognition and measurement of revenues and expenses

The federal budget law gives a definition of revenues and expenses, which is generally in line with IPSAS. Due to the complexity with regard to the recognition of transfers and taxes (IPSAS 23), some differences occur. Expenses or revenues from transfers, which cannot be assigned to a specific financial year, have to be recognized at the moment of payment, while multi-year transfers have to be apportioned to the years for which they have been granted. The recognition of revenues from taxes follows the cash principle (§ 41 BHV).

2.3.3 Financial reporting

The BHG 2013, together with the respective regulation (RLV 2013), defines the compulsory elements of the annual financial statements, which are the following:

- The statement of financial performance, taking the form of budget execution statements.
- The statement of cash flow, taking the form of budget execution statements.
- The statement of financial position.

These statements are prepared for each of the 30 functional chapters and are also available for the detailed budget level. The predominant importance of budgeting and the political-administrative system's habituation to budgets and budget execution reports is reflected in the presentation of budget execution statements for the financial performance statement and for cash flows compiled by the Court of Audit after auditing the statements delivered by the ministries, as another set of separate financial statements besides the consolidated financial statements for the federal government. Consolidated financial statements in line with international regulation were only implemented with the reform in 2013. They consist of the following elements:

- The consolidated statement of financial performance.
- The consolidated statement of cash flows.
- The consolidated statement of financial position.

Financial statements and consolidated financial statements that followed the new regulation were produced for the first time for the financial year 2013. Though some kinds of aggregated financial statements also existed in the past, these did not comply with consolidation as defined in IPSAS 6–8 but could be interpreted as an aggregated budget execution statement with a core balance sheet.

With the new regulation, the consolidation scope and consolidation perspective, changed and control became the major principle for consolidation. This means that more than 130 investments in associates had to be included in the single financial statements of the functional chapters (Steger, 2012). Thus, for the federal consolidated financial statements, legislation is broadly compatible with IPSAS 6–8. The rules for full consolidation of entities of the federation (IPSAS 6) however were only followed sometime after 2013 in a third stage of reform (Steger, 2009). Until then, all investments of the federation were measured using the equity method (IPSAS 7).

The consolidated financial statements containing the budget execution statements are completed with the *notes to the financial statements*. They disclose the following information, in addition to that provided in the financial statements:

1. Investment in associates
2. Liabilities
3. Financial instruments
4. Property, plant and equipment and intangible assets
5. (Financial and operational) leases
6. Inventories
7. Financial assets and liabilities
8. Provisions
9. Revenue from exchange transactions
10. Revenue from non-exchange transactions (transfers)
11. Expenses and expenditure
12. Earmarked reserves and funds
13. Events after the reporting date

14. Transactions with related entities or persons
15. Information about federal employees
16. Future pension expenses
17. Deductions from tax revenue
18. Tax claims
19. Changes to the previous year
20. Budgetary indicators/financial statistics

The qualitative characteristics of the statements are also laid down in the BHG and are mostly in line with IPSAS 1.

2.3.4 Auditing

In Austrian central government, there are three main types of control: internal, internal audit and external audit. While internal control is defined in the BHG and regulations, the internal audit function is defined in the organizational law rather than the financial law of central government. Most ministries today have a separate unit responsible for the internal audit, which either reports directly to the minister, or – more often – serves as a unit in the line organization with reporting responsibilities to the minister. Internal audit involves activities like cost–benefit analysis, compliance checks to accounting principles, compliance checks to procurement procedures, analysis of the costs of regulation planned, advice on reorganization issues, as well as other control activities within the ministry. Furthermore, the federal accounting agency at central level has a range of auditing duties, which are laid down in the BHG 2013.

External auditing in Austria follows the federal principle and is carried out by the Austrian Court of Audit (ACA). Its independence is laid down in the constitution and it acts as an auditing institution at central, regional and local levels. At central level its audit focus comprises not only the core government, but also funds and entities under the control or administration of the federal government and other entities defined by law. The Court of Audit performs several activities, which are defined in the Court of Audit Law (*Rechnungshofgesetz*). Its main activities are in the field of compliance, financial and performance audits. The ACA reports to Parliament as it supports it in the execution of political control. With the reform of budgeting and financial accounting, the ACA has adjusted its audit principles accordingly. The ACA also carries responsibility for auditing and publishing the budget execution statements and indicators according to financial statistics, as it used to publish such information before the reform. In this context, it must be noted that the Court of Audit was a strong supporter of the recent budget reform and, together with the Ministry of Finance, was mainly responsible for preparing the technical framework and legal documents (Seiwald, 2013).

2.4 Regional government

2.4.1 Budgeting

The nine federal states are autonomous in regulating and designing their budgeting and accounting systems. Each federal state passes its own budgetary regulation through a public act that states how to elaborate the annual budgets. Nevertheless, the latter must not contradict the budgeting and accounting standards laid down in the VRV (see Sections 2.2.2 and 2.2.4). This results in budgets with the same structure/format for each regional and local government. Since 1997 each region has prepared a budget statement at an aggregate level, which can be compared to a cash flow statement, consisting of three parts. Considering the ongoing negotiation processes between the relevant actor groups (see Section 2.2.2) it seems likely that a "new" VRV will be issued in 2015. In this case regional and local governments will have to apply – adapted to their needs – budgeting and accounting standards similar to those at central level from 2018 (the application date is currently under negotiation).

2.4.2 Accounting

Accounting principles, which are laid down in regulations, rarely exist at regional level. Although – as described in Section 2.2.3 – a plurality of accounting models can be observed (ranging from budgetary accounting to accrual accounting), budgeting and accounting are always closely linked. From a technical perspective accounting does not fall under the scope of the VRV. Moreover, the recognition and measurement of criteria for assets and liabilities differ between states. Some states apply the regulations and directives that were issued for the central level in the 1980s, while others who apply accrual accounting, or at least accrual reporting, follow their own internal rules or the recognition and measurement standards laid down in the UGB.

2.4.3 Financial reporting

According to the Budgeting and Accounting Regulation (VRV 1997), federal states have to publish closing accounts, which have to be cash and commitment (receivables and payables) based and take the form of budgetary accounting (execution) statements. Moreover, a large number of compulsory notes, which include additional information (e.g. financial liabilities, transfers payments), have to be enclosed. A balance sheet is only requested for specific types of public enterprise, and is not regulated in detail. Based on their own regulations, most states enclose a financial position or a financial performance statement but, due to the high diversity of accounting standards applied by the states, the statements cannot be compared. Most of them also enclose a statement, which takes the form of a cash flow statement and assists in calculating the Maastricht "result" for each state.

2.4.4 Auditing

In all regions internal and external controls are present. Most regional governments have a separate unit responsible for the internal audit. Most of these units have gone through audits by the ACA in the last years to check for proper functioning.

The external audit is carried out by both the ACA and the regional courts of audit, as allowed for by the federal constitution, and the states therefore have implemented their own courts of accounts in recent years. While the ACA may audit all three levels of government and controlled and administered entities and enterprises, the activities of the state court of accounts are limited to: the activities of the respective state government and its controlled and administered entities, subsidies and guarantees; the activities of its municipalities; the social security institutions and the compulsory professional associations. So, basically within the limits of the state boundaries, the scope of activities is the same as with the ACA. To coordinate their activities, the ACA and the nine state courts of accounts consult each other and discuss their working plans.

2.5 Local governments

2.5.1 Budgeting

In the case of local governments, as with regional governments, budgeting and accounting regulations must not contradict the budgeting and accounting standards laid down in the VRV and therefore budgets at local government level follow the same logic (see Sections 2.2.4 and 2.4.1).

2.5.2 Accounting

Comprehensive accounting reforms at local government level make legal amendments necessary and are laid down in the Municipal Act or the Municipal Budgetary Act of each state. The latter are autonomous in regulating the budgeting and accounting systems of local governments within their jurisdiction. Therefore, complexity further increases, as local governments follow different accounting frameworks. The execution process for revenue and expenditure at local government level is mainly based on a modified cash basis – although in some regions this is not mandatory. All revenues and expenditures are recorded twice, when due and when collected or paid. The accounts list the amount of revenue and expenditure due but not yet received and collected at the end of the given fiscal year (this equates to the calendar year) as receivables and payables. This represents a further development of the single-entry bookkeeping method called cameralistics mentioned above (Lüder, 2002). At the moment, only local governments from one state (Vorarlberg) have to formally apply a modified version of accrual accounting, while local governments from other states apply extended forms of cameralistics or accrual accounting on a voluntary basis.

2.5.3 Financial reporting

According to the VRV, local governments have to elaborate the same financial statements as regional governments (see Sections 2.2.4. and 2.4.3), with one exception: the statement which takes the form of a cash flow statement and assists in calculating the Maastricht "result" for local government is compulsory. Depending on their region, local governments have to include a balance sheet but, in this case as well, the high diversity of accounting standards applied by the states makes comparisons impossible.

2.5.4 Auditing

Basically, municipalities are controlled by oversight bodies, which are situated within their state administration. Audit comprises *ex-ante* and *ex-post* controls. Depending on the size of the local governments, larger municipalities have separate control units, which are responsible for internal controls, internal audit and external audit, therefore following a monistic structure. In the case of indirect federal administration (activities performed by municipalities in executing federal law), specific units in the regional administration are endowed with the audit of these local governments activities. Additionally, the ACA may carry out audits for local governments with more than 10,000 inhabitants. Smaller municipalities fall within the sphere of the state administration audit.

Also for municipalities, audits comprise not only the core governmental sector but also funds and entities under the control or administration of the local government, as well as other entities defined by law. Moreover, the audit also comprises enterprises controlled by a municipality. The control focus is the same as at central and regional levels.

2.6 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

Accounting standards at central level are oriented towards IPSAS. As a consequence, it appears that the application of EPSAS – which use IPSAS as reference model – will not be a difficult task, as just a few new adaptations or modifications will probably be necessary. However, both challenge and potential lies in a development of EPSAS that also considers and tests the suitability of standards from countries that have already implemented budgeting and accounting reforms and have conducted evaluations thereof. In this context, it is also necessary to deal with and to overcome some of the weaknesses associated with IPSAS, and to consider the special information needs of public sector decision makers and the public. Some of the, so-called, weaknesses have been overcome by countries, with reference to specific needs of the public sector while staying in line with IPSAS, for example, the valuation of assets used for service potential is certainly different from assets used for cash generation. While IPSAS offers different methods of valuation anyway, implementation examples could help others to find their way of dealing with these aspects. The specific role and function of budget execution also needs to be addressed, which means that accrual accounting needs to be linked to budget execution. This domain is clearly outside the focus and mandate of the IPSASB. However, those countries that have implemented accrual budgeting so far have demonstrated that it is possible to provide both sets of information, and to link the dominant budgetary process with the accounting process (Meszarits and Seiwald, 2009).

2.7 Main challenges: problems identified

Nevertheless, one important deficiency of the current budget reform is that it has only covered the federal level, and not the sub-national levels. Originally, there were plans to integrate all levels of government, but the regions and the associations of towns and municipalities were skeptical and lobbied successfully against their integration in the reform process (Steger, 2010). At present, a plurality and complexity of budgeting and accounting models at the different levels of government can still be observed. However, since 2011, four regional governments have voluntarily started to adapt their budgeting and accounting standards in line with the reform at central level, some of them also including their local governments. Financial scandals, of which some are due to unclear or vague fiscal rules, might have played their role in this context as well. A major step towards harmonization could be the new budgeting and reporting regulation (VRV, 2014), which is currently at the negotiation stage and should take effect in 2018 (Saliterer, 2013). As this regulation uses the reform at central level as a reference model, the accounting standards therein show a strong orientation towards IPSAS and also include accrual budgeting elements (Meszarits and Saliterer, 2013). Another important harmonization instrument is the Austrian Stability Pact, which aims to improve fiscal coordination between levels of government and which committed regional and local levels to new fiscal rules, medium-term budget frameworks, reporting requirements, and new enforcement arrangements and sanctions (Seiwald, 2013). Both instruments have to be aligned in the future as they represent different but intertwined accounting spheres, allowing the connection of macro and micro accounting. In this context, the intersection between the two spheres has to be better aligned.

Note

1. The rubrics follow a functional perspective, with (1) law and security; (2) work, social affairs, health and families; (3) education, science, arts and culture; (4) economy, infrastructure and environment; and (5) cash and interest. An institutional entity (= a minister) therefore could have lump sum budgets from different rubrics.

References

E. Anessi Pessina and I. Steccolini (2007), "Effects of Budgetary and Accruals Accounting Coexistence: Evidence from Italian Local Governments", *Financial Accountability and Management*, 23 (2), 113–131.

P. Gschiel and J. Seiwald (2014), "Eröffnungsbilanz des Bundes – Wieviel neue Transparenz entsteht"?, *Das öffentliche Haushaltswesen in Österreich*, 55 (1–3), 27–45.

G. Hammerschmid and R. Meyer (2005), "Public Management Dynamics in a Federal Legalistic Rechtsstaat System: Results from an Executive Survey in Austria", *The International Journal of Public Sector Management*, 18 (7), 629–640.

R.H. Jones and M. Pendlebury (2000), *Public Sector Accounting*, fifth ed. London: Pitman.

K. Lüder (2002), "Government Budgeting and Accounting Reform in Germany", *OECD Journal on Budgeting*, 2 (1), 225–242.

V. Meszarits and I. Saliterer (2013), "Die Haushaltsrechtsreform des Bundes – Ausgangspunkt oder Zielkorridor für eine neue Voranschlags – und Rechnungsabschlussverordnung", *Zeitschrift für Recht und Rechnungswesen*, 7 (8), 43–59.

V. Meszarits and J. Seiwald (2009), "Budgetary Reform in Austria: Towards Tighter Coupling within the Financial and Management System", Working Paper 3/2008. Vienna: Federal Ministry of Finance.

G. Nasi and I. Steccolini (2008), "Implementation of Accounting Reforms", *Public Management Review*, 10 (2), 175–196.

I. Saliterer (2013), "Einheitliche Weiterentwicklung des Haushalts – und Rechnungswesens der Länder und Gemeinden. Implikationen und Vorschläge für eine VRV Neu (Teil I)", *Öffentliches Haushaltswesen*, 53 (1) 1–14.

G. Steger (2009), "Stand der Haushaltsrechtsreform des Bundes in Österreich", in R. Schauer (ed.), *Neue Formen der Steuerung und Rechnungslegung in öffentlichen Haushalten*. Linz: Trauner Verlag.

G. Steger (2010), "Austria's Budget Reform: How to Create Consensus for a Decisive Change of Fiscal Rules", *OECD Journal on Budgeting*, 10 (1), 7–20.

G. Steger (2012), "From Cash to Accrual Accounting Budgeting in Government – The Austrian Case", Presentation Held at the IFAC Global Seminar on the Sovereign Debt Crisis, Vienna, 19 March 2012.

Useful sites

J. Seiwald (2013), "Austria – From an Incremental Improver to a Comprehensive Reformer", Public Financial Management Blog: Making Public Money Count, http://blog-pfm.imf.org/pfmblog/2013/04/austria-from-an-incremental-improver-to-a-comprehensive-reformer.html (homepage), date accessed 6 July 2014.

Useful sites (further reading)

https://english.bmf.gv.at/budget-economic-policy/The-Austrian-Federal-Budget-Reform.html

3

Public Sector Accounting and Auditing in Belgium

Johan Christiaens and Simon Neyt

3.1 Introduction

Belgium and its public administration has evolved into a more efficient, but also more complex, federal structure following several state reforms between 1970 and 2011. The pyramid of a unitarian state made way for a multi-level structure with a redistribution of power between two levels. The top level of government now consists of the federal state, three communities (inspired by language and culture: Flemish-, French- and German-speaking Communities) and three regions (inspired by the establishment of more economic autonomy: Flemish, Walloon and Brussels-Capital). They are on an equal footing but have different powers and responsibilities for different policy domains. The lower level of government is occupied by the provinces and municipalities. These are supervised by the federal state, the community or the region depending on the powers or tasks they exercise. The power to make decisions is therefore no longer the exclusive preserve of the federal government, but leadership is in the hands of various partners who independently exercise their authority within their domains (Bellanca and Vandernoot, 2013).

Like many other continental European countries, reforms take place through the legislative process. The governments made an effort to modernize their accounting systems, mainly driven by the same principles, but a lack of harmonization has led to divergent accounting practices, which has created a high level of heterogeneity and diversity in the existing public sector accounting systems (Christiaens and Vanhee, 2012).

3.2 Public sector accounting standards in Belgium

Both the federal government (considered as the central government) and the regions and communities (considered as regional governments) have their own sovereign legislative powers regarding public sector accounting regulations (Bellanca and Vandernoot, 2013; www.belgium.be, 2014).

In addition to the legislators, who have decision-making powers with regard to auditing, accounting and budgeting, the commission for the standardization of public service accounting was of particular importance during the recent reforms. The Commission, created in 1991, had the objective of establishing a chart of accounts of the state's financial, budgetary and patrimonial operations and had to set rules concerning budgetary and economic charging. In 2010, the concept was developed to replace the Commission with a Public Accounts Committee but its creation, organization, membership and function still needs to be further defined.

3.2.1 Accounting systems in the Belgian public sector

Belgium has undergone a serious modernization of its public accounting systems in the last two decades. A series of new legislation made the country evolve from budgetary/cash accounting to a dual system of budgetary and accrual accounting.

Changes were inspired by the accounting systems used in the business sector (as in the law of 1975 on company accounting) and driven by New Public Management principles such as the strengthening of accountability, transparency and policy making. Politicians wanted more information on public assets and liabilities and public debts to increase public management and governance, information that budgetary accounting on a cash basis fails to provide.

A series of external pressures facilitated that change (Bellanca and Vandernoot, 2013):

- The pressure towards compliance with the European Accounting and Reporting Requirements: the imposed regulations by the European Union relating to national accounts (European System of National and Regional Accounts, ESA).
- The evolution of the Belgian state: which made it necessary to design general principles that could be commonly applied to all entities. Although communities and regions can freely determine their budgetary and accounting rules, they have to respect the general principles implied by federal law.
- The major restructuring of (federal and Flemish) administrations ("Copernicus Reform" and "Beter Bestuurlijk Beleid" in 2000): this showed the need to make the administrative organization of the state compatible with the budget and accounting systems.

The evolution started at local government level and then occurred at higher levels. An important change in public sector accounting for Belgium occurred in 2003,[1] when multiple laws were designated that introduced accrual accounting (instead of the cash-based accounting systems then in existence) for all entities depending on the federal state, regions and communities (Ghysels et al., 2011; Christiaens and Vanhee, 2012; Bellanca and Vandernoot, 2013), following the early example at local level. The 2003 reform wanted to introduce a uniform accounting system that strove for reconciliation of the existing systems at different government levels, based on the following elements and characteristics:

- It integrated double-entry bookkeeping, as the accounts were drawn up based on a closed dual system of budgetary and accrual accounting. The reform did not replace the budgetary accounting system but completed it with accrual accounting (Khrouz and Tsatsis, 2009). The benefit of a dual system is that it provides more and accurate information about the financial and economic situations of public entities, which enables us to estimate, among other things, public property and public debt. Budgetary accounting still enables entities to have budgets for separate departments and to monitor spending (Ghysels et al., 2011; Christiaens and Vanhee, 2012; Bellanca and Vandernoot, 2013).
- The principle of simultaneous bookkeeping: transactions are methodically recorded in the accounts of the general ledger and, insofar as they represent a budget operation, simultaneously recorded in the accounts of the budget classes (Ghysels et al., 2011).
- An accrual accounting system according to a chart of accounts, which includes a system of standardized accounts and rules for the recording, charging and assessment of operations.
- Accounting based on transactions, in conformity with the requirements of ESA (European System of National Accounts, ESA 95 at that time). It implies that, apart from budgetary and accrual accounting criteria, the accounting system separately recognizes transactions in terms of their ESA 2010 consequences (Bellanca and Vandernoot, 2013).

3.2.2 Measurement and recognition of assets, liabilities, equity, revenues and expenses

The chart of accounts was developed with a minimum of accounts and basic rules for the valuation of assets and liabilities, for the preparation of financial statements and for the accounting and billing of transactions.

Apart from these basic rules, more particular accounting rules, for example, those regarding buildings and equipment, have not been elaborated yet. Therefore, organizations themselves determine whether they apply, for instance, historical cost or fair value. These rules have to remain consistent however. In addition to the valuation rules, which are based on the Belgian legislation for business entities, a number of specific policies have been imposed that originate in the ESA 2010 regulations (Christiaens and Vanhee, 2012).

3.2.3 Financial statements

Financial statements consist of (Christiaens and Vanhee, 2012):

- Annual accounts, which represent the economic interpretation of an entity's activities, include:
  - Balance sheet
  - Income statement
  - Notes, to provide clarification for relevant information about equity, financial position, results, and so on, which does not appear in the balance sheet or income statement
  - Summary of accounts of budgetary operations, covering receipts and expenses recorded in the budget items of the chart of accounts on the basis of the economic classification and of an appendix
- Budget execution account, which gives information about the way the budgetary authorizations were used, for cases where there is no statutory provision to prepare a budget for an entity
- Annual report which establishes a link between accounting and activities, gives information about the evolution of financial data

3.2.4 Links between the budget and financial accounting

Both budgetary and accrual accounting systems have been integrated as much as possible and contain accruals codes, budgetary codes and ESA 2010 codes. In addition to the reporting in the financial statement an account of budget implementation has to be drawn up (Christiaens and Vanhee, 2012).

3.2.5 Accounting standards for consolidated statements

Although consolidation does not seem to be an explicit topic in the recent reforms, there is an intention to realize some point of consolidation at each level of government, following the requirement of ESA regulations. Entities are therefore required to attach all the additional information necessary for their respective consolidation.

Furthermore, consolidation of government accounts is nearly impossible for the Belgian public sector due to the highly divergent use of accrual accounting systems and incompatible accounting policies. Therefore, it is not possible to gain an overall picture of this large group of organizations (Christiaens and Vanhee, 2012).

3.3 Central government

All services of the federal power and of federated entities have to comply with the new legal framework for state accounting, which was introduced in 2003. For the central government, this consists of (Bellanca and Vandernoot, 2013):

- General administration (federal public services included).
- Administrative services with self-accounting (services without a legal personality and a separate patrimony from the state but with managerial autonomy).
- State administrative bodies (non-profit making state services with legal personality and whose main purpose is to satisfy general interest needs).
- State-owned enterprises (state services with a commercial, industrial or financial nature and with legal personality).

3.3.1 Budgeting

The 2003 reform introduced a new budgetary system. There are three steps to registering a transaction in the new budgetary accounting system (Christiaens and Vanhee, 2012):

1. Registration of appropriations: the registration of all planned revenues and planned spending per year on the basis of which both long-term plan and budget are drawn up.
2. Registration of commitments: with a distinction between the recording of an obligation and the recording of a transaction.
3. Registration of charging: the registration of actual receipts and expenditures at the time the transaction occurs.

Budget operations recorded in the accrual accounts are simultaneously added to the budget accounts (Buffel, 2009).

3.3.2 Accounting

The implementation of the legal framework at central level was handed over to FEDCOM (an interdepartmental working group) which started in 2004 but only got up to full speed in 2008. The same name was given to the SAP ERP tool that was developed to computerize the new accounting system. The actual implementation only started in 2009 in four pilot administrations (Buffel, 2009; Christiaens and Vanhee, 2012).

The accrual accounts must be booked in accordance with the customary rules and principles of double-entry bookkeeping and covers all operations, assets, rights, liabilities and obligations. Private sector legislation was used as a reference framework.

The general administration of the federal state has applied accrual accounting under the 2003 law since 2012. For all other entities on the federal periphery, the date of entry was initially planned for 2012, but was rescheduled to 1 January 2014. A bill is being drafted to postpone it again to 1 January 2016 (Supreme Audit Institution, 2013). As a consequence, the first general administration accounts were published in 2013.

3.3.3 Financial statements

Entities must submit their financial statements annually, and not later than 31 August of the following year, consisting of budgetary and accrual accounting information (Christiaens and Vanhee, 2012). As discussed in Section 3.2.4, this consists of an annual account (including the balance sheet, income statement, notes and summary of accounts), a budget execution account and the annual report.

3.3.4 Auditing

The 2003 reform redefined the role of the Supreme Audit Institution, including a move from ex ante towards *a posteriori* controls (Supreme Audit Institution, 2013).

Without referring to them as such, internal audits and oversight activities are mostly performed by the department for monitoring commitments and the Inspectorate of Finance (Christiaens and Vanhee, 2012):

- Department for monitoring commitments (part of the federal budget administration): audits the accounts of commitments, ensures the correctness of submitted documents, their compliance with the rules and monitors public tender processes.
- Inspectorate of Finance: an independent body responsible for administrative and budgetary control; for the prior assessment of the legality, regularity, financial feasibility, efficiency and effectiveness of certain activities; it is under the authority of the Federal Minister for the budget and civil services.
- Internal audit activities within public administration: all entities of the federal government have to evaluate the reliability of its internal control system. This should be done independently and under the supervision of the Audit Committee of the federal government (a group of seven independent experts who monitor advice and make recommendations on internal audits). However, only a few of these evaluations have been performed since the start in 2007.

The Supreme Audit Institution has been given full responsibility for the *external audit* at federal level. It exercises scrutiny over the budgetary and financial operations of the federal state, the communities, the regions, the public service institutions dependent upon them and the provinces. The review of local government falls outside its remit. The external audit at federal level is carried out from four different angles: financial control, budgetary control, regulatory control and performance audits.

3.4 Regional government

Regional government level includes all ministries, agencies with a legal personality and entities that fall under the regional governments due to

European regulations. This last group of organizations is not subject to the accounting rules applicable to the rest of regional government.

3.4.1 Budgeting

When the budget is prepared, the revenues and expenditures for the coming year are estimated and approved. In this budgetary system the different stages of budget approval, recognition of economic transactions and, finally, the relevant payments are reported. Because of this last stage of payments this system is sometimes called a cash budgeting system. Loans are also provided in the longer term (Cock, 2013).

3.4.2 Accounting

The Flemish government implemented the 2003 accrual reform through the approval of the, so-called, *Rekendecreet* (accounting decree) of 2011. The decree was partly driven by the same principles as those discussed for central government: the introduction of double-entry bookkeeping together with cost accounting, the same valuation principles, the same structure for financial statements (except for those entities with legal personality, who are allowed to use the chart of accounts for the private sector), and so on. Furthermore, it focused on elements such as the introduction of a modern multi-year and annual budget, the principle of single audit and a more effective and efficient approach to subsidies (Cock, 2013). As well as the accrual and budgetary accounting information, Flemish entities have to incorporate an analytical accounting system. This makes it possible to calculate costs and revenues associated with a particular activity or project (Cock, 2013).

The Brussels government worked in stand-alone position to enable the implementation of the 2003 reform in 2006 for ministries and in 2008 for its autonomous administrative organizations. Therefore, the regions developed their own chart of accounts and implementation decrees and did not wait for their issuance from the federal government (such as the normalized chart of accounts for all governments in 2009). Given that the normalized chart of accounts did not exist at that time, the regions relied on the private sector's chart and, to some extent, International Public Sector Accounting Standards (IPSAS) to produce its reports. The first accrual accounts were published in 2008 and the first consolidated accounts in 2012 (Gruson, 2009).

The Walloon Regional government and the French Community government postponed the introduction of the accrual reform several times. Their current accounting software was GCOM, which is not designed for accrual accounting and no longer satisfies the modifications in the budgetary accounting system. Therefore, the "Walcomfin project" was originally launched to help both the Walloon Region and the French Community with the implementation of the accrual reform. The necessary decrees only came into force in 2012 when the Government also approved the legislation needed for internal control and internal audit on budgeting and accounting. The project, now called WBFIN, is ongoing and, without any further delays, accrual accounting should be in place by January 2015. Implementation started in 2012 and is far from being finished. Thus far, these governments only comply with regard to the budgetary accounting component (Supreme Audit Institution, 2014).

3.4.3 Financial statements

The Flemish government is using a system called "Orafin" to incorporate all three levels of bookkeeping into one integrated system. The Flemish Department for Finances and Budget is responsible for this system and also prepares financial statements for all the Flemish ministries. These include the annual accounts (balance sheet, income statement and summary of accounts of budgetary operations), the budget execution account (a document reconciling the annual accounts to the budget execution account) and the notes. Flemish legal personalities have to hand this information over to the Department for Finances and Budget themselves before 31 March (Cock, 2013).

3.4.4 Auditing

In both the Walloon and Brussels-Capital regions modernization is rather limited, certainly when compared with the Flemish Region. Auditing within the Flemish government is particularly interesting due to the single audit approach. This system, in which the various forms of internal and external audit are divided among different auditing bodies (the Supreme Audit Institution, the internal audit agency and the external registered auditor), makes sure that an audit always builds on the previous one to avoid multiple audits on the same subject.

Internal audits in the Flemish Region are performed by a separate agency, Audit Flanders, powered by an independent audit committee for the Flemish Region and Community. Their mission is twofold: evaluating the internal control system of all entities in the Flemish Region and Community and the performance of ad-hoc audit tasks. Entities are allowed to have their own internal audit department and committee. Audit Flanders then comes in as an evaluator of that organization within the entity (audit on audit). As at federal level, the Inspectorate of Finance is responsible for administrative and budget control.

The external audit of the accounts for most of the departments and some of the agencies with legal personality are performed by the Supreme Audit Institution. This is also the case for the other regional governments, as this was part of the 2003 laws. Flemish entities with legal personality and a board of directors are the exception, as an external registered auditor is responsible for the certification of financial statements (Christiaens and Vanhee, 2012).

3.5 Local government

Local governments consists of the municipalities, public welfare centres (one per municipality) and the provinces.

The Belgian municipalities (both Flemish and Walloon) were the first to reform their accounting systems in the nineties into the twofold system of budgetary and accrual accounting. Local governments have always been one step ahead of the rest and have already undergone a reform of the reform beyond the twofold systems with budgetary accounting dominance (Ghysels et al., 2011).

3.5.1 Budgeting

A huge step forward was introduced for Flemish local government in 2010 with a new policy and management cycle (BBC – *Beleids-en beheerscyclus*). The BBC reform was the first to link strategy, planning, budgeting and control. The new model enshrines a long-term perspective beyond the period of one year. The strategy is linked to a multi-year plan with both a policy and a financial component. This revolutionizes the role of the budget in the sense that it is no longer limited as a controlling function but becomes a management tool. The budget, which was formerly input oriented, became output focused (Khrouz and Tsatsis, 2013).

3.5.2 Accounting

As in auditing, accounting modernization has remained limited in the Walloon and Brussels-Capital regions. Unlike in the Flemish Region the accrual accounting reforms of the nineties have not been updated. Except for certain improvements in the recognition and valuation of capital assets and the consolidation issue that has been postponed, BBC is almost completely in compliance with IPSAS standards. Flemish local government reform in Belgium was the first to align with IPSAS (Ghysels et al., 2011; Khrouz and Tsatsis, 2009). The BBC accounting system enables both budgetary and accrual accounting, but it integrates them both in one registration system in which accrual accounting is used as a basis (Christiaens and Vanhee, 2012). The reform includes the valuation principles for both assets and liabilities and determines the financial processing of expenditure and revenue. The registration enables cost accounting, but the reform did not include the manner in which this should be done.

3.5.3 Financial reporting

Reporting has been partly standardized and mainly consists of the prescribed financial statements. These have been broadly interpreted, consisting of a policy part (goal achievement, goal statement, financial condition), a financial note (operating account, investment account, cash account), the summary of accounts and the notes. The budget execution account and the annual report were fully integrated in the financial reporting through BBC. BBC therefore maintained the budgetary/cash accounting system and added the benefits of an accrual accounting system (Christiaens and Vanhee, 2012).

3.5.4 Auditing

The BBC reform did not contain any obligations with regard to the internal audit. Nonetheless, some local entities began an initiative to launch the internal audits anyway in the form of an autonomous entity, called AudiO.

With regard to the external audit for local governments, the Flemish government decided in 2011 not to go through with the implementation of a financial external audit. On the contrary, the external audit was interpreted as the evaluation of the internal control systems, including the periodical external audit of the main processes that lead to the policy and management reports. In addition, the ability to implement thematic audits or fraud investigations has been provided. All these tasks are organized within the Flemish agency Audit Flanders, which has two separate audit teams and committees for audits at regional and local levels. The Supreme Audit Institution retained its external audit function over the financial statements of the provinces. The Flemish local governments therefore do not undergo an annual, independent financial audit of their financial reporting, so that the reliability of their financial statements is not guaranteed.

In Wallonia, municipalities have continued with the 1995 reforms and fall back on their long experience with accrual accounting, which relies on the same chart of accounts. Their budgetary accounting uses the same functional and economic codes.

A project called PST (Plan Stratégique Transversal) for local governments in Wallonia is currently being analysed. This project shows great similarities with the BBC reform in Flanders, with policy making anchored to a long-term (six-year plan) political vision for the municipality. This implies the setting up of strategic objectives, themselves divided into a set of actions. These would be coupled to both financial and non-financial means. Indicators would help the measurement and follow-up of achievements (Tefnin, 2013).

3.6 Readiness to change: technical facilitators, comparison of national accounting standards with IPSAS framework, readiness to adopt EPSAS

3.6.1 Comparison of national accounting and IPSAS

Implementation of the accounting systems implied by law has not been plain sailing thus far. The execution of multiple laws has been delayed several times. Therefore, the implementation of the 2003 reform is still in full swing and has not reached its expected rate. Moreover, the quality of the first accounts following the 2003 reforms has been very doubtful. While some governments are still working on compliance with the 2003 law, others have made additional steps to further modernize their compatibility.

It has to be noted that even though some entities use a system that complies with IPSAS, at least partially, no formal measures have been taken in Belgium to comply with IPSAS. Reforms were mainly inspired by accounting principles in the private sector, whereas the IPSAS approach, unfortunately, was not considered (Christiaens and Vanhee, 2012). Such a phenomenon is also called "Law of the handicap of a head start" (Romein, 1937), in that countries that have reached a higher level of development, are not so keen to improve their systems any further. The Flemish local entities are seen as an exception, as they deliberately chose to apply IPSAS according to the BBC reform. The BBC reform could be leverage for similar IPSAS based reforms at other government levels in the near future.

Despite the lack of attention to IPSAS, a certain level of IPSAS compliance has been reached in Belgium. The study by Benito et al. (2007) on the degree of compliance of accounting standards in different countries with IPSAS (based on a survey carried out in 2003), placed Belgium among the group of states whose compliance with IPSAS is generally between 55 per cent and 65 per cent. This percentage will now be higher due to reforms in the last decade. Bellanca and Vandernoot (2013) noticed major differences in the compliance of Belgian public accounting systems with IPSAS, due to the lack of harmonization between systems.

A comparison of all levels of government and their compliance with IPSAS results in the following ranking, with the most modern first and the least developed at the bottom (Camus, 2014):

1. Flemish municipalities
2. Walloon municipalities
3. Region of Brussels-Capital
4. Flemish Region
5. German Community
6. Walloon Region
7. Federal State
8. Federation Wallonia-Brussels

The lower levels of government have been able to adopt the measures in the 2003 accounting reform and have even been able to put their accounting system on the next level. However, the application of the accrual system is widely divergent between the north and the south of the country. The Flemish municipalities are the clear leaders, as the BBC reform went far beyond accrual and cash accounting. Today, Flemish municipalities can claim the reform is 90 per cent compliant with IPSAS, which is by far the highest rate in Belgium (EY, 2012). Little information is available on the compliance of Walloon local municipalities' accounts with IPSAS. But, in terms of providing information, the current system is rather respectful. However, this information is not necessarily depicted according to IPSAS requirements, as the accrual system has been launched without considering IPSAS.

The Brussels-Capital Region, which had implemented the 2003 reform by 2006, is the first of the regions to operate with the new accounting system and hopes to become IPSAS-compliant in the near future. IPSAS compliance was not an objective as such, but IPSAS was seen as a solution for the lack of a conceptual framework in the 2003 laws. A survey carried out by Christiaens et al. (2010) confirmed that the Flanders Region complies more with IPSAS than the Walloon Region, which uses an accrual accounting system that does not comply with IPSAS. The German Community is in the process of implementing the 2003 reform, as they started the process in 2009. As for the Federal State, their accounting is still limited to budgetary accounting, except for some pilot public services. Federal accounting is currently indifferent to IPSAS. Instead, the decision has been taken to focus entirely on ESA (Bellanca and Vandernoot, 2013).

3.6.2 Readiness to change: technical facilitators

IPSAS adoption does not seem to be a high priority. Unless it becomes mandatory, it is highly unlikely that there will be a general and voluntary acceptance of these standards in Belgium, which is mainly due to ignorance and because of the assumed dominance of business accounting as one size fits all. The priority is to continue the efforts made to settle in the new system. This implies the setup of an internal control process and the development of consolidation-related operations. Despite the fact that all accounting forms were driven by the same basic principles and drivers, public sector accounting systems are far from being uniform throughout all levels of government. This is the direct result of fragmented legislative power.

Nonetheless, the fact that the 2003 reform was indifferent to IPSAS does not mean that it does not contain technical facilitators which could simplify a transition towards IPSAS or EPSAS (European Public Sector Accounting Standards). The recent reforms could be a leverage towards future IPSAS or EPSAS adoption, as they are compliant with IPSAS to some extent.

3.7 Main challenges: problems identified

There are quite a few lessons to be learnt following the 2003 accrual reform in Belgium. There are multiple challenges to face and problems to overcome when the adoption of a new accounting system, which is likely with EPSAS, takes place:

- The first risk of failure for any change is the *lack of political motivation*. Belgian politicians are not entirely interested in accounting reforms as they have other priorities. It is often regarded as a waste of time and money compared to other political objectives. Given the fact that IPSAS is non-mandatory, politicians showed little enthusiasm for or interest in adopting these stringent rules. The added value that IPSAS could leverage for the government has not been sufficiently demonstrated to convince government of the benefits of change (Bellanca and Vandernoot, 2012).

  The BBC reform was the first to convince politicians of the importance of these kinds of IPSAS-compliant systems. Politicians were more convinced to leverage the change by arguments on accountability, transparency, complete and understandable (non-)financial information, benchmarking, the existence of international standards and European regulations, as well as the incomprehensible character of their old reporting.
- The lack of motivation is closely linked to the lack of knowledge. The introduction of accounting in Belgium has failed so far to contribute to better decision-making and accountability. This is mainly because politicians rarely use the new financial information, relying instead on their knowledge of the budget. Politicians and public accountants are not all trained in finance and accounting and it is easier to understand a budget than a financial statement. Training is of great importance in increasing the comprehension of finance and accounting. Yet, only a *change of mind set* can ensure the proper functioning of new systems.

  However, they are not all to blame. IPSAS has been unknown and unpopular for a long time, both amongst politicians and most professionals. Eurostat activities on the development of EPSAS have now raised awareness of IPSAS in a lot of public administrations.
- The 2003 reform necessitated the adoption of approximately twenty implementation decrees (Supreme Audit Institution, 2013; Ghysels et al., 2011). Indeed, royal decrees should have organized additional and specific rules regarding the presentation and valuation methods of annual accounts, and so on. To date, only one has been voted on: the royal decree setting the normalized chart of accounts. Unfortunately, this is highly insufficient. This *lack of juridical framework* creates postponements and undermines the chances of success of the reform and the risk of more interpretations of the legislation by the entities.
- In the Brussels-Capital Region, where IPSAS was needed as a reference due to the lack of explanation and conceptual framework in the 2003 accrual reform, highlighted the *importance of a conceptual framework* during an accounting system reform. A conceptual framework should have been placed at the core of the reform because it sets the boundaries for the project and concentrates on the fundamentals regarding the different user needs to be met.

- More than training and motivation is needed. Managerial skills of the project leaders in *change management* could have a huge impact on the time needed for the implementation.
- New accounting systems are often accompanied by new IT systems, which increases the difficulty of the change for all users. *Adapting older IT platform tools* could simplify the implementation for all employees.
- The 2003 accrual reform foresaw the setup of a Public Accounts Committee (*Commission de la Comptabilité Publique*), to advise on and review government accounting rules and legislation. Unfortunately, the commission has not yet met since the royal decree instituting its members has not been voted on. The *application* of many accounting principles is therefore *unclear* or may result in divergence.
- Finally, the last element regards the *size of the entities*. Implementation is much faster and simpler in smaller and more flexible governments, who offer fewer barriers. Therefore, according to Lüders' contingency theory, implementation is easier in smaller governments. On the other hand, many other research papers show empirically that larger entities are faster in implementing reform for different reasons (Christiaens and Vanhee, 2012).

Note

1. National decree of 22 May 2003 concerning the organization and budgeting of the federal state, the regions and the communities as well as the organization and control by the Supreme Audit Institution.

References

S. Bellanca and J. Vandernoot (2013), "Analysis of Belgian Public Accounting and Its Compliance with International Public Sector Accounting Standards (IPSAS) 1, 6 en 22", *International Journal of Business and Management*, 8 (9), 122–133.

B. Benito, I. Brusca and V. Montesinos (2007), "L'harmonisation des systèmes gouvernementaux d'information financière: le rôle des IPSAS", *Revue Internationale des Sciences Administratives*, 73 (2), 323–350.

L. Buffel (2009), "De modernisering van de boekhouding van de Federale Overheid: algemene opzet", *Documentatieblad van de FOD Financiën*, 69 (1), 99–125.

D. Camus (2014), *Accounting in the Public Sector in Belgium* [Master Thesis]. Liège: Université De Liège, Master Financial Analysis and Audit.

J. Christiaens, B. Reyniers and C. Rollé (2010), "Impact of IPSAS on Reforming Governmental Financial Information Systems: A Comparative Study", *International Review of Administrative Sciences*, 76 (3), 537–554.

J. Christiaens and C. Vanhee (2012), *Handboek Accountancy in de Publieke en Non-profitsector: Accounting, Financieel Management en Auditing*. Brugge: Die Keure.

G. Cock (2013), "Begrotings-en boekhoudsysteem in de Vlaamse Gemeenschap", *Documentatieblad van de FOD Financiën*, 69 (1), 191–203.

R. Ghysels, P. Phan and C. Tsatsis (2011), "Synthese van de accrual-hervorming van de Belgische Staat en de gewesten", *Accountancy and Tax,* 4, 8–19.

D. Gruson (2009), "Brussels Hoofdstedelijk Gewest. De financiële hervorming: de interne boekhoudkundige controle", *Documentatieblad van de FOD Financiën*, 69 (1), 205–225.

F. Khrouz and C. Tsatsis (2009), "Le nouveau système comptable fédéral. Valeur ajoutée de la comptabilité générale", *Documentatieblad van de FOD Financiën*, 69 (1).

J. Romein (1937) *The Dialectics of Progress (in Dutch: De dialectiek van de vooruitgang).* Amsterdam: Querido, 9–64.

Supreme Audit Institution (2013), "*170e Boek van het Rekenhof* (=Supreme Audit Institution)", Algemene vergadering van 7 oktober 2013.

M. Tefnin (2013), "*A l'heure du PST en Wallonie, la Flandre adopte le BBC*", UVCW, No. 875.

Useful sites

Accounting Research Public Sector (ARPS) Ghent University–EY, www.arps.be

Belgian Institute Registered Auditors, https://www.ibr-ire.be/nl/pages/default.aspx

Belgian Supreme Audit Institution, https://www.ccrek.be/en/

Belgium generally, www.belgium.be

EY Government and Public Sector (2012), "Overview and Comparison of Public Accounting and Auditing Practices in the 27 EU Member States", http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/study_on_public_accounting_and_auditing_2012.pdf, date accessed 31 July 2014.

Infocenter Registered Auditors, http://www.icci.be/nl/Pages/default.aspx

Supreme Audit Institution (2014), "De boekhoudsoftware van het Waals bestuur in het raam van de nieuwe overheidscomptabiliteit", https://www.ccrek.be/.../ 2014_07_BoekhoudsoftwareWaalsBestuurRaamNieuweOverheidscomptabiliteit_Samenvatting.pdf, date accessed 31 July 2014.

4

Public Sector Accounting and Auditing in Denmark

Caroline Aggestam Pontoppidan

4.1 Introduction

Denmark is a constitutional monarchy, which has three levels of government: national (*staten*), regional (*regioner*) and local (*kommuner*). In addition, since Denmark is a member of the European Union, there is the European level. At the EU level, legal harmonization is carried out through the issuance of Directives, thus far accounting harmonization has been limited to private sector accounting practices,[1] but with the development of European Public Sector Accounting Standards (EPSAS) harmonization will also be undertaken in the public sector arena (see EC, 2012a, 2012b, 2013). In addition to these three levels, Denmark also segregates out financial governance of its social funds as they follow private sector accounting standards.

Pina et al. (2009) describe the Nordic countries (Denmark, Finland, Norway and Sweden) as unitary states which belong to a public administration model concerned with meeting citizens' needs. The search for efficiency and effectiveness is therefore driven, to a large extent, by an aspiration to satisfy citizens' wishes (ibid.).

Denmark has undertaken numerous administrative and structural reforms of its government during the last 20 years.[2] The reforms have brought about the creation of executive agencies, the use of trusts, boards and councils, the corporatization and privatization of public enterprises, and the involvement of private for-profit and non-profit organizations in the delivery of public services (Greve, 2003; see also Greve et al., 1999).

Although Denmark was initially reluctant to adopt private sector management tools, the country has now implemented a certain level of accrual accounting and disclosures (Pina et al., 2009). The reform towards accrual accounting in Denmark was formally initiated in 2003[3] with the publication of a report by the Ministry of Finance on *Costs and Effectiveness of the State* (2003). Legislative reforms have been the main tool of the Danish government in the change towards accrual accounting. The government sets accounting standards in law. There is a chart of accounts for the central level of government that serves as a framework for all the entities in the public sector.[4]

Following these reforms Denmark is seen today as embracing complex accounting arrangements in the public sector at central level (see Elm-Larsen, 2001, 2010 for detailed accounts of this development). Ernst and Young (2012: 27) noted that accounting standards applied in Denmark (excluding its cash-based municipalities) "are rather similar and close to the IPSAS principle (more than 70% compliant)". Nevertheless, the Danish National Audit Office (NAO) has outlined a number of key differences between IPSAS and the accounting done at central and regional levels in Denmark (Rigsrevisonen, 2014). The National Audit Office also highlight that they consider the basic approach of IPSAS and its influence from the private sector to be problematic in several respects (ibid.).

4.2 Public sector accounting standards in Denmark

The introduction of accrual accounting at the central level of government in Denmark was implemented through accounting reform in 2003–2004. The purpose of the reform was to strengthen the basis for financial management in state enterprises in particular. One objective was to strengthen the clarity as to what individual activities cost. Another aim was to encourage these enterprises to increasingly think long-term and invest in efficiency. The Danish Ministry of Finance has indicated that the cost of accounting reform in Denmark at the central level of government is approximately 22.8 million euros, to which we need to add the cost of implementing new information systems, approximately 32.9 million euros[5] (Rigsrevisionen, 2014). The total implementation cost is thus estimated at approximately 55.7 million euros.[6]

Since the reform, accounting practices at central government level can be characterized as a combination of full accrual practices and (modified) accrual accounting practices (cf. the 70 per cent compliance with IPSAS). Significant parts of government revenue and government expenditure in national accounts continue to follow modified accrual accounting principles. This applies, for example, to tax revenues.

The basic purpose of financial reporting for the public sector is to enforce state control. Generally, accounts must be read in conjunction with appropriations. As the Danish National Audit Office points out, the balance is not the primary purpose of public sector financial reporting (Rigsrevisionen, 2014). The state will not be sold and therefore what matters is not the actual value of the assets, so the state does not deem it necessary to valuate national property. The state may well have negative equity because, by definition, it is perceived as a going concern, that is, an undertaking for continuing operations. In terms of revenues and expenses these are accrued as soon as there is a legal entitlement to the revenue or expense.

In Denmark government accounting practices can be divided into three categories:

- Central government and extra budgetary entities: at this level government accounting laws are applied.
- Regional level: at this level, the regions are using budget, accounting and auditing orders.[7]
- Local level: at this level municipalities are applying the budget, accounting and auditing orders for municipalities.[8]

It should be noted that the regional and local levels are closely aligned in terms of their accounting practices.

It is important to highlight that public sector accounting laws at the central level of government are developed through a complex development process which involves the interaction of the Danish parliament (in particular their Finance Committee). This follows the democratic form of government practised in Denmark.

In Denmark virtually all public services for individuals and families (schools, elderly care, health care, etc.) are delegated to local authorities. The result is a relatively high degree of decentralization of the public sector (see Lotz, 2005).

4.2.1 Public sector accounting regulation in Denmark

In Denmark public sector accounting is regulated by law. Central government accounting is thus governed (1) by § 47 of the Constitution and (2) by the law on state accounting. Following § 47 of the Constitution:

- Public accounts shall be presented to parliament within six months of the financial year end.
- Parliament elects a number of auditors. The auditors examine the annual public accounts and ensure that all state revenues appear, and that no expenditure has been incurred without reference to the budget or other appropriation.

The law on state accounting then specifies that:

- The Minister of Finance shall, by the end of June, present to the parliament the full state accounts for the previous financial year. The public accounts shall include all state revenues and expenditures for the past fiscal year, the state's assets and liabilities and the movements therein during the year.
- The rules on state accounting include all ministries, institutions, and so on, whose operating budget is included in the appropriations bill.

It is the Minister of Finance who lays down rules on state accounting. The more detailed rules include the following key headings:

- Accounting purposes
- Accounting application
- Accounting organization
- System application
- Ministry, corporate and accounting instructions
- Accounting registration
- Report from the Treasurer
- The keeping of accounting records
- Exceptions to the rules

Ministry of Finance Decree No 1163 of 20 December 1994, as amended by Decree No 1161 of 16 December 1996 on State Accounting, provides the following overarching standards:

- Public sector institutions shall keep budgetary accounts relating to their activities. The financial statements shall include institutions' appropriations, expenditure and income, as well as assets and liabilities.
- A registration of assets and liabilities that are not state funds is required.
- The budget accounts shall be subject to the registration of commitments that have been charged in a future fiscal year.
- Accounting registration must be organized so that, if necessary, it is possible to measure in monetary terms the registration of agreements and liabilities assumed that result in revenue expenditure in current or future fiscal years.
- Government departments and equivalent authorities shall make their accounts available to the Ministry of Finance and the National Audit Office for approval.

4.2.2 The conceptual framework

The Ministry of Finance provides basic accounting principles and explains how they relate the governmental accounting. These accounting principles have a basis in law but are not issued as law per se. The accounting principles include going concerns, money as a common unit of measure, periodization of transactions and disclosures, objectivity, caution, continuity, materiality, reliability, gross principle and understandability.

4.2.3 Measurement and recognition of assets, liabilities, equity, revenues and expenses

The precise delimitation of what are considered state assets and liabilities is available in the "National Chart of Accounts" included in the Finance Ministry's Economic Administrative Manual.[9]

Measurement and recognition of assets

Historical cost is used as the general measurement basis for assets and liabilities in Danish financial statements. The Danish Agency for Governmental Management[10] has "chosen historical cost as a measurement basis because it is easy to use and because it has a high degree of verifiability. A further important factor for choosing historical cost is that historical cost is particularly suitable for comparing cost incurred against budgets" (Økonomistyrelsen, 2011: 2).

The assets on the balance sheet consist of the public sector entity's inventories, receivables and tangible and intangible assets acquired for long-term use, including fully developed IT systems, buildings, machinery and IT equipment.

Overall, the fixed assets accounts are divided into the following asset types: intangible assets property, plant and equipment, and financial assets. The characteristics of the three categories are inherently different, but all fixed assets are recognized on the balance sheet when the asset is acquired for permanent use or ownership and is included as an operating asset of the public sector entity, and the cost of the asset can be reliably measured. At the point of recognition it is stipulated that the asset will contribute to the public sector entity's objectives. Fixed assets are valued at cost, including all costs related to the purchase or directly attributable to the asset produced until the time when the asset is ready for use.

An intangible asset is an identifiable non-monetary asset without physical substance held for production, distribution, rental or for administrative purposes.

Intangible assets are shown as the first main item on the assets accounts and are classified as:

(1) Development projects in progress.
(2) Completed development.
(3) Acquired concessions, patents, licenses and so forth.

Intangible assets include those assets both acquired and produced by the public sector entity itself.

Replacement cost as a measurement basis is not used in central government financial statements in Denmark.

Recognition and measurement of liabilities

In Denmark there is a requirement that all assets and liabilities must be identified, but that does not mean that all assets and liabilities should also be included in the entity's financial statement. The decision whether assets and liabilities should be included in the financial statement must be made on the basis of whether the costs of making a precise and complete measurement are commensurate with the benefits associated with such assets and liabilities.

Commitments may be liabilities or provisions. Liabilities can be short-term or long-term. Long-term debt includes internal state loans and sovereign debt, mortgage debt and loans to finance assets that few public sector entities have.

Current liabilities include accounts payable to suppliers of goods and services, wages and salaries, holiday pay and overtime, and so on. Deferred income is recognized as such under current liabilities. Provisions are a separate item placed between debt and equity in order to emphasize the uncertain nature of this balance sheet item.

In Denmark early retirement obligations and pension obligations are not included in the financial statement, in the same way as the natural resources or assets and liabilities related to socio-economic activities are not included in the financial statement.

Recognition and measurement of revenues

The Danish public sector applies accounting requirements as a modified transaction-based approach (revenue and expense-led approach). This choice is based on the view that the purpose of the financial statement is to monitor and compare the application of resources and the performance of central government institutions. The general principle here is that revenue is recorded when delivery has taken place and no later than at the time of payment.

Nevertheless, Denmark does deviate, in some instances, from the revenue and expense-led approach. One example is that of donations. Significant donations are not allowed to affect the income statement as income nor the expenses arising from depreciation of donated assets.

Recognition and measurement of expenses

Accounting records include economic events that relate to, or are a consequence of, the institution's activity. Economic events should be recorded accurately and as soon as possible after the events have occurred and financial statements can be made. It is specified that the accounting records shall include as a minimum:

Revenues and expenses

1) Payment transactions in the form of deposits and withdrawals.
2) Income transactions in terms of operating income, investment income, tax and transfer income, and so on.
3) Cost transactions in terms of operating costs, capital expenditures and transfer spending.

Balance sheet related items

4) Depreciation of tangible and intangible assets.
5) Impairment of fixed assets.

6) Supply and consumption of inventories for production.
7) Supply and consumption of provisions.
8) Assets in the form of intangible and tangible fixed assets and current assets, including assets that are not state funds, but for which the administration and the state are responsible.
9) Liabilities in the form of provisions and short- and long-term liabilities, including liabilities which are not state resources but for which the administration and the state are responsible.

In addition, public sector entities are to keep separate records of inventories, unless stocks are insignificant. Registration must be done in such a way that it is a suitable basis for control of inventories and management of stocks in general.

Records must also be kept of assets acquired through other institutions' investment or transferred from other state institutions. Records shall be provided with information about the assets' acquisition value and any changes in the valuation and other information relevant to the administration.

Similar provisions apply to the records of the institutions' fixtures, equipment, libraries and other more valuable equipment acquired with the institutions' operating budget. Records shall also include equipment that is made available by other institutions.

4.2.4 Financial statements

Ministries, government businesses and institutions that are accountable under the rules determined by the Danish Agency for Governmental Management shall be in accordance with the principles underlying the licensing laws.

The annual report shall provide an overall, comprehensive and reliable picture of each entity's finances and achievements. The annual report is to consist of the following elements:

1) Report
2) Performance reporting
3) Financial reporting and supplementary notes
4) Audit report.

4.2.5 Links between the budget and financial accounting

Since 2000 Denmark has expanded the use of accruals in public sector budgeting without moving to full accrual budgeting. Beginning in 2007, Denmark moved departmental operating budgets and associated capital spending to an accrual basis, primarily to support efforts to improve the performance of government departments. In the Danish system, all capital expenditure by government ministries is financed by internal loans from the Ministry of Finance, which must be repaid and upon which interest is charged. Parliament sets loan limits for each spending ministry as part of the annual budget legislation. Robinson (2009, p. 9) noted that "something like this type of capital loan arrangement may be found in some other Scandinavian countries which operate cash budgeting systems. However, the Danish accrual budgeting system has given this arrangement a distinctively accrual twist, the most important element of which is that ministries now repay the principal on its capital loans when they are charged depreciation against their expenses appropriations" (see also Ministry of Finance, 2006). The technical standards used for the budget in Denmark were based substantially on private sector accounting standards (United States Government Accountability Office (GAO), 2007).

In addition to developing the accounting standards to be used in the budget, GAO (2007, p. 22) noted that a key challenge "when switching to accrual budgeting, particularly for countries that choose to treat capital on an accrual basis (i.e. to capitalize assets and record them on the balance sheet) and provide funding for noncash depreciation costs, is to ensure that the recorded value of the capital asset is as accurate as possible". The value of the capital asset is used to calculate annual depreciation costs and in turn fund future capital acquisitions (replacements). If a public sector agency overvalued its assets, it could be difficult to reduce the level of assets once accrual budgeting is implemented because the excess value represents a source of funding for the agency in the form of depreciation. On the other hand, if assets were undervalued, they may not provide good information on the cost of maintaining or replacing the asset (see GAO, 2007).

4.2.6 Accounting standards for consolidated statements

The basis for preparing the public accounts is provided for in § 47 of the Constitution, which specifies that no income (tax collection) or expenditure may take place without complying with this law. The concept of control in Denmark is thus governed through the parliament's notion of control over appropriations.

4.3 Central government

The central government includes the government, ministries and public entities. Extra-budgetary units include the public church, universities, high schools, private schools, and so on (cf. Ernst and Young, 2012). All entities within central government apply government accounting law (described above) and state budget law in terms of accounting, preparation and presentation of annual financial statements and budgeting and reporting.

4.3.1 Budgeting

The state budget is the basis for government business in a fiscal year. It is adopted as the budget of parliament, which is the licensing authority and which also scrutinizes the utilization of appropriations. The Minister of Finance is responsible for the coordination of state budgeting. Budgeting at central level in Denmark currently follows a top-down approach based on policy objectives. It is framed at the top level and then implemented within the relevant public sector entities.

During the financial year the ministries and other state institutions receive revenues in accordance with appropriations.

There must be verification that this is consistent with the general and special conditions under which the grant was awarded, and in accordance with other provisions, such as law, decree, circular and internal instructions.

Appropriation and accounting principles for the operating range follow a cost basis, while allocation and accounting for infrastructure, defence, various grants and other types of expenditure, mainly follow a vesting principle.[11]

4.3.2 Accounting

In Denmark the purpose of financial statements from central government agencies is to support the monitoring and comparison of the performance and application of resources in the institutions.

4.3.3 Financial statements

The public accounts form the basis of the subsequent parliamentary control of the administration's use of funds, including checking that no expenditure has been incurred without reference to a particular licence.

In Denmark there is a common chart of accounts that is to be used by all public sector entities that follow the government accounting laws.

In Denmark there are also government business enterprises (GBEs). All government business enterprises are required to prepare an annual report, including a presentation of the public sector entity and its activities, performance reporting, financial statements and supporting notes. The annual report thus follows the Danish Financial Statements Act (for private sector entities) and must include an income statement and a balance sheet for the managed operating areas of the public sector entity.

Statement of financial position

On the asset side of the statement of financial position at the central level of government the following is included:

- Property, plant and equipment recorded on an accrual basis using historical cost.
- Intangible assets, recorded on an accrual basis using historical cost.
- Financial assets, recorded on an accrual basis using present value.
- Investments are recognized on an accrual basis using historical cost.
- Recoverables from non-exchange transactions, recorded on an accrual basis using historical cost.

- Receivables from exchange transactions, recorded on an accrual basis using historical cost or fair value.
- Cash and cash equivalents recorded on an accrual basis using historical cost.

On the liabilities side of the statement of financial position at the central level of government the following is included:

- Taxes and transfers payable, recorded on an accrual basis using historical cost.
- Payables under exchange transactions, recorded on an accrual basis using historical cost.
- Provisions, recorded on an accrual basis using historical cost.
- Financial liabilities, recorded on an accrual basis, stated at face value.
- Minority interests, recorded on an accrual basis using historical cost or fair value.

Statement of financial performance

The statement of financial performance at the central level of government must include the following:

- Revenue, recorded on an accrual basis using historical cost.
- Finance costs, recorded on an accrual basis using historical cost.
- Share of surplus or deficit of associates and joint ventures, recorded on an accrual basis using historical cost.

At the central level of government in Denmark neither a statement of changes in net assets nor a cash flow statement are prepared. However, a comparison of budgeted and actual accounts is prepared either as a separate additional schedule in the financial statements or as a budget column in the financial statements.

The financial statements are always accompanied by notes, including a summary of significant accounting policies and other explanatory information.

Differences in the measurement and disclosure practices of central government, regions and accrual based municipalities should be noted (see also Ernst and Young, 2012).

4.3.4 Auditing

Danish public internal control has developed and strengthened during recent decades. The following events especially have influenced the design of today's setup of internal control:

- the creation of an independent National Audit Office;
- expansion of goals and performance management;

- cost reform; and
- establishment of administrative service.

In 1975, the audit departments merged as a result of the Auditor General Act, under which the National Audit Office was established as an institution under the Ministry of Economic Affairs. In 1991, the National Audit Office transferred from the Ministry of Economic Affairs to Parliament, where the National Audit Office is now a fully independent audit authority. The extent of National Audit Office activities are also set out in the Auditor General Act. In Denmark all public sector entities are mandated to submit their annual financial statements to audit.

An audit of state accounts is carried out by the parliament-elected state auditor in cooperation with the Auditor General.

Central government is audited by the National Audit Office (NAO), and governmental institutions (universities, high schools, etc.) are audited by private authorized public accounting firms. When audits are undertaken by private audit firms, it is under instruction from the National Audit Office, which also reviews the working papers filed by the private audit firms (see also Ernst and Young, 2012). The levels of central government, government, ministries, public entities, public church and universities and high schools (etc.) undergo mandatory financial audit, as well as performance and compliance audits.

The audits take place on an annual basis and the financial audit report is available to the public. Reporting is required by law.

4.4 Regional government

4.4.1 Budgeting

Budgeting and accounting is governed by the order on regional budget, accounting and auditing.[12] This order is governed by the Ministry of Finance who determines the rules for budgetary and accounting systems for the regions with regard to their annual and multiannual budgets and the accounting rules on the areas within which there must be a balance between revenue and expenditure and/or costs in those budgets. Budgeting and accounting at regional level follow the same accrual accounting principles as at the central level of government.

4.4.2 Accounting

At regional level accounting follows the accrual principles of accounting, as seen at the central level of government in Denmark. The order on the regional budget and accounting provides for a chart of accounts to be used by the regions.

4.4.3 Financial reporting

Statement of financial position

On the asset side of the statement of financial position at the regional level of government the following are included:

- Property, plant and equipment, recorded on an accrual basis using historical cost.
- Intangible assets, recorded on an accrual basis using historical cost.
- Financial assets, recorded on an accrual basis using historical cost.
- Investments, on an accrual basis using historical cost.
- Inventories, recorded on an accrual basis using historical cost.
- Receivables from exchange transactions, recorded on an accrual basis using historical cost.
- Cash and cash equivalents recorded on an accrual basis using historical cost.

On the liabilities side of the statement of financial position at the regional level of government the following are included:

- Taxes and transfers payable, recorded on an accrual basis using historical cost.
- Payables under exchange transactions, recorded on an accrual basis using historical cost.
- Provisions, recorded on an accrual basis using historical cost.
- Financial liabilities, recorded on an accrual basis, using historical cost.

Statement of financial performance

The statement of financial performance at the regional level of government must include the following:

- Revenue, recorded on an accrual basis using historical cost.
- Finance costs, recorded on an accrual basis using historical cost.
- Surplus or deficit, recorded on an accrual basis using historical cost.

4.4.4 Auditing

All regions, municipalities and other public entities, such as private schools and public corporations, are audited by authorized public accountants.

4.5 Local governments

Local government (local subsector) is composed of the local administrations of the municipalities.

Local governments apply the Budget, Accounting and Auditing Order. Annual financial statements are audited by private audit firms. However, the National Audit Office audits state refunds. The private audit firms prepare separate audit reports for certain types of state refund for the different ministries. These reports are reviewed by the authorities in charge and follow up reports can be required.

4.5.1 Budgeting

Budgeting follows the same principles as for the central and regional levels of government. It is important to note that there is not a requirement for applying accrual principles in budgeting.

4.5.2 Accounting and financial reporting

The municipalities use several different bookkeeping systems, which are double-entry and double accounting for budget systems. The transaction systems are different at local levels across Denmark and transactions are recorded in real time (Ernst and Young, 2012).

Statement of financial position

On the asset side of the statement of financial position at the local/municipality level of government the following is included:

- Property, plant and equipment, recorded on an accrual basis using historical cost.
- Intangible assets, recorded on an accrual basis using historical cost.
- Financial assets, recorded on an accrual basis using historical cost Inventories, recorded on an accrual basis using historical cost.
- Recoverables from non-exchange transactions (taxes and transfers), recorded on a *cash basis* using historical cost.
- Receivables from exchange transactions, recorded on a *cash basis* using historical cost.
- Cash and cash equivalents, recorded on a *cash basis* using historical cost.

On the liabilities side of the statement of financial position at the local level of government the following is included:

- Taxes and transfers payable, recorded on a *cash basis* using historical cost.
- Payables under exchange transactions, recorded on a *cash basis* using historical cost.

Statement of financial performance

The statement of financial performance at the local level of government must include the following:

- Revenue, recorded on a *cash basis* using historical cost.
- Finance costs, recorded on a *cash basis* using historical cost.
- Share of surplus or deficit of associates and joint ventures recognized are recorded on a *cash basis* using historical cost.
- Surplus or deficit, recorded on a *cash basis* using historical cost.

In Denmark it is not a requirement to apply accrual principles of accounting in preparing the statement of financial performance for municipalities.

4.5.3 Auditing

Municipalities are audited by authorized public accountants.

Danish social funds

Danish social funds include unemployment insurance funds and the Danish Employees' Fund (see Ernst and Young, 2012). Both are audited by private audit firms through financial audits, but the National Audit Office carries out a performance audit.

Reports from the private audit firms and from the National Audit Office are sent to the audited executive level and are composed of opinions on financial statements, findings and recommendations.

The audits take place each year and the audit reports will normally be sent directly to the audited unit and may only be published in a more generalized form in the annual report. An annual report is mandatory.

4.6 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework

For central government authorities the application of IPSAS is an issue that has been and is being discussed (see Rigsrevisionen, 2014). The Danish accounting standards were implemented prior to the development of IPSAS, but when adaptations are made in the Danish public sector accounting framework certain IPSAS standards are used as an inspiration (cf. Ernst and Young, 2012). If the methods in IPSAS make sense for Danish purposes they are implemented in line with these other changes. A significant challenge in implementing IPSAS is that some valuation principles differ from historical cost and give rise to steering challenges. The Danish Agency for Governmental Management has, for example, highlighted that Danish accounting and financial reporting requirements aim to make visible the cost related to different activities rather than to ensure a true and fair valuation of the balance sheet, because the focus is different from the situation in the private sector where the focus is more on company valuation, future earning capacity and financial performance as an expression of return on invested capital.

It is also the view that, although all assets and liabilities must be identified and managed for accountability purposes, not all assets and liabilities should also be included in the entity's financial statement. Overall, the purpose of public sector financial statements from central government agencies in Denmark is to support the monitoring and comparison of the application and performance of resources across public sector entities. The content of financial statements should, as such, form the basis for pricing public services and measuring the use of appropriations. Hence, revenue and expenses, and assets and liabilities are only recognized in the financial statements if the items are part of operating activities. Visibility of pricing and a focus on operating activities are the reasons why, for example, donations do not impact the income statement and why heritage assets do not impact the balance sheet (cf. Økonomistyrelsen, 2011).

If Denmark were to move towards accounting under the requirements of accrual-based IPSAS, a study by the Danish State Auditors identified that the following would be required:

- A certain organization of the accounting function.
- A computing system that is able to record the transactions.
- A legal framework.
- A large amount of training.

4.7 Main challenges: problems identified

IPSAS are based on accounting standards for private companies, and thus Denmark recognizes this as a basically different approach to accounting than that required when accounting for the state. The key purpose of financial reporting for the public sector is to enforce state control, and therefore the focus is primarily on whether authorization and conditions have been met. IPSAS, by contrast, are focused on corporate value and the company's future ability to provide public services. The Danish National Audit Office (Rigsrevisionen, 2014) noted that the influence of private sector accounting on IPSAS is problematic.

Firstly, IPSAS are not applicable as the standard for the presentation of the national budget. IPSAS do not relate to the special circumstances that apply to states, for example, in relation to going concerns and political aspirations, but to business judgments that are essential for transactions in the state.

Secondly, in the Danish public sector accounting system there are material items of income and expenditure arising from cash-based principles. This is especially true of taxation, investment grants and statutory transfers. This would deviate from accrual-based IPSAS.

Thirdly, IPSAS allow for more choice and thus more room for discretion than current state rules on cost-based accounting do. In the implementation of the cost accounting reform the Ministry of Finance based accounting changes on the provisions of the Danish Financial Statements Act for private entities, but adapted them in a number of key areas in order to ensure tight funding management and mitigation of the use of estimates in financial reporting. It is thus argued in Denmark (Rigsrevisionen, 2014) that the absence of these constraints in IPSAS increases the risk of buoyancy in appropriations.

The increased estimates and different methods of valuation and regulation raise the risk of misstatement in accounts and create expanded freedom for new forms of accounting manipulation to emerge in the public sector.

Accounting following accrual-based IPSAS would require frequent value adjustments and the use of fair value. This is considered to require more administrative resources for general financial administration in Denmark. As such, more knowledge on the potential benefits of such accounting changes would be required.

Overall, there is a general view that the use of IPSAS drawing on concepts from the private sphere cannot be translated to the public sphere. There are also several IPSAS which, in general, are less relevant to the public sphere.

Notes

1. In the private sector accounting arena the new European Union Accounting Directive (Directive 2013/34/EU) is replacing the current fourth and seventh Directives and covering both single company and consolidated accounts. The 2013 Directive must be implemented into the national legislation of each member state by 20 July 2015 at the latest and the provisions within the Directive will first apply to financial statements for financial years commencing on or after 1 January 2016. In addition, in 2002 the EU agreed that from 1 January 2005 International Accounting Standards/International Financial Reporting Standards would apply for the consolidated accounts of the EU listed companies (see http://ec.europa.eu/internal_market/accounting/legal_framework/index_en.htm (accessed 15 August 2014)).
2. For studies on public sector reform in Denmark, see Greve (2003) and Greve et al. (1999).
3. The accounting principles applied at the central level of government had been discussed since 2000, and in 2001 the Ministry of Finance appointed a task force to consider accrual accounting (Ministry of Finance, 2003).
4. See www.modst.dk/OEAV/5-Kontoplan/Statens-kontoplan-2011 (accessed 8 June 2014).
5. This corresponds to approximately 170 million and 245 million Danish kroner respectively (cf. Rigsrevisionen, 2014).
6. The estimated cost of the accounting reform can be viewed against Danish GDP, which was worth 330.8 billion US dollars, or approximately 263.7 billion euros, in 2013.
7. To access please visit this site: http://budregn.oim.dk/budget-og-regnskabssystem-for-regioner.aspx (last accessed 30 August 2014).

8. To access please visit http://budregn.oim.dk/budget-og-regnskabssystem-for-kommuner.aspx (last accessed 30 August 2014).
9. See http://www.modst.dk/OEAV/5-Kontoplan/52-Statens-kontoplan-2007 (accessed 14 June 2014).
10. The Danish Agency for Governmental Management, part of the Ministry of Finance, is responsible for supporting and developing administrative processes throughout the entire government.
11. Vesting principle is a legal term that refers to the separation of powers. In this context the expense (if for a grant) is recognized when the granting entity has handed over control to the receiving entity.
12. The order on regional budget and accounting is available at https://www.retsinformation.dk/Forms/R0710.aspx?id=161760 (last accessed 1 August 2014).

References

R. Elm-Larsen (2001), *Offentligt regnskab og revision-Et dansk og international perspektiv*. Copenhagen, Denmark: Forlaget Thomson.

R. Elm-Larsen (2010), *Offentlig revision-Empiri og teori*. New York, USA: Thomson Reuters.

Ernst and Young (2012), "Overview and Comparison of Public Accounting and Auditing Practices in the 27 EU Member States", Prepared for EuroStat 19 December 2012.

European Commission (2012a), "Public Consultation Paper. Document Accompanying the Public Consultation on the Suitability of the International Public Sector Accounting Standards for the EU Member States", http://epp.eurostat.ec.europa.eu/portal/page/portal/public_consultations/documents/IPSAS_stakeholders_consultation_paper.pdf, date accessed 15 June 2014.

European Commission (2012b), "Public Consultation – Assessment of the Suitability of the International Public Sector Accounting Standards for the Member States, Summary of Response", http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/D4_2012/EN/D4_2012-EN.PDF, date accessed 15 June 2014.

European Commission (2013), "Report from the Commission to the Council and the European Parliament. Towards Implementing Harmonised Public Sector Accounting Standards in Member States, the Suitability of IPSAS for the Member States", http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0114:FIN:EN:PDF, last accessed 15 June 2014.

GAO (2007), "Accrual Budgeting Useful in Certain Areas but Does Not Provide Sufficient Information for Reporting on Our Nation's Longer-Term Fiscal Challenge", Report to the Committee on the Budget, U.S. Senate, GAO-08-206.

C. Greve (2003), "Public Sector Reform in Denmark: Organizational Transformation and Evaluation", *Public Organization Review: A Global Journal*, 3, 269–280.

C. Greve, M. Flinders and S. Van Thiel (1999), "Quangos – What's in a Name? Defining Quangos from a Comparative Perspective", *Governance*, 12 (2), 129–146.

J. Lotz (2005), "Accountability and Control in the Financing of Local Government in Denmark", *OECD Journal on Budgeting*, 5 (2), 55–67.

Ministry of Finance Denmark (2003), "Omkostninger og effektivitet i staten", www.fm.dk, accessed 1 July 2014.

Ministry of Finance Denmark (2006), "Introduktion til et omkostningsbaseret bevillingssystem", www.fm.dk, accessed 1 July 2014.

Økonomistyrelsen (2011), "Comments to the Consultation Paper Concerning Measurement of Assets and Liabilities in Financial Statements, ØKO/SRH, 30 May 2011".

V. Pina, L. Torres and A. Yetano (2009), "Accrual Accounting in the EU Local Governments: One Method, Several Approaches", *European Accounting Review*, 18 (4), 765–807.

Rigsrevisionen (2014), "Position Paper: Fælles eurpæiske regnskabsstandarder for den offentlige sector (EPSAS)".

M. Robinson (2009), "Accrual Budgeting and Fiscal Policy", IMF Working Paper, WP/09/84.

5
Public Sector Accounting and Auditing in Finland

Lasse Oulasvirta

5.1 Introduction

Finnish public administration is organized on two levels: national central government and local governments (as of 1 January 2014, 336 municipalities, 320 on the mainland and 16 in the Åland autonomous region). Local government also includes around 200 joint municipal authorities that have been established for those public services that need a wide population base, such as special health care and vocational education.

Budgeting, accounting and auditing is uniform inside central government, which consists of ministries and agencies below ministries, all forming the budget entities of government. Correspondingly, budgeting, accounting and auditing is uniform inside the local government sector. No regional governments (except Åland) exist in Finland, which is a unitary state.

5.2 Public sector accounting standards in Finland

5.2.1 Accounting systems in the Finnish public sector

Commercial accrual accounting was established in the Finnish public sector in the 1990s (in local governments on 1 January 1997, and in central government on 1 January 1998). *Central government* set its accounting rules in its budget law and statute. These rules were taken as much as possible from the general accounting rules followed in the business sector. The practical ordinances and instructions for state budget entities are given by the Treasury under the Ministry of Finance. The Finnish central government has also had in the past a Government Accounting Board (FGAB) tasked with making instructive statements, but this body has not been nominated since 2009.

In the *local government sector*, the basic Local Government Act stipulates that the general accounting law (Accounting Act 1336/1997) must be followed in local governments in a way that is specified by the Local Government Sub-Committee of the Accounting Board of the Ministry of Employment and Economy. Although this sub-committee is a state organ, it includes a strong representation of accounting experts from both the Association of Finnish Local and Regional Authorities (AFLA) and leading municipal audit firms. The AFLA gives out recommendations about municipal budget and economy planning.

So, both central and local governments have applied commercial accrual financial accounting rules since the late 1990s (Monsen and Oulasvirta 2008). Public sector financial accounting reforms were inspired by the New Public Management (NPM) movement and by the national business accounting practices that used to be based on the income statement approach, prudence and historical costs (Oulasvirta 2014). Since Finland joined the EU in 1995, the EU's impact on Finnish business financial accounting has grown and, hence, International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) standards have also had an impact upon business accounting legislation (Accounting Act). The traditional approach has been partly put to one side when faced with the international accounting standards promoted by EU legislation. Finnish listed companies must follow IFRS standards, while unlisted companies may voluntarily follow IFRS (Accounting Act 3 § (30.12.2004/1304). However, in public sector financial accounting, the historical costs and income statement approach (the revenue-expense approach) (Hintz, 2007: 328–330) has prevailed.

5.2.2 Measurement and recognition of assets, liabilities, equity, expenses and revenues and the links between budget and financial accounting

The conceptual frameworks for accrual accounting of both central and local governments originate from the national standards and accounting

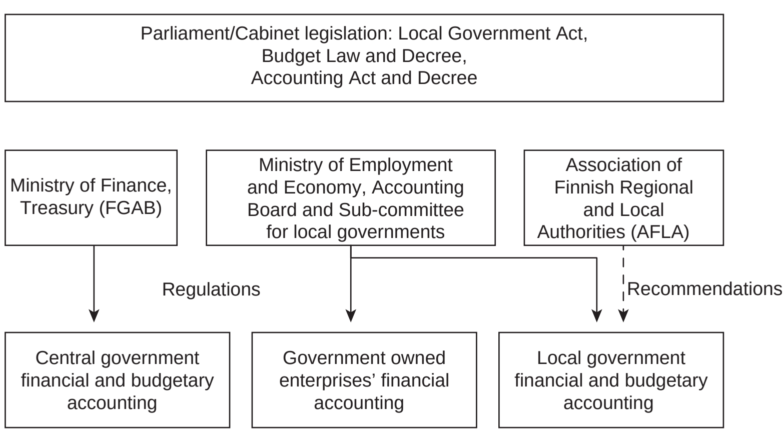

Figure 5.1 Public sector accounting rules in Finland

Source: Prepared by the author.

rules and not from the International Public Sector Accounting Standards (IPSAS). Accounting legislation and financial accounting practice have been influenced strongly by the domestically formulated expenditure-revenue theory of accounting introduced by Professor Martti Saario (1906–1988) in the 1940s and 1950s. His expenditure-revenue theory formed the core of accounting thinking in Finland for several decades. This national historical background and the, so-called, NPM are important factors in understanding the institution of accounting in Finland. The Finnish reforms were driven, at least partly, by an interest in following new public financial management trends in order to make the government appear modern and gain legitimacy in the eyes of those who were demanding more efficiency of public sector entities (Oulasvirta, 2014).

The chosen public sector accrual accounting model was based on historical costs and transaction based income, and emphasized the income statement rather than changes in assets and liabilities in the balance sheet. Public sector tax-financed entities have no equity owned by shareholders; equity is a measurement of net assets owned by the entity.

The relevance of the developed Finnish national model subsequently declined in the 1990s because of EU directives and the introduction of IAS/IFRS standards (Pirinen, 2005; Pajunen, 2010). However, local government reform in 1997 and central government accounting reform in 1998 were not influenced by the IAS/IFRS.

The comprehensiveness of *local government* accounting has been widened by the accounting reforms since the 1990s. A local government that controls a company must consolidate the accounts of controlled entities. Central government does not merge the accounts of controlled off-budget entities, which means that central government makes a book closure containing only on-budget entities.

There are no separate documents delineating conceptual frameworks for either central or local government sectors. However, the *Accounting Manual of Central Government* describes the government accounting system: the accounting entities, the dual system of accrual and budgetary accounting, the basic principles of bookkeeping and the modes of financial and budgetary reporting. Financial statements and annual reports must give a true and fair view of the financial performance and position of the whole central government as well as of the separate accounting entities of central government. Corresponding matters for municipal accounting are described in the *subcommittee's regulations* for local government income sheets, balance sheets and cash flow statements (Sub-Committee, 2011a, 2011b, 2011c, 2012, 2013).

Because the budget presentation structure of *local governments* has been synchronized with the financial statement presentation mode, local governments do not require separate budgetary accounting from their financial accounting, but only one bookkeeping system fulfilling both the external financial reporting and the budgetary out-turn reporting needs.

In contrast to municipal accounting, *central government accounting* consists of a dual bookkeeping system, one for budgetary follow-up and one for preparing general purpose financial statements (Monsen and Oulasvirta, 2008). AFLA has recommended a chart of accounts for local governments, and this differs from the corresponding chart of accounts for central government.

5.3 Central government

Central government is made up of different types of on-budget entities, and each of them applies the same accrual financial and budgetary accounting principles and rules defined in budget law and decree and in the *Manual of Accounting* kept by the Treasury. State-owned enterprises (SOEs) apply the same accounting rules as private business enterprises. State-owned funds apply the same accrual financial accounting as government on-budget entities.

5.3.1 Budgeting

The Ministry of Finance is responsible for preparing the national budget that will be approved by the incumbent Cabinet, usually at the beginning of September. Then the budget proposal is sent to the plenary first session of Parliament, thence to the parliamentary Finance Committee and later to the final plenary session of Parliament.

The annual budget follows a modified accrual basis. It differs from the financial accounting accrual basis in some points; for instance, investment expenditures of long-term assets are financed and recognized fully to the annual budget, which means that no depreciation costs appear in the budget and budgetary bookkeeping.

Finnish budgetary legislation classifies appropriations into different classes according to their nature, divided into current operating expenditure items and financial and non-financial investment items. The repayment of debt is shown in the expenditure class of loan instalments.

Revenue budget classification is structured into four classes, which differentiate between tax and tax-like revenues, income from fees and charges, revenues from dividends and sales income and revenues from loan recoveries and new debts. New long-term debts are not earmarked to specific expenditures, for instance, to financing investments.

Appropriations are mainly allocated to budget entities according to the one-line-item budgeting model. This means that most of the on-budget entities get only one appropriation, which can be used for all current and normal annual investment purposes. This fixed allocation is usually also a net appropriation and is a deferrable appropriation to the next budget year, if not completely used during the budget year. The appropriations are connected to performance goals decided on in the budget and they are also specified in agreement between the steering ministry and the budget entity after the budget decision in Parliament.

Recording to both financial and budgetary accounts happens simultaneously inside one combined information system. Information technologies with sophisticated software allow the integration of the two subsystems. Budget entities must also carry out an obligatory reconciliation between accrual accounting and budgetary accounting. Output figures for performance accountability and evaluation purposes are also recorded during the budget year of each budget entity.

5.3.2 Accounting

Recognition and valuation principles

The recognition of exchange transactions in government accrual accounting is made according to the realization principle: when services or goods are delivered or when factors of production are received. In non-exchange transactions, which constitute over half of the expenditures and about 85 per cent of the income in the budget, cash and short-term liability principles are mainly followed in recognition. Tax income is recognized and recorded when money from tax payers is paid to the tax administration bank account. State subsidies and other money transfers to enterprises, households, local governments, and so on are recognized and recorded according to the short-term liability principle, which means recording when the individualized legal obligation has arisen for the government to pay a transfer to the recipient. This may mean either at the time the decision was made (for instance, discretionary subsidies to enterprises) or at the time the actual amount of a statutory transfer payment was determined. Because these above-mentioned moments are normally before cash payments are made, the recognition also happens before the cash payment.

The Finnish government's viewpoint has been that accruals must not be pushed too far and that valuation is based mainly on historical costs. This is illustrated in the Budget Decree, Section 66c, which stipulates the valuation of balance sheet items.

(1) The final accounts shall include entries as follows:

1) receivables at their face value, but not in excess of their probable value;
2) securities and other similar financial assets included in financial assets at their cost value or at their estimated market value at the end of the financial period, if lower than cost value;
3) liabilities at face value adjusted by the positive or negative issue premium arising when a loan is taken out or, if the debt is tied to an index or to another similar standard of comparison, at the higher value resulting from changes therein (1175/2002).

Revaluations can be undertaken on non-current assets. On the credit side of the balance sheet, revaluations are recorded to the revaluation fund without impacting upon the income statement.

Long-term liabilities that are difficult to predict are explained in the notes to financial statements and in the annual report narratives instead of being recognized on the balance sheet as auditable and reliable figures.

Employee pension liabilities are not recorded as long-term debts in the balance sheet of central government. Pension benefits to retired state pensioners are recognized when the payments take place. The government finances part of the paid pension benefits on a yearly basis with a money transfer from the State Pension Fund. In government bookkeeping, either obligatory or optional provisions are recorded, in contrast to Finnish enterprises and local governments, which record such items according to bookkeeping law (Act number 1336/1997, Section 5: 14 §).

Liabilities and the unfunded part of pension liabilities are included in the notes to the balance sheet of central government and in the notes on the State Pension Fund. The liability and the unfunded part of the liability are calculated by actuary experts at the State Pension Fund.

The Social Insurance Institution of Finland (Kela) delivers basic pensions and most social cash transfers to households. It applies commercial enterprise bookkeeping as stipulated in the general accounting law (1336/1997) according to the law concerning the institution (Act 17.8.2001/731). Both of these basic pension and social policy cash transfers to households and other recipients are not recognized and recorded before the individualized legal obligations for the government to pay these transfers emerge.[1]

Central government final accounts

According to Budget Degree, Section 67, the statement on the budget outturn is prepared on the basis of the general ledger for budget accounting and of information regarding budget authorization accounting. The statement on the budget outturn also presents information on deferred appropriations from previous budget years and on deferred appropriations from the current year to the following budget year.

The general purpose financial statements (the income sheet, balance sheet and cash flow statement) are prepared in accordance with the forms provided by the Ministry of Finance. The effects of revenue and expenditure between government agencies and of mutual receivables and payables are excluded, depending on their significance.

5.3.3 Financial reporting

The Finnish Budget Law and Decree define the presentation of central government's financial statements and its on-budget entities.

The State Treasury merges the ledgers of all the, approximately 90, accounting entities into a consolidated central government financial statement. This contains the accounts of all government budget entities, but not of government funds, government utilities, state owned companies or universities.[2] They prepare their own financial statements.

The present *book closure model of central government* bookkeeping in Finland consists of four basic calculations:

1) A statement of revenues earned and expenses incurred (financial performance accounts). Budget entities do not pursue profit, and this is why the statement is not referred to as a profit and loss statement, but as a revenues earned–expenses incurred statement. Moreover, the pattern of this statement differs from the Finnish enterprise profit and loss statement.
2) A comprehensive balance sheet that includes all assets and all liabilities. Because Finnish governmental commercial bookkeeping is based on semi-strong accruals, it does not push accruals too far, for instance, by presenting such speculative items as long-term pension and social benefit liabilities in the balance sheet.
3) A cash flow statement for central government (separate budget entities do not have to prepare their own cash flow statements).
4) An annual statement of budget accomplishment, which is achieved with budgetary bookkeeping.

Central government does not have a separate statement of net assets or equity.

The *notes to financial statements* disclose additional information and statements in order to complete the information provided in the financial statements and the budget execution statement. Notes cover 16 different topics, for instance: information concerning the valuation principles observed; the grounds on which an exchange rate is used to convert foreign currency receivables, debts and other commitments of a government agency into Finnish currency; and an account of other factors affecting the comparability of current final accounts with those of the previous year (Budget Degree, Section 66 h).

5.3.4 Auditing

There are two types of audit for Finnish central government: internal and external. The internal audit is carried out by internal auditors. The Budget Law and Decree Section 69 (263/2000) stipulates that the agency management shall ensure that proper internal control procedures are established. Furthermore, Section 70 requires that if there is due cause to ensure an efficient internal control system, the management of a government agency shall arrange for internal auditing. As a rule, all ministries have internal auditors, as do the larger budget entities under ministry control.

The external auditing of government entities is exercised by the National Audit Office (NAO), which is Finland's supreme audit institution and operates in affiliation with Parliament (Act 14.7.2000/676). The NAO conducts financial, compliance, performance and fiscal policy audits, and oversees election and party funding. Audits apply the International Standards of Supreme Audit Institutions (ISSAI) endorsed by the International Organisation of Supreme Audit Institutions (INTOSAI), which are based on the International Standards on Auditing (ISA). These are supplemented by the office's financial and performance audit manuals (https://www.vtv.fi/en, accessed 10 June 2014).

The NAO audits *all* government budget entities yearly. Based on sampling, the NAO also audits SOEs and non-governmental organizations that receive government financing and are under its auditing power.

5.4 Local government

5.4.1 Budgeting

The Local Government Act (17.3.1995/365) changed both the budget and accounting models of Finnish local governments. The budget was reformed to consist of four plans: the current economy plan, the investment plan, the income statement plan and the financing plan. In addition, the law stipulated that book closure consist of an income statement, a balance sheet, a financial statement (based on cash flows) and notes to those statements. As well as these general purpose financial statements, book closure also contains budget realization calculations regarding all four budget plans and an annual activity report.

It is very important to note that this reform meant that from then on municipal budget structures followed the book closure model of financial accounting, whereas previous administrative bookkeeping had been tied to the traditional budget model (consisting of a budget plan for current operations and a budget plan for investments).

The Finnish budgeting model stipulated in the Local Government Act, Section 65, is based on the idea of performance budgeting. According to the Act, the budget must include those performance objectives and appropriations needed to fulfil the performance objectives.

Local councils must approve a budget for the municipality for the next calendar year by the end of each year. In connection with this approval, local councils must also approve a financial plan for three or more years. The budget year shall be the first year of the financial plan.

The same section stipulates that if the balance sheet for the year in which the budget is drafted is not expected to show an accumulated surplus combined from current and previous years' income statements, the financial plan must remain in balance or in surplus for a planning period of no more than four years. If a balance sheet deficit cannot be covered during the planning period, specific measures (an operational programme) must be decided on, in conjunction with the financial plan, to cover the deficit over a given offsetting period, determined separately by the local council (deficit coverage obligation).

The municipal board must explain to the council in its annual activity report, or otherwise, how it will cover the deficit and balance the economy (current revenues in relation to current expenditures).

When the council approves the budget it also decides on the local income tax rate and the real estate tax rate. After budget approval the municipal board decides on the practical instructions for municipal agencies and committees regarding budget implementation.

5.4.2 Accounting

Principles, recognition and valuation

The three fundamental principles of accruals, matching and realization are followed. Revenues are earned and recognized in that period when the goods are released, while expenses are incurred and recognized in that period when the factors of production are received. The accruals basis means that income accrued but not yet received and expenses accrued but not yet paid are taken into account. Matching means that costs are matched against the revenues to which they relate when computing the annual result. The realization concept states that profit should be recognized only when it has been realized or when realization is assured. Because local governments hold assets for long periods and most of them do not bring in revenues and are tax financed, local governments also use matching of fixed asset costs (depreciation) against the use of those fixed assets in the production of services (Sub-Committee, 2011: 9).

According to the Finnish Accounting Sub-Committee, prudence is a general guiding principle. Prudence means, among other things, that all costs must be recognised fully and that only realized profits are recognized in the income statement (Sub-Committee, 2011: 7). Historical costs are normally the most relevant valuation basis. These are the conventional starting points for measurement and valuation in the income and balance sheets (Sub-Committee, 2011a, 2011b), even if the historical cost approach is not followed consistently, because in some cases revaluations are possible.

Tangible assets are measured and valued mainly based on the historical costs of acquisition. Fixed and interest costs of financing the investment during the production phase may also be added to the acquisition costs (Sub-Committee, 2011: 17). Fixed assets with a limited lifespan must be depreciated and the depreciation costs allocated to the relevant accounting periods of the lifespan. If the real value of the asset is permanently lower than the book value, the local government must complete a write-off corresponding to the impairment of the asset.

Revaluations can be undertaken on the following non-current assets: real estate, water and stocks and bonds. Revaluations cannot be undertaken on property, plant and equipment. On the credit side of the balance sheet, the revaluation is recorded to the revaluation fund without impacting upon the income statement (Sub-Committee, 2011: 18–19).

Current financial instruments must be valued at their cost value or at their market value, if lower than their cost value. A reversion is obligatory if the market value is no longer lower than the cost value. Only in exceptional circumstances can current financial instruments be revalued at fair value, which revaluation, since it has an impact on the income statement, should only be undertaken under really significant circumstances (Sub-Committee, 2011: 29–30).

Finnish local governments must treat establishment and research costs as annual costs in the income sheet. Development costs may be accrued to the balance sheet only with special caution (Sub-Committee, 2011: 10). Valuation of stock is based on the principle of lower than cost or net realizable value (Sub-Committee, 2011a: 23–24).

Tax income is recorded according to the principles of cash-based accounting. In other words, tax revenues are recorded in the accounting period in which the state tax administration pays local tax revenues into a municipality's bank account. Besides these tax payments, remedial actions by the tax administration applied to the allocation of municipal tax income, and known before the closing date for the municipal books, must also be recognized, even if transfers equivalent to the remedial measures have not yet occurred.

Accounting of debts and pensions

The main principle in Finland is that local governments value their debts at their nominal value (face value). According to the instructions of the Sub-Committee (2011a: 11), a capital discount related to a loan, transaction costs of borrowing and costs of the emission of a debt instrument may be accrued to the balance sheet with special caution. This must be conducted according to a plan based on the maturity of the loan and repayments.

The pension liabilities and pension assets of local governments are taken care of collectively by the pension institution Keva according to the Local Government Pensions Act (13.6.2003/549). Local governments pay Keva yearly payments that form part of the financing of Keva's expenditures. This arrangement means that municipal pension liabilities are included in the balance sheet and notes of Keva and not in the balance sheets of the separate Finnish local governments. Only Finnish local governments that have pension liabilities outside this collective arrangement must show pension liabilities in their balance sheets. These are the, so called, old system pensions and some additional pensions (Sub-Committee, 2011a: 39).

5.4.3 Financial reporting

According to the Local Government Act § 67, accounting obligations and accounting and financial statements of municipalities are subject to the applicable provisions of the Accounting Act (655/1973, substituted later with 1336/1997). Thus, municipalities have to comply with this act and all its amendments as the Sub-Committee instructs. The Accounting Board and its Sub-Committee is a state body under the Ministry of Employment and Economy. However, the Sub-Committee includes a strong representation of accounting experts from both the Association of Finnish Local and Regional Authorities and leading municipal audit firms.

According to the Local Government Act, Section 68, financial statements shall comprise a balance sheet, income statement and cash flow statement, with appended notes and a budget review and activity report. The financial statements must provide accurate and sufficient information on the municipality's operations, financial position and financing. Additional information necessary for this purpose must be reported in the notes to the financial statements.

According to the Local Government Act, Section 69, the report on operations must give an account of the extent to which the operating and financial targets set by the local council have been achieved in the municipality and the local authority corporation. If the municipality's balance sheet has an uncovered deficit, the report on operations must also include an explanation of the extent to which the finances were balanced in the accounting period and of the adequacy of the current financial plan and operational programme to balance the finances.

Local governments in Finland must also prepare a cash flow statement. This contains the net cash flow from ordinary operations, cash flows from investment activities and, lastly, capital financing flows. The statement ends with changes in liquid cash assets.

A Finnish municipality or a joint authority of municipalities must, with some exceptions (related to the insignificance of the affiliates in the municipal economy), prepare a group book closure if it has any affiliates. The consolidated financial statements must combine the balance sheets, income statements, cash flow statements and appended notes of the local authority corporation's entities. The consolidation must be undertaken using the acquisition method or the less complicated method called the nominal or parity method.[3] In practice, the nominal method is used more often than the acquisition method in Finland (Sub-Committee, 2012).

5.4.4 Auditing

Finnish local governments have a dual auditing system: external financial auditing is executed by certified public finance auditors (CPFA) and performance auditing is executed by local authority audit committees. These local authority audit committees are nominated by local councils and their members are local persons elected to a position of trust, not professional auditors.

Financial auditing

According to the Local Government Act, Section 72, the local council shall appoint one or more auditors, they must be persons or corporations authorized by the Board of Chartered Public Finance Auditing (CPFA auditors or CPFA corporations). The auditors must be able to perform impartial audits. If the preconditions for an impartial audit do not exist, the auditor must refuse to accept the assignment or must abandon it.

According to Section 73 (duties of auditors), the auditors are required to examine, among other matters, whether the municipality's financial statements have been drawn up in accordance with the provisions concerning the preparation of financial statements, and whether they provide accurate and sufficient information on the activities, finances, financial trends and financial obligations of the accounting period. They must also examine whether internal control and risk management have been properly arranged.

Performance auditing

External CPFAs carry out compliance auditing. Performance auditing is accomplished by a special Local Government Committee. According to the Local Government Act, Section 71, local councils shall set up a local authority audit committee to arrange audits of the administration and finances during the council's term. The Committee must, among other matters, assess the extent to which the operating and financial targets set by the local council have been achieved in the municipality and the local authority corporation. The local authority audit committee must also ensure the coordination of the external auditing of the municipality and its subsidiaries executed by CPFAs.

5.5 Readiness for change: comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

The conceptual approach of both central government accrual accounting and local government accrual accounting originates from national standards and accounting rules and not from the IPSAS. The Finnish commercial accrual accounting institution has, since the 1960s, been strongly based on the revenue-expense approach rather than on the balance sheet approach. The accrual accounting principles have emphasized prudence, the realization principle and historical costs.

The FGAB stated in 2009 that the information needs of the public sector are fulfilled better by the national model than by the balance sheet and fair value approach (FGAB, 2009). According to the committee that prepared the Local Government Act and the government law proposal, the suitable framework was the expense-revenue theory and the matching principle (law proposal HE 192/1994, 112, The Local Government Committee, 1993:33: 281–282).

The Finnish public sector accounting institution firmly chose the revenue-expense led approach, as against the International Public Sector Accounting Standards Board (IPSASB), which has been vague when confronted with the choice between the revenue-expense led approach and the asset and liability led approach (Müller-Marqués Berger, 2012: 16–17). The majority of public sector accountant experts in Finland have been quite satisfied with the present accounting framework. Very few, if any, of the Finnish central government and local government accounting experts favoured the idea that IPSAS standards and IPSASB should have an important influence on Finnish accounting.[4] In addition, the National Audit Office is sceptical about making IPSAS-like standards compulsory. When it comes to the theoretical underpinning of the standards, few local government or central government accounting experts consider that fair value accounting is a good solution for public sector accounting needs.[5]

5.6 Main challenges: problems identified

A comprehensive set of detailed standards for public sector entities on all levels would be very expensive for EU Member States. It is possible that the fiscal standard rules in the EU can be managed and policed by Eurostat for statistical and national accounts purposes without introducing at the same time compelling and detailed rules for public sector entities' general purpose financial statements. Eurostat, with its added mandates, has the ability to police member states' statistical authorities efficiently, which should then guarantee adherence to the *Manual of Government Deficit and Debt* (Eurostat, 2013) and prohibit illegalities and fraud in member states' governmental fiscal statistics.

According to the unit head of Statistics Finland (discussions in the Finnish EPSAS (European Public Sector Accounting Standards) group nominated by the Ministry of Finance in April 2014), it is particularly important to develop statistical data from local governments, which is actually currently done in collaboration between Statistics Finland and local governments. From the point of view of Statistics Finland, it is crucial to obtain reliable data from public sector entities irrespective of the financial accounting system in use. It is not necessary to change the content of financial accounting to another mode because of national statistical requirements, especially because the statistical principles of the system of national accounts have diverged from financial accrual accounting principles. From a Finnish national viewpoint, possible EPSAS should be such that they do not compel unnecessary changes in the Finnish public sector accounting institution, which functions fairly well at the moment. Furthermore, the standards should be based on a conceptual framework (CF) explicitly developed for the public sector.

Notes

1. However, the Social Insurance Institution of Finland records the pension liability of its own personnel in its balance sheet.
2. Before 2010, universities were on-budget entities but since 2010 they have been government off-budget entities.
3. In the parity method no goodwill or gains are recorded in the consolidation.
4. The Government Accounting Board of Finland took a negative stand on IPSAS standards twice, in 2006 and 2009 (Oulasvirta, 2014). See also Vehmanen (2008).
5. This conclusion is based on the author's previous study (2014) and on discussions in the Finnish EPSAS group of which the author is a member. This group has met several times during 2012–2014, and it consists of accounting experts from central and local government, the National Audit Office, the Ministry of Finance and Statistics Finland.

References

Eurostat (2013), *Manual on Government Deficit and Debt. Implementation of ESA95*. Eurostat Methodologies and Working Papers. 2013 edition. Luxembourg: Publications Office of the European Union.

FGAB (Finnish Government Accounting Board) (2009), Comments on the Consultation Paper Phase 1 of the IPSASB Framework Project, 31 March 2009, Helsinki.

J-M. Hintz (2007), "The Decision Usefulness of Fair Value Accounting – A Theoretical Perspective", *European Accounting Review*, 16 (2), 323–362.

Local Government Committee (1993:33), *Kuntalakikomitea*. Helsinki: Government Publisher. Finnish.

N. Monsen and L. Oulasvirta (2008), "Evolution of National Government Accounting: A Comparative Study of Finland and Norway", in S. Jorge (ed.), *Implementing Reforms in Public Sector Accounting*. A Conference Paper Presented at the 11th CIGAR Biennial in Coimbra, 29 pages. Coimbra: Coimbra University Press.

T. Müller-Marqués Berger (2012), *IPSAS Explained. A Summary of International Public Sector Accounting Standards*, second ed. Chichester: Wiley, and Ernst and Young.

L. Oulasvirta (2014), "The Reluctance of a Developed Country to Choose International Public Sector Accounting Standards of the IFAC. A Critical Case study", *Critical Perspectives on Accounting*, 25, 272–285, online version doi:10.1016/j.cpa.2012.12.001.

K. Pajunen (2010), "Current Finnish Accounting Thought in Relation to International Financial Reporting Standards and Earlier Finnish Accounting Traditions: Results from a Survey of Finnish Accounting Professionals", *The Finnish Journal of Business Economics*, 2, 145–177.

P. Pirinen (2005), "Economic and Normative Pressures as Drivers for the Adoption of International Accounting Standards in Finland since 1976", *European Accounting Review*, 14, 213–235.

Sub-Committee of Accounting Board in Finland (2011a), *General Instruction of Producing a Balance Sheet for Municipalities and Joint Authorities of Municipalities*. Helsinki: Ministry of Trade and Industry.

Sub-Committee of Accounting Board in Finland (2011b), *General Instruction of Producing Depreciations According to a Plan for Municipalities and Joint Authorities of Municipalities*. Helsinki: Ministry of Trade and Industry.

Sub-Committee of Accounting Board in Finland (2011c), *General Instruction of Producing an Income Statement for Municipalities and Joint Authorities of Municipalities*. Helsinki: Ministry of Trade and Industry.
Sub-Committee of Accounting Board in Finland (2012), *General Instruction of Producing a Group Book Closure for Municipalities and Joint Authorities of Municipalities*. Helsinki: Ministry of Trade and Industry.
Sub-Committee of Accounting Board in Finland (2013), *General Instruction of Producing a Funds Flow Statement for Municipalities and Joint Authorities of Municipalities*. Helsinki: Ministry of Trade and Industry.
P. Vehmanen (2008), "The Conceptual Framework of IPSASB from Theoretical Point of View. A Comment Paper on the Consultation Paper Phase 1 of the IPSASB Framework Project", A Discussion Paper. Tampere: University of Tampere.

Useful site

National Audit Office (NAO), https://www.vtv.fi/en, date accessed 10 June 2014.

Legislature

Accounting Act (655/1973)
Accounting Act (1336/1997)
Budget Law (423/1988) and Decree (1243/1992)
Government proposal of a local government law (HE 192/1994), Finnish Parliament.
Law of State Pension Fund (1297/2006)
Local Government Act (365/1995)
Local Government Pensions Act (549/2003)
National Basic Pensions Law (568/2007)
National Audit Office Act (676/2000)
Social Insurance Institution Act (731/2001)

6

Public Sector Accounting and Auditing in France

Marine Portal

6.1 Introduction

French public administration is organized on two main levels: national and territorial (local and regional levels).

We can distinguish four main sub-levels of territorial governments: 27 regions and 101 departments at regional level; 36,681 municipalities and 2,581 inter-municipalities at local level. This is one of the highest number of local governments in Europe.

Budgeting, accounting and auditing are quite different at national and territorial (local and regional) levels, particularly since the accounting reform issued on 1 August 2001, the constitutional by-laws on budget (Loi organique des Lois de finances, LOLF), that replaced those of 1959 at central level.

This accounting reform has two main components. The first part deals with transparency and is based on new accounting standards (detailed in Section 6.2) to provide more accounting information drawn from private accounting principles while taking into account the specificities of the state. The second aspect is reliability because LOLF stipulates that financial audits are implemented on consolidated financial statements by the Court of Auditors (the national supreme audit institution) from the year 2006 (detailed in Section 6.2.4).

The accounting reform modified the functions and organization of public sector accounting. While accountants used to check only accounts, after the reform they have to check and control beyond accounting purposes. These controls must bear on the responsibility of everyone involved in public management. The reform favours process assessment to undertake control based on risk, issues and quality management. Concerning the organization of public accounting, the new Directorate of Public Finance (*Direction Générale des Finances Publiques*) combines the former Directorate of Taxes (*Direction Générale des Impôts*) and the Directorate of Public Accounting (*Direction Générale de la Comptabilité Publique*). At central level, the new organization includes the creation of support jobs for accounting internal control and the budgetary and departmental accounting controllers to represent public finance in each ministry.

Finally, the accounting reform emphasizes links among the three main accounting systems, detailed for central level in Section 6.2.

1. *Budgetary accounting* on a modified cash basis, with authorization and monitoring of commitments and cash limit appropriations as accounting mechanisms.
2. *Financial accounting* based on an accrual system and on the measurement and evaluation of assets and liabilities.
3. *Management accounting* to measure costs through budgetary and financial accounting.

This chapter discusses the first two accounting systems at central and regional/local levels. Concerning management accounting, the main objective is to define links between objectives, available resources and results. Management accounting is based on a cost accounting system and is a tool of management and information in addition to budgetary and financial accounting. Cost or management accounting is, in fact, another way of presenting accounting information. Its purpose is to reconstruct the full cost of public policies for the information of parliament and for the managers in charge of implementing these policies. The information is presented in two main documents, the annual performance plan and the annual performance report, which are subsequently compared in order to understand and evaluate differences.

6.2 Public sector accounting standards in France

Since September 2009, the French public sector accounting standards board (*Conseil de Normalisation des Comptes Publics*, CNOCP) has been responsible for issuing advice on all proposed accounting standards applicable to the public sector. It has its own structure and is independent of the French private sector accounting standards authority (*Autorité des Normes Comptables*).

Public accounting standards are based on three different national and international accounting standards:

1. The chart of accounts for the private sector.
2. The international public sector accounting standards, IPSAS.
3. The international private sector accounting standards, International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS).

French accounting standards are, in fact, related to all three frameworks but more directly to the IPSAS; they refer to IAS and IFRS only for specific elements, such as control. A main pillar of the legislation is to use convergences between the chart of accounts and the international public sector accounting standards in order to provide more accounting information consistent with private accounting principles, while taking into account the particularities of the state.

6.2.1 General accounting plan for the public sector

After a first edition in 2004, the actual GAP (*Plan Comptable Général*), published in February 2013, is now structured around 17 standards and a conceptual framework. This GAP applies to central government, and includes all services, entities and institutions related to the state (without their own legal personality).

Each standard is developed with the same structure:

1. scope
2. recognition
3. measurement
4. disclosure in the notes.

Every accounting entity is required to name its accounts according to the chart of accounts and to code them consistently with the chart of accounts coding system. The chart of accounts itself, as it occurs in the private sector, is organized into ten classes related to specific codes:

1. capital, reserves, long-term borrowings
2. fixed assets
3. inventories
4. accounts receivable
5. accounts payable
6. expenses
7. revenues
8. income (operating, extraordinary, financial, etc.)
9. cost accounts
10. statistical special (e.g. guarantees given and received).

6.2.2 The conceptual framework

In the French conceptual framework we find information included in the set of French public accounting standards available online (http://www.economie.gouv.fr/cnocp-en) about its generic goals, the purpose of financial statements and a list of principles and rules to govern future standards. From a formal point of view, these overlap with those covered by the International Accounting Standards Board (IASB) framework. There is a similar hierarchy: an overview of the objectives of the accounting framework, a presentation of information objectives assigned to financial statements and presentation features (Lande and Scheid, 2003).

The first principles for public accounting developed in the framework are regularity, sincerity and true and fair view. The principles of accruals, going concerns and permanence for the chart of accounts methods are also included. Finally, the framework refers to the principles of comprehension, relevance and reliability to explain accounting information quality.

The conceptual framework's objective is to define public sector specificities according to three concepts (net worth, net position and financial position) and to a number of technical specificities, such as scope for rights and obligations, the concept of equity, assets measurement and recognition (Lande, 2009).

6.2.3 Measurement and recognition of assets, liabilities, equity, revenues and expenses

Measurement and recognition of assets

Assets are defined "as a balance sheet item that has a positive economic value for the Central Government, meaning that it is a resource controlled by the government that is expected to produce economic benefits in the future" (Accounting Standards, February 2013, Conceptual Framework: 20). Fixed and current assets are included. Fixed assets include intangible, tangible and financial assets, along with the associated claims. In the set of French accounting standards, we find a standard for each type of asset, with number seven dedicated to financial assets. Current assets include inventories, claims related to current assets and cash. Moreover, in the central government's financial statements, control over the resource is understood as direct control of the asset by entities within the central government structure. Therefore, assets controlled by entities that are incorporated as separate legal entities under the control of the central government are not tracked as such in the central government's financial statements. But when the government has long-term use of goods that it does not own, these goods are recorded in its financial statements as long as it has control of them. Assets covered by financial leases are a good example of this: they are recognized if the risks and rewards incident to ownership are substantially transferred to central government. The assets made available to central government are another good example because they can be recognized in the financial statements if government has control (management of the asset and risks and associated expenses) even if they are free of charge for a nominal rent (management of the asset and risks and associated expenses). This is the case in buildings made available to central government as part of a sharing agreement covered by decentralization legislation.

The measurement of assets and liabilities are based on business rules. "The value on the reporting date is determined by comparing the recoverable amount of each asset and liability on the reporting date to its initial amount, with such adjustments as necessary for depreciation and impairment losses (net carrying amount) and then using the lower of the two values" (Accounting Standards, February 2013, Conceptual Framework: 23). In recognition rules for assets, all the terms in use come from private regulation, such as net selling price and value; but there are some particularities, such as value in use, which are determined with regard to expected services (and not cash flows). Another important issue is the depreciation schedule for assets, which is based on a measurement of the potential volume of services expected from the use of the asset.

Recognition and measurement of liabilities

"A liability is an obligation towards another party at the reporting date, which, at the date the accounts are finalised, will probably or certainly give rise to an outflow of resources necessary to settle the obligation towards the other party" (Accounting Standards, February 2013, Conceptual Framework: 20).

Liabilities are recorded in the financial statements for the year in which the related obligations arises. The concept of obligation is related to regulations or contract but it can also be related to the control of an asset.

In accounting standards, several standards detail accounting principles and rules for each category of liabilities, such as for financial debt and derivative financial instruments (standards n. 7); here again, private regulation has a huge impact. Indeed, principles and rules governing enterprises also apply to debt denominated in foreign currencies and to interest rate and currency swaps.

Recognition and measurement of revenues

"Revenue is an increase in assets or a decrease in liabilities that is not offset by the corresponding outflow of an asset or an increase in liabilities. In the case of the central government, there is a distinction made between sovereign revenues and revenues from sales of goods and services, revenues from investments in financial assets and revenues from user fees" (Accounting Standards, February 2013, Conceptual Framework, p. 20).

The recognition issue is linked to the delivery of a good or service. In the specific case of sovereign revenues, we need reliable amounts and raising authorization. Furthermore, on the recognition issue, the conceptual framework emphasizes differences between sovereign revenues and revenues derived from intangible assets. Indeed, sovereign revenues are not recorded in the financial statements but revenues derived from other intangible assets must be recorded.

Recognition and measurement of expenses

"An expense is a decrease in assets or an increase in liabilities that does not cause the corresponding arrival of a new asset or a decrease in liabilities.

Expenses correspond either to the consumption of resources in the production of goods or services, or to an obligation to make an irrevocable payment to another entity that has no direct counterpart in the financial statements. Expenses are recorded in the financial statements for the year in which they were consumed" (Accounting Standards, February 2013, Conceptual Framework, p. 20). We can also add that expenses are presented according to ministry tasks and programmes (for more information, see Section 6.2.1).

There is a specific rule for the recognition of expenses, such as compensation paid or purchase of services, where the delivery of goods is the concept for recognition while the inventory is the concept to tell purchases consumed from purchases held in inventory.

6.2.4 Financial statements

The different documents contained in the annual financial statement are the following:

- *Balance sheet* discloses state assets and liabilities, the difference between them representing the state's net position. The information concerning liabilities is supplemented by data presented in the notes and concerning "off-balance sheet commitments" because of their materiality and their impact on assets and liabilities. Some long-term obligations, apart from public debt (as pensions and social benefits), are included in those off-balance commitments.
- *Income statement* consists of three additional tables that represent all the revenues and expenses of the accounting period: a net expenses statement, a net sovereign revenues statement and a net operating surplus/deficit statement. These determine the account balance (or net worth position) of the exercise. The net worth position and the budgetary outcome are reconciled in order to highlight and explain the differences.
- *Cash flow statement* shows the cash inflows (receipts) and outflows (disbursements) classified into three categories: cash flow related to operations, cash flow related to investment operations and cash flow related to financing operations. Cash for the state is the difference between active cash and, so-called, passive cash, which corresponds to amounts collected by third parties (local communities, institutions). The, so called, cash position is "made up of assets (balances with banks and cash on hand, deposits in transit – inflows minus outflows – other cash and cash equivalents) and liabilities (deposits of Treasury correspondents and other authorised persons, other cash items)" (Accounting Standards, February 2013, Conceptual Framework, p. 28). This cash position is generally negative and the cash flow statement is used to present the funding requirements of the state or the cash surpluses generated over the year (Lande and Scheid, 2003).

– *Other documents*, complementing the state's general accounts are:

- a report on internal control of government accounts to address key risks identified;
- the annual performance report;
- the monthly deficit/surplus – a cumulative presentation of all month-end transactions recorded in the state accounts since the beginning of the year.

6.2.5 Links between the budget and financial accounting

The relationship between budgetary accounting and financial accounting was not raised by the LOLF but processed by the conceptual framework. Indeed, budgetary and financial accounting systems are independent from each other because rules and standards relating to evaluation and recognition are specific. For traceability requirements, an operation that involves several stages (ordering, delivery, payment) must be followed consistently in financial and budgetary accounting even if different amounts are recorded, depending on the specific set of accounts considered. Differences must then be explained and results presented in a table of transition between the balance of budget implementation and accrual outcome. The consistency between the two accounts must be achieved both conceptually and on a technical level.

For budgetary accounting, the budgetary balance is the difference between revenues received during the year and expenditures of the same year. Financial accounting describes the assets of the State (land, buildings controlled, debt, credit, etc.) and presents the net operating surplus or deficit (difference between costs and revenues for the year).

The difference between the budgetary balance and the surplus or deficit in financial accounting are explained by following main factors:

- Investments, which are a budgetary expenditure but which do not impact on the financial accounting result, since they are recorded in the balance sheet.
- Expenditures and revenues not recognized in budgetary accounting because they have not been paid yet.
- Accrual liabilities, accrual income, expenditures and deferred revenues which do not affect budgetary accounting.
- Depreciation and provisions which did not affect the budget outcome.
- Revenues received in advance, expenditures paid in advance (Lande and Scheid, 2003).

6.2.6 Accounting standards for consolidated statements

In France, at central level, accounting standards are adopted by the government in consultation with a committee of qualified public and private personalities, the Committee on Standards in Public Accounting, which reports to the Minister for the Budget.

There are 17 different standards at national level supporting the preparation of the consolidated statement, including one specifically devoted to heritage assets.

Accounting standards are then divided into accounting instructions, a regulatory text, signed by the Director General of Public Accounting. It regulates the activity of the executive management of public finance services in all areas (revenue collection, taxation, deposit management, financial control, accounting systems, etc.).

For accounting standards for consolidated statements, there is a single instruction divided into nine books. This specifies financial statements templates, accounting classifications, the terms of centralization and transfer between accountants, and the recognition and evaluation rules for the various accounting operations.

6.3 Central government

According to the conceptual framework, "the scope encompasses all of the Central Government departments, establishments and institutions that are not incorporated as separate legal entities" (2013: 18). For entities with juridical personality, we refer to separate financial statements.

The state entity comprises all the services, facilities or state institutions which do not possess juridical personality, and some public authorities. It mainly covers entities or services for which operational resources are defined and allowed by law and excludes financial and public institutions and organizations or similar bodies with juridical personality. That means that governmental businesses or enterprises with their own juridical personality will not be included in the consolidation scope or in governmental financial statements.

To define the scope of consolidation, we also need the concepts of control and joint interest. These are developed in Section 6.2.3 devoted to asset measurement and recognition.

6.3.1 Budgeting

The primary aim of budgetary accounting is to trace the responsibilities entrusted to parliamentary authority and to provide public financial information on the evolution of commitments, revenues and expenditures during the year. It should also enable managers to better manage the funds available and to follow the budgetary consequences of transactions over several exercises.

Budgetary accounting can be divided into two parts. The first is based on a modified cash basis. According to the nomenclature of the IPSAS, the modified cash basis is a system based on receipts and disbursements with an additional period at the end of the year to match costs and products in the year. The other part is based on the notion of commitment. Article 28 of the Constitutional by-law budget act explains this point: "Recognition of budget revenues and expenditure obeys the following principles: 1) revenue is recognized for the budget of the year in which it is collected by a public accountant; 2) expenditure is recognized for the budget of the year in which it is paid by the accountants commissioned to the expenditure. All expenditures must be charged to the appropriation for the year in question, regardless to the receivable date".

The presentation and consolidation of the budget is based on a new organization of public policies in France. Parliament has organized public policies into missions that may be the domain of several ministries; each mission comprises several programmes (each of which concerns only one ministry) and finally each programme is split into several actions. Of the 33 missions, 23 (or 70 per cent) and their respective programmes are within one department and 10 (or 30 per cent) cut across departments (Portal et al., 2012). Budgetary accounting is the consolidation of accounts by actions and is based on two main concepts: interchangeability for funds inside programmes and cash-based accounting for commitments. The interchangeability allows each manager to freely use credits and change their allocation to implement the programme.

Finally, the state budget is the act in which revenues and expenditures of the state are planned and authorized. It includes:

- *La Loi de Finances*, the general budget or budget execution statement structured into three levels: missions, programmes and actions.
- *Les bleus budgétaires*, subsidiary or budget appendices for expenditures and revenues of a state service whose business is essentially to produce goods or services giving rise to payment. They are related to a mission and specialized in programmes.
- *Les jaunes budgétaires*, special account, to show a kind of balance between operations that are highly correlated (e.g. loan account).

The annual Finance Law has to be voted by parliamentarians every year and is organized and published following two distinct parts, one for general requirements of the financial balance (details of expenditures and revenues) and the other one for resources dedicated to public policy.

This traditional budgetary accounting system reflects the relationship between the legislature and the executive (Jones et al., 2013). In French public accounting, budgetary accounting is included in a system of legislative control with formal controls of commitments. "However, in both cases, their annual voted budgets do not largely restrict the executive's spending to that year" (Jones et al., 2013: 22).

6.3.2 Accounting

According to the IPSAS classification, financial accounting refers to a system of accrual accounting very close to that in force in the private sector. Accounting for revenues and expenses is based on the accrual principle. The connection on a cash basis to the fiscal year is explained as follows in article 30 of the constitutional by-law: "the general accounts of the State are based on the principle of determining the rights and obligations. Transactions must be taken into account in the year to which they relate, regardless of their date of payment or collection".

6.3.3 Financial reporting

The General Account of the State is published every year and presents the state's financial position made up of four elements: the balance sheet, the income statement, the table of cash flows and the notes. The statement of budgetary execution is not included in the general account but in the budgetary documents because, as mentioned in article 27 of the constitutional by-law: "The State shall keep accounts of budgetary revenues and expenditure and a general accounting for all of its operations". That is why the statement of budgetary execution is presented in a different document, the annual Finance Law (detailed in Section 6.3.1).

The General Account of the State is reflected in several documents for different users and purposes:

- The handbook: a shortened version of the General Account of the State primarily devoted to explaining and presenting the financial aggregates and their mode of development.
- The format of the report, in order to develop the General Account of the State.
- Notes attached to the General Accounts of the State, to identify the accounting principles used and their impact on the main figures and statements.

6.3.4 Auditing

The French supreme audit institution, *Cour des comptes*, is responsible for the auditing function at central level. This institution is in charge of different audits:

- Management audit (related to performance audit) on a public institution or public policy.
- Jurisdictional audit for public accountants.
- Financial audit on consolidated financial statements at central level.
- Financial audit for international organizations.

The French audit institution also supports Parliament in executing the annual Finance Law by controlling and evaluating the budgetary statements to help parliamentarians to adjust the different budgetary documents before the annual vote.

There are three different levels for audit and control of the public accounting system at national level: internal control, internal audit and, the most recent level introduced with the accounting reform, financial audit (or certification) by the national supreme audit institution.

Internal auditing is an independent and objective activity providing reasonable assurance regarding the degree of control over an entity's operations. Located in an independent position in relation to the hierarchical structure, it ensures the quality of internal control of the entity and it provides advice for improvement. To this end, it helps an entity achieve its objectives through evaluation using a systematic and methodical process of risk management and control. The *MAEC* (Audit, Evaluation and Control Mission) is the department devoted to internal audit in the Finance Ministry. Besides its work in public accounts, it conducts audits and financial services involving inspection or internal audit for every department.

The external financial audit is defined as the written opinion indicating reasonable assurance of compliance for the financial statements on a given set of accounting rules and principles. This audit is framed by a specific methodology based on risk-based approach and the concept of materiality. The standards are the international ISA (International Standards on Auditing) by IFAC (International Federation of Accountants). Since the first audit on 2007 financial statements, the *Cour des Comptes* gives a qualified opinion on central government financial statements every year. Details of the financial audit are given in the last section of this chapter.

6.4 Regional government

France is organized into 27 regions and 101 departments with regulatory power but no legislative autonomy. Moreover, regional governments are financially autonomous and their revenues derive mainly from state grants and taxation.

Financial autonomy is also recognized at local level, whose budgeting and accounting share most features with that of the regions. This section about regional government will thus develop the basic principles for regional and local accounting and budgeting, and the specific regional features. Section 6.5 only presents what is specific to local government.

6.4.1 Budgeting

Budgetary execution in regional and local government is framed by three principles: annuality, unity (exceptions made for additional budget and adjustments) and budgetary universality (achieved through a non-shrinking mechanism for revenues and expenditures and prohibition of re-allocation). The budget details resources and expenditures collected or spent in a year at regional level.

For regional and local levels, capital (investing) and operating financial operations are registered in separate sections. Operating funds include operating expenditures (such as grants) and revenues (such as taxation) and capital funds include loan repayment, capital revenues, and so on. Both sections have to balance after transfers between operating and capital funds and the, so-called, result affectation. This "balanced budget" principle is one of the most important for regional and local budgets (Lande and Scheid, 2003). As budget documents are on a modified accrual basis and record future commitments, the budget records also calculate items such as depreciation. Those calculated items have to be eliminated and grouped in a specific transfer fund in order to mention a self-financing surplus. This surplus is also presented in the capital and operating funds. Finally, a transfer from the operating fund to the capital fund will balance each section (operating and capital) by pooling together items as current year expenditures and revenues, past year report and previous year's result affectation (Lande and Scheid, 2003).

Finally, for regional and local government the budget statements include five different documents providing an overview of the financial position:

- preliminary budget (expenditures and revenues);
- budget adjustments;
- additional budget with modifications to the preliminary budget, such as budget adjustments. This additional budget also presents the results of the previous fiscal year;
- budgetary execution statement, *compte administratif* (this statement combines the preliminary and additional budgets) for investing or capital section and to explain differences between two fiscal years;
- management statement, *compte de gestion*, which is the exact counterpart of the budgetary execution statement but for the operating section.

6.4.2 Accounting

There are different accounting regulations for the different territorial governments. Reference here is not to accounting standards but to the, so-called, instructions, specific for each government level and for each type of entity. The most important instructions are:

- M71 for regions
- M52 for departments
- M14 for municipalities

In each instruction, accountants and managers find information about the accounting framework (chart of accounts, recognition and evaluation rules) and the budgetary framework (plan for budgetary chapters, budgetary principles, budget presentation and adoption, execution of payments and revenues). The other common elements are a modified accrual based accounting and accounting principles of independence, sincerity and prudence. The different instructions are finally in line with the private chart of accounts (PCG) and can thus be related to IAS/IFRS or IPSAS standards. However, we cannot conclude there is an adaptation to IAS/IFRS or IPSAS because of major differences, mainly based on more juridical than economic overview (e.g. leasing is not recognized as assets) and on alleged obligations for accounting and disclosure (as IAS/IFRS for small and medium enterprises).

At departmental level, the M52 is adapted to legal environments (decentralization, various legislative reforms). Applied since 1 January 2004, the M52 strengthens accrual accounting. The functional classification traces specific departmental policies, including social legislation (with, e.g. minimum income) or grants to other regions for the construction of public facilities. M52 also allows provisions for risks and reserves, and provides accounting support for active debt management.

At regional level, M71 has the same objective as M52. It reinforces the patrimonial aspect of budgets and accounts by acting on two main concepts: depreciation and financial position or accounting income with techniques such as income correction (with a closer matching of income and expenses to the relevant period to technically respect the independence principle for the fiscal year). M71 aims to give a better understanding of regional net worth.

6.4.3 Financial reporting

The financial statements are mainly presented through a balance sheet and an income statement. The balance sheet records intangible, tangible and financial assets, creditors, debtors, cash and equity situations (this last item is obtained by adding together capital and operating funds outcomes as presented in Section 6.4.1). Analyses can be made to obtain a forecast based on old financial positions, as well as to measure debt level and taxation for international comparisons using a specific software. This software is part of a global project called Helios; it is under the responsibility of the Ministry of Public Finance. Financial statements record intangible, tangible and financial assets, creditors and debtors and cash and equity situations.

Financial statements are also presented using two main statements, at both regional and local levels: the administrative statement and the management statement.

The administrative statement is a summary document tracing budget execution during the year (revenue and expenditure mandates) and budget authorizations (initial budget, amendments and supplementary budget decisions). It also traces transfers between the different budgets and shows the financial position for the fiscal year. This execution statement is organized as a budget (operating and investment income and expenditure) and can therefore be related to budgetary logic and rules.

The management statement is also a summary document, tracing not only the budget execution during the year but also the entire accrual accounting. It therefore contains much more than the administrative statement to explain income for financial accrual accounting. The management statement is comparable to traditional financial statements, including a balance sheet and an income statement.

6.4.4 Auditing

Auditing activities are based on management control and financial/budgetary control for both regional and local levels.

Management controls are first undertaken by the supreme audit institution and, more specifically, by their regional or local entities: the regional court of accounts.

According to the Court of Auditors, the management review covers:

- regularity of management actions and, more specifically, regularity of expenditure and revenue;
- efficiency in the use of public resources;
- evaluation of results achieved against objectives set by the deliberative assembly or the legislative body; this assesses the effectiveness of community action.

Management control is generally coupled with financial controls. These are first devoted to budgetary control (adoption, balance, recognition and payment), *ex-post* audit under the responsibility of the Prefect and within the scope of regional Court of Auditors. Indeed, as the *ex-ante* audit is no longer effective, the Court of Auditors can undertake budgetary control in several situations:

- if the preliminary budget is adopted at a late date;
- when the adopted budget does not balance;
- when a mandatory expenditure is not recognized.

The second financial control is still in the charge of the regional supreme audit institution but it is a jurisdictional audit. Indeed, the regional Court of Auditors controls the regularity of public accounts. This control is the original audit of the regional Court of Auditors and its purpose is to check not only regularity but also whether public accountants performed every necessary test and control.

6.5 Local government

According to article 72-2 of the constitution, local entities (municipalities and inter-municipalities) have financial autonomy. Moreover, each local government can have several public services located in different entities (publicly owned enterprises, such as hospitals or universities). Therefore, it is really difficult for the citizens to understand the local perimeter and to know all the local entities.

6.5.1 Budgeting

We find the same specific characteristics for budgets in local as in regional government: three principles (annuality, unity and universality), two sections (for investing and financial operations) and the same budget statements.

At the local level, government is enforced to create a secondary budget (*budget annexe*) in three cases: for industrial or commercial public services with self-financing obligation, for public services subject to value added taxation and for social or medical public services. Secondary budgets give information to follow revenues and expenses to a specific activity realized by private companies or by mixed companies. Budget execution statements show only amounts transferred to private or mixed companies and not the detail of each operation. Finally, concerning their presentation, budgets are detailed by nature and function in local entities with more than 3,500 inhabitants. For smaller municipalities there is no obligation concerning budget presentation.

6.5.2 Accounting

At local level, accounting regulation is based on the M14 instruction, which details rules and principles about:

- Part 1 – Accounting framework
- Part 2 – Budgetary framework
- Part 3 – Public companies

Due to M14, local public accounting is based on the general chart of accounts and on accrual accounting. A set of accounting techniques detailed in this instruction allows for the introduction of principles of independence, sincerity and prudence in local public accounting:

- Accrual accounting for revenue and expenses (operating expenses) to recognize commitments (e.g. debts to suppliers) and the rights acquired by the local authority (e.g. taxes due).
- Mandatory amortization of renewable assets (such as vehicles).
- Provisioning, including loan guarantees, litigation and delayed debt repayment.

6.5.3 Financial reporting

Although municipalities must set up aggregated statements with capital and operating funds for major and secondary budgets, there is no aggregation or consolidation with associated organizations and subsidiaries. Financial reporting is consequently organized around the same two statements as at regional level: an administrative statement and a management statement.

6.5.4 Auditing

Concerning auditing, local government and the local budget and accounts are submitted to the same control and auditing as at regional level: budgetary and regularity control every year and management audit depending on the regional Court of Auditor's agenda.

6.6 Readiness for change: technical facilitators, comparison of national accounting standards with the IPSAS framework and readiness for adopting EPSAS

Comparatively speaking, French public accounting is specific because of its standards adoption process. Indeed, the conceptual framework and the 17 standards have been validated and officially accepted by the Finance Ministry resulting in a major consequence: the development of very precise accounting directives, a French specificity that implies rigidity in the regulation of accounting. The public accounts are also submitted to a vote with a finance law every year, another specificity that strengthens the juridical aspect of accounting standards (Eyraud, 2013).

Moreover, in a report issued in January 2014, the French public sector accounting standards board (CNOCP) analysed the adequacy of IPSAS for France and recognized several breaches and issues. This analysis compared IPSAS with national accounting standards and IFRS. The CNOCP highlighted the lack of specific standards on key topics for the public sphere:

- Social advantages for the purposes of social security, including the issue of pensions (excluding civil servants) and other social benefits;
- Transfer expenditures (aids and grants).

Three subjects were also identified as subject to standards: entity combinations in the public sector, historical and cultural assets and CO_2 quotas. Finally, among the most problematic standards included are those for consolidation (and, more specifically, concerning the concept of control) and financial instruments (standards for financial instruments dealing with particularly complex operations that have no equivalent in the public sector).

In addition to this report, which highlights key topics to consider when studying readiness for adopting European Public Sector Accounting Standards (EPSAS), two other subjects can be developed. The first is related to the information system. As noticed by the French audit institution in its annual financial audit report (presented in the next section), the French information system is not yet ready or completely developed and so is not able to ensure the maintenance of governmental accounts. The new IT system, called Chorus, has been implemented to apply public accounting reform but is still too complex for public accountants. So this seems to be one of the technical problems to solve before considering adoption of EPSAS. Secondly, in a broader approach and in link with the Information system (IS), the management accounting system for measuring costs through budgetary and financial accounting, as mentioned in the Introduction, has not yet been successfully completed. The French audit institution highlights this point in its 2011 annual report and explains it through a lack of fiscal and accounting information in the cost overflow methodology. Consequently, managers have difficulties in measuring costs for their activities.

Despite these specificities, central government has produced financial statements with the new accounting standards since 2006 and no important problems have arisen so far. Consequently, applying EPSAS in France, with certain adaptations, should not be a major problem. Moreover, as explained earlier, since accounting standards need to be adopted on a ministerial level, if they have subsequently to become directives, the juridical dimension will be essential for the adoption of EPSAS.

6.7 Main challenges: problems identified

The main challenges in applying the French standards based on IPSAS in French financial statements are detailed in the supreme audit institution's financial audit report published in May 2014. Indeed, in this audit report, the French supreme audit institution gives a qualified opinion on consolidated financial statements because of several observations:

- The financial information system of the state is not sufficiently adapted to the maintenance of general accounts. The Chorus software package, implemented from 2008, cannot yet guarantee the reliability and integrity of accounting information for auditing financial statements.
- Departmental internal control and internal audit are not effective and efficient enough. No ministry is able to make a sufficient assessment on the degree of risk control. Improvements must be implemented by bodies responsible for internal audit, for all or part of the management process.
- Recognition of sovereign revenues and receivables and payables are affected by uncertainties and significant limitations. The problem is the amount of net sovereign revenues, 279 billion euros in 2013.
- Significant uncertainty surrounds the measurement and recognition of inventory and fixed assets (and liabilities attached to them) for the Ministry of Defence. Uncertainty is related to the following issues:
  - accounting for outstanding liabilities;
  - comprehensive recognition and proper inventory measurement;

- reliability of the assessment of stocks;
- physical inventories and inventory of assets made available to industry;
- reliability of so-called former assets, acquired before the year 2006;
- comprehensive recognition and accounting rules for specific assets.

In conclusion, the main challenges are based on recognition and measurement issues and we can stress one of these important issues concerning assets, in particular intangible assets. No assets representing sovereignty are recorded in the financial statements, since it is impossible to identify such assets separately and to evaluate them correctly. The distinction made between intangible assets to be recorded in the financial statements and assets representing the exercise of sovereign powers is based on the analysis of the corresponding revenues.

This issue is an excellent illustration of specificities in public accounting and after a major public accounting reform applied in 2006 "the major challenges for public accounting and audit now lie in the evolution of norms and adapting to new rules" (Eyraud, 2013).

References

CNOCP (2014), "Classement des normes de l'IPSAS Board par le CNOCP – Note de synthèse".

Cour des comptes (2011), "La mise en œuvre de la loi organique relative aux lois de finances (LOLF): un bilan pour de nouvelles perspectives", Synthèse du Rapport Public Annuel.

C. Eyraud (2013), *Le capitalisme au Cœur de l'Etat, Comptabilité privée et action publique*, Edition du Croquant.

R. Jones, E. Lande, K. Lüder and M. Portal (2013), "A Comparison of Budgeting and Accounting Reforms in the National Governments of France, Germany, the UK and the US", *Financial Accountability and Management*, 29 (4), 419–441.

E. Lande (2009), "Comptabilité de l'État", *Encyclopédie de Comptabilité, Contrôle de gestion et Audit,* second ed. Paris: Bernard Colasse, Economica.

E. Lande and J-C. Scheid (2003), "France", in K. Lüder and R. Jones (eds), *Reforming Governmental Accounting and Budgeting in Europe*. Frankfurt: Fachverlag Moderne Wirtschaft, 153–271.

M. Portal, E. Lande, R. Jones and K. Lüder (2012), "French Revolution and German Circumspection: Reforming Budgeting and Accounting in National Governments", *Public Money and Management*, 32 (5), 357–361.

Useful sites

http://www.ccomptes.fr
http://www.collectivites-locales.gouv.fr
http://www.economie.gouv.fr/cnocp-en
http://www.performance-publique.budget.gouv.fr

7
Public Sector Accounting and Auditing in Germany

Thomas Müller-Marqués Berger and Jens Heiling

7.1 Introduction

Public administration in Germany is subdivided into three levels of government: federal, state (16 states or *Bundesländer*) and local (over 11,000 municipalities). Mainly due to the federal structure, governmental budgeting, accounting and auditing at all three levels of government are characterized by a high degree of disparity.

The current status quo of governmental accounting in Germany can therefore be described as manifold and diverse. Whereas at local level, many municipalities and cities have moved to accrual accounting and output-based accrual budgeting, at federal level the majority of state governments still adhere to their cameral accounting and budgeting system.

In the last couple of years there have been some reform initiatives at state and federal levels (e.g. reform of the Budget Principles Act in 2009, modernization of the budgeting and accounting system at federal level, see Jones and Lüder, 2011: 267). The effect of those reforms on the actual form of budgeting, accounting, financial reporting and auditing of the federal and the state governments was rather limited.

7.2 Public sector accounting framework in Germany

7.2.1 Accounting systems in the German public sector: legal framework

In Germany, as in other continental European countries, there is a strong legalistic tradition. The law codifying the regulations for governmental accounting and budgeting in Germany is the, so-called, *Haushaltsrecht* (Heiling and Chan, 2012). This term refers only to governmental budgeting and not to accounting, which underlines the dominant role of budgeting in German public financial management.

The accounting system at German federal level is governed by laws and regulations that are quite similar to those of the state governments.

At federal level, the main legal sources for public sector accounting and budgeting are the Basic Law (*Grundgesetz*), the Budgetary Principles Act (*Haushaltsgrundsätzegesetz*), the Federal Budget Code (*Bundeshaushaltsordnung*) and some further budgeting and accounting regulations. The Budgetary Principles Act aims to harmonize federal and state budgeting and accounting (Jones and Lüder, 2011). It obliges federations and states to regulate their budget law in accordance with the principles as set out by the Act (Bundesministerium der Finanzen, 2008). Some of its provisions are even generally and directly valid for both levels of government. The German budgeting laws define a series of budgeting principles, like completeness of the budget, balanced budgeting, separate budgeting of expenditure appropriations and commitment appropriations or annuality. These principles apply in general to budgeting at federal and state levels.

In the Federal Budget Code the Federation regulates its budget law in accordance with the Budgetary Principles Act and, in turn, the states fulfilled their obligations by each adopting a State Budget Code. The sequence of provisions in all budget codes is largely identical.

Due to the tendency of diverging developments in governmental accounting in Germany, around 2007/2008 discussions started about harmonizing public sector accounting. In July 2009 the German Federal Parliament (*Bundestag*) and the Federal Council (*Bundesrat*) approved the law for the modernization of the Budgetary Principles Act. The main part of the law came into force by 1 January 2010. The aim of this law was to ensure harmonization of governmental accounting at federal and state levels.

One of the essential elements of the law is to acknowledge accrual accounting as an adequate system for budgeting and accounting purposes for both federation and states. Since 1 January 2010, the federation and state governments have been able to implement accrual accounting without having the burden of operating a cash-based accounting system at the same time. However, because of the fact that the Finance and Personnel Statistics Law still requires cash-based information the states which have moved to accrual accounting still need to report cash based information for finance statistics purposes. This might be one of the reasons why, currently, only the states of Bremen, Hamburg and Hesse have implemented accrual-based accounting systems, with North Rhine-Westfalia currently on its way to accrual accounting.

At the beginning of 2010 a board for the standardization of governmental accounting at state and federal levels in Germany was installed (Heiling, 2011). The board should guarantee a minimum level of comparability in governmental accounting. One of the board's main tasks is, therefore, to develop and pronounce on Standards For Governmental Accrual Accounting (*Standards staatlicher Doppik*). Next to these principles the board defines a, so-called, public administration chart of accounts. This chart of accounts applies when a federal or state government entity applies the Standards

For Governmental Accrual Accounting. In addition, the board elaborates standards for output-based budgets for entities applying cameral or accrual accounting. The board's remit is solely federal and state governments, it has no mission to set standards for local government authorities.

The Standards for Governmental Accrual Accounting are based on the German business accounting rules, the German Commercial Code (*Handelsgesetzbuch*, HGB). The explanation to the law states that because there are only minor differences between the German Commercial Code and IPSAS, only the German business accounting rules will be considered by the board when setting governmental accounting rules. Therefore, according to the law and its explanatory memorandum, the IPSAS are not considered by German standard setters.

Next to the Basic Law and the Budgetary Principles Act, each state has its own state budget code and accompanying regulations for budgeting, accounting, financial reporting and auditing. The structure and content of the state budget codes are rather similar. In Bremen, Hesse and Hamburg, where each state government prepares accrual-based financial statements, an additional paragraph was added to their state budget code that allows for accounting and financial reporting according to the German Commercial Code.

At local level, the states are in charge of the legal affairs of local governments. The Ministries of Interior of each state set the legal framework for the accounting and budgeting of the municipalities, cities and counties. Next to the communal regulation (*Gemeindeverordnung*) the main legal document for budgeting, accounting and financial reporting is the communal budget regulation (*Gemeindehaushaltsverordnung*). The communal budget regulations differ from state to state with respect to budgeting, accounting/financial reporting and auditing (KGSt and Bertelsmann Stiftung 2008).

7.2.2 Common chart of accounts

In Germany, the board for the standardization of governmental accounting at state and federal levels is responsible for the Public Administration Chart of Accounts (*Verwaltungskontenrahmen*). This chart of accounts needs to be applied when an entity applies the Standards for Governmental Accrual Accounting. The chart of accounts is seen as the basis for a consistent recognition of accounting transactions at state and federal levels. So far only the state of Bremen applies these principles. In case a federal or state entity is required to apply a chart of accounts because of other reasons, then the Public Administration Chart of Accounts shall also be implemented.

At local level in 2003 the conference of the ministers of interior defined a common chart of accounts for local governments of all states. This chart of accounts defined the first three levels of accounts (e.g. account class 0, intangible assets and property, plant and equipment, level 1; sub-class 02, property and property similar rights, level 2; account 021, non-realizable assets, *Verwaltungsvermögen*; and account 022, realizable assets, *realisierbares Vermögen*). However, comparability of accounts between local governments of different states is limited as each state has defined its own, more detailed, chart of accounts.

In terms of being able to compare the charts of accounts between levels of government, the Public Administration Chart of Accounts differs from the charts of accounts at local government level.

7.2.3 Conceptual framework

German governmental accounting is law and principles based. As the Standards for Governmental Accrual Accounting rely on the German Business Code, the Principles of Orderly Bookkeeping (*Grundsätze ordnungsmäßiger Buchführung*) also apply to federal and state entities applying accrual accounting. No specific public sector conceptual framework has been defined so far. In German business sciences some authors (e.g. Wirtz, 2010) have developed a set of principles of orderly public sector bookkeeping (*Grundsätze ordnungsmäßiger öffentlicher Buchführung*). However, they have not been formerly acknowledged and have not found their way into practice.

7.2.4 Financial statements

The financial statements as required by cameral accounting are described in the section on the federal level. Therefore, no further explanations are provided in this section.

At the federal and state levels the Standards for Governmental Accrual Accounting require the following separate financial statements:

- *Statement of financial position* (*Vermögensrechnung*) displays the assets and liabilities of the entity and also shows the equity or net assets as the difference between them. The structure of the statement of financial position follows the structure of the balance sheet as required by HGB in the private sector.
- *Statement of financial performance* (*Erfolgsrechnung*) shows the surplus or deficit of the entity in a period and its structure is close to the profit and loss account required by HGB for business entities. Revenues and expenses of the year are reported on an accrual basis in this statement.
- *Cash flow statement* displays the origin and use of monetary assets consisting of cash and cash equivalents. The statement classifies cash flows into three types: a) *cash flows from operating activities*, using either the direct or the indirect method; b) *cash flows from investing activities*; c) *cash flows from financing activities*.
- *Notes to financial statements* disclose additional information and statements to complete the information provided in the statements of financial position and financial performance and the cash flow statement.

– *Financial statement discussion and analysis* (FSD&A, *Lagebericht*) contains an explanation of the significant items, transactions and events presented in an entity's financial statements and the factors that influenced them. The FSD&A also contains forward looking information. The, so-called, risk and rewards report presents those risks and rewards of a public sector entity which will have a material effect on their financial position and operations when they materialize.

7.2.5 The links between the budget and financial accounting

In the cameral accounting system the budget plan and the budget report are an integrated system. Even when an entity applies the accrual basis for their financial reporting, it has to prepare a budget report. In the budget report planned cash inflows/outflows are matched to actual cash inflows/outflows.

The Standards of Governmental Accrual Accounting do not require the presentation of budget information in financial statements. There is no reconciliation between information reported in financial statements and information presented in the budget. Furthermore, entities need to produce information in accordance with European System of National and Regional Accounts, ESA 2010, which is obtained from the budget reporting, with some adjustments, because the criteria for national accounting and budgeting are different.

7.2.6 Consolidated financial statements

The technique of consolidation is not known in the cameral accounting system. With regards to accrual accounting, the focus of the Standards for Governmental Accrual Accounting is on separate financial statements. With regards to consolidated financial statements they state that separate financial statements can be supplemented by consolidated financial statements. The criteria of control is relevant in defining the consolidation perimeter. Consolidated financial statements of a government comprise a statement of financial position, a statement of financial performance, a cash flow statement, a statement of changes in net assets/equity, notes and a FSD&A. Consolidated financial statements can be supplemented by a segment report.

7.3 Federal government

Federal authorities in Germany are classified in four categories:

1. Supreme federal authorities (*Oberste Bundesbehörden*), like federal ministries or the federal court of audit;
2. Higher federal authorities (*Obere Bundesbehörden*);

3. Medium federal authorities (*Mittlere Bundesbehörden*);
4. Lower federal authorities (*Untere Bundesbehörden*).

Other entities in the federation are special funds (*Sondervermögen*), public (business) enterprises (which can have private or public legal forms), state foundations, and other agencies and public entities with special characteristics.

Entities at federal level do not apply the Standards of Governmental Accrual Accounting but typically apply the cameral accounting system, which is a cash-based accounting system. There are only a few entities at federal level that apply accrual-based accounting, for example, *Bundesanstalt für den Digitalfunk der Behörden und Organisationen für Sicherheitsaufgaben* (BDBOS). Also, publicly owned business enterprises prepare accrual-based financial statements based on the German Commercial Code.

7.3.1 Budgeting

According to the Basic Law (*Grundgesetz*), the federation and the *länder* are autonomous and mutually independent in budgeting affairs. They must take into account in their budgeting the requirement of macroeconomic stability.

The federal budget systematically classifies the expenditure estimated for the fiscal year and the revenue intended to cover it (Bundesministerium der Finanzen, 2008). The budget plan functions as the legal basis for the government's budget and economic management. The approved budget authorizes the federal administration to perform expenditure and to incur liabilities. It determines the purposes and the amount of money that can be spent for those purposes and how the financial needs can be covered by appropriate cash inflows. From a legal point of view the German federal government is not required to actually perform any expenditure that has been included in the budget. This means that if there is no need for a certain expenditure, then the government does not have to make this payment (despite the fact that the expenditure is stated in the budget).

The federal budget is prepared on an annual basis and is structured in sections (also called departmental budgets, *Einzelpläne*). All sections are summarized in the aggregate budget (*Gesamtplan*). The aggregate budget contains (a) a budget summary (*Haushaltsübersicht*), (b) a calculation of the admissible borrowing (*Berechnung der zulässigen Kreditaufnahme*), (c) a financing summary (*Finanzierungsübersicht*) and a borrowing plan (*Kreditfinanzierungsplan*). The budget summary contains an overview of the aggregate cash inflows, cash outflows and commitment authorizations for each section of the budget, the financing summary shows the calculation of the financial balance, and in the borrowing plan cash inflows from borrowing are set against the repayments due.

The departmental budgets contain estimates of revenue, expenditure, commitment authorizations, established posts and other posts in the respective department. The structure of the departmental budgets corresponds in general to the structure of the administration, that is, a budget for each department. However, some areas of government activity are covered on a non-ministerial basis. From a structural point of view each departmental budget is further subdivided into budget chapters and budget titles, with titles being the smallest subdivisions in the budget.

The main parts in the section "Overview of the budget plan" are the summaries of budget data classified by object (*Gruppierungsplan*) and by function (*Funktionenplan*), the cross-section of the budget (*Haushaltsquerschnitt*) and an overview of federation personnel.

Next to the annual budget the Federal Ministry of Finance annually prepares a medium-term financial plan and within each governmental period a sustainability report of public finances. That medium term financial plan covers a forward-looking period of five years whereas the sustainability report covers 50 years.

The Federation's Competence Centre for Federal Cash Management and Accounting (*Kompetenzzentrum für das Kassen- und Rechnungswesen des Bundes*) maintains the computerized budget, cash management and accounting procedure for the federation and its sub-procedures. It is the Federal Ministry of Finance's central source of information on the current status of budget execution.

7.3.2 Accounting

The Federation's Competence Centre for Federal Cash Management and Accounting is in charge of the accounting function at the federal level and renders accounts on behalf of the Federal Ministry of Finance and draws up the budget report and the Federation's balance sheet (property account).

The budget report (*Haushaltsrechnung*) is a summary statement of the departmental budgets that provides information on how the budget is being executed (actual amounts) in comparison to budget estimates (planned amounts) over the fiscal year. The property account shows the assets and liabilities of the federation at the start of the fiscal year, the changes during the fiscal year and the position at the end of the fiscal year. Currently the property account does not provide a complete picture of all the assets and liabilities of the federation.

7.3.3 Financial reporting

According to the Basic Law the Federal Ministry of Finance is required to render account of all the federation's revenues, expenditures, assets and debts. The Federal Ministry of Finance submits to the *Bundestag* and the *Bundesrat* on a yearly basis an account of all revenues, expenditures, assets and debts for the preceding fiscal year. The purpose of this procedure is to discharge the federal government (Bundesministerium der Finanzen, 2008). The main financial statements elaborated by the federation are therefore the budget report and the property account.

At the end of each fiscal year a cash account (*kassenmäßiger Abschluss*) is also prepared. The cash account shows the actual cash inflows and outflows and any variations between the two for the fiscal year (payment balance, *Zahlungssaldo*). The payment balance is then extended by the payment balances of former years (*kassenmäßiges Jahresergebnis*). Finally, the financing balance of the cash account shows the scope of the net credit financing and any resulting changes in reserves (*Rücklagen*). As outlined before, the federation is not required to prepare any form of consolidated financial statements.

7.3.4 Auditing

The German Basic Law foresees that the *Bundesrechnungshof* (Federal Court of Audit), whose members enjoy judicial independence, shall audit the account and examine the performance, regularity and compliance of financial management. As an independent body of government auditing, the Federal Court of Audit is subject only to the law (Bundesrechnungshof, 2009). No other government entity has the power to instruct the German supreme audit institution to perform an audit. The Federal Court of Audit alone determines what is to be audited, when, how and where.

The financial management of the Federation and its trust funds (e.g. Federal Railway Assets Fund) are subject to audits by the Federal Court of Audit. In addition, the court audits public enterprises established under federal law (e.g. the Federal Employment Agency) and other social security institutions established under federal or state laws, receiving grants from the federal government or where the federation has entered into guarantee commitments (e.g. German Federal Pension Insurance). Besides the audits required by the German Commercial Code, which need to be done by private sector auditors, the Federal Court of Audit audits the activities of the federation in private-law enterprises in which the federation is a shareholder (e.g. Telekom AG and Deutsche Bahn AG).

Audits at federal government level comprise the audit of federal government financial statements, budgeting and budget execution. The audit findings of the Federal Court of Auditors are presented in a management letter addressed to the audited bodies. Key findings of its audits are incorporated in an annual report submitted to the federal parliament, the federal council and the federal government.

The Federal Court of Audit carries out (a) regularity and compliance audits and (b) performance audits. In its audit of regularity and compliance it examines whether the laws, the budget, any pertinent regulations, provisions and rules have been followed. Performance audits are carried out according to the criteria of economy, efficiency and effectiveness with the aim of ensuring value for money.

The Federal Court of Audit has no power to enforce its recommendations.

7.4 State government

The federal structure of Germany is based on 16 states. All states have a similar general administration structure including a parliament and a state government. Some states have a three-tier administrative structure and some have a two-tier administrative structure. In addition, each state has a certain number of universities, applied universities (*Fachhochschulen*) and other higher education institutions, as well as other public sector enterprises such as airports, banks, fair companies, gambling houses, hospitals, ports, transportation companies, farms, and so on.

As the states have legislative power, they regulate accounting, budgeting and auditing aspects by themselves. Nevertheless, the Budgetary Principles Act obliges the states to regulate their budget law (which also includes accounting, financial reporting and auditing) in accordance with the above described regulations of the Budget Principles Act.

7.4.1 Budgeting

As the Budget Principles Act applies to the federation as well as to the state, budgeting regulations at state level are similar to those at federal level. Budgets at state level are prepared as either annual or bi-annual budgets. Budget plans are approved by the state parliament in form of a budget law. Entities within the budget are bound to the budget law. Next to the budget, state governments prepare medium-term budgeting frameworks which cover a period of five years.

Hamburg is the only state in Germany, so far, moving to full accrual budgeting by 2015.

7.4.2 Accounting

Accounting at state level is currently mixed. A majority of states still apply a cash basis of accounting for budgeting and accounting/financial reporting purposes. The cameral accounting and budgeting of the states is quite similar to the system at federal level. Thus, the ministries of finance prepare a budget report. It is important to note that not every state prepares a balance sheet (property account).

7.4.3 Financial reporting

At present, the states of Bremen, Hamburg and Hesse prepare accrual based financial statements. Bremen and Hamburg are city states, that is, they are cities and states at the same time and typically much smaller than territorial states. For that reason the implementation of accrual accounting in Hesse, a territorial state, was more comprehensive and complex than in the other two states. The state of North Rhine-Westfalia is currently implementing accrual accounting. The Ministry of Finance is piloting the new accounting systems in some places. The state of Hamburg was the first state in Germany to prepare accrual-based financial statements, starting in 2006. Its first consolidated financial statement was prepared for 2007. The state of Hesse has been preparing consolidated financial statements since 2009.

7.4.4 Auditing

Tasks, responsibilities and the legal position of the Courts of Audit at state level are quite similar to those of the Federal Court of Audit. The state Courts of Audit are in charge of auditing the complete budget execution and economic governance of the states. They report their audit results annually to the state parliament and the state government.

Next to the core government, the state Courts of Audit are in charge of the audits of public enterprises of the respective states, universities and other state shareholdings.

7.5 Local government

Local governments in Germany comprise: cities, municipalities and counties (*Landkreise*). Traditionally, the accounting and budgeting systems of local governments in Germany were based on the cameral accounting system. Then in the early 1990s, inspired by the New Public Management reform, the German municipalities began to set up the New Steering Model (*Neues Steuerungsmodell*).

In 1998, a sub-committee for reforming local government budgeting and accounting was installed at the standing conference of the Ministers of Interior of the *Bundesländer*. In November 2000 this standing conference passed guidelines on local government accounting and budgeting. This was just a general agreement between the 16 states, which meant that each state had to include these guidelines and regulations in its own budget law for local governments. However, because of the sovereignty of the states, they had the authority to adapt these regulations.

The sub-committee suggested two alternative accounting models to the standing conference. One was the full accrual accounting model and the other the, so-called, *Erweiterte Kameralistik*, which is a cameral accounting system complemented by accrual accounting elements. In 2004, the *Bundesländer* started to amend their laws.

The reform model based on accrual accounting is characterized by the following elements:

- output oriented, accrual based budgeting;
- decentralized budgets;
- adequate reporting structures;
- full accrual accounting and final reporting;
- consolidated financial statements.

One central element of the reform model for local governments is that it was decided that budgeting should still be closely linked to accounting and financial reporting, that in budgeting the accrual basis of accounting is also used. The inclusion of changes to provisions and depreciation in the budget leads to the fact that it might get harder for a municipality to achieve a balanced budget. Another crucial element of the new accounting model is output orientation. Next to a budget plan based on accrual figures, local governments are obliged to also present the budget on an output basis.

Through decentralized budgets each department receives its own budget and is more or less free to use these resources in order to reach its goals. Adequate reporting structures are a further element of the model.

With the introduction of full accrual accounting, the registration and valuation of the assets and liabilities of local governments becomes necessary. One of the milestones of this reform project was to come up with an opening balance sheet. Because of the fragmented structure of local governments, a consolidated financial statement was also required by this reform. In order to have a complete financial picture of a local government, public enterprises (like *Eigenbetriebe* or *GmbHs*) have to be consolidated with the financial statements of the core budget of the local government.

The aim of the alternative to the accrual-based accounting and budgeting model, the so-called *Erweiterte Kameralistik* (extended cameral accounting), was to generate similar information to the accrual model. The cameral accounting system will be kept and be complemented by some sort of a balance sheet, from where some accrual information may be derived. The main difference to the accrual model is that the extended cameral accounting model does not require an integrated accounting system, that is, the balance sheet and the statement of financial performance do not need to be connected. This approach was mainly directed at smaller local governments. Nevertheless, most local governments reforming their accounting system chose the full accrual approach.

The following table gives an overview of the reform of governmental accounting at local level.

Table 7.1 Overview of accounting reform in German local governments

State	**Accounting/budgeting system**	**Latest point in time for implementation of accrual accounting/budgeting**
Hesse, North Rhine-Westphalia, Rhineland-Palatinate, Saarland	Solely accrual	1 January 2009
Brandenburg	Solely accrual	1 January 2011
Lower Saxony, Mecklenburg-Western Pomerania	Solely accrual	1 January 2012
Saxony, Saxony-Anhalt	Solely accrual	1 January 2013
Baden-Württemberg	Solely accrual	1 January 2020
Schleswig-Holstein, Thuringia	Choice between (extended) cameral system and accrual	No fixed date
Bavaria	Choice between existing cameral system and accrual	No fixed date

Since each state is responsible for its own budgeting/accounting law, each state developed its own approach to governmental accounting and budgeting. Besides the different implementation dates of accrual accounting, there are several differences in the recognition and valuation of assets and liabilities. Also, the disclosure requirements differ from state to state. In consequence, the budget documents and the financial reports cannot be compared. The need for convergence has been expressed by various parties but no action has been undertaken so far.

7.5.1 Budgeting

As outlined before, in most of the states where accrual accounting is mandatory budgeting is also based on accrual accounting. Therefore, in general, expenses in the current reporting period for future pension payments and depreciation are part of the budget. In the cameral accounting system principal payments need to be considered for a balanced budget, whereas depreciation is not relevant. In an accrual-based budgeting system principal payments are no longer part of the accrual budget. Instead, depreciation of fixed assets, amortization of intangible assets and allocations to provisions (e.g. pensions) need to be considered in the budget. Depreciation is related to the recognition and measurement strategy in the opening balance sheet, that is, the higher the value being recognized in the opening balance sheet, the higher future depreciation will be. Allocations to provisions are a new element in local government budgeting as in the past it was mainly allocations for current pension payments which needed to be fulfilled. Because of the latter effect, achieving a balanced budget became harder for local governments. The main argument for this approach was the principle of intergenerational equity. Another crucial element of the new accounting model was output orientation. Next to a budget plan based on accrual figures, local governments are also obliged to present the budget on an output basis. In this model, each local government department is obliged to define outputs and goals and those performance measures that control whether those goals are actually reached.

7.5.2 Accounting

With the exception of Bavaria, Schleswig-Holstein and Thuringia, all states have decided that their local governments are required to implement accrual accounting. The status of implementation is rather diverse since in some states, like Hesse, North Rhine-Westfalia or Rheinland-Palatinate, local governments have already implemented accrual accounting, whereas in the state of Baden-Württemberg local governments are only required to implement accrual accounting by 1 January 2020.

Because of the decentralized approach towards implementing accrual accounting in local governments, there are variations in the accounting rules from state to state.

7.5.3 Financial reporting

Those local governments in Germany which are obliged to apply the accrual basis have to present an annual report at the end of each budget year. As outlined before, the annual reports of the local governments differ from state to state. Typically the accrual-based financial statements of a local government consist of a balance sheet, a statement of financial performance, a cash flow statement and notes. Where local governments still apply the cash basis they have to present annual accounts (*Jahresrechnung*). The annual accounts show the cash inflows and cash outflows separately for both the administration budget (*Verwaltungshaushalt*) and the property (or investment) (*Vermögenshaushalt*) budget. Those revenues and expenditures are shown by each budget position (*Haushaltsstelle*). In addition, the budget positions (either revenues or expenditures) committed but not executed are shown (*Haushaltseinnahmerest* or *Haushaltsausgaberest*). Entities still applying the cash basis are required by law to show their financial position, but in practice they usually do not prepare a balance sheet.

The preparation of consolidated financial statements is required by all states that have a requirement to apply accrual accounting. Depending on the state, the budget laws foresee a transition period of one to six years for the preparation of consolidated financial statements.

7.5.4 Auditing

Irrespective of the accounting basis applied, local governments in Germany are required by law to let their accounts be audited. They are allowed to make use of third parties in auditing the accounts. Where a local government has an audit office (*Rechnungsprüfungsamt*) the local government should make use of that office for the audit instead of engaging a third party.

7.6 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

The heterogeneous situation in governmental accounting in Germany, with disparities not only between different levels of governments and sectors, but also within government levels (e.g. local or state governmental accounting or accounting of public higher education institutions) is mainly a result of German federalism. Some argue that a harmonization of governmental accounting in Germany will only be possible through supranational influence, as is currently happening with the European Public Sector Accounting Standards (EPSAS). As the European Commission envisages that EPSAS will be based on International Public Sector Accounting Standards (IPSAS), representatives from different levels of government have expressed their concerns about IPSAS and consider them as unsuitable for public sector accounting in

Germany. The Standards for Governmental Accrual Accounting are favoured instead. One of the main arguments used for using those standards is the prudence principle.

At state level, the adoption of EPSAS is seen by those states that already apply the accrual basis of accounting as relatively less problematic. The differences between financial statements prepared on the basis of German GAAP and financial statements based on EPSAS/IPSAS are not seen as considerably high. However, there are significant gaps between a cash-based system and an accrual-based IPSAS accounting system. Therefore, states still applying the cash basis of accounting are not in favour of implementing accrual accounting and are opposed to the implementation of EPSAS. Cities and municipalities at local level have mixed views regarding the implementation of EPSAS. One of the reasons is that they have just implemented accrual accounting and spent significant efforts on that. Another issue is that they have concerns with EPSAS being based on IPSAS.

7.7 Main challenges: problems identified

During the last couple of years, besides reforms at local government level, no major reforms in governmental accounting have happened in Germany. At local level, it is mainly local governments in the state of Baden-Württemberg that are still converting to accrual accounting. In other states preparing consolidated financial statements is one of the main challenges for many local governments.

The years 2013 and 2014 were dominated by discussions around the European Public Sector Accounting Standards (EPSAS). The German *Bundestag* and *Bundesrat* decided that they will follow closely the reform developments of the European Commission. In April 2014 the *Bundesrat* expressed several concerns about the EPSAS reform plans. Regulation of public sector accounting at European level would affect the budget autonomy of the *Länder*. In the view of the *Bundesrat* a co-existence of different accounting systems for the state sector should be preserved, that is, German states should be able to keep their cameral accounting/budgeting systems. The *Bundesrat* also stressed the cost–benefit relationship of the reforms. According to the Eurostat 2013 report, costs of about 2.65 billion euros are expected for Germany. In addition, the *Bundesrat* expressed concerns about the use of IPSAS and possibilities that the private sector might influence public sector accounting standard setting.

In May 2014 the conference of the presidents of the German federal and state Courts of Auditors welcomed the intention of the European Commission to harmonize fiscal reporting within the European Union but questioned the necessity of using EPSAS to achieve that goal. According to the presidents of the German federal and state Courts of Auditors, a decision with regards to a mandatory implementation of EPSAS in Europe should not be taken before alternatives are considered.

References

Bundesministerium der Finanzen (2008), The Budget System of the Federal Republic of Germany, Berlin.

Bundesrechnungshof (2009), The Bundesrechnungshof and the Regional Audit Offices, http://www.bundesrechnungshof.de/en/bundesrechnungshof/en/veroeffentlichungen/the-bundesrechnungshof-and-the-regional-audit-offices, 19 June 2014, Bonn.

J. Heiling (2011), "Governmental Accounting in Germany: Current State and Future Direction in an International Comparative Perspective", in D. Greiling et al. (eds), *Accounting, Accountability and Governance in the Public Sector*. Linz: Trauner Verlag, 67–83.

J. Heiling and J. Chan (2012), "From Servant to Master?", *Jahrbuch der Schweizerischen Verwaltungswissenschaften*, 3, 23–38.

R. Jones and K. Lüder (2011), "The Federal Government of Germany's Circumspection Concerning Accrual Budgeting and Accounting", *Public Money and Management*, 31 (4), 265–270.

KGSt and Bertelsmann Stiftung (2008), Zukunftsfähiges Wirtschaften in einem demokratischen Gemeinwesen auf der Basis vergleichbarer doppischer Haushalte. Gütersloh and Köln.

H. Wirtz (2010), *Grundsätze ordnungsmäßiger öffentlicher Buchführung*, second ed. Berlin: Erich Schmidt Verlag.

Useful sites

http://www.bmf.bund.de
http://www.haushaltssteuerung.de

8

Public Sector Accounting and Auditing in Greece

Sandra Cohen

8.1 Introduction

The Greek public sector comprises two basic components: general government; public enterprises and organizations. General government is further divided into: central government, local governments and social security entities.

Central government comprises the central administration, legal entities of private law, and legal entities of public law. The central administration incorporates the Presidency of the Republic, ministries, independent authorities and decentralized authorities. Local government level is further split into regions and municipalities (OECD, 2011), which are discussed separately in the text since they have different accounting, budgeting and auditing systems. A graphical representation of the public sector structure in Greece is shown in Figure 8.1.

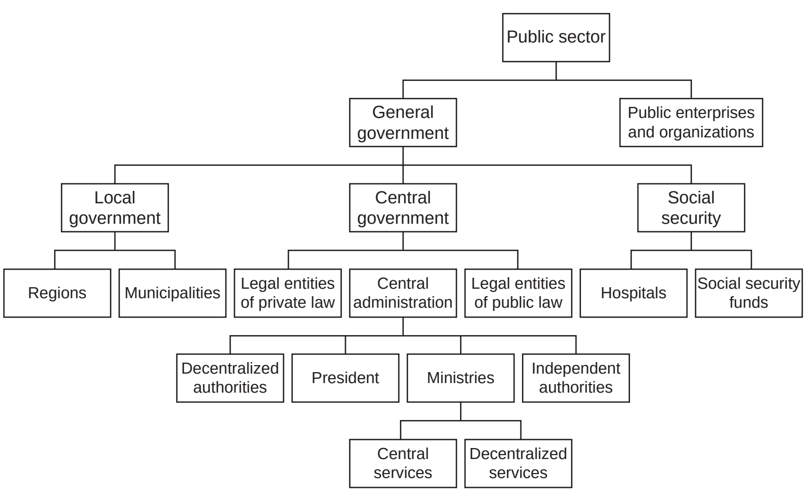

Figure 8.1 Greek public sector

8.2 Public sector accounting standards in Greece

The three levels that are analysed in this chapter are central government, the self-governed regions (13) and the municipalities (325). While budgeting in all cases is cash-based, there is great heterogeneity among them in accounting and auditing requirements.

The rules pertaining to budgeting, accounting and auditing in the public sector are part of Presidential Decrees (PD) and Laws (L). These laws are usually prepared by committees appointed by the government or bodies that are eligible to legislate. The involvement of the accounting profession in the formulation of these laws is rather limited.

In 2010 Greece signed a Memorandum of Understanding (MoU) with the Troika (i.e. European Commission, International Monetary Fund and European Central Bank – L 3845/2010) in return for a bailout plan that, in the end, amounted to approximately 240 billion euros. Among the measures included in the MoU public financial management and budgeting reform were a priority, with the declared aim to address both short-term fiscal challenges and longer term performance, accountability and transparency issues. This chapter describes both the measures that have been partly implemented and others that are still in the process of being realized.

Central government and local government (regions and municipalities) apply fundamentally different accounting systems. That used by central government is governed by PD 15/2011 and is based on a modified-cash basis that borrows elements from International Financial Reporting Standards (IFRS), accrual based International Public Sector Accounting Standards (IPSAS) and Greek accounting standards. Despite some similarities, mainly in terms of disclosures and layouts, the variations between Greek central government accounting and international accounting standards are substantial, starting with the major difference that the central government's are not accrual based.

Regions apply the simplest form of accounting; that is cash accounting. Nevertheless, it is expected that in the near future they will start applying accrual accounting. While a law governing the regions' accounting systems has already been issued (L 3852/2010 commonly called the Kallikratis reform[1]) it has not been implemented, mainly due to technicalities.

Municipalities abide by PD 315/1999, which mandates the use of an accrual accounting system. This system is heavily influenced by Greek private sector accounting standards, which exhibit considerable differences to IFRS.

Budgeting in all three cases is on a cash basis and the presentation of budget items is made in an item by item format. There are no performance budgets at any level of government in Greece. Therefore, budgets do not offer any information regarding the connection between inputs, outputs and outcomes. Recently, the cash basis has been complemented with the application of commitment accounting. The development of commitment registers was a measure included in the MoU with the Troika.

The auditing function of the budget execution is mainly performed by the Court of Audit (CoA), which performs extensive pre-audit controls to expenditures. The Court of Audit also reviews the state's annual financial statements. Private sector audit firms are commissioned to audit the accrual financial statements produced by municipalities.

8.2.1 General accounting plan for the public sector

Greece is a country characterized by high formalization. As a result, there are mandatory codifications of accounts, forming charts of accounts for the public sector for both budgeting and accounting purposes. The first type of chart of accounts is used in the public sector solely for budget development and follow up. It includes revenue and expenditure codes. It uses four digit codes and is called Public Accounts (*Dimosio Logistiko*). This chart is used with slight modifications, mainly on the revenue side, by central government, the regions, municipalities and all public sector entities.

The second type of chart of accounts is used for accounting purposes and is heavily reliant on the private sector chart of accounts. More specifically, central government uses an accounting chart of accounts based on and following the codification of the Greek private sector accounting plan with small modifications, however, to account for transaction particularities in central government. The chart of accounts for local governments is also a slight modification of that used in the private sector. Regions do not use a chart of accounts for accounting purposes as still they do not have accounting reporting obligations. They just use the budgeting chart of accounts for budget development and follow up.

The accounting chart of accounts for the public sector contains the following nine main groups: 1 – fixed assets; 2 – inventories; 3 – receivables, cash and cash equivalents; 4 – equity, provisions and long-term liabilities; 5 – short-term liabilities; 6 – expenses; 7 – revenues; 8 – profit and loss accounts; and 10 – memo accounts. Group 9, the autonomous cost accounting system, is a group of accounts used only by municipalities for cost analysis.

An interesting feature that characterizes the budget chart of accounts and the accounting chart of accounts is that the accounts are mapped against each other at the lowest level of detail, provided that a meaningful mapping can be performed. Therefore, it is easy to identify the code of an item under both systems.

The most recent law governing public sector accounting, published in July 2014 (L 4270/2014), mentions that a common chart of accounts applicable to the entire public sector will be issued in the near future.

8.2.2 Conceptual framework

Until today Greece has not developed a conceptual framework governing the entire public sector. However, there is a set of accounting principles that pertain to PD 15/2011, which refers to central government. These principles cover the following:

- The historical cost principle
- The accrual principle
- The matching principle
- The objectivity principle
- The consistency principle
- The full disclosure principle
- The conservatism principle.

However, it has to be noted that even if these principles may resemble at headline level the ones promoted by international standard setting bodies, in essence they show considerable differences. For example, neither the accrual nor the matching principles can be properly applied under a modified cash accounting basis.

Regarding local governments, there is no explicitly stated conceptual framework.

Finally, there are some principles pertaining to budget development. They refer to the principle of yearly duration (i.e. the budget should refer to a fiscal year) and the principle of unity and ubiquity (i.e. the budget should be inclusive of all revenues and expenses of the entity).

8.2.3 Measurement and recognition of assets, liabilities, equity, expenses and revenues

One of the longest unresolved issues in public sector financial management in Greece is that central government property, mainly land, has not yet been registered. This is due to several technical and legal problems. The registration and valuation of heritage assets have not yet been discussed. A significant factor that obstructs the process of registering central government property is the non-existence of a complete and accurate cadastre. Therefore, several fixed assets are missing from central government's financial statements, providing an incomplete view of its property. Apart from this drawback, which is expected to be dealt with in the near future, measurement and recognition adhere to the following principles:

- At central government level, assets, liabilities and equity are recognized in a business-like accrual manner and there are several cases where the influence of IFRS or IPSAS is evident. For example, leases are treated according to IAS 17 (distinction between financial and operating leases, and relevant treatment; recognition of sales and leaseback), long-term investments are measured either based on their market value or based on the equity method, depending on whether or not they refer to publicly trading firms. Revenues and expenditures are recognized when they occur. However, as the central government accounting system is a modified cash one there are several particularities that are thoroughly discussed in Section 8.3.2.

- The regions' accounting systems so far do not provide for recognition of assets, liabilities and equity. Revenues and expenditures are recognized under the cash basis, that is when cash is received and when it is paid.
- Municipalities recognize assets, liabilities and equity in the same way as those Greek private sector companies not applying IFRS. As the accounting principles governing the private sector had been in force since 1987 and were just updated in the beginning of 2015, they are not influenced by IFRS. As a result, they include policies that are different to those imposed by IPSAS. Nevertheless, the accounting legislation for private sector companies not following IFRS has just changed. A new set of Greek Accounting Standards for the private sector became effective by 1 January 2015. It is not clear yet whether these changes will influence municipalities' accounting principles. New revenues and expenditures are recognized when they are incurred.

8.2.4 Financial statements

Depending on the governmental level, different sets of financial statements are prepared and published:

- Central government uses the format and layout of financial statements proposed by IPSAS 1. These include a statement of financial position, a statement of financial performance, a statement of changes in net assets/equity, a statement of cash flows and accompanying notes, which contain a plethora of disclosures.
- Regions do not publish financial statements apart from a report in which the initial budget and the actual amounts are presented.
- Municipalities prepare and publish financial statements based on the applicable until the end of 2014 financial reporting requirements of the Greek private sector firms that do apply IFRS. These financial statements include a balance sheet, a profit and loss account and a statement of income distribution. They are accompanied by an auditor's report. Moreover, municipalities are obliged to prepare an annex in the role of notes, albeit less detailed, and an analytical statement of expenses, neither of which are published.

8.2.5 Links between the budget and financial accounting

Budgeting and the financial accounting system are very closely linked at both central government and municipal levels. There is a mapping of the accounts included in the budgetary chart of accounts with the accounts included in the financial accounting system. Specific accounts at the lowest level of the accounting plan are linked with the respective accounts of revenues and expenditures used in the budget in every possible case (e.g. depreciation accounts are not mapped against any budget account). Therefore, whenever a transaction is incurred it is properly translated into accounting entries in both systems following the principles that govern the operation of each one of them.

8.2.6 Accounting standards for consolidated statements

Up until now there have been no consolidated financial statements in the Greek public sector. This holds true for both central and local governments.

8.3 Central government

Central government in Greece comprises the central administration, the legal entities of public law and the legal entities under private law that are mainly controlled and funded by the government.

8.3.1 Budgeting

Central government prepares the central government budget. Public enterprises and organizations, social security funds and hospitals, regions and municipalities, and public law entities are not included in this budget, however, budgetary transfers to these organizations are. The budget is developed on a cash basis. An attempt to introduce program budgeting that operated complementarily to the traditional line-item budget was initiated in 2008 but abandoned in 2012 due to re-prioritizations in financial management reforms in public administration deriving from the recent financial crisis (Cohen and Karatzimas, 2014).

More specifically, the MoU signed between Greece and the Troika prioritized several public financial management and budgeting reforms. L 3871/2010 for Fiscal Management and Responsibility passed in 2010 set a new framework for budget preparation, execution and monitoring/reporting obligations. The new law has introduced a three-year fiscal and budgetary strategy (including government goals) and top-down budgeting, with expenditure ceilings and frequent fiscal reporting.

The central government budget, or state budget, is annually approved by Parliament. The budget year corresponds to the calendar year. The state budget consists of two parts:

- the ordinary budget
- the public investment budget.

The *ordinary budget* is prepared and executed in the form of a line-item budget, classifying the various expense categories based on their nature. The *public investment budget*, on the other hand, is presented in a form and structure that resembles a program budget. However, it does not possess any qualitative characteristics, such as matching inputs and outputs or outcomes.

Apart from the cash budget all public sector entities are obliged, on an ongoing basis, to register their expense commitments in commitment registers applying, in a sense, commitment accounting. In this way, it is possible for the general government to have an updated and accurate view of arrears and liabilities necessary for reporting purposes and for monitoring fiscal consolidation. Information on commitments is uploaded to a web based portal and reports are produced monthly and quarterly.

8.3.2 Accounting

Until the end of 2010 central government did not actually have any other accounting system but the one following budget execution on cash basis. Under this system the government had only limited information on its financial position and performance. From the beginning of 2011, a new accounting system was adopted following a modified cash basis of accounting. This new system borrows several characteristics from full accrual methodology while it adopts several others from cash accounting. In several cases these accrual characteristics are even influenced by IFRS or IPSAS policies (Cohen et al., 2015). For example, the template for the layout of financial statements is based on the guidelines provided by IPSAS 1.

The most important feature of central government's financial reporting is that significant information regarding the value of public property is missing (i.e. the majority of non current assets are not included in the statement of financial position) and thus the equity (called citizen's equity in the statement of financial position) unavoidably has a negative value. The main characteristics of the accounting system are the following:

- Revenues are recognized independently of the period in which they are received, and they are accounted for when assured and of fixed amount. Loan receipts and proceeds from privatization and sales of property are not registered as revenues.
- Expenses are recognized independently of the payment period provided that they fall into the following categories:
  - They correspond to expenses other than those made for the purchase of fixed assets, investments or interest payments.
  - They refer to expenses of a continuous nature (e.g. lease rentals).
  - They correspond to inventories purchases, which means that the total value of inventories purchased is considered an expense.
  - They refer to accrued expenses for which provisions are formed at the end of the year (e.g. public debt interest).
  - In order for all the other expenses to be recognized, they should have been cleared by the CoA or the Fiscal Audit Offices (FAOs) through pre-audit.
- Acquisitions of assets are recognized as follows:
  - Acquisitions of fixed assets are treated as assets and not as expenses.

  - Assets existing before 1 January 2011 are not registered.
  - Depreciation is only conducted for "expenses of perennial depreciation", which mainly refers to expenses related to governmental bonds issues. Fixed assets are not depreciated.
- Receivables correspond to revenues not yet received and prepayments to organizations.
- Liabilities include the public debt, accrued expenses and expenses payable for salaries and pensions. Liabilities do not include long-term obligations referring to pensions and social benefits.

8.3.3 Financial reporting

Central government publishes the following financial statements:

- Statement of financial position
- Statement of financial performance
- Statement of changes in net assets/equity
- Statement of cash flows
- Accompanying notes.

As mentioned before, the general layout of the central government's financial statements follows the one proposed by IPSAS 1. Apart from the statement of financial position, which contains some special features presented below, all other statements follow traditional reporting lines.

Statement of financial position

The statement of financial position clearly recognizes assets and liabilities accounts, without the provision of any information on public property or long-term obligations other than government debt (e.g. long-term liabilities for pensions are not recognized). More specifically, the layout of the statement of financial position is the following:

Total assets
Non-current assets:

- Equipment
- Fixed assets under construction
- Investments
- Expenses of perennial depreciation

Current assets:

- Debtors
- Doubtful debtors
- Prepayments
- Cash and cash equivalents

Total liabilities

- Long-term liabilities
- Public debt
- Other long-term loans
- Short-term liabilities
- Creditors
- Provisions

Net citizens' equity

Net citizens' equity is the difference between total assets minus total liabilities.

8.3.4 Auditing

Budgeting system

The Greek budget execution system focuses on ensuring the legality and propriety of expenditure through pre-audit activities (i.e. the audits performed before the fact). Pre-audit activities are performed by the Fiscal Audit Offices (FAOs) that answer to the General Accounting Office (GAO) and the Court of Audit (CoA) depending on the public sector body and the transaction type. There are however cases where the CoA carries out an overlapping pre-payment review of major expenditures already reviewed by FAOs.

The Court of Audit is the supreme audit institution responsible for auditing. It is the highest judicial authority dealing with the use of public finance, and more specifically with the legality and regularity of spending. The CoA is primarily responsible for auditing expenditure and monitoring the revenue of the state. It has the authority to impose sanctions on officials who misuse funds. The Court's jurisdiction includes central government ministries, local governments (i.e. municipalities and regions) and other public sector bodies, but it excludes private law legal entities.

The FAOs and the CoA are responsible for the review of each transaction to ensure that the expenditure meets legal requirements and that it is appropriately documented. The CoA also performs post-audits (i.e. the audits performed after the fact). L 3871/2010 has taken steps to modernize audits and strengthen accountability and transparency. The implementation of these measures is in progress.

Accounting system

The Court of Audit reviews the financial statements of central government produced under the modified cash basis system. The CoA is also required to submit an annual report on the state's annual financial statements to Parliament.

8.4 Regions

Over the last few years the regions in Greece have been the recipients of continuous reform. Most recently L 3852/2010, which gave legal status to the Kallikratis reform, reduced the number of regions from 54 to 13 (organized as seven decentralized authorities), at the same time it introduced significant changes in regional policies. Before the reform regions were mainly dependent on central government. Their authority was limited to planning activities concerned with managing European regional programmes and their co-ordination (Hawkesworth et al., 2008). This status gradually changed resulting in major reforms which widened their authority and changed their relationship with central government (Spanou and Sotiropoulos, 2011).

For the time being, in accounting terms, the regions are the least developed part of the public sector. Nevertheless, new laws aimed at improving the accounting information provided are going to be implemented.

8.4.1 Budgeting

Budgeting in regions is developed and followed up on a cash basis. Budgets, accompanied by their execution are published annually. During the fiscal year, adjustments of budget amounts can be made with the agreement of the regional council. At the end of the year the department responsible for the preparation of the budget, submits it to the regional council.

Two months after receiving the actual amounts, the council decides on their approval and comments on them. The monitoring of budget execution has recently been assigned to a newly formed committee, the Observatory for Financial Autonomy of Local Governments (with members from the GAO, the CoA and the Ministry of Interior), whose objectives are: to oversee the proper implementation of the budgets of local governments (*both regions and municipalities*) without negative variations; to monitor budget execution based on monthly and quarterly budgetary goals; and to suggest measures for their correction. If a local government does not follow the suggested measures and fails to correct the variations in due time, then the committee can recommend to the Minister of Interior that the local government should follow certain obligatory measures to secure its financial viability and be funded through a special earmarked account to cover its deficits.

8.4.2 Accounting

Regions are governed by L 3852/2010. However, until the issuance of a PD that explicitly deals with regions' accounting stipulations, they only monitor their transactions on a cash basis. Therefore, what happens practically is that they issue the budget and they monitor and follow up its execution. There are however some exceptions where regions have started applying accrual accounting before the legislation sets out in detail the accrual accounting framework pertaining them. They base their implementation on the accounting system of municipalities.

8.4.3 Financial reporting

The regions do not yet prepare and publish business-like financial statements. They just report their budget and its execution. This is expected to change soon.

8.4.4 Auditing

The pre-audits of regions' expenditure are made by the Fiscal Audit Offices (FAOs) that answer to the General Accounting Office. They are typical pre-audits that assess legitimacy and regularity. On the other hand, the review of the budget is performed by the Legitimacy Auditor. This is the supervising auditor in charge of the Autonomous Local Governments' Oversight Committee. The budget, the annual action plan, and decisions of the regional council regarding taxes, fees, loan agreements, contracts, and so on, are submitted to the Legitimacy Auditor. When errors in the budget items are detected, or when the budget preparation guidelines sent by the Ministry of Interior have not been followed, the Legitimacy Auditor has the authority to return the budget and call the regional council to apply the appropriate adjustments. As the structure of the regions has recently been changed, additional changes in the auditing procedure may emerge in the future.

8.5 Municipalities

Budgeting and accounting requirements imposed on municipalities are found in several law documents. In 1999 the issuance of PD 315/99 mandated the introduction of accrual accounting. According to PD 315/99 Greek municipalities with revenues above approximately 1.5 million euro or with more than 5,000 citizens were to adopt accrual accounting from 1 January 2000 onwards and produce and publish a set of financial statements every fiscal year. The same law, however, preserved and upgraded the operation of the traditional budgetary cash accounting system. In other words, Greek municipalities operate two independent accounting systems simultaneously (i.e. accrual accounting and budgeting cash accounting). This process is facilitated by the mapping of the budget and accounting accounts discussed in Section 8.2.1. Since 2011, the number of municipalities in Greece has decreased due to amalgamation as part of the Kallikratis reform. The 325 new municipalities are all obliged to follow this dual system.

8.5.1 Budgeting

The budgeting system for municipalities follows the cash basis system. Cash accounting tracks the execution of the budget by monitoring expenditures and revenues throughout all the legitimate phases and procedures for municipalities via double-entry journal entries in the memo accounts. By applying legitimate public sector budget principles these double-entry entries monitor: budget approval, commitment of amounts for purchases, payments, receipts and prepayments (Cohen et al., 2007). The chart of accounts used for these memo accounts is based on the budgeting chart of accounts against which revenues and expenses can be posted (see Section 8.2.1).

Municipalities follow up their commitments on the commitment registers (see Section 8.2) and are subject to the control of the Observatory for Financial Autonomy of Local Governments (see Section 8.4.1).

8.5.2 Accounting

Since 1999 and the issuance of PD 315/99, the accounting basis that is applied by municipalities is accrual accounting, which registers transactions in a similar way to that of the Greek private sector accounting standards for companies not obliged to adopt IFRS. These standards are in conformity with the directions of the fourth EC Directive for company accounts. Similarly, the chart of accounts applicable to the municipalities is based on the applicable till the end of 2014 chart of accounts for the private sector. The financial accounting cycle uses the first eight groups of accounts as discussed in Section 8.2.1.

8.5.3 Financial reporting

Municipalities produce and publish a set of accrual based financial statements every fiscal year. More specifically, these statements comprise:

- a balance sheet
- a profit and loss account
- a statement of income distribution.

At the same time there is no obligation for the preparation of a cash flow statement. The above mentioned accrual accounting statements are accompanied by an auditor's report, while an annex serves as accompanying notes, without the provision of detailed notes. Finally, accrual accounting reports are not reconciled with cash based reports and budget information is not presented in the body of the financial statements.

8.5.4 Auditing

Budgeting

The Court of Audit is responsible for the pre-audit of a certain part of the expenditures of municipalities. Salary expenses, rents, recurring expenses for utilities and low value expenses are not subject to pre-audit. Pre-audits focus on assessing the accuracy, legality and regularity of the expenditure.

Through the pre-audit, the CoA has the authority not to give approval to a payment order in cases where the administrative act creating the payment obligation is deemed to be illegal, and so the initiated expenditure is not paid. The CoA also reviews contractual agreements before they become definite. However, revenues are not subject to pre-audits, while spot reviews are not permitted by law as a process of pre-audit. At the end of the fiscal year the CoA undertakes a post-audit of the accounts of the municipalities. The post-audit is performed on a sample of transactions (audit sampling) unless there are findings that justify a full scale audit. At the post-audit the CoA has the power to put the accounting officer and any third party into judicial proceedings if a deficit or an illegal payment is identified. Finally, the CoA monitors the flow of receipts of revenues of municipalities and it has the authority to impose sanctions on those who deliberately do not act towards receiving these revenues.

The yearly budget developed by municipalities is submitted to the Legitimacy Auditor for review. The Legitimacy Auditor is the supervising auditor in charge of the Autonomous Local Governments' Oversight Service. The yearly budget is compliant to the five-year technical plan that municipalities have to analyse and develop into yearly action plans. Moreover, municipalities are obliged to present their revenues, expenditures and balance sheet items (financial assets and liabilities) to a central database so that supervising authorities can have immediate and valid information on their financial items.

Accounting

The accrual based financial reports prepared by municipalities have to be audited by certified public accountants. More specifically, the duties of auditors are the following:

- they should apply the rules and principles of the Greek association for certified auditors and accountants, developed for private sector audits.
- the audit report should comment on whether the local government had correctly applied PD 315/99, the municipal code and other legislative requirements.

The audit performed by statutory auditors is the traditional financial statements audit and its scope does not expand to any form of performance audit. In other respects, according to legislation, the format and content of the audit report for municipal audits follows that of private sector financial audits.

Municipalities have to appoint their financial statements auditor(s) from the pool of statutory private sector auditors that are members of the Institute of Certified Auditors and Accountants of Greece via a public bidding process (Leventis and Cohen, 2013).

8.6 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS.

As already discussed, there are different sets of accounting systems applicable at different governmental levels in Greece. Apart from this diversity their convergence to the IPSAS framework is very low.

Although the quality of Greek public sector accounting systems highlights the necessity for their reform, the next steps require thorough consideration. Within this framework, a move towards adopting IPSAS or EPSAS (European Public Sector Accounting Standards) would definitely constitute a major reform that could potentially lead to various beneficial outcomes in the long term. On the other hand, it could be related to several risks and face considerable impediments. Among the most important ones are the costs of such a project, including, training expenses, IT systems related expenses, consulting fees, which should be carefully analysed. It cannot be ignored, that the country is currently operating under tight budget constraints that prohibit the roll out of major expensive projects.

Apart from technical factors that affect the implementation of any accounting change, the success of the reform is also subject to other, softer in nature, parameters. Paraphrasing the words of Holt et al. (2007) in order to achieve the successful implementation of a change, a country must first detect the interior climate, that is assess its level of readiness for change, before reaching the stage of institutionalizing the change. Readiness requires that the organization's structure, context and personnel are in a state to allow for a smooth endorsement of the forthcoming change.

Thus, apart from the technical difficulties recognized above, and the immaturity of the Greek public sector accounting systems, a review of the level of readiness to accept and adopt IPSAS or EPSAS in the Greek public sector might reveal several factors that would block any effort to proceed. For example, the strong bureaucracy that is a deep-rooted characteristic of the Greek public sector, the frequent change of high-level managers and the aged workforce are considerable obstacles that have to be overcome. Political will and commitment are prerequisites for a successful transition to IPSAS or EPSAS and it is up to political leaders to create a clear and inspiring vision towards this end.

Greece is a country that appears to respond slowly to modernizing efforts. However, over the last years, especially under the Troika-imposed financial management and budgeting reforms, several actions have been taken for central government in Greece to close the gap between the Greek accounting and budgeting systems and the ones adopted in other advanced European countries. It seems that there is now political will to adopt new systems that correspond to European best public sector accounting and budgeting practices. It is to be seen whether they will eventually bear fruit. However, there are currently no discussions at any governmental level regarding moving either to accrual IPSAS or to EPSAS. The new law on public sector accounting and budgeting (L 4270/2014) passed in June 2014 does not raise this prospect for central government.

8.7 Main challenges: problems identified

There are various challenges that can be identified regarding the Greek public sector.

A forthcoming decision by the European Commission that would mandate member states to proceed to adopting EPSAS holds a prominent position among the most challenging reforms to come. However, before reaching that stage, efforts should be directed towards the creation of a public sector that would use the same accounting standards throughout all government levels. This would facilitate the preparation of consolidated financial statements and the provision of a "whole of the government" financial view.

The benefits of a transition to EPSAS would be significant for Greece and would signal that the country invests in transparency, accountability and provides the necessary breadth and depth of accounting information that could, potentially, decrease the cost of public debt. These are all positive aspects following a period when financial information concerning Greece had lost its credibility. On the other hand, significant costs are associated with EPSAS adoption. The size, the limited existing IT infrastructures and the complexity of the Greek public sector, to name but a few parameters, exacerbate them.

Other significant issues that need to be taken into consideration are conceptual and technical ones accompanying the new accounting standards that have to be clarified, such as the education and training of public servants, the likelihood of hiring highly skilled personnel with business-accounting knowledge, the granting of flexibility to public sector entities to commission the necessary consulting services and the successful diffusion of the new system's philosophy to all layers of the public sector.

The budgeting system throughout the public sector suffered until recently from several shortcomings, mainly due to ineffective processes in budget development and ineffective monitoring of budget execution. There is an immediate need to proceed to the strengthening of control mechanisms that would allow for the better monitoring of the procedures and enhance efficiency. Staff resources at all levels are mainly used to process transactions rather than to analyse budget policy or performance. The next steps, apart from those already planned and materialized based on L 3852/2010, should involve the development of performance-based budgets that would provide for a better allocation of funds and a better monitoring of the processes. Budgets in the public sector in Greece completely miss out the relationship between input and output and outcome. Budgets should be set with clear targets consistent with public policies.

For the time being both the GAO and the CoA are mostly concerned with pre-audit activities almost exclusively focused on documents review to assess the accuracy, legality and regularity of expenditures. On-the-spot reviews are rarely performed and the emphasis is solely given to expenditures. A reduction of these activities is necessary and a move to the more modern approach that focuses on post-audits should be adopted. Auditing should also expand to all parameters of activity, such as revenues, assets and liabilities. However, this has to be accompanied by an intensification of internal control processes, which are currently limited within central public sector entities, and a change in mentality concerning the assumption of responsibility. Pre-audits are used to safeguard public servants from future sanctions in cases of mismanagement. Therefore public servants favour them in order to feel safe about their actions. Apart from this, the CoA should expand its activities to performance auditing. Notwithstanding that performance auditing is a difficult activity which takes time to develop, it may be the necessary next step in the evolution process of auditing enhancement in Greece.

Note

1. In Greece reforms are usually named after reputable persons either initiators of the reform or with historical significance. Kallikratis was an ancient Greek architect active in the middle of the fifth century BC. He and Ictinus were architects of the Parthenon.

References

S. Cohen, E. Kaimenaki and Y. Zorgios (2007), "Assessing IT as a Key Success Factor for Accrual Accounting Implementation in Greek Municipalities", *Financial Accountability and Management*, 23 (1), 91–111.

S. Cohen and S. Karatzimas (2014), "Reporting Performance Information in the Public Sector: The Moral behind the (Non) Application of Program Budgeting in Greece", *International Review of Administrative Sciences*, 80 (3), 619–636.

S. Cohen, S. Karatzimas and G. Venieris (2015), "The Informative Role of Accounting Standards in Privatizing State-owned Property: Comparing Greek Governmental Accounting Standards and IPSAS", *Global Business and Economics Review*, 17 (1), 51–62.

I. Hawkesworth, D. Bergvall, R. Emery and J. Wehner (2008), "Budgeting in Greece", *OECD Journal on Budgeting*, 8 (3), 1–50.

D. Holt, A. Armenakis, S. Harris and H. Feild (2007), "Toward a Comprehensive Definition of Readiness for Change: A Review of Research and Instrumentation", *Research in Organizational Change and Development*, 16, 289–336.

International Public Sector Accounting Standards Board (2014), *Handbook of International Public Sector Accounting Pronouncements*.

S. Leventis and S. Cohen (2013), "An Empirical Investigation of Audit Pricing in the Public Sector: The Case of Greek LGOs", *Financial Accountability and Management*, 29 (1), 74–98.

Organization for Economic Co-operation and Development (2011), *Greece: Review of the Central Administration*. Paris: OECD Public Governance Reviews, OECD Publishing.

C. Spanou and D. Sotiropoulos (2011), "The Odyssey of Administrative Reforms in Greece, 1981–2009: A Tale of Two Reform Paths", *Public Administration*, 89 (3), 723–737.

Useful sites

www.elsyn.gr
www.minfin.gr
www.ypes.gr

Legislature

L 3845/2010, Measures for the Application of the Support Mechanism for the Greek Economy by Euro Area Member States and the International Monetary Fund.

L 3852/2010, Reorganization of Local Government – Kallikrates programme (*in Greek*).

L 3871/2010, Fiscal Management and Responsibility (*in Greek*).

L 4270/2014, Principles of Fiscal Management and Surveillance, Public Sector Accounting and Other Provisions (*in Greek*).

PD 15/2011, Content of Modified Cash Basis of Accounting (*in Greek*).

PD 315/1999, Sectoral Accounting Plan for Municipalities (*in Greek*).

9

Public Sector Accounting and Auditing in Italy

Francesca Manes Rossi

9.1 Introduction

Italian public administration has a three-tier structure: national government, regional governments (20) and local governments, comprising 110 provinces and 8,057 municipalities. Traditionally, budgeting, accounting and auditing at the three levels have followed different rules, although they were all inspired by the typical budgetary culture of public management that Italy shares with other European countries in accordance with the, so-called, Napoleonic tradition. Moreover, the large number of reforms at all governmental levels in Italy since the 1990s – even if inspired by the New Public Management wave – have always been dominated by a strong legalistic approach to accounting and management (Caperchione and Mussari, 2000; Reginato et al., 2011).

To date, the government has always set accounting regulations, while the influence of other standard setters and academia has been relatively weak, although it is possible to see some signs of a change.

9.2 Public sector accounting standards in Italy

Accounting in the public domain is regulated by central government. The Ministry of Economy and Finance (MEF) is responsible for the presentation of the annual budget and reporting. Within the MEF, the State General Accounting Department (*Ragioneria Generale dello Stato*, RGS), has the duty to guarantee both the proper administration and the rigorous planning and programming of public resources. The RGS has acquired a central role over recent years in relation to the harmonization process and is currently carrying out activities to support the identification of accounting standards suitable for the entire public administration system.

The Ministry of Interior also has a strong influence in setting accounting regulation. In 1999 the Observatory for Local Government Accounting and

Finance was created within this Ministry, with the duty to prepare accounting standards and support entities in accounting matters.

In 1983 a department for public service (*Dipartimento della Funzione Pubblica*) was created to support the Council of the Ministries in innovating Italian public administrations. It is responsible both for issuing recommendations and for producing documents and initiatives aimed at innovating the public administration system.

The evolution of public accounting in Italy has been marked by the need to achieve accounting harmonization. In fact, there are currently different accounting systems throughout the country, each one characterized by a different financial reporting format. Prior to the last reforms, the central government used a modified cash basis of accounting. The regions have always adopted a modified cash basis system, with each region being able to set its own accounting, budgeting and reporting rules. Local governments also followed a modified cash basis of accounting but, since 1995, financial reporting was supposed to be completed with accrual accounting data. However, the changes in most cases were meaningless rhetoric and did not actually affect the management of local governments (Caperchione, 2003; Anessi Pessina et al., 2008).

In 2006 the, so-called, SIOPE (information system for public entities' operations) – inspired by the government accounting system ESA95 (European System of National and Regional Accounts) – was introduced in all regions and local governments, as a sort of common chart of accounts mainly aimed at monitoring financial flows.

9.2.1 Accounting systems in the Italian public sector

The path towards harmonization was revitalized by two laws issued in 2009:

– Law 196, dedicated to central government, which is aimed at satisfying the economic and financial demands of the European Union (EU), offering at the same time a high level of transparency of the accounting documents;
– Law 42, which led to national reform with the aim of creating a federal structure in Italy.

In 2011 Decree 118, the so-called Harmonization Law (hereafter HL), was issued – based on the premises posed by Law 42 and in accordance with Law 196 – offering a common accounting system for all regions, local governments and other public entities controlled by them. The decree was updated in August 2014 by Decree 126, in order to incorporate some revisions suggested by a national commission after two years of experimentation in a large number of public entities. The new system has been enforced in January 2015.

The accounting regulation for public entities lacks a conceptual framework, although a common set of accounting principles have been developed for both central government (Law 196/2009), regions and local governments (Decree 118/2011). In addition a chart of accounts was introduced by the HL for regions and local governments which should help to transform cash-based data into accrual.

Despite the new system leading to the complex coexistence of two accounting methods (a modified cash-basis accounting and accrual accounting, the latter being required only for reporting and cost accounting), the recent reform represents an important step in providing a harmonized accounting system within different governmental levels, supporting the consolidation of public accounts and the greater monitoring and understanding of public expenditure in the whole public sector. The reform is still mainly oriented towards a budgetary approach to accounting, while accrual accounting only completes the information provided.

The common principles provided by Law 196 and Decree 118 are the following:

1. *Annuality*: both the budget and the financial reporting relate to an annual period, coinciding with the calendar year, even though all the documents related to planning and programming are prepared in accordance with a longer period, equal to at least three years.
2. *Unity*: since the entity has to be considered as a unit, all the revenues are addressed to cover all the expenditures.
3. *Universality*: the budget includes any kind of operation affecting the entity's economic or financial situation.
4. *Integrity*: the total amount of all revenues and expenditures have to be recorded.

Additionally, Decree 118 provides a further set of principles for regions and local governments (i.e. true and fair view, reliability, understandability, and materiality) dictated by the co-existence of accrual and modified cash-based systems and oriented to ensure both the faithfulness and reliability of accounting data and the control of financial resources.

The budget is still a pivotal document for Italian public administrations, with a set of principles issued to reinforce the coexistence of the budget and reporting, both prepared in accordance with the new modified cash-based (so-called *reinforced* modified cash-basis) and accrual systems.

In addition, the HL calls for the creation of a single database, managed by the MEF, to favour consolidations and comparisons/benchmarks, as well as to monitor public finance.

9.2.2 Measurement and recognition of assets, liabilities, equity, revenues and expenditures

The HL provides accounting principles concerning the recognition and evaluation of single items in the financial reporting of regions, local governments and other public entities adopting the accrual-basis system as a complement to information based on a modified cash-basis system. The Ministerial Decree issued in 2002 set out criteria and models for central government to follow.

Most of the attention is still given to the financial aspect, so that the law related to central government, and Annexes 4.1 and 4.2 of the HL, explain when to ascertain an entry or recognize the commitment to an expenditure. In relation to accrual-basis accounting, Annex 4.3 of the HL sets out the principles described hereafter.

Assets

Assets are included in the financial statement if the entity is the legal owner. They are divided into long-term and current assets.

The former are evaluated in accordance with either their historical cost or the value recognized in the cadastre, rectified by the depreciation, or at their market value, whichever is the lowest.

Long-term assets can be differentiated into three groups, following definitions provided by the civil code and accounting principles established by the Italian accounting standard setter (the OIC, Organismo Italiano di Contabilità), which provides accounting standards for the business sector:

- *Intangible assets*;
- *Tangible assets*, which are divided into public property (*demanio*, assets which, because of their nature, can only be a collective property) and other assets; the latter can be sold only under some conditions, and especially when they are not used to provide services;
- *Financial Assets*.

Current assets are divided into:

- *Stocks*, recognized at cost or market value, whichever is the lower;
- *Credits,* evaluated according to their recoverable amount;
- *Financial assets available for sales*, recognized cost or market value, whichever is the lower;
- *Cash* (including bank deposits) as at year-end;
- *Accrued revenues and prepaid costs*, in accordance with civil code rules.

Equity and liabilities

Net equity is divided into:

- *Endowment funds*, which is the equity initially attributed to the entities; they can be increased with the annual income;
- *Retained earnings*, available to cover losses;
- *Annual income*.

Liabilities fall into different classes:

- *Risk funds*, divided into:
  Provisions, when an entity is likely to incur future expenditure in relation to specific events or obligations that are not exactly quantifiable;
  Integrative pension fund, in case of agreements that require considering integrative pensions;
  Risk fund for covering losses of controlled entities.
- *Pension funds;*
- *Debts,* divided into financial and operating debts;
- *Accrued costs and prepaid revenues.*

All the liabilities have to be recognized at their nominal value, while risk funds have to be measured in accordance with future payments that are reasonably foreseeable. In any case, the decree recalls the principles set out by the civil code and the national generally accepted accounting principles (GAAP).

Revenue and expenditure

Revenues can be recognized when the entity has delivered the goods or rendered the services and the related costs have been recorded. Thus, the law recalls the accrual principles and the matching principle between expenses and revenues as defined by the OIC. In addition, the law identifies each kind of operation when it is possible to recognize revenues and costs.

9.2.3 Financial statements

Central government's financial statement differs from those of the regions and local governments, as will be discussed in the next paragraphs. In accordance with the HL, there is a common structure requiring for the preparation of:

- a *balance sheet statement*, which discloses the assets, liabilities and equity of the entity;
- an *operating statement*, adopted to disclose expenses and revenues of the entity, following a structure similar to that provided by the civil code or private entities;
- a *budget execution statement*, in which the entity demonstrates how the expenditure and revenue foreseen in the budget have been executed/collected during the year;
- *notes to financial statements*, which disclose additional information and statements to complete the information provided in the balance sheet and in the operating statement.

9.2.4 Links between the budget and financial accounting

The new accounting model provided by the HL is trying to connect budgetary and financial accounting. The aim is to improve control and accountability for the costs of services and political programmes, as well as to enhance the evaluation of performance and to measure the impact of public policies. At the same time, the budgetary system based on modified cash-basis accounting is intended to preserve the function of authorization, in relation to missions and programmes chosen by politicians.

The new model should allow politicians and managers to make rational and efficient choices, while controlling the cost of services and effectiveness (Anselmi et al., 2012).

9.2.5 Accounting standards for consolidated statements

The recent implementation of accrual accounting in the Italian public sector – even if limited to information purposes in regard to reporting – has also led to the introduction of the consolidated financial statement. This is consistent with the privatization process of public services, the diffusion of contracting out and the wide recourse to public–private partnerships, which have characterized Italy in the last decades (Grossi and Mussari, 2008).

The principle set out in Annex 4.4 to the HL requires consolidated financial reporting from regions and local governments so as to identify, from a true and fair perspective, the financial and economic conditions of the public entity and its wealth, including all organizations, entities and companies controlled by or related to it. The aim of this document is twofold: to identify the economic and financial condition of the group; and to highlight the policy adopted with regards to the management of public services and all related strategies. The law explicitly refers to a double concept of control: legal (or depending on contracts) and *de facto*. Consolidation has to be applied with regard to both direct and indirect participation, regardless of the legal form of the entity or the kind of activity managed.

Two different consolidation methods are proposed: a full consolidation method for totally controlled entities, or a proportional method for entities where only a percentage of the equity is publicly owned.

However, central government only provides a consolidation of accounts for statistical purposes, in accordance with the requirement of ESA 2010, while whole government accounts are not required.

9.3 Central government

Central government is composed of the following entities:

a) Central government administration (Ministries and the Presidency of the Council of Ministers);
b) Autonomous entities depending on central government;
c) Agencies and authorities.

Accounting regulations for central government administration is discussed hereafter because special rules and different accounting systems (partially inspired by private sector accounting standards) are provided for other entities.

The number of ministers varies with every cabinet. At the time of writing Italy has 16 ministers (including three in charge of special functions, who are not formally leading a ministry). The RGS, for which the Treasury has political responsibility, is the body that supports parliament and government on budget policies, processes and procedures, being in charge of the preparation of the annual and multi-annual budgets, including any adjustments and/or variations during the year, the reporting, the Finance Bill and related provisions.

9.3.1 Budgeting

The national budgets (both annual and multi-annual) have to be approved by government and sent to parliament before 15 October, coupled with the Bill for the Stability Pact. It contains all revenues and expenditures for a three-year period, in accordance with the law in force. Parliament has to approve the final version of the budget and the stability law by 31 December, with the aim of achieving objectives defined in the Document of Economy and Finance (DEF).

There is only a comprehensive budget for revenues, while each ministry has its own expenditures budget.

The revenues are classified in:

- *Titles*, related to the source of revenue and subdivided into recurring and non-recurring;
- *Typologies*, on which the Parliament has to take decisions;
- *Categories*, which concern the nature of the revenue (i.e. tax);
- *Chapters*, which further specify typologies.

Expenditures can be distinguished between *missions* and *programmes*. The former describe the main functions, while the latter – representing points on which parliament has to vote – disclose how the missions have been divided into homogeneous activities. Each mission (34 in total) is divided into programmes (174) with regard to expenditures. These are an aggregation of the activities carried out in each ministry in order to address institutional targets. Thus, each programme is divided into macro-aggregates that, in turn, are sub-divided into chapters, eventually divided into management plans. Chapters are classified according to an economic and functional point of view, consistent with national accounting criteria. This approach creates an easier conversion of accounting data into statistical data, in accordance with ESA 2010.

Budgets for expenditures are complemented with notes to explain the objectives achieved and criteria followed in preparing the budget. Objectives have to be related to programmes and performance indicators, in relation to set resources. Thus, for each budget for expenditures, all the costs (in accordance with the accrual principle) are settled. The budgets are divided both in relation to programmes and operating units. A reconciliation between the accrual and financial forecasts also has to be provided.

In addition, other documents are prepared to complete the planning and programming activity of central government:

- *Simplified financial budget*, including all the forecasts on which the Bill is based.
- *Financial budget at a glance*, synthesizing the main information on public finance.
- *Annex*, includes a report for each budget in which the programmes, objectives and related performance indicators are discussed.
- *Missions and programmes*, as explained earlier.
- *Accrual budget* in accordance with the accrual principle. It represents cost considering nature, mission/programmes, cost centres and illustrates the costs projected for each objective, taking into account the financial resources requested by each central administration.
- *Budget summary*, aimed at divulging the main items representing costs that each central administration has to bear.
- *Environmental reporting*, showing the expenditures related to initiatives for managing and improving the environment and natural resources.
- *Stability law*, which introduces all the changes in the legislation necessary to achieve the objectives declared in the DEF.

9.3.2 Accounting

The accounting system follows a modified cash-based approach, even if accrual accounting is required for cost accounting. In addition, a cash report is issued every three months. The cash report shows the state sector's consolidated cash and demonstrates the state of cash reserves or the need to cover future outflows. Moreover, it supports the control of pay outs, based on the expenditure trends declared by each department.

Basically, the focus is on the financial aspect, with the aim of maintaining financial health and controlling public debt and expenditure.

The cycle for expenses starts with a commitment and is completed with the payment. Unpaid expenditures have to be reported in the following year. Similarly, the cycle for revenues starts with ascertainment and is completed when cash is received. Uncashed revenues have to be reported in the following year.

The main novelty of the new accounting system introduced with the last reforms – the, so-called, *reinforced modified cash-basis* – is the moment in which revenues and expenditures are recorded, that occurs when payables and receivables expire and not when the right arises. This innovation aims to avoid the registration of a high number of uncashed revenues and unpaid expenditures.

9.3.3 Financial reporting

The results of the financial year are disclosed through the general statement of the state's accounts. This document is prepared by the RGS by collecting the balance sheet accounts and the general assets accounts from each ministry by the end of April. No later than 31 May the MEF submits the general statement of accounts for the expired budgetary year to the State Auditor's Department. Upon obtaining this certification, the MEF presents the general statement of accounts, with a preliminary note, in June, consisting of two documents:

a) the *budget execution statement*, which includes:
   - year's revenue, ascertained, collected or to be collected;
   - year's expenditures, committed, paid or to be paid;
   - management of asset and liability residuals from previous periods;
   - the amounts paid by the Treasury and those paid out for each chapter of the balance sheet, divided into an assets and liabilities account and a residuals account;
   - total account of residual assets and liabilities passed on to the subsequent period.

The report follows a format similar to that used for the budget. In this way, it allows for assessments of public sector policies followed and results achieved in relation to the objectives defined in the planning phase.

b) the *general assets account*, which shows assets and liabilities. The former are divided in accordance to their availability for economic use.

To allow for the economic analysis of assets, an annex is prepared showing the positive and negative components. The general assets account includes:

- the financial and property assets and liabilities, which highlights any variations, both from operations and for external reasons, like grants or donations;
- points of equivalence between budget accounting and assets accounting.

Other documents have to be provided in order to specify the activities run by the central Treasury, including a profit and loss account.

9.3.4 Auditing

There are two types of audit for Italian central government: internal and external. The internal audit is provided by the RGS, which has the duty of supporting parliament and government on budget policies, processes and procedures in managing public resources. This agency also has to ensure the uniform interpretation and application of accounting rules. Moreover, it controls public institutions through inspection activities. The RGS has an increasing role in monitoring and analysing expenditure trends, with regard to compliance with the limits set by the EU through the Growth and Stability Pact.

The external audit is carried out by the National Audit Court (*Corte dei Conti*), which is responsible for both the *ex-ante* audit, monitoring the legality of government acts, and the *ex-post* audit of the state budget's management. The Court sets annual audit programmes and criteria. In addition, it has the task of verifying the effectiveness of the internal audit in each state department.

The Court reports to parliament at least once a year on the results of its audit. Even if the Court participates in the activities of International Organization of Supreme Audit Institutions (INTOSAI) and European Organization of Supreme Audit Institutions (EUROSAI), it makes no clear reference to international audit standards.

9.4 Regional governments

The federalization process of the administrative structure in Italy has given increased power to its 20 Regions. Moreover, five of them (Sicily, Sardinia, Valle d'Aosta, Trentino-Alto Adige and Friuli-Venezia Giulia) have a special regulatory regime, which gives them (and to the Provinces of Trento and Bolzano in Trentino-Alto Adige Region) major financial and administrative autonomy. Each of the regions has a similar organizational structure: a regional council, an executive board and a president, directly elected by the citizens. The regions carry out their activities through decentralized entities (autonomous organizations, regional foundations, regional business entities). In addition, the regions are responsible for managing healthcare (through local health authorities and hospitals), as well as programming, coordinating and supervising activities related to the environment, transport, university and higher education.

In accordance with their autonomy, each regional council approves its own statute regulating the region's activity through a specific law. Moreover, regions have both legislative power and the power to raise taxes, although central government keeps most of the tax revenues. Depending on their autonomy, Italian regions can define their own accounting, budgeting and auditing systems. As an effect of the HL, from 2015 on all regions have to follow the same rules and forms for the preparation of budget and financial reporting and accounting. To this aim, four regions are currently involved in the trial process.

9.4.1 Budgeting

Before the approval of the HL the regions had the power to pass their own budgetary regulations through a public finance act that stated how to develop their annual budgets and was approved by the regional parliaments.

With the HL, the budget (which is the same both for regions and local governments) was divided into missions and programmes, similarly to the state budget, and followed the same accounting standards.

Missions represent the main functions and strategic objectives pursued by the relevant administration.

Programmes represent the aggregate of activities that achieve the objectives defined by politicians and each programme is under the responsibility of a specific organizational unit. Furthermore, the programmes are divided into *titles* and *macro-aggregates*, according to the economic category of expenditure. As for the state, this structure should create a clear relationship between objectives and policies.

The classification of revenues follows the pattern already described for central government. Thus, *titles* are related to the source of revenue, *typologies* to the nature of the revenue and represent the level on which the regional council has to take decisions, *categories* identify the objects, detailed in *chapters*.

The budget is prepared for a three-year period and separately for the following year, both having an authorization role, and in relation to both a cash and a modified-cash basis. They have to be approved by 31 December, before the beginning of the budget period.

Along with the budget, the regional council has to approve:

- the preliminary note;
- a synthesis of the multi-annual revenues and expenditures, according to their classification;
- a table to show the expected financial result of the period (cash plus uncashed revenues less unpaid expenditures);
- the list of programmes for which the region has subscribed to new debts;
- the list of expenditures and revenues (both in terms of a cash and modified-cash basis) in accordance with the chart of accounts;
- the composition of the provision for doubtful debts.

At the end of each year, the multi-annual budget has to be updated. A restrictive multiannual fund has to be located in the budget in order to afford future outflows, depending on operations concluded in the current year.

In addition, in accordance with the transparency law, a simplified version of the budget has to be published for citizens on the region's website, in a specific section called transparent administration.

9.4.2 Accounting

The adoption of the common chart of accounts introduced by the HL is aimed at achieving homogeneity in regional accounting systems. In addition, a system of cost accounting has to be applied, in order to provide information suitable for calculating performance indicators. It is clear that in the new approach, followed by the Italian legislator, accrual accounting is not the primary scope, since attention is still on the control of financial resources and the debt level. So far, the costs cannot be properly calculated (Anselmi et al., 2012).

9.4.3 Financial reporting

The HL provides a uniform model for financial reporting, that is the same for regions and local governments.

The reporting documents are:

- the balance sheet;
- the operating statement;
- the budget execution statement;
- the notes.

In addition, some documents have to be annexed: an outline of ascertained revenues (with details of the classification of the revenues), a scheme of commitment for expenditures (with details of the classification of the expenditures), an outline of the financial results, a table showing the costs divided according to functions, in comparison with the standard; the management commentary, including explanations of items in the balance sheet and the operating statement.

In accordance with the transparency law, the financial reports should be available on the website in the transparent administration section.

9.4.4 Auditing

Regions are subject to both internal and external audits. The accounting department, which is also the office responsible for the preparation of the budget and reporting, carries out the former. Its activity is aimed at verifying whether the resources are employed in accordance with the plans and programmes formulated by the regional councils and translated into the operating budget.

In accordance with autonomy principles, external controls have been limited to the correct use of financial resources. This kind of audit use to be delivered directly by specific sections of the National Audit Court. Nowadays, as a consequence of recent regulation, even if the Court still has a duty to verify the use of public resources by regional councils, a board of three auditors also has to be appointed to verify compliance by the management of the region with laws and strategies, with the stability pact and their ability to maintain financial health. The results of the control are communicated to the regional council, so that they can implement any necessary action. In 2012, a new decree (n. 174) reinforced control over the regions, with the aim of improving the coordination of public finance. The control is both *ex-ante* (on the budget) and *ex-post* (on the report), including the documents related to all the entities involved in the health services. In addition, councils are required to prepare a report every six months in order to prove how they have obtained financial resources and the amount of expenditure occurred. Furthermore, the law requires special attention to be paid to controlled and related entities. The board of auditors also has to verify the effectiveness of the internal control system.

9.5 Local governments

Local governments (which include municipalities, provinces, mountain communities or associations) represent the third level of decentralized government in Italy. They have been involved in several reforms since the 1990s, aimed at introducing performance management, accrual accounting and strategic planning.

The HL now requires local governments to follow the same rules already described for regions.

9.5.1 Budgeting

Local governments work out their annual budget, which represents the main way to authorize expenditures and manage the entity, both for the coming year and the next three-year period. It consists of the same documents previously described for regions. In addition, auditors have to prepare a report on the budget to certify whether it is consistent with all the accounting principles and in line with Stability Pact rules.

9.5.2 Accounting

As already stated, local governments were the first level involved in the implementation of accrual measurement in 1995. Nevertheless, as previous research highlights, this change was almost advisory, so that only a few local governments have implemented a double-entry bookkeeping system (Caperchione, 2003; Anessi Pessina et al., 2008).

The new accounting system for local government follows the same rules described for regions. To date, the new modified cash-basis system has been in use, while accrual information has the role of complementing budgetary accounting data.

9.5.3 Financial reporting

Local entities must produce an annual report that includes the same documents described for regions. In addition, an audit report has to be released by the auditors, certifying the fulfilment of all the accounting principles and the stability pact.

9.5.4 Auditing

Italian local governments, similarly to other levels of government, have to comply with both internal and external audits. During the 1990s, the reforms carried out in the organization of local governments changed the internal control and audit system, asking for the introduction of independent and professional auditors (certified public accountants, enrolled in a national registry as auditors for public entities). In addition, since 1999, strategic control and the evaluation of managers' performances have been introduced.

As to the audit activity, the law requires a single auditor for entities with less than 15,000 inhabitants, while a board of three auditors has to be appointed in more populated entities. Since March 2013, in order to improve auditor independence, the law requires the random appointment of professionals from regional lists, managed by the Ministry of the Interior.

Auditors are required to control budget compliance with accounting principles. During the year, they have to check that expenditures do not exceed the budget and to verify the compliance of decisions made by the city executive board with accounting regulations. At the end of the year, they have to prepare an audit report, in which they express remarks and proposals aimed at achieving greater efficiency, productivity and performance. With the enforcement of the National Audit Court reform in 1994 – which reduced its controls on legitimacy of local governments – the role of auditors has become more relevant.

In addition, since 1995 auditors have to cooperate with city councils in improving management efficiency and effectiveness, even monitoring cash flow equilibrium during the year, especially when variations to the original budget occur. A quarterly audit on cash is also compulsory.

The National Audit Court exercises its control in order to safeguard public finance and guarantee compliance with the law. To this end, auditors are required to fill in at the end of each fiscal year a questionnaire about the controls exercised during the financial year, the report and budgeting activity and the entity's financial health.

9.6 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

The trial process of accounting harmonization undertaken by Italian public administrations in the last two years and subsequent extension of the HL to the whole public sector is a great challenge. The new law has not considered the adoption of International Public Sector Accounting Standards (IPSAS), despite a strong process of convergence towards International Financial Reporting Standards (IFRS) occurring in the country.

The process of change, driven by the legislature and some institutional forces, mainly the RGS, has led the shift towards a new set of accounting rules and the adoption of harmonized budgeting and reporting documents.

Although some scholars have been directly involved in supporting the RGS in the implementation process, no interest in following international standards has been shown.

Central government has applied the new legislation since 2009, while regional and local governments under trial are facing relevant difficulties connected to the change of the evaluation rules for assets and liabilities and to the lack of adequate IT tools.

As a consequence, many difficulties can be expected for the application of international standards prepared in accordance with the accrual principle, not only because IPSAS have been ignored in the recent reform, but also because the main focus of the political actors is still on controlling financial resources and financial equilibrium in the public domain, in accordance with the rules set by the European Stability Pact (Anselmi et al., 2012). Nevertheless, it is worth noting that a study group has been created inside the RGS to discuss the suitability of international accounting standards for Italian public administrations, and possibly European Public Sector Accounting Standards (EPSAS).

9.7 Main challenges: problems identified

Several economic and political reasons are pressing for the creation of a single system of accounting standards for Italian public administrations. First of all, a traditional approach to modernizing by law, where the key players are the RGS and the ISTAT (National Institute of Statistics), both of which are interested in the dynamics of public finance and public accounts. Secondly, the pivotal points in the last public accounting reform were the coordination of public finance – in accordance with requests made by the EU – and the harmonization of accounting systems throughout different governmental levels. Thirdly, the need to implement measures aimed at increasing public spending transparency and controllability requires a harmonized system to facilitate the consolidation of public accounts.

The main consequences of this process of change can be synthesized as follows:

1. The move towards a "reinforced" cash-basis accounting system coupled with accrual-basis accounting, common to all public entities;
2. A strong push towards the standardization of behaviours and practices within Italian public administrations, both to better satisfy accountability requirements and to allow cross-comparisons of costs and quality of services;
3. The need to facilitate more effective control by supervising organizations both within the country and in Europe.

Other important challenges – almost ignored at the moment by the legislature – are represented by the need to move towards accounting standards capable of increasing comparison and benchmarking with other European countries. From this viewpoint, there is a great deal of pressure to adopt cost accounting.

One of the problems in the near future will be the preparation of consolidated accounts. Even if the HL has introduced this tool as mandatory, in Italy there are only a few occurrences of consolidation in the public domain, despite the large number of entities (both private and public) controlled or connected with central, regional and local governments.

The process of change requires the development of adequate skills and knowledge connected to the introduction and diffusion of the accounting standards, tools and techniques, partially unknown in the Italian public administrations. So far, one of the main problems has been an inadequate training process for civil servants involved in accounting matters.

A further problem, which Italy shares with other European countries, is the limited use of accrual data, considering that the political debate is focused mainly on the budget.

References

E. Anessi Pessina, G. Nasi and I. Steccolini (2008), "Accounting Reforms: Determinants of Local Governments' Choices", *Financial Accountability and Management*, 24 (3), 321–342.

L. Anselmi, A. Pavan and E. Reginato (2012), "Cassa, competenza finanziaria e competenza economica: la scelta delle basi contabili in un Sistema armonizzato di contabilità pubblica", *Azienda Pubblica*, 1, 53–67.

E. Caperchione (2003), "Local Government Accounting System Reform in Italy: A Critical Analysis", *Journal of Public Budgeting Accounting and Financial Management*, 15, 110–145.

E. Caperchione and R. Mussari (eds) (2000), *Comparative Issues in Local Government Accounting*. Kluwer Academic Publishers.

G. Grossi and R. Mussari (2008), "Effects of Outsourcing on Performance Measurement and Reporting: The Experience of Italian Local Governments", *Public Budgeting and Finance*, 28 (1), 22–38.

E. Reginato, P. Paglietti and I. Fadda (2011), "Formal or Substantial Innovation: Enquiring the Internal Control System Reform in the Italian Local Government", *International Journal of Business and Management*, 6 (6), 3–15.

Useful sites

http://www.corteconti.it/english_corner
http://www.rgs.mef.gov.it/ENGLISH-VE/
http://www.rgs.mef.gov.it/VERSIONE-I/e-GOVERNME1/ARCONET/Sperimentazione/

Legislature

Decree 118/2011
D. Lgs. 267/2000
D. Lgs. 126/214
D.M 18/4/2002
Law 42/2009
Law 196/2009

10

Public Sector Accounting and Auditing in the Netherlands

Tjerk Budding and Frans van Schaik

10.1 Introduction

The Netherlands has a long history in the use and development of accounting and auditing methods. According to Soll (2014: 72), Amsterdam was "the world center of accounting expertise" in the 16th century. Dutch entities were frontrunners in government accounting and auditing, applying state-of-the-art practices. Dutch municipalities made the move from cash accounting to accrual accounting in 1985. In the 14th and 15th centuries regional courts of audit were established and in 1814 the Dutch court of audit was legally anchored in the Dutch constitution, making this the second court (after France) in Europe.

Bearing this history in mind, it is remarkable that nowadays the Netherlands is one of the few countries in the EU that has not implemented accrual accounting in central government ministries, and is currently even reverting some central government agencies from accrual back to modified cash accounting. Also, the preparation of the central government balance sheet, a practice dating from 1947, was discontinued as of 2014.[1] Furthermore, although Dutch local governments use modified accrual accounting, recent changes in legislation have not taken the International Public Sector Accounting Standards (IPSAS) into account. These developments are in clear contrast with those in other EU countries.

10.2 Public sector accounting standards

10.2.1 Accounting systems in the public sector

An overall framework for public sector accounting and auditing in the Netherlands is lacking. The arrangements for central and local government entities are developed separately and bear little resemblance to each other. Central government ministries apply a modified cash basis of accounting, central government executive agencies apply an accrual basis of accounting, while local governments apply a modified accrual basis of accounting. Water authorities' accounting standards are slightly different from the ones applied by provinces and municipalities.

10.2.2 Measurement and recognition of assets, liabilities, equity, expenses and revenues

As an overall framework for the measurement and recognition of assets, liabilities, equity, expenses and revenues does not exist in the Netherlands, the requirements for both tiers of government will be discussed later.

10.2.3 Financial statements

Financial statements of different tiers of government in the Netherlands are completely different from each other. For example, while the essential statement in central government financial reporting (the statement of receipts and expenditures) is modified cash based, a cash flow statement is altogether missing in local government financial reporting. There is, however, one common denominator of financial reporting by government entities in the Netherlands: they all submit financial information to Statistics Netherlands (the national bureau of statistics) to be included in the country's European System of National and Regional Accounts (ESA) reporting.

10.2.4 Links between the budget and financial accounting

In the Netherlands there is a conviction that budgets and financial statements should be prepared on a comparable basis. There are therefore no entity differences, basis differences, time differences or classification differences in any comparison of budget and actual amounts in any government entity. Central government entities that prepare modified cash basis budgets present the actual amounts in the statement of receipts and expenditures on the same modified cash basis of accounting. Similarly, local governments, that prepare modified accrual budgets, present the actual amounts in the statement of financial performance on the same modified accrual basis of accounting.

10.2.5 Accounting standards for consolidated statements

Consolidated financial statements are rare in financial reporting by Dutch governments. There are no whole-of-government financial statements. Central government, provinces and municipalities do not consolidate, even if they have 100 per cent of the shares in the entity. The reporting entity boundaries of government entities are delineated even more narrowly than in the past, due to the emergence of agencies, boroughs and joint ventures, which are not included in the consolidation.

10.3 Central government

In 2014, Dutch central government consisted of 11 ministries, 38 executive agencies and 118 non-departmental public bodies. Furthermore, it had shares in about 30 companies, including Dutch Railways (fully owned) and Schiphol Airport (76 per cent state-owned). None of these state-owned enterprises are included in the scope of consolidation.

Dutch reporting regulations and practices vary considerably between these entities. The most remarkable differences are those between the ministries and the state-owned public companies. The ministries use a modified cash basis for their budgeting and reporting. Regulations for the ministries are laid down in the Central Government Finance Management Act (*Comptabiliteitswet*), which is issued by the minister of finance. The state-owned public companies follow Dutch accrual-based generally accepted accounting principles (GAAP), issued by the Dutch Accounting Standards Board. This board is part of a foundation under private law. Dutch GAAP has many elements in common with International Financial Reporting Standards (IFRS). Non-departmental public bodies and executive agencies hold a middle position. Regulations for non-departmental public bodies are laid down in public law. However, there is only one sentence in the Central Government Finance Management Act which applies to all these entities. This sentence states that all non-departmental public bodies "provide our minister with periodic information about their intended and realized performance". However, another law, the *Kaderwet*, prescribes that the entities which fall under this law (in practice this is most of the non-departmental public bodies) should prepare their annual report as far as possible in accordance with Dutch GAAP. From 1996 to 2012, the executive agencies were also obliged to follow a large part of Dutch GAAP. In the Netherlands, these executive agencies are an important part of central government and they perform important activities, such as managing and maintaining government buildings. Approximately, one out of three central government public servants is employed by these entities, which vary in size. However, the reporting regulations changed in 2013, when the law was altered and two types of executive agency were distinguished: those using a modified cash basis (matching their parent ministry, see below), and those following accrual accounting principles. New agencies have to "earn" the right to use accrual accounting; only when an agency has budgeted depreciation costs of more than five per cent of all costs, is it allowed to use accrual accounting. Existing agencies were reviewed as to whether it was considered desirable to maintain their status as an accrual accounting agency. This analysis showed that only ten out of the 45 (in 2011) executive agencies met the criterion. The distinction between these types was motivated by a statement by the minister of finance, saying that in those instances where accrual accounting offers insufficient advantage, the additional cost of carrying it out should not be borne. In the remainder of this section, we will focus on the modified cash basis of reporting.

10.3.1 Budgeting

The starting point for the budgeting cycle is the coalition agreement which is set by the governing parties after each election. This agreement does not contain multi-year budgets, but instead indicates policy priorities for the coming years.

Each annual budgeting cycle takes approximately two-and-a-half years and consists of three phases: (1) budget preparation, (2) budget execution and (3) accountability. Budget preparation starts in year *t*–2 with state budgetary guidelines being sent by the minister of finance to ministerial colleagues. These guidelines are a further interpretation of the rules laid down in the Central Government Finance Management Act. In January of year $t - 1$ budget preparation at each ministry starts. Here the figures from the Central Economic Plan, which is prepared by the CPB Netherlands Bureau for Economic Policy Analysis, play an important role, indicating the financial situation and outlook at that time. In spring, negotiations take place, both on a civil service and a political level. Over the summer months each ministry prepares its own budget and the Ministry of Finance drafts the Budget Memorandum. In mid-August the final drafts are sent to the council of ministers for a decision. The documents are presented, with great ceremony, to parliament on the third Tuesday of September, the so-called *Prinsjesdag* (Prince's Day). Execution of the budget starts on 1 January of every year. Only after parliament has approved the budget, is a minister formally allowed to spend up to the specified ceiling. In cases where a minister wants to spend more, they have to ask permission from parliament. Before doing so, the minister of finance has to be asked for his/her opinion. Furthermore, ministers are subject to rather strict budget rules, which are set at the start of each coalition period. These rules include (among others) that a minister's new policy should be covered within his/her own budget and that overruns should be compensated for within the ministry in which these take place.

At year end, each ministry prepares its own annual report and the Ministry of Finance also produces the Central Government Annual Financial Report, which combines the financial statements of all ministries. The reports of each ministry are audited by the Central Government Audit Service (see Section 10.3.4) and are presented to parliament on the third Wednesday in May, the so-called *Verantwoordingsdag* (accountability day). The Central Government Annual Financial Report has to be approved by the Dutch Court of Audit. The budgetary cycle formally ends with the approval of the so-called *Slotwetten* (final laws) by parliament, which discharges each minister of their financial management. The Central Government Annual Financial Report does not play a role in the discharge of responsibilities.

Between 1999 and 2002, central government implemented a form of performance-based programme budgeting, labelled under the acronym VBTB (translated as policy budgets and policy accountability). One of its elements was the move from a traditional line-item budget to a programme budget where funds were authorized according to general policy objectives.

In daily practice, the Ministry of Finance felt that the reforms "only partly lived up to expectations" and that there was not much evidence that they had led to a major reallocation of spending, while the information value of the budgets and the administrative burden for line ministries have been continuous sources of debate (de Jong et al., 2013). In 2013, a new reform, called accountable budgeting, was introduced. Some main elements were (de Jong et al., 2013):

- A more detailed, centrally defined, presentation of policy expenditures.
- Separate presentation of organizational (personnel and material) and policy expenditures.
- Limitation of policy information as to what is related to a minister's sphere of influence and the financial instruments used.
- More strict criteria for the use of performance targets and indicators.

Budgets only contain a description of intended expenditures and expected revenues and a discussion of the debt position of Dutch government. They do not contain a projected income statement nor a projected balance sheet.

10.3.2 Accounting

The preparation of central government financial statements in the Netherlands is governed by the Central Government Finance Management Act, which requires a modified cash basis of accounting. By following neither a cash basis nor an accrual basis, there is inconsistent accounting and reporting of assets, liabilities, revenues and expenditures. For many users, the financial statements of the central government of the Netherlands would not be readily recognizable. The notes to the financial statements do not include a description of significant accounting policies. The central government's operating statement is neither a cash flow statement, nor a statement of financial performance. This section provides an overview of accounting practices by Dutch central government.

Central government applies a number of modifications to the cash basis of accounting. This encompasses a unique set of modifications, making the financial statements non-comparable to those of any other government in the world:

- The first modification is the accounting for *deposits received* from third parties. As the government does not consider these amounts to be its own receipts, it treats them as short-term liabilities representing the right of the depositor to obtain cash from the government. Deposits from third parties are presented as a liability on the trial balance.
- The second modification relates to *interest payments* on the government's debt. At year end an accrual is recognized on the trial balance

for accrued but unpaid interest, thus making the amount referred to as interest payment in the government's statement of receipts and expenditures equal to the interest expense for the year. Central government thus reports interest on public debt on an accrual basis. The same applies to interest received.

- The third modification is the use of *budget reserves* and *budget funds*. The government reports an addition to a budget reserve or budget fund as an expenditure, even though the cash outflow to a third party has not yet occurred in the reporting period. The budget reserves and budget funds are presented as a credit-account on the trial balance. Budget reserves are maintained within the financial statements of a line ministry, while separate financial statements are prepared for budget funds.
- The fourth modification relates to *extra-budgetary receipts and payments that will be settled with third parties*. These are never reported as receipts or payments, but remain on suspense accounts (receivables or payables) on the trial balance from which they are cleared when settled with the inside or outside third party. This policy is not in accordance with the cash basis of accounting, because neither the cash receipt nor the cash payment is reported, unless it becomes clear that the receipts or payments will never be settled with a third party.

Ministries may choose to report four types of transactions on a net basis even though gross amounts have been exchanged between parties (offsetting):

- The first type is cash flows arising from *short-term transactions on the financial markets*. These transactions may be reported on a net basis if the maturities are less than 12 months at inception. Only the difference between opening and closing balance is reported as a net receipt or payment during the year.
- The second type relates to government *expenditures that have been reimbursed* to the government within the same reporting period, which may be reported on a net basis.
- The third type relates to *reimbursements by the government of receipts* reported previously, irrespective of the year in which the receipts were reported initially. Receipts may be reported net of these reimbursements.
- The fourth type relates to the *conversion of borrowings*. Neither the gross redemption of the old loan, nor the gross borrowings raised on the new loan are reported. Only the net increase or decrease in borrowings is reported as receipt or payment.

Ministries may report two types of transactions on a gross basis, even though they are net settled between parties (grossing up). One type is the reporting of gross amounts while *receivables and payables* are in fact net settled between parties. Even though only the net cash flow has been exchanged between parties, gross amounts are reported as receipts and expenditures. The second type is *trading-in and similar transactions*, which are reported on a gross basis. Both a sale and a purchase are reported as receipts and expenditures, even though only the net cash amount has flowed between the government and the third party.

In addition to the above-mentioned modifications to the cash basis of accounting, there are a number of other accounting practices. First, the financial statements of ministries present a comparison of original budget and actual amounts on a comparable basis. Second, the statements of receipts and expenditures do not reconcile to opening and closing cash and cash equivalents. The Central Government Annual Financial Report provides a breakdown of expenditures by institutional unit, such as the king, ministries and various funds, and by policy area. Ministries themselves also classify expenditures, mostly by institutional unit and policy area. Cash flows are not classified by operating activities, investing activities or financing activities.

The statement of receipts and the statement of expenditures (two separate statements) presented in the Central Government Annual Financial Report match those in the financial statements of the individual institutional units. Transactions between these units are not eliminated. These financial statements are therefore referred to as combined, rather than consolidated.

The financial statements for the ministries and the Central Government Annual Financial Report do not always present comparative information for the previous reporting period.

10.3.3 Financial reporting

The financial statements of ministries in the Netherlands consist of a statement of commitments, expenditures and receipts (the budget execution statement), a trial balance and note disclosures. Since commitments, expenditures and receipts are presented in a single statement, the framework is also known as an integrated commitments-cash framework. Presented in this statement are the total commitments entered into during the reporting period. Commitments are obligations that commit the government to future cash payments, usually on receipt of specified goods or services. This statement presents a breakdown and the total commitments, expenditures and receipts in comparison to the budget, but does not present a surplus or deficit for the reporting entity. The trial balance is a statement that mixes flows and stocks. Flows presented are receipts and expenditures during the reporting period, while stocks are receivables, payables, budget reserves, budget funds and commitments outstanding, all at reporting date. The trial balance thus presents some, but not all, receivables and payables of central government.

The Central Government Annual Financial Report consists of a statement of receipts, a separate statement of expenditures, a trial balance, a statement of guarantees and note disclosures. A statement of commitments entered into during the reporting period is not included; neither is a statement of outstanding commitments at reporting date. The notes to these financial statements explain that the difference between total receipts and total expenditures differs from surplus or deficit according to the ESA framework; however, no reconciliation is provided.

10.3.4 Auditing

The financial statements of the ministries are audited according to the International Standards on Auditing (ISAs) by the Central Government Audit Service (*Auditdienst Rijk*), a unit within the Ministry of Finance. Its audit opinions on the financial statements of the ministries are not made publicly available, but are submitted to the Court of Audit (*Algemene Rekenkamer*), which is the Dutch supreme audit institution.

The audit by the Court of Audit is mainly a legality and regularity audit, rather than an audit of the true and fair view of central government's financial performance and position, presented by the central government financial statements. However, the Court of Audit also carries out performance audits in the sense that it analyses whether the ministers' policies do produce the intended results.

The Court of Audit determines that the statement of receipts, statement of expenditures and trial balance, which are included in the combined central government financial statements, match the financial statements issued by the ministries and are prepared in accordance with laws and regulations. The Court of Audit issues a statement approving the combined central government financial statements, which is then addressed to parliament and is subject to parliament's decision to approve the financial statements.

10.4 Local government

In 2014, local government in the Netherlands consisted of 403 municipalities, 24 water authorities and 12 provinces. Of these, the municipalities are the most visible level of government and are the primary level with which citizens come into contact, for example, when applying for a new passport or driver's license. The water authorities take care of the surface water, and in doing so they manage water levels, build dikes, and treat wastewater. Provinces are responsible for supra-local points of interest, such as public transport and environmental issues. They are also in charge of the financial supervision of municipalities and water authorities.

In 1931 the first accounting regulations for municipalities were introduced. In the early 1980s a new regulation came into force obliging provinces and municipalities to use accrual accounting, from 1982 (provinces) and 1985 (municipalities) onwards. In 1995, the regulation was again renewed. The most important change was that Dutch GAAP, which are mainly private sector oriented, were used as a point of reference, as much as possible and justifiable (Bac, 2002). If provincial or municipal accounting regulations did not deal with an issue, Dutch GAAP should be followed.

However, within ten years a new regulation, entitled a decree on budget and accountability for provinces and municipalities (*Besluit begroting en verantwoording provincies en gemeenten*, BBV), was implemented. This regulation was accompanied by the construction of a conceptual framework for provincial and municipal reporting requiring accrual accounting budgeting and reporting. This framework includes qualitative characteristics, such as transparency, understandability and prudence. These characteristics do not include comparability between entities, because it is considered more important that political actors can construct their own format for programme budgeting and reporting. The conceptual framework does not refer to Dutch GAAP anymore. The *Commissie BBV* was established, which serves as an interpretations committee.

A separate set of accounting standards is in force for water authorities, included in the Water Authorities Decree (*Waterschapsbesluit*). These standards are similar but not equal to the BBV; Section 10.4.2 highlights the differences between the accounting standards applicable to provinces and municipalities, and those applying to water authorities.

10.4.1 Budgeting

This section discusses the budgeting procedure for municipalities. The procedure for provinces and water authorities is similar.

After elections, the board of mayor and aldermen draws up a programme expressing the political priorities for the coming four-year period. In most municipalities, the annual budgeting cycle starts with the publication of a memorandum just before the summer holidays in year $t-1$, which lists and details the board's programme. The municipal budget has to be established by the municipal council before 15 November in year $t-1$. The budget expresses the policy plans and associated costs for the coming year. Each municipality is free to establish its own programmes and products.

With the approval of the budget, the board of mayor and aldermen are allowed to spend the money as expressed in the budget at programme level. Within a programme they are entitled to adjust individual expenditures within a budget, thus this document is called the programme budget. In case additional funds are needed, the board has to ask for approval by the municipal council. This is generally accompanied by the publication of interim reports. After the budget year, an annual report is drawn up, which has to be approved by the municipal council before 15 July in year $t+1$.

10.4.2 Accounting

The current legislation for accounting and financial reporting for municipalities and provinces is laid down in the BBV, and for water authorities in the Water Authorities Decree. Although the accounting standards of provinces, municipalities and water authorities partly align with IPSAS, they deviate from it in major areas. This section provides an overview of accounting practices by Dutch local government.

Property, plant and equipment

In Dutch municipalities and provinces, two kinds of asset are distinguished: those that are not marketable and do not generate economic benefits to the entity, and those that do. The first-mentioned category is referred to as "investments in public spaces with a public benefit" and consists mainly of infrastructure assets. The BBV states that it is not obligatory to capitalize such assets, and that arbitrary depreciation is allowed, for example, to make depreciation dependent on a surplus or deficit in a given year.

Property, plant and equipment are measured at acquisition or manufacturing cost, taking into account impairment.

Provinces and municipalities should disclose long-term lease contracts as a contingent liability; they are not required to recognize the leased asset on their statement of financial position. Water authorities, instead, should record assets for which they have contracted financial leases and whose beneficial ownership is held by the water authority under property, plant and equipment.

Assets acquired through non-exchange transactions are measured at zero. Furthermore, contributions from third parties directly related to an asset may be deducted from the asset's measurement.

Provinces and municipalities should not consolidate related parties, even if they are the full owner of an entity. Water authorities should consolidate legal entities that have been incorporated as part of financial lease contracts entered into by the water authority and in which the water authority has a 100 per cent financial interest.

Associates are measured at cost, or market value if lower. This applies likewise if the reporting entity exerts significant influence over the other entity or controls it.

Provisions

Local governments should form provisions for obligations and losses where amounts are uncertain as of the reporting date, but can be reasonably estimated. Likewise, they should form provisions for risks existing as of the reporting date on account of certain obligations or losses to be expected, where amounts can be reasonably estimated.

Local governments are permitted to form a provision if it serves to distribute expenses evenly across a number of reporting periods, provided those costs are partly incurred in the current or a prior reporting period.

Local governments are not allowed to recognize any liability relating to recurring employee benefits of an approximately constant size. Examples of employee benefits liabilities are holiday allowances, holiday entitlements, pensions and redundancy pay obligations. Obligations whose amounts increase or decrease other than in line with inflation do need to be recorded as provisions, for example, redundancy pay obligations following staff cuts. Determining whether employee benefits liabilities have an approximately constant size should be based on a four-year period. Water authorities, however, should always record any employee benefits liability they may have.

10.4.3 Financial reporting

The financial statements of local governments consist of a statement of financial position, a statement of financial performance which also serves as a budget execution statement, and note disclosures. Changes in net assets/equity are presented as a note disclosure rather than in a primary financial statement. Dutch local governments do not prepare a cash flow statement. Furthermore, Dutch local governments do not present comparative information for the previous period in the financial statements.

Dutch local governments present an analysis of the differences between the final budget and the actual amounts in the notes to the statement of financial performance. However, they do not provide an explanation of the differences between original and final budget. Local governments should disclose key management remuneration, as required by the Senior Officials in the Public and Semi-Public Sector (Standards for Remuneration) Act (*Wet normering bezoldiging topfunctionarissen publieke en semipublieke sector*).

10.4.4 Auditing

The financial statements (including budget outturn report) of all provinces and water authorities and nearly all municipalities are audited by independent audit firms. Only a few municipalities maintain their own government audit offices that audit their financial statements. The authority to appoint the auditor lies with the municipal council or provincial council. Auditors conduct their audit in accordance with the International Standards on Auditing (ISAs).

The auditor examines whether the financial statements present fairly, in all material respects, the entity's financial position and performance and audits the regularity of the entity's revenues and expenses. The auditor also verifies whether the financial statements meet the requirements set down by law and regulations, and whether the financial statement discussion and analysis are consistent with the financial statements.

The auditor reports the outcome of the audit by means of an audit opinion on the true and fair view of the financial statements and the regularity of the municipality's revenues and expenses, and changes in balance sheet items.

The auditor does not carry out a performance audit. However, Dutch law prescribes that the board of mayor and aldermen are obliged to periodically review the effectiveness of their policies. Furthermore, each municipality and province should have a court of audit, which generally is in charge of carrying out or supervising performance audits.

10.5 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

Central government ministries use a modified cash basis for their reporting, and thus have many dissimilarities with accrual-based IPSAS. In 2012, the Ministry of Finance expressed their reservations on the suitability of implementing IPSAS (refer to Figure 10.1).

Local government entities use a modified accrual basis, which deviates from accrual IPSAS in areas such as arbitrary depreciation of infrastructure assets and a prohibition of consolidation. In 2008 the *Commissie BBV* released a report analysing whether the BBV should be adapted to IPSAS (Commissie BBV, 2008). The committee concluded that BBV allows the application of

> In its comment letter to the European Union, the Ministry of Finance of the Netherlands (2012) commented as follows about the suitability of IPSAS for the member states: "The balance to choose IPSAS is negative, amongst others for the following reasons:
>
> - Introduction of IPSAS is a costly and time-consuming process. Costly investments are needed for the implementation, e.g. ICT.
> - IPSAS is a complex system. Standards have been described in a high level of abstraction, which turns implementation into a labour-intensive and costly process. This also applies to the costs of auditing (which will rise). On the other hand, cash accounting is a fairly simple system and easily understood.
> - IPSAS needs hiring in external experts due to its complexity. The accounting by government becomes (too) dependent on external parties.
> - IPSAS standards are partly incompatible with the ESA rules for EDP and IPSAS rules are less detailed than ESA rules.
> - IPSAS standards do not provide unique solutions for comparable problems.
> - Motives for the introduction of IPSAS are amongst others the improvement of financial management. In the Netherlands, financial management is sound and therefore, introduction of IPSAS is not needed for this purpose.
> - IPSAS will not prevent fraud with data. Practice has shown many cases of fraud with IFRS related accounting systems.
> - Experience with IPSAS shows a lot of country specific variations on IPSAS. As a consequence, IPSAS based data are not comparable, although the data are labelled as IPSAS based.
> - Manipulation and fraud are risks with IPSAS: cash is a fact, profit is an opinion.
> - Discussions on IPSAS presume an accrual accounting system. As cash data are still needed, e.g. for debt management, a costly dual system is needed."

Figure 10.1 Ministry of Finance (2012) comments on the suitability of IPSAS for EU member states most IPSAS requirements except for consolidation. Local governments are free to choose to disclose additional information, such as a cash flow statement, comparative information for previous year or fair values. The committee did not propose to include these requirements in BBV.

As there is no intent to move to accrual accounting IPSAS, there are no processes in place to make the transition. However, in many ways, governments at all levels in the Netherlands are technically able to make the change towards accrual accounting IPSAS. They all have *IT systems* that support the financial reporting process in accordance with double-entry bookkeeping. Cost savings could be achieved by using enterprise resource planning (ERP) systems, which are off-the-shelf accrual based, avoiding costly system modification to the cash basis of accounting. The *time and training* required for government accountants would be limited, as the Netherlands has a large number of qualified accountants who all learnt accrual accounting at school and university rather than cash accounting. The impact of IPSAS conversion on *budgeting* would be limited, as IPSAS does not require any amendments to budget preparation or budget execution statement. Finally, the Court of Audit and Statistics Netherlands have always been strong proponents of accrual accounting and IPSAS, and stand ready to participate actively in the IPSAS transition to help ensure that all significant differences between current accounting practices and IPSAS are properly addressed (Algemene Rekenkamer, 2003).

10.6 Main challenges and problems identified

Challenges to IPSAS adoption in the Netherlands include accounting for *infrastructure assets* at central government level. Modifications required by a cash-to-accrual transition at central government level would include fixed asset accounting using additional modules in their ERP packages. Basic data are available, as central government has prepared a government balance sheet for many years. Many other fixed assets at central government level are already accounted for on an accrual basis, such as its buildings, which are held by a building agency that reports under the accrual basis of accounting. Changing *legislation* to enable and enforce the implementation of IPSAS might be a lengthy process because of Dutch consensus-based policy making (*poldermodel*). The government should establish a policy to create a high degree of *transparency* by providing clear information on its assets and liabilities, including disseminating information on its websites (big data). A final challenge would be in the *communication* to key stakeholders, including politicians, for them to appreciate the logic behind the government's strategy for the transition to IPSAS.

As local governments are already familiar with accrual-based accounting and have already witnessed a number of reporting changes, they would find a move to reporting in accordance with international accounting standards less of a challenge.

Note

1. This balance sheet presented a comprehensive statement of assets and liabilities for central government, albeit partially based on statistical estimates. Going forward, only a balance sheet for the general government sector will be published.

References

Algemene Rekenkamer (2003), *Begroting en verantwoording in balans. Het baten-lastenstelsel voor de rijksoverheid*. 28 860 (2002–2003). KST67342, Sdu Uitgevers, 's-Gravenhage 2003.

A.D. Bac (2002), "Dutch Private Sector and Local Government Accounting Regulations: A Comparison", *Journal of Public Budgeting, Accounting and Financial Management*, 14 (4), 595–618.

Commissie BBV (2008), *Het BBV en de IPSAS*, www.commissiebbv.nl.

M. de Jong, I. van Beek and R. Posthumus (2013), "Introducing Accountable Budgeting: Lessons from a Decade of Performance-based Budgeting in the Netherlands", *OECD Journal of Budgeting*, 12 (3), 1–34.

Ministry of Finance (2012), *Comment Letter – Assessment of the Suitability of the IPSAS for the Member States of the European Union – Public Consultation*. The Hague, the Netherlands.

J. Soll (2014), *The Reckoning – Financial Accountability and the Rise and Fall of Nations*. New York: Basic Books.

Useful sites

www.overheid.nl (this website presents itself as the central access point to all information about government organizations of the Netherlands).

www.rjnet.nl (provides information about Dutch GAAP).

www.commissiebbv.nl (provides information about Dutch municipal and provincial reporting regulation).

11
Public Sector Accounting and Auditing in Portugal

Susana Jorge

11.1 Introduction

According to its Constitution, Portugal is a unitary state with two levels of government: central and local (constitutionally autonomous). There are also two autonomous regions (Azores and Madeira archipelagos) with independent regional governments. Local government embraces municipalities and civil parishes. The 1997 Constitution created administrative regions but a national referendum in 1998 prevented these being implemented so, currently, there are 308 municipalities (278 in continental Portugal, 18 in Azores and 11 in Madeira) and 3,091 civil parishes (2,882 in continental Portugal, 155 in Azores and 54 in Madeira).

Due to strong centralization and legalistic tradition, public sector activities are based on administrative laws and any reforms have been centrally driven. Consequently, budgetary and financial accounting and reporting regimes are established by law and legislative changes are the main government's tools for the implementation of reforms, since professional influence is still very weak (Jorge, 2003).

Nevertheless, since 1998 (Law decree 68/98) there has been a standard-setting committee for public sector accounting, which works independently although it is under the Ministry of Finance.

Budgeting and accounting systems are, at both levels of government, generally separated, although linked in the same final reporting. There is currently a Plan of Accounting for the Public Sector (POCP) that covers the whole of public sector accounting and reporting, and has been adapted to the main subsectors within public administration: local government, health, education and social security.

Excessive fragmentation, new informational needs for accountability and decision-making and national and international harmonization issues, have raised the need for a reform of the current system, highlighted by government in the Document of Fiscal Strategy 2012–2014. In 2012 the organization and functions of an accounting standard-setter were revised (Law decree 134/2012) and a Committee for Public Sector Accounting (CNCP) was created, which has been working since 2013 on a new public sector accounting system (SNC-AP) for the whole of the Portuguese public administration. This system is adapting International Public Sector Accounting Standards (IPSAS) to the particularities of the Portuguese context, combining financial accounting with budgetary accounting.

11.2 Public sector accounting standards in Portugal

The public sector in Portugal, as in other countries, embraces the administrative public sector and the business public sector. The latter comprises business enterprises owned either by central government or by municipalities. The business public sector is beyond the scope of public sector accounting, as public business enterprises generally follow the business accounting system. Nevertheless, recently, several issues have arisen concerning the scope of the, so-called, general government sector (GGS) both in public sector (micro) accounting and in the national accounts. Several public business entities, for example, hospitals, have been reclassified within the GGS because of the national accounts, due to non-market criteria, so they continue to use the business accounting system for financial accounting and reporting purposes, while preparing budgets and budgetary reporting according to public sector regulations. This chapter concentrates on the administrative public sector, which is undoubtedly under public sector accounting.

The system currently in practice in public sector accounting in Portugal goes back to the beginning of the 1990s, when the Public Sector Accounting Framework Law was passed (Law 8/90). This law established a new regime for the state's financial administration, considering the types of autonomy of the entities within the central administration, with consequences in the accounting systems (Law decree 155/92) – entities with administrative autonomy should use a cash and commitment-based accounting (single-entry), while entities with administrative and financial autonomy (with the requirement that their own revenue covers two-thirds of total expenditure) should additionally have a financial accounting system close to that used in business accounting (accrual-based with double-entry bookkeeping).

As a consequence, in 1997 the POCP was passed (Law decree 232/97) and became a landmark in Portuguese public sector accounting reform by creating an integrated system that brought cash-based budgetary accounting together with accrual-based financial and cost accounting. POCP was mainly derived from the then existent business accounting plan, which was revoked in 2009 and replaced by a new International Financial Reporting Standards (IFRS)-based system (SNC). Between 1997 and 2002, POCP was adapted to the main relevant subsectors of public administration, starting with local government (Law decree 54A/99), education (Order 794/2000), health (Order 898/2000) and social security (Law decree 12/2002). Entities within other sectors, for example, defence, use POCP directly. Nowadays POCP has been extended, either directly or via a sectorial plan, to all entities within public administration, regardless of their degree of autonomy.

A simplified regime for small entities, consisting basically of traditional cash-based budgetary accounting and reporting, is allowed within the plans of accounting for local government and for education.

Currently, accounting standards for the public sector as a whole in Portugal might be seen as fragmented and inconsistent, because there are five different accounting plans for public administration plus an IFRS-based system for the public business sector (central and local) and yet another special regime for non-profit entities. Additionally, since the previous business accounting plan, which POCP was based upon, was revoked, POCP lost its reference and conceptual basis. The public sector accounting system is still very much based on detailed rules, while the business accounting system builds upon general principles. This fragmentation is creating several inconsistency problems and generating inefficiencies, for instance when preparing consolidated accounts, implying adjustments that are non-desirable and might affect financial information reliability while it is being integrated. The solution for these problems is seen as a change towards a single system, adapting IPSAS, hence bringing public sector accounting back to being close to business accounting.

Therefore, the reforms of public sector accounting in Portugal have been following those in business accounting, regardless of criticism by some (Jorge et al., 2007).

11.2.1 General accounting plan for the public sector

It follows from the above that POCP is the general framework for public sector accounting in Portugal, being the basis for other sectorial plans that differ essentially on technicalities concerning the chart of accounts, derived from particularities of the sector in which it is applied. Notwithstanding, the plans for local government (POCAL) and for the education sector (POC-E) comprise already detailed rules for cost accounting. POC-E also embraces rules for consolidated accounts. These rules exist in separate guidance and instructions both for central and local government. These matters will be addressed further on in this chapter.

POCP overcame the problems of traditional budgetary cash-based single-entry accounting, which had the main objective of showing how the budget was accomplished. By bringing three subsystems together into one integrated system, gathering budgetary (cash-based), financial (accrual-based) and cost (accrual-based) accounting, POCP created conditions for a harmonized public sector accounting system, allowing entities to have information to:

- Control legality, financial regularity and effectiveness of their operations;
- Monitor the budget accomplishment, determining budgetary deficits/surpluses and debt levels;

- Prepare the balance sheet, presenting assets and liabilities, as well as their evolution;
- List and control tangible assets;
- Evidence costs, and revenue when applicable, of public goods, services or activities, determining analytical results and analysing performance;
- Prepare the annual accounts to be sent to oversight bodies, namely the Court of Accounts (supreme audit institution);
- Make available more and different economic and financial information to support decision-making, both of a political and a management nature;
- Improve transparency while managing public resources and in the financial relationship with the state;
- Get the required elements to calculate the main relevant aggregates for national statistics, contributing to a better assessment of EU convergence criteria.

POCP is organized in eleven chapters (Law decree 232/97), the most important regarding: technical considerations on how to prepare the balance sheet, the income statement, the statements of budgetary execution and the notes, and on how to deal with specificities regarding the record of budgetary operations; accounting principles and measurement criteria; models of the main financial and budgetary statements and of some statements included in the notes (e.g. statements of budgetary alterations, investment projects accomplishment, debt, and transfers and grants); and the chart of accounts with explanatory notes (detailed accounts to record both budgetary and financial accounting operations; double-entry is required in both subsystems).

The new system now being prepared, moving towards national and international harmonization, will approach the structure and elements of the SNC for business accounting, adapting IPSAS to specificities of Portuguese public administration. It will be a single system for the whole of the public sector, except public (central and local) business enterprises.

The main structural elements of SNC-AP are:[1]

- *Object* (budgetary, financial and management accounting and reporting).
- *Accounting bases* (modified cash basis for budgetary accounting and full accrual basis for financial and management accounting).
- *Conceptual framework* which, allowing for the theoretical basis for the standards, establishes underlying concepts to both budgetary and financial statements (DOF), helps their preparers applying the standards and dealing with matters not included in these, and supports users while reading the information presented in the DOF.
- *General and simplified regimes*, defining the scope of application of each one; since it is believed that accrual accounting is important to all public sector entities, regardless of their materiality, the simplified regime will

also work on a full accrual basis, endorsing an integrated, more informative and transparent budgetary and financial reporting, also using double-entry bookkeeping.

- *Accounting and reporting standards* (NCP), as in Table 11.1.

Table 11.1 Budgetary and financial accounting and reporting standards

NCP	**Adapted from**
Group I – Presentation of budgetary, financial and management information	
NCP 1 – Structure and content of financial statements	IPSAS 1 IPSAS 2 POCP SNC
NCP 2 – Accounting policies, changes in accounting estimates and errors	IPSAS 3
NCP 24 – Structure and content of budgetary statements	POCP LEO
RT1 – Management reporting[a]	RPG 1 e 2 (IPSASB) INTOSAI (October 2001) AASB 1055
Group II – Financial position and performance – annual (single) accounts	
NCP 3 – Intangible assets	IPSAS 31
NCP 4 – Service concession arrangements: grantor	IPSAS 32
NCP 5 – Tangible fixed assets	IPSAS 17
NCP 6 – Leases	IPSAS 13
NCP 7 – Borrowing costs	IPSAS 5
NCP 8 – Investment properties	IPSAS 16
NCP 9 – Impairment of assets	IPSAS 21 IPSAS 26
NCP 10 – Inventories	IPSAS 12
NCP 11 – Agriculture	IPSAS 27
NCP 12 – Construction contracts	IPSAS 11
NCP 13 – Revenue from exchange transactions	IPSAS 9
NCP 14 – Revenue from non-exchange transactions	IPSAS 23
NCP 15 – Provisions, contingent liabilities and contingent assets	IPSAS 19
NCP 16 – The effect of changes in foreign exchange rates	IPSAS 4
NCP 17 – Events after the reporting date	IPSAS 14
NCP 18 – Financial instruments	IPSAS 28 IPSAS 29 IPSAS 30
NCP 19 – Employee benefits	IPSAS 25

Continued

Table 11.1 Continued

NCP	Adapted from
Group III – Consolidation and controlled entities	
NCP 20 – Related party disclosures	IPSAS 20
NCP 21 – Interests in joint ventures and investments in associates	IPSAS 7 IPSAS 8
NCP 22 – Consolidated and separate financial statements	IPSAS 6
Group IV – Special matters	
NCP 23 – Segment Reporting	IPSAS 18
NCP 25 – Management and cost accounting	IFAC Study 12 POCAL POC-E PCAH (hospitals)
NCP-PE – Standard for small entities (simplified regime)	–

Note: [a] This is not a regular standard, but a technical recommendation.

- *Interpretation guidelines*, when necessary, to clarify and complete NCP gaps.
- *Multidimensional chart of accounts*, a single chart of accounts, encompassing accounts to control budgetary and financial accounting operations, as well as tangible assets; it assures consistency with the one used in the SNC; it contributes to increased rigour in the records, improving accuracy in the values of individual and consolidated accounts, and in national statistics aggregates (alignment with European System of National and Regional Accounts (ESA)).
- *Budgetary and financial statements*, modified cash-based budgetary statements (expenditure and revenue control); accrual-based financial statements (balance sheet, income statement, by nature and by function, statement of changes in equity); a cash flow statement (reconciling the budgetary balance – cash – with cash and cash equivalents – accruals); and notes.

11.2.2 Conceptual framework

POCP does not have a conceptual framework (CF); no references are made to budgetary or financial information objectives and users, nor to qualitative characteristics. No recognition criteria are presented. However, there is a chapter on accounting principles and another on measurement criteria. Budgetary principles, relating to budgeting classical rules, are established in the Budget Framework Law (LEO), referred to later.

POCP accounting principles are: reporting entity, continuity, consistency, accrual, historical cost, prudence (conservatism), materiality and non-compensation (gross amounts). Substance over form is not accepted as a general principle, due to its conflict with the predominant legality principle; yet, it is applied in certain situations (e.g. financial leasing). It is clearly stated that the application of these principles will lead to a true and fair view of the entity's financial position, performance and budgetary accomplishment. Cases where the application of these principles is not possible should be indicated in the notes.

SNC-AP, as presented, comprises a conceptual framework which is going to be an adaptation from both that existent in business accounting (International Accounting Standards Board (IASB)-based), and that of International Public Sector Accounting Standards Board (IPSASB). Since the system brings cash-based budgetary accounting together with accrual-based financial accounting, issues concerning the former have to be included. Therefore, concepts specific to Portuguese public sector entities, namely linked to administrative and budgetary execution processes, will be added (e.g. public domain assets, expenditure appropriations and commitments, revenue liquidations, arrears, available funds, budgetary execution degree, among others). For the same reasons, adaptations for measurement criteria are also considered, for example, the notion of fair value for non-current tangible assets does not come from market value, but from the property's value for taxation purposes. The elements addressed by the conceptual framework are: its authority over the standards, the definition of a reporting entity (where "the State" as a reporting entity is of utmost importance), accounting bases for both budgetary and financial accounting, objectives for and users of the reported information, qualitative characteristics, definition of the main concepts linked to the information presented in budgetary and financial statements, and respective recognition and measurement criteria.

11.2.3 Recognition and measurement of assets, liabilities, equity, expenses and revenues

POCP endorses full accrual basis, so assets, liabilities, revenue and expenses are recognized as much as possible. Non-current assets embrace tangible and intangible assets, investment properties and financial investments. Given the dominance of a patrimonial perspective, public domain assets (including infrastructure and heritage) are also recognized, on the basis of controlling criteria. Liabilities include provisions, but not for future pensions (since the pension scheme is based on contributions not benefits). Equity structure follows that of business accounting, which will continue with SNC-AP.

Substance over form is not generally accepted, due to the fact that legality and property control are overriding concerns. In SNC-AP, despite the fact that heritage and cultural assets are required to be recognized as much as possible, substance over form will be established as a generally accepted principle.

There is a general prevalence of the historical cost convention (purchasing of production cost) in POCP. Nevertheless:

- Cash and cash equivalents – exchange rate adjustments are required at the reporting date; financial instruments follow business accounting criteria.
- Receivables and payables – exchange rate adjustments are required at the reporting date; impairment adjustments allowed.
- Inventories – net realizable value or replacement cost is used, when lower than the historical cost, hence impairment adjustments are allowed; cost formulas are FIFO, LIFO, weighted average cost and specific cost.
- Non-current tangible assets – exceptions are allowed when purchase or production costs are not known (donated assets, transferred assets, initial recognition and public domain assets): asset value to the entity where it comes from, or as a result of a legal or technical evaluation (e.g. replacement cost), is used when possible; insurance value is admissible when applied; zero value, just disclosing qualitative information in the notes, is used when measurement is not possible (e.g. heritage) until the asset undergoes substantial repair, which value is then used for recognition. Revaluation is not allowed, except by legal authorization.

SNC-AP keeps the measurement criteria as close as possible to business accounting criteria, hence allowing revaluation after the initial recognition, taking market and fair values as reference. Still, for tangible assets this will approach the value used for taxation purposes.

Expenses and revenue are recognized on a cash basis regarding budget accomplishment (cash-based deficit/surplus in the cash flow statement), and on an accrual basis in financial accounting. The income statement is prepared under the matching concept, given that the annual deficit/surplus is obtained by the difference between total revenue and total cost. SNC-AP will continue with these.

11.2.4 Financial statements

Under POCP the financial statements are: balance sheet, income statement by nature and notes. The cash flow statement is a budgetary statement, presenting payments and receipts from budget execution and from treasury operations; it includes cash balances from the previous year and to the following year.

Additionally, while reporting on the budget execution two main budgetary control statements are prepared, linked to the amounts of receivables and payables presented in the balance sheet. For expenditures the statement shows the final budgeted amounts, payments and commitments still to be paid. Regarding revenue it also shows the final estimated values, liquidations, amounts received and those to be received at the end of the year. Both statements present, for each item of expenditure/revenue and globally, the degree of budget execution (amounts paid/received over the final budget). The final estimated amounts come from statements of budgetary alterations presented in the notes.

SNC-AP changes the format of the financial statements according to current business accounting models, and requires (for some entities) an income statement by function and a statement of changes in equity. The cash flow statement becomes that of business accounting (dividing the flows into activity categories), but linking to budgetary accounting through a reconciliation between budgetary cash balance and cash and cash equivalents. In reality, there is (and will be) budgetary and financial reporting, since the annual accounts also include budgetary statements.

The simplified reporting model in POCAL and POC-E must include budgetary control cash-based statements (revenue and expenditure). In SNC-AP it will also include a balance sheet and an income statement, using simpler and more summarized models.

11.2.5 Links between the budget and financial accounting

It comes from the above that in the current (as in the forthcoming) public sector accounting system in Portugal, budget and financial accounting are linked, as they are parts of (and work together in) the same system of accounting and reporting.

The annual budget is the starting point for all transactions made yearly by either governments or other public sector entities. Each expenditure or revenue transaction follows a cycle of accounting records, comprising more stages for expenditure than for revenue, due to reasons of control. Expenditure operations are: budget initial amount, alterations, appropriation, commitment,[2] processing (obligation), payment authorization and payment. Revenue operations are: budget initial estimate, alterations, processing (right), liquidation and receipt.

Some operations are recorded within budgetary accounting, using budget classifications (all related to expenditure and revenue internal operations, plus payment authorization/liquidation and payment/receipt), while others are in financial accounting (obligation/right and payment/receipt), since they create rights and/or obligations for the entity towards third parties.

The forthcoming SNC-AP will continue the link between budget and financial accounting, controlling different operations in both expenditure and revenue cycles, as well as merging the current budgetary and financial classifications, using a multidimensional chart of accounts for both purposes. Budgetary control statements will remain in the same terms, but a new statement of budgetary performance will be added, which will replace the currently existent cash flow statement. It is expected that the new cash flow statement within financial accounting, while approach that of business accounting, will reconcile the cash-based budgetary balance with the deficit/surplus in the income statement.

11.2.6 Accounting standards for consolidated statements

Whole-of-government accounts (WGA) are not yet prepared, partially because "the State" still does not exist as a reporting entity.

At an organizational level, entities already prepare group accounts following general guidance adapted to public administration (Order 474/2010), essentially derived from both IPSAS and the 7th EU Directive. Therefore, control or presumption of control is the criterion to establish which entities are within the consolidation perimeter. Consolidation methods are: simple aggregation[3] (no interest in the controlled entity equity, but an effective administrative control); full consolidation (interest higher than 50 per cent in the controlled entity); and equity method (interest in the controlled equity between 20 per cent and 50 per cent, allowing significant influence on operational and financial management, or when none of the other methods apply). Consolidated financial statements are: balance sheet, income statement by nature, cash flow statement from budgetary operations and notes. There is also a requirement to prepare consolidated management reporting. SNC-AP is likely to maintain this.

These pronouncements were adapted through specific instructions to local government, to which there was a requirement, since the 2007 Local Finance Law, for municipalities to prepare consolidated accounts, but no proper rules existed until 2010.

11.3 Central government

11.3.1 Budgeting

The rules for preparing the State's Budget and State's General Account (budget execution) are established in the Constitution (articles 105–107) and particularly in the Budget Framework Law (Law 91/2001; 8th revision by Law 41/2014, to include issues concerning EU fiscal discipline).

Main budgetary principles are: annuity (civil year) and multi-annuity; unity and universality; detail (specification, gross amounts, non-allocation of revenue); balance; equity between generations; stability and sustainability; reciprocal solidarity; economy, efficiency and efficacy; public debt limits; and responsibility and transparency.

Budgets are cash-based, essentially incremental and line-item (Jones and Pendlebury, 2010). Revenue and expenditure are grouped in current and capital. SNC-AP will replace the present budgetary classifications (by nature) with a multidimensional chart of accounts. Programme budgets are also prepared, focusing on control of inputs and responsibilities (Pinto et al., 2013).

The state budget embraces the budget of all entities belonging to the central administration (integrated and autonomous services). Social security and local government present separate budgets due to autonomy statutes. All entities submit their budgets to the general budget department (DGO) within the Ministry of Finance, using electronic platforms, by the end of August. The state budget is prepared and presented to parliament by 15 October, to be approved within 45 days.

Budget accomplishment at entity level is demonstrated in budgetary control statements and in cash flow statements, and must be sent to the appropriate ministries by the end of April of the following year. At the level of the state (central administration) is the State's General Account, annually prepared by end of June and audited by the Court of Accounts by the end of December the following year. This is the main source of information for national statistics on the GGS. Since it is cash-based, while ESA is accrual-based, accounting basis adjustments (apart from other adjustments regarding specific operations requiring reclassifications) are needed when moving from micro to macro public sector accounting (Jesus and Jorge, 2015).

11.3.2 Accounting

The accounting system of entities within central government is based on POCP with: cash-based budgetary accounting, to record operations relating to controlling budget accomplishment; accrual-based financial accounting, aimed at recognizing assets, liabilities, expenses and revenue; cost accounting, to obtain costs of goods, activities and services provided. There are budgetary and financial accounts, but the whole system uses double-entry. The main features have already been presented. SNC-AP will keep the three subsystems. Some existent standards on cost and management accounting will be included and adapted in NCP 25.

11.3.3 Financial reporting

POCP-based budgetary and financial reporting is prepared for each entity (e.g. central government agencies, universities and health centres). SNC-AP will maintain this, approaching the statements models to those used in business accounting, hence adding the statement of changes in equity (for some entities) and transforming the existent budgetary cash flow statement into a financial statement. The notes include, among others, a statement demonstrating the annual (and up to date) financial accomplishment of the entity's investment programmes and projects.

For the state as a whole, only budgetary reporting continues to exist in the form of the state's general account. The state does not currently exist as a financial reporting entity; SNC-AP will change this, creating conditions for preparing WGA in the future.

11.3.4 Auditing

As in other jurisdictions, auditing of public sector accounts in Portugal is an important requirement to assure reliability. Regular audits allow for the prevention and detection of irregularities in financial matters, either due to corruption of the agents or simple negligence while pursuing procedures, thereby ensuring that public resources are properly used (Jones and Pendlebury, 2010).

The national system of control is concerned with the state's budgetary and financial administration. It comprises external and internal control (Law 41/2014).

External control is essentially a financial and regularity (presumed independent) control, to ensure the good use of public money (Jones and Pendlebury, 2010). The two national bodies of external control are the Court of Accounts and parliament (Fardilha, 2004). Whereas the former exerts financial control (technical-jurisdictional), the latter exercises political control; both concern managing and accomplishing the state's budget. Jurisdictional control is a financial control, applied following proper legislation regarding the Court of Accounts' procedures; it relates to financial responsibilities. Political control relates to political responsibilities, according to that established by the constitution, the Budget Framework Law and parliament's regimen (Pinto et al., 2013). These types of control are *a priori* and *a posteriori*: the budget is previously passed by parliament and some budget appropriations have to be sanctioned by the Court of Accounts; the state's general account is approved in parliament and then submitted to the Court of Accounts.

Internal control is to ensure that management purposes are attended to (Fardilha, 2004). Traditionally, it focuses on the accounting system and seeks to safeguard financial resources, the prevention and detection of illegal, fraud and error situations, the accuracy and integrity of the accounting records, and reliable financial reporting, prepared in time (Jones and Pendlebury, 2010).

Law decree 166/98 establishes three levels within the national system of internal control (bottom-up): operational control, sectorial control and strategic control, embracing budgetary, financial and property matters.

Operational control is developed internally by the entities, namely via internal auditing departments (possibly employing certified auditors). It verifies, monitors and informs on internal management (budgetary regularity, financial statements compliance and economy, efficiency and effectiveness). Sectorial control embraces the first level, additionally assessing how the entity and its activities as a whole fit in with the global plans of the region or ministry; it is a responsibility of sectorial and/or regional bodies (e.g. ministries). Strategic (horizontal) control embraces the two lowest levels, adding in the evaluation of entities' activities regarding compliance with the government general plan and the state budget; it is a responsibility of the, so-called, internal control bodies, such as the Inspectorate General of Finance (IGF), Budget General Department (DGO) and Social Security Financial Management Institute (IGFSS). At all these levels, internal control is essentially administrative; entities might when necessary, resort to external certified auditors (Pinto et al., 2013).

11.4 Local government

Many issues already presented for POCP and central government, also apply to local government; they have been adopted, given the centralizing tradition. Still, differences must be highlighted (namely regarding budgeting) in respect of constitutional autonomy. This implies independence from the State's Budget (the budget of local government as a whole is presented as an appendix), since municipalities run their own property, budgets and finances separately, notwithstanding the high level of financial dependency some have on central government transfers, and the generally low level of discretion regarding local taxes.

11.4.1 Budgeting

Local government budgetary rules and principles are established in both the Local Finances Law (Law 73/2013) and POCAL. Many are copied or slightly adapted from the Budget Framework Law (central government), since there has to be solidarity and cooperation regarding fiscal discipline, namely in the accomplishment of the Stability and Growth Pact. The coordination between central and local government public policies, finances and budgetary constraints is assured by the Financial Coordination Council.

As at central level, budgets are cash-based, incremental and line-item, inputs-based and aimed at controlling responsibilities. Budgetary classifications will be replaced by the multidimensional chart of accounts in SNC-AP.

11.4.2 Accounting

A local government accounting system is established in POCAL, which derives from POCP. A simplified regime is admitted for small entities (civil parishes) consisting of cash-based budgetary accounting. SNC-AP, as a single system for the whole of public administration, is also going to apply to local government, adding accrual-based accounting and reporting to the simplified regime, as established in the standard for small entities (NCP-PE).

There are special rules for cost accounting, endorsing full costing; indirect costs are allocated firstly to functions/activities, and then to goods and services within each function/activity, proportionally to direct costs (single basis). These rules may be adapted to NCP 25.

11.4.3 Financial reporting

Local government financial reporting is defined in POCAL and hence is similar to POCP in embracing budgetary and financial reporting. Notes include, among others, statements of budget alterations (expenditure and revenue) and a statement demonstrating the current state of financial accomplishment of the multi-annual investments plan. With SNC-AP local budgetary and financial reporting will be similar to that at central level.

11.4.4 Auditing

As at central level, local authorities are also subject to external and internal control.

External control is, as explained, essentially the responsibility of the Court of Accounts, both *a priori* (some budget appropriations need to be sanctioned) and *a posteriori*, since all local authorities send their annual accounts for certification, after approval by their local council (assembly).

Recently, Local Finances Law 73/2013 required that a municipality's annual accounts be legally certified by an independent external auditor nominated by the council, from those proposed by the executive as certified public auditors or auditing firms.

As to internal control, POCAL provides general guidance for each municipality to develop, approve and apply its own internal control system (including the definition of controlling positions and functions), which embraces the plan of organization, policies, methods and procedures of control, established by those who are responsible for the entities. Specifically, the elements to be prepared are:

- Internal control norm – comprising methods and procedures to control cash and equivalents, payables and receivables, stocks, and non-current assets, to be sent to the Court of Accounts after approval;
- Organization's plan – structure, emphasizing departments related to budget, accounting and finances;
- Specific (internal) regulations (e.g. regarding working capital funds);
- Charts of accounts;
- Accounting procedures manual;
- Internal (control) auditing procedures manual.

The executive is responsible for approving and maintaining the operation of the internal control system.

11.5 Readiness for change: technical facilitators, comparison of national standards with IPSAS framework and readiness for adopting EPSAS

Public sector accounting in Portugal is currently changing. The shift from POCP (and sectorial plans) towards an IPSAS-based system seems irreversible. Meanwhile, in March 2013, the EU pronounced concerning the suitability of IPSAS for member states, highlighting a number of accounting-related technical issues as problematic in the IPSAS standards, subsequently grouped as: standards that might be implemented with minor or no adaptation; standards that need adaptation, or for which a selective approach is needed; and standards that are seen as needing amendment prior to implementation.

In the SNC-AP developing process, the above-mentioned groups were considered, so while some IPSAS were considered not relevant to the Portuguese context (*IPSAS 10 – Hyperinflationary economies* and *IPSAS 22 – General Government Sector*), others were directly adopted as NCP, a third group has been adapted and a fourth group radically changed (IPSAS 25, 28, 29 and 30). Therefore, it can be said that the strategy followed by Portugal has created a system ready for European Public Sector Accounting Standards (EPSAS) and that these will not require serious amendments to what has been done so far.

Referring to the working document accompanying the EC Report of 6 March 2013, there are some factors that could either hamper or encourage the reforms, namely SNC-AP development and implementation:

- Political environment and support – in Portugal currently very favourable to public sector fiscal and accounting reforms.
- Reform scope – SNC-AP is part of a more embraceable reform process of public administration financial management as a whole, including administrative, budgeting and financial areas.
- Implementation timing and phases – an implementation period of four to six years is expected (starting with pilot entities), allowing for better testing of the new system and preparing all groups involved, namely politicians and civil servants. Staff training actions aimed at providing/reinforcing skills, first-time adoption rules and an implementation manual are being considered by the standard-setter.
- Implementation process – the centralizing tradition of reforms in Portugal implies a single SNC-AP for public administration as a whole, imposed by a legal framework centrally approved (top-down process), searching for an integrated system that, in the future, would allow for the preparation of WGA.
- Approving the relevant legal regulations – since Portugal is a civil law country, all elements of SNC-AP have to be passed as a form of law/law decree to be formally in force. The bureaucratic process associated with issuing legal regulations will determine the pace of reform.
- Accounting basis – SNC-AP endorses full accrual-based financial accounting and reporting, together with cash-based budgetary accounting and reporting. Nevertheless, it aims at creating conditions for accrual-based budgets to be prepared in the future, while already requiring the preparation of prospective financial statements.
- Information reliability concerns – since, so far, the accounts of most entities within the public administration are essentially audited for legal form (by the Court of Accounts), in order to reinforce credibility of the information prepared, there is the need for accounts to be independently certified (need for an auditor's independent opinion).

11.6 Main challenges: problems identified

The development and implementation of SNC-AP takes into consideration a cost–benefit analysis, searching for a balance between changes required and the standards and supporting structures (e.g. information systems and technological platforms) currently in place.

Although an urgent need to reform public sector accounting (replacing POCP) is generally recognized, the eventual high costs of the process are also acknowledged which, given the current context of budgetary constraints, becomes an enhanced critical issue. Considering other countries' experiences, costs are expected to be affected by the scale and rhythm of the reforms, as well as by the size of the jurisdiction; even if it is not possible to estimate an accurate amount, they are expected to be higher if the reforms, as happens in Portugal, extend to the whole of public sector budgetary and financial management.

Considering the current implementation of accrual-based accounting and reporting (POCP or sectorial plans) across all subsectors of public administration, and the technological platforms developed in conformity, it is admitted that reform costs might be mitigated, the great amount concerning staff training costs. Indeed, one of the main challenges to overcome in order to implement SNC-AP successively concerns giving (and/or reinforcing) technical capacity and skills to those who have to deal with the system. This requires considerable investment in staff training at all organizational levels and the assigning of certified accountants to key positions.

Finally, despite the favourable fact that most public sector entities are already used to accrual-based financial accounting and reporting, and some are even familiar with cost accounting, further improvements regarding the integration of information are required.

Notes

1. According to the preliminary document published in July 2013 by the accounting standard-setter (CNCP), titled "*Linhas Orientadoras para o Sistema de Normalização Contabilística – Administrações Públicas (SNC-AP)*"; available at http://www.cnc.min-financas.pt/.
2. Law 8/2012 and Law decree 127/2012, while regulating commitments assumption, created strict restrictions, among which commitments cannot be assumed if entities do not have available funds to cover amounts due within 90 days.
3. While in full consolidation, elements of the financial statements of the controlled entity(ies) are integrated in those of the one consolidating, evidencing minority interests, in simple aggregation financial statements are simply summed up; there are not minority interests. Eliminations of transactions and results intra-group are compulsory in both methods.

References

M. P. Fardilha (2004), “Os novos caminhos da Contabilidade (e da) Auditoria Pública”, *Revisores and Empresas*, 27, 36–44.

M. A. Jesus and S. Jorge (2015), “Governmental Budgetary Reporting Systems in the European Union: Is the Accounting Basis Relevant for the Deficit Reliability?”, *International Review of Administrative Sciences*, 81 (1), March, 110–133.

R. Jones and M. Pendlebury (2010), *Public Sector Accounting*, sixth ed. Harlow: Pearson Education Ltd.

S. Jorge (2003), *Local Government Accounting in Portugal in Comparative-International Perspective*, PhD Thesis. UK: Birmingham Business School, The University of Birmingham.

S. Jorge, J.B. Carvalho and M.J. Fernandes (2007), “Governmental Accounting in Portugal: Why Accrual Basis Is a Problem”, *Journal of Public Budgeting, Accounting and Financial Management*, 19 (4), 411–446.

A. Pinto, T. Melo and P. Santos (2013), *Gestão Orçamental e Contabilidade Pública*. Lisboa: ATF Edições Técnicas.

Useful sites

https://appls.portalautarquico.pt
http://www.cnc.min-financas.pt
http://www.dgo.pt
https://dre.pt/
http://www.en.parlamento.pt/Legislation/
http://epp.eurostat.ec.europa.eu
http://www.ifac.org/public-sector

12

Public Sector Accounting and Auditing in Spain

Isabel Brusca, Vicente Montesinos and José Manuel Vela

12.1 Introduction

Spanish public administration is organized on three levels: national government, regional governments (17) and local governments (8,108 municipalities). Budgeting, accounting and auditing show a high degree of uniformity among the three levels of government.

In Spain, as in other continental European countries (Pina et al., 2009), there is a strong legalistic tradition and the administrative law model has always been dominant in the functioning and reform of the public sector. Legislative reforms have been the main tool of government for the implementation of accounting reforms. Accounting standards are established by law and the influence of the accounting profession is very weak. There is a general accounting plan that serves as a framework for all entities in the public sector. Following this general standard, adaptations are issued for the different levels: central, regional and local.

12.2 Public sector accounting standards in Spain

The Institute of Accounting and Audit (*Instituto de Contabilidad y Auditoría de Cuentas*, ICAC), an autonomous body accountable to the Ministry of Economy and Competitiveness, regulates both, accounting and audit standards for the business sector. For public sector entities, the body in charge of issuing governmental accounting standards is the Government Comptroller's Office (*Intervención General de la Administración del Estado,* IGAE), see Figure 12.1. The IGAE is an office of the Ministry of Finance and Public Administration, also responsible for the internal control of the central government entities and their accounting processes.

Even when both standard-setting bodies depend on different ministries, they work in close collaboration, which may explain in part why public sector accounting always follows business standards.

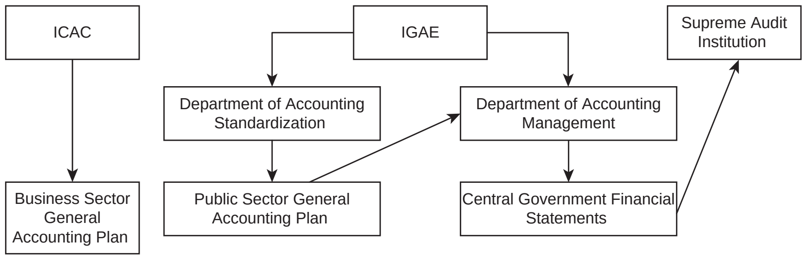

Figure 12.1 Process of issuing accounting standards in Spain

The evolution of public accounting in Spain has been marked by the evolution of business accounting standards, in spite of some criticism in the literature (Arnaboldi and Lapsley, 2009). All the general accounting principles (GAPs) approved until now have been in accordance with business GAP.

In the business sector, the European Union strategy of applying the International Accounting Standards, the International Financial Reporting Standards (IAS and IFRS) and in particular, Regulation 2002/1606/EC of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, has had an important impact in the accounting field. This sparked off a debate about the advisability of adapting Spanish law to the IAS/IFRS with the aim of avoiding accounting heterogeneity between individual accounts and consolidated accounts. After a considerable period of discussion and reflection, the issue concluded with the adoption of GAP and a special plan for small and medium-sized enterprises in 2007, both based on IAS/IFRS.

As a consequence, the organization responsible for public accounting began a process of reforming the public sector general accounting plan and, in April 2010, a new GAP for the public sector adapted to the IPSAS was approved in Spain.

12.2.1 General accounting plan for the public sector

The GAP is a framework for all public sector entities (except public sector business entities) and adaptations for different levels of government are developed. Reforms in the governmental accounting system have always been introduced first at national level and then extended to other administration levels.

The 2010 GAP is structured in five parts:

I. Conceptual framework
II. Recognition and measurement standards
III. Annual accounts
IV. Chart of accounts
V. Definitions and accounting entries

12.2.2 Conceptual framework

The conceptual framework follows the concepts established in the business GAP, which is based on that of the International Accounting Standard Board (IASB), as well as the preface to the International Public Sector Accounting Standards (IPSAS) and the definitions of IPSAS 1. When the GAP was passed, the International Public Sector Accounting Standards Board (IPSASB) had not elaborated the conceptual framework.

The conceptual framework has six sections: true and fair view in financial statements, qualitative characteristics, accounting principles, elements of financial statements, recognition of the elements of financial statements and measurement of those elements.

The chart describes the objectives of the accounting information as being to provide useful information for government decision-making and for accountability purposes. In order to achieve these objectives, the financial statements should show the financial situation, the economic results and the budgetary execution of the reporting entity. In this way, the importance of the budget is maintained in Spanish public entities and mechanisms are established to allow the coexistence of the budgetary (modified cash) and accrual criteria.

The characteristics of the accounting reporting are: understandability, relevance, reliability and comparability.

In accordance with the duality of the system, the accounting principles are classified as accrual and budgetary principles.

The accounting principles for financial accounting are: going concern, accrual basis, consistency over time, prudence, no compensation and materiality. The principles for the budgetary area are budgetary recognition and lack of specific connection between concrete budgetary items of resources and expenses. The budgetary recognition states that revenues and expenditures should be recognized in the budget when the obligations and receivables occur.

12.2.3 Measurement and recognition of assets, liabilities, equity, revenues and expenses

Measurement and recognition of assets

Assets are defined as goods, rights and other resources controlled by the entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

This implies that, within the concept of asset, two general types can be differentiated:

– *Assets that generate future economic returns*, which are owned in order to use them for the provision of goods or services. There are no differences between these and assets in the business sector.
– *Assets that generate service potential*, which are those that have a purpose other than to generate a commercial return, such as social economic flows

generated by these assets that benefit the community, that is, their social benefits or service potential.

The main implication of the definition of the concept of asset is that it can include infrastructure and property assets for general use, which were not considered as assets in previous accounting plans (Benito et al., 2007).

With reference to *valuation criteria*, the main innovation introduced by the GAP of 2010 is *fair value*, which is used to measure certain assets and liabilities. In line with IPSAS 17, the plan allows the use of the revaluation model for valuing assets, subsequent to acquisitions, whose fair value can be measured reliably. The plan also includes IPSAS 16, "investment property", not previously regulated in the public sector.

For intangible assets, the regulation is similar to that of IPSAS 31 but with some differences for research expenditures, which can be recognized as assets if certain characteristics are present.

With respect to financial assets, the GAP is based on accounting standards for Spanish business entities (taking as its reference IAS 32, 39 and IFRS 7) and on IPSAS 28, IPSAS 29 and IPSAS 30.

Recognition and measurement of liabilities

Liabilities are defined as present obligations of the entity arising from past events and include provisions. A liability shall be recognized in the balance sheet when it is probable that an outflow or transfer of resources embodying future economic benefits or service potential will result from the settlement of the obligation, and provided that the value can be measured reliably.

For measurement purposes, financial liabilities shall be classified into one of the following categories:

1. Financial liabilities measured at amortized cost. This applies to the main type of liabilities: operating payables, debts and loans.
2. Financial liabilities at fair value through profit or loss.

Recognition and measurement of revenues

Revenues are defined as increases in the entity's equity during the reporting period in the form of inflows or enhancements of assets or decreases in liabilities, other than those relating to monetary or non-monetary contributions from equity holders or owners. In accordance with this, revenue shall be recognized when there is an increase in the entity's resources that can be reliably measured.

The GAP details the problem of recognition of revenues from non-exchange transactions (taxes and transfers) and is, in general, in line with IPSAS 23.

Recognition and measurement of expenses

Expenses are defined as decreases in equity during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities, other than those relating to monetary or non-monetary distributions to equity holders or owners.

Expenses shall be recognized when there is a decrease in the entity's resources or service potential that can be measured reliably. Recognition of an expense therefore occurs simultaneously with the recognition or increase of a liability or the decrease of an asset.

12.2.4 Financial statements

The 2010 GAP defines the different documents and models of financial statements contained in the annual accounts of public entities, which are the following:

- The *balance sheet statement*, or statement of financial position, which discloses the assets and liabilities of the entity, and also shows the equity or net assets as the difference between them. Assets are presented according to their liquidity, the least liquid being shown first. Liabilities are also ranked from long- to short-term liabilities.
- The *operating statement* or statement of financial performance, used to report the economic result of the entity and its structure is very close to the profit and loss account for business entities. Revenues and expenses of the year are reported on an accrual basis in this statement.
- The *statement of changes in net assets or equity*, introduced into the 2010 Accounting Plan, incorporating both the business accounting standards and the IPSAS 1 requirement to elaborate this statement. It has three parts:
  1. Statement of recognized income and expense, which reflects changes in equity due to results for the period and income and expenses recognized directly in the entity's equity.
  2. Statement of operations with holder or owner entity, which also includes the revenues and expenses recognized during the period.
  3. Statement of total changes in equity, which reflects all changes in equity.
- The *statement of cash flow* discloses the origin and use of monetary assets representing cash and cash equivalents. In its regulation, both the business accounting plan and IPSAS 2 have been considered. The statement shows cash flows classified into four types:
  a) *cash flows from operating activities*, shown using the direct method;
  b) *cash flows from investing activities;*
  c) cash flows from financing activities;
  d) cash flows that are pending classification, which include payments and proceeds whose origin is not known when the statement is elaborated.
- The *budget execution statement* contains four statements:
  1) *The expenditure budget execution* statement illustrates how the expenditures budget has been executed.
  2) *The revenues budget execution* statement shows the amount of revenues recognized and collected during the fiscal year.

3) *The budgetary result of commercial activities*, elaborated only by entities that carry out commercial or industrial activities.
4) *The statement of budgetary result* shows whether the revenues recognized during the fiscal year have been enough to finance all the expenditures. It is perhaps the most important statement of the four execution statements.

– The *notes to financial statements* disclose additional information and statements to complete the information provided in the balance sheet, the operating statement, the statement of changes in net assets, the cash flow statement and the budget execution statement.

12.2.5 Links between the budget and financial accounting

One of the most important objectives of the accounting system to date has been to allow the control of budget execution and there is a connection between the budgetary and accounting systems. Traditionally, the accounting system allows the registration of budget execution and financial recording at the same time, connecting both subsystems.

The GAP provides two completely integrated recording systems: financial accountancy and budgetary accountancy. The first applies a full accrual-based system while the second applies a modified cash based system. Even if budgeting and financial accounting use different measurement focuses and bases of accounting, the two processes are closely linked. Information technologies with sophisticated software allow the integration of the two subsystems.

The system produces two types of reports: financial accounting reports (balance sheet, operative statement, cash flow statement and statement of changes in equity) and budgetary statements (statement of execution of the budget). However, there is no reconciliation between accounting and budgeting reporting in the financial report. Furthermore, entities need to produce some information in accordance with European System of National and Regional Accounts, ESA 95, that is obtained from the budget reporting, with some adjustments, because the criteria between national accounting and budgeting are different.

12.2.6 Accounting standards for consolidated statements

In July 2013, an accounting standard for the elaboration of consolidated statements in the public sector was passed, based on IPSAS 6, 7 and 8. The standard focuses on the concept of control for defining the group contained in the financial statements, and includes some particularities of public sector consolidation.

Control is defined as the power to manage financial and operating policies of another entity in order to obtain economic benefits or service potential. Control is presumed to exist when at least one of the conditions of power and one of the conditions of equity are fulfilled, unless there is clear evidence of control being held by another entity.

- *Power conditions*:
  - The entity has, directly or indirectly through controlled entities, more than 50 per cent of the voting rights of the other entity.
  - The entity has the power, either through legislation or formal agreements, to appoint or remove a majority of the members of the board or governing body.
  - The entity has, either through legislation or formal agreements, a majority of the voting rights on the board of another entity.
  - The entity has the power, either through legislation or formal agreements, to cast a majority of the votes in meetings of the board of directors or governing body and control is exercised by that board or body.
  - The entity has appointed the majority of the members of the governing body when consolidated accounts must be formulated and for two years before.
- *Equity conditions*:
  - The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or bear significant obligations.
  - The entity has the power to take assets out from the other entity, and/or may be liable for certain obligations of the other entity.

12.3 Central government

Central government is composed of the following entities:

a) Central government administration.
b) Autonomous entities dependent on central government or state administration.
c) Public business entities dependent on central government or state administration.
d) National health service and dependent entities.
e) State business and corporations (entities where the state has a shareholding of more than 50 per cent).
f) State foundations (those that have been created with state contributions).
g) Other agencies and public entities with special characteristics.

Public sector accounting standards are applicable only to entities that carry out their activity within the public sector framework, that is, financed by public revenues and providing services with non-exchange revenues. Business entities included in the public sector must apply the GAP for the business sector, while public foundations must apply the adaptation for foundations, which is based on the business GAP.

12.3.1 Budgeting

The Ministry of Finance is responsible for preparing the national budget to be approved by government and sent to Parliament before 30 October.

Central government or state budget includes four sets of budgets:

- Budget of the administrative sector of central government, which includes: central administration, autonomous entities that depend on the central administration, the national health service and agencies and other entities in the administrative sector
- Budget of state corporations
- Budget of state foundations
- Budget for special entities.

The measurement focus used in the budget is modified cash basis of accounting or current financial resources focus, given that budgetary revenues and expenditures are recognized when cash is collected or paid, or when related receivables and payables have a short term to maturity. This means that no depreciation appears in the budget.

Spanish budgetary legislation classifies expenditure into three different types: economic, programme and organizational. The budget of revenues is only presented following the economic and organizational classifications.

The economic classification discloses the expenditures and revenues according to their nature. For expenditure the economic classification differentiates between operating, capital and financial expenditures. The revenue budget economic classification is structured in nine chapters, and differentiates current revenues, capital revenues and financial transactions.

Investments are included as expenditure in capital expenditures and the sale of investments in capital revenues.

In a similar way, operations of debt are registered in financial revenues and repayment of debt in the expenditure budget as financial expenditures. New operations of long-term debt are only possible to finance investments.

The execution process

The execution of the expenditures has different phases:

1. The *appropriation phase*. Appropriations represent the legal authorization to spend, and are further subdivided through an allocation process that fixes maximum amounts by expenditure nature, programme or function.
2. The *commitment phase*, when encumbrances are made. In this phase, purchase orders or contracts are placed against appropriations, but goods or services have not yet been received.
3. *Registration of obligation phase*, when goods and services provided have been received, so a liability and an asset or expenditure appear. Therefore,

this budgetary phase is recorded in the financial accounting system and in the budget.
4. *Payment order phase*.

With respect to the revenues budget, the execution process has a unique phase: the recognition of revenues. As budgetary revenues recognized always imply a change in assets or liabilities, this execution phase is also recorded in financial accounting.

The information about the execution of the budget and the comparison with forecasted amounts are registered in the budget execution statement.

12.3.2 Accounting

Central government is made up of different types of entities and each of them has to apply different accounting standards:

a) Administrative sector of the central government, which applies the adaptation of the GAP to the general administration of the state. As a consequence, the accounting standards applicable to this part of central government are those contained in the GAP, so we recommend the reader to return to Section 12.2 of this chapter.
b) Not for profit entities of central government, which apply the adaptation for not for profit entities, based on the Business Accounting Plan.
c) Business entities, which apply the same accounting plan as private business.
d) National health service, which applies a particular adaptation of the public sector GAP for the national health service.

12.3.3 Financial statements

The financial statements elaborated by central government are those included in the GAP: balance sheet, operating statement, net assets equity, cash flow statement, statement of execution of the budget and notes to the financial statements.

Consolidated statements are required for central government after 2014, following the accounting standards for consolidated statements in the public sector.

At present, aggregated financial statements are elaborated for each sector and the central government financial report contains three independently elaborated documents:

a) Financial report for the general government or administrative public sector that includes a consolidation of all the administrative sector.
b) Financial report for governmental corporations, which are entities that apply business accounting.
c) Financial report for public not for profit organizations.

12.3.4 Auditing

There are two types of audit for Spanish central government: internal and external. The internal audit is carried out by the IGAE (or bodies depending on it), which is also responsible for preparing financial statements and issuing accounting standards for the public sector. As a consequence, in the Spanish system the functions of elaborating financial reporting and controlling are both carried out by a single body.

In 1998, the IGAE passed the auditing standards, used for the internal audit, and they are still valid. Since then, the IGAE has passed some standards on the elaboration of the audit report. In the preparation of these standards, the International Standards of Supreme Audit Institutions, INTOSAI, have been taken as a reference, but they are not directly applicable to the Spanish audit function.

The external audit is carried out by the Court of Auditors (*Tribunal de Cuentas*), and its jurisdiction covers all entities in the Spanish public sector, specially focused on central government. As there are insufficient resources to audit all the entities, a sample procedure is applied, which implies that some of the public sector entities are not necessarily audited every year by an external institution. Furthermore, public sector corporations and foundations that surpass the size limits of the Spanish Law of Audit undergo private audit.

The external audit of the Court of Auditors is mainly a legal and financial audit, while performance audit is not very usual in Spain.

With respect to auditing standards, there have been no initiatives on the direct application of the international auditing standards of IFAC or of INTOSAI.

12.4 Regional government

The decentralized political and administrative structure of Spain is based on 17 autonomous communities plus two autonomous cities (Ceuta and Melilla). Each autonomous region has a similar structure: a general administration, decentralized entities (autonomous organisms, regional foundations and regional business entities) and universities.

Regional governments have the right to autonomy (although not to independence), which implies that they have a legislative power. This autonomy and legislative power includes accounting, budgeting and auditing. Every regional government has its own autonomy statute that has been approved by a national organic law, and constitutes the basic norm of the region. There is, however, a Common Financial Law for regional governments.

12.4.1 Budgeting

Each of the regions has the power to pass its own budgetary regulation through a public finance act that states how to elaborate the annual budgets that are voted on in the regional parliaments. However, the Common Financial Law for regional governments states that the budget must be annual and must include all the expenditures and revenues of the decentralized entities. It also states that budgets for regions must be elaborated with homogeneous criteria, so that they can be consolidated with the budget of the central government.

As a consequence, the regional governments have taken the General Budgetary Law of 2003 as a reference for the elaboration of budgetary laws. Consequently, we can say that the phases for the elaboration and execution of the budget are the same as those for central government.

12.4.2 Accounting

The autonomous communities are free to determine which accounting regime to apply, there being no legal obligation to apply the GAP. Nevertheless, in most of the laws that regulate their economic-financial regime, there is an express reference to a regional chart of accounts coordinated with the GAP. Thus, most of the autonomous communities have tended to adopt accounting systems with similar characteristics to that of central government.

The autonomous regions adapt their standards to the general framework of 2010 GAP. However, only some of the regions have adapted their accounting standards to the 2010 Plan (based on IPSAS), and many of them continue with the adaptation to the previous GAP (1994).

As a consequence, at present all regional governments apply accrual accounting for the financial statements and modified cash accounting for the budget, but there are some heterogeneities in the accounting standards they use.

12.4.3 Financial statements

As there is some diversity in the accounting standards applied by regional governments, not all of them elaborate the same financial statements. The common financial statements are: balance sheet, operating statement, cash flow statement and budget execution statement. Those governments that have adapted their accounting standards to the new GAP also elaborate the statement of changes in net assets.

There are also differences in the availability of financial statements when regional finance law does not require the publication of the financial statements of regional governments. So, sometimes is difficult to access information on regional governments.

12.4.4 Auditing

There is also autonomy for the control of regional public sector activity, but in all regions there are internal and external controls. As in the central government, the internal control is carried out by regional intervention, with two perspectives: *ex-ante* and *ex-post* control. Regional intervention is also responsible for elaborating the financial statements and proposing to parliament the accounting standards applicable to regional government.

This autonomy is also valid for external control although all the regions are under the control of the national supreme audit institution. Most regions have created a regional audit institution that carries out the external control of the regional public sector, without undermining the work of the court of auditors. The control includes control of legality and financial control and only in occasional cases of economy, efficiency and efficacy control.

12.5 Local government

The third level of decentralized government is the local public sector, which comprises: municipalities, provinces, counties and the decentralized entities of all the above (autonomous organisms, business entities and not for profit entities). For local government, there is a single legal framework established by central government that, at the moment, is defined in Law 7/1985, regulating the basis of the local regimen and Law 39/1988, regulating local finances. These laws contain the framework for the development of accounting and budgetary criteria.

12.5.1 Budgeting

Local administrations elaborate an annual budget that integrates three different entities: the budget of the main entity (i.e. municipality and province), the budget of the autonomous organism and a prevision of expenditures and revenues of business entities that are owned by the main entity.

In the structure of the budget, expenditures are in three different classifications: programmes, economic and organizational. The economic and programme classifications are compulsory by law. For revenues, only organizational and economic classifications are adopted. For entities with fewer than 5,000 inhabitants, the level of disclosure is lower than for bigger entities.

The execution process for revenues and expenditures is the same as at national government level and is on a modified cash basis.

12.5.2 Accounting

The Ministry of Finance and Public Administration is responsible for approving the accounting standards applicable to local governments that are prepared by the IGAE. Financial accounting on an accrual basis was implemented in 1992 and since then, local government has always followed similar principles to central government.

In October 2013, a new adaptation of the 2010 GAP for local governments was approved, but it is not applicable until 2015. So, in 2015, the Spanish local sector will apply accounting standards adapted to the IPSAS.

As in central government, there is a link between the financial accounting system, based on the accrual principle, and the budgetary system, based on modified cash accounting.

There are three types of accounting models for local government, depending on the size of the entity:

– Basic model, which allows the use of the cash accounting system for entities with a revenue budget lower than 300,000 euros. In this model reporting is exclusively budgetary.
– Simplified model, which can be applied to entities that have a budget of less than 3 million euros and, in the case of municipalities, they must also have fewer than 5,000 inhabitants. Financial accounting uses the accrual basis and there are some simplifications for the presentation of financial statements.
– Normal model, which must be applied to entities that exceed the limits for the simplified model. It is based on the accrual principle for financial accounting and on a cash basis for the budget.

12.5.3 Financial statements

Local entities must elaborate an annual report that includes annual reports for the main entity and for all dependent entities.

The financial statements elaborated by local government are different depending on the accounting model used:

– Basic model, entities elaborate only budgetary reporting; they do not need to elaborate a balance sheet or an operating statement.
– Simplified model, with the financial statements: a balance sheet, an operating statement, a statement of changes in net assets, a statement of budgetary execution and notes to the financial statements. There is a simplified model for the presentation of the statements.
– Normal model, with the financial statements: a balance sheet, an operating statement, a statement of changes in net assets, a cash flow statement, a statement of budgetary execution and notes to the financial statements. The structure for the presentation of the financial statements is very similar to that of the GAP.

The annual accounts of business entities are elaborated according to the accounting plan for the business sector. For the moment, the individual annual accounts are included in the annual report of the entity but consolidation is not compulsory.

However, in 2017, local administrations will have to apply the standards for consolidated statements in the public sector and when control exists, consolidated statements should be elaborated.

12.5.4 Auditing

As in other levels of government, there is a differentiation between internal and external control. Internal control covers not only the main entity but also the autonomous and business entities dependent on it, that is, the decentralized entities. It has a triple perspective: intervention, financial control and efficacy control.

Internal control is the responsibility of officials or controllers who, at the same time, are responsible for the elaboration of the financial statements.

The external control is carried out by the national supreme audit institution and the regional audit institutions. The latter have competencies over all the public sector entities of the region, including local government, and should coordinate their activity with the national institution (Court of Auditors).

Neither internal nor external control applies the international auditing standards of IFAC or INTOSAI.

12.6 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

At present, accounting standards in Spain are based on IPSAS, so there are no important differences from international standards. The EU's strategy of adopting International Financial Reporting Standards (IFRS) has been an important driving force in increasing the credibility of parallel systems such as IPSAS (Brusca et al., 2013). The accounting reform has been based on legislative changes with a new GAP issued by the standard-setters that makes accounting standards compulsory and contains formats for financial statements. Progress from initial rationalization to final adoption was rapid, aided by a code-law system of governance that concentrates decision-making powers on accounting standard setting and reduces the national debate about accounting standards.

Central government has applied this new legislation since 2011 and no major problems have been found with it. Local government must apply the new standards as of 2015. In regional governments, there are some differences but the forecast is that in coming years most of them will change their accounting standards to adapt them to the new GAP.

As a consequence, it appears that the application of EPSAS in Spain will not be a difficult task. First, because actual standards are based on IPSAS, so few new adaptations or modifications will probably be necessary. Second, because the administrative law model dominates the public sector and central government is the key accounting regulator, if the European Union sets compulsory standards, the central government will be responsible for including them in Spanish regulation and no opposition is expected.

12.7 Main challenges: problems identified

A deep reform of Spanish governmental accounting has been carried out, which started in 2010 and is still in the process. The consolidation of the reform is the main challenge, with the following aspects worth highlighting for future interest:

- The generalization of the IPSAS-based model to the whole public sector, including autonomous regions and local authorities, is an important challenge for the coming years. Particularly given that regional governments have their own competences in this area and that some entities have adopted the 2010 Accounting Plan but many of them maintain the old one. The existence of European Accounting Standards could be a solution to eliminating internal differences.
- Local governments must adopt the new accounting system adapted to IPSAS in 2015, which is a new challenge. At the same time, there is a process of reform that intends to modernize local government.
- The elaboration of consolidated statements is another challenge for public sector accounting in Spain. Central government had to prepare them for 2014 and local government in 2017. Consolidated accounting standards are also in line with IPSAS.
- The last aspect that needs to be improved is performance reporting because, in spite of the mandatory requirements of the GAP for including performance indicators in the notes to the financial statements, entities are encountering difficulties in preparing the information, considering that most of them do not have cost accounting systems.

There are also some problems that will need to be solved in the near future:

- The use of accrual reporting is still undervalued because the political debate is focused on the budget (Brusca and Montesinos, 2013).
- It is early days in the implementation of management accounting and major efforts are necessary in this respect.

References

M. Arnaboldi and I. Lapsley (2009), "On the Implementation of Accrual Accounting: A Study of Conflict and Ambiguity", *European Accounting Review*, 18 (4), 809–836.

I. Brusca and V. Montesinos (2013), "From Rhetoric to Practice: The Case of Spanish Local Government Reforms", *Financial Accountability and Management*, 29 (4), 354–377.

I. Brusca, V. Montesinos and D. Chow (2013), "Legitimating the International Public Sector Accounting Standards: The Case of Spain", *Public Money and Management*, 33 (6), 437–444.

V. Pina, L. Torres and A. Yetano (2009), "Accrual Accounting in the EU Local Governments: One Method, Several Approaches", *European Accounting Review*, 18 (4), 765–807.

Useful sites

http://www.oficinavirtual.pap.meh.es
http://www.igae.pap.minhap.gob.es
http://www.minhap.gob.es

Legislature

Ley 47/2003, de 26 de noviembre, General Presupuestaria.
Ley Orgánica 2/2012, de 27 de abril, de Estabilidad Presupuestaria y Sostenibilidad Financiera.
Orden EHA/1037/2010, de 13 de abril, por la que se aprueba el Plan General de Contabilidad Pública.
ORDEN HAP1489/2013, de 18 de julio, por la que se aprueban las normas para la formulación de cuentas anuales consolidadas en el ámbito del sector público.
Orden HAP/1781/2013, de 20 de septiembre, por la que se aprueba la Instrucción del modelo normal de contabilidad local.

13
Public Sector Accounting and Auditing in Sweden

Torbjörn Tagesson and Giuseppe Grossi

13.1 Introduction

Swedish public administration is organized on two levels: national and local. However, the local government sector is divided into two administrative systems: county councils (21) and municipalities (289). Gotland is a hybrid of a county council and a municipality, with responsibilities covering the duties of both. National and local government levels have different regulations and legislation regarding budgeting, accounting and auditing.

The Swedish administrative model diverges in a number of ways from models prevalent in the rest of Europe.

At national level, the Swedish people are represented by the *Riksdag* (Swedish parliament) which has legislative powers. Proposals for new laws are presented by the government which also implements decisions taken by the *Riksdag*. The government is assisted in its work by government offices, comprising a number of ministries and 300 agencies. The Swedish ministries are small and much of the implementation of government policies is carried out by relatively independent agencies (ESV, 2003; Swedish Government Offices, 2014). Government agencies are an important tool in the governing of the country. The government controls these agencies and their activities primarily to achieve political objectives (Küchen and Nordman, 2007).

The local governments are, by law and tradition, relatively autonomous and have extensive powers of self-determination (Argento et al., 2010). Historically, this has also meant that accounting, auditing and budgeting in the local government sector have developed through voluntary and praxis-driven development, rather than through legislation (e.g. Falkman and Tagesson, 2008). From 1997 the Swedish parliament decided to regulate municipal accounting through legislation (ibid.). Citizens can appeal municipal decisions to the Administrative Court, but there is no connection between the Municipal Accounting Act and the Penal Code. Thus, the degree of formal accountability is generally low in Sweden (Knutsson et al., 2008) and the introduction of accrual accounting in the 1980s occurred through soft regulation and an interaction between the norm system and the action (practice) system (Bergevärn et al., 1995).

13.2 Public sector accounting standards in Sweden

In Sweden there are a number of standard-setting bodies. Accounting standards for corporations are issued by a governmental body, the Swedish Accounting Standards Board (SASB). SASB standards are based on International Financial Reporting Standards (IFRS) for small and medium enterprises (SME), but adjusted and adapted to Swedish institutional and legal conditions. The Swedish National Financial Management Authority (SNFMA) is a central agency under the Ministry of Finance with responsibilities that include the development of generally accepted accounting principles in central government. The standard-setting body for local government accounting is the Swedish Council for Municipal Accounting (SCMA). SMCA is run as a nonprofit organization by the Swedish central government and Swedish Association of Local Authorities. Representatives from the SASB and the SNFMA are included in SCMA's board and planning body along with representatives from municipalities, county councils, the auditing profession and academia.

Consequently, there is some element of coordination between the various standard-setting bodies; from SCMA's point of view, they are trying to avoid differences in relation to SASB that are not institutionally or legally justified, in order to facilitate consolidated reporting. The national and local government sectors have different regulation and standard-setting bodies.

13.3 Central government

During the 1980s, Swedish budget and accounting systems underwent significant reforms with a focus on flexibility and performance linked to an increase in accountability for financial and operating results, and the annual reports are a very important tool (Mattisson et al., 2003).

13.3.1 Budgeting

The Swedish Budget Act contains financial and non-financial information (Sterk, 2007). The act has been organized into 27 expenditure areas, for which parliament, in a first stage, defines an expenditure ceiling within the total expenditure limit. In a second stage, parliament votes on the appropriations to individual agencies. Annual appropriation directions establish both an economic framework for each agency and the aims and focus of their activities (Swedish Government Offices, 2014).

The performance budgeting project (the, so-called, VESTA) has also introduced a non-financial activity structure into the act. According to the Budget Act, the basis of all performance management is that it must be adapted to specific activities. This means choosing and combining those means of control that, overall, are best suited to the management of a specific agency and its activities (Küchen and Nordman, 2008). This is used to allocate resources in accordance with political priorities and thus to relate to the planning and budgeting process. It consists of policy areas and programmes for which objectives, outcome budgets and costs are defined (Sterk, 2007). Currently the budget is divided into 18 policy areas (e.g. defence, education and research; EU; foreign policy; legislation and justice; national economy and budget).

Most of the policy areas are subdivided into activity areas. At this level too, goals are normally set, as determined by the government.

13.3.2 Accounting

Accrual accounting was implemented in Swedish central government in 1993. It was one of many management reforms that started in the late 1980s and were fully implemented in the 1990s (ESV, 2001). The introduction of accrual accounting in central government was part of a wider reform agenda, and the most important official argument put forward in connection with the reform was that accrual accounting was needed to support the performance management system that was introduced in the late 1980s (Mattisson et al., 2003; Paulsson, 2006).

The Swedish central government introduced accrual accounting by taking one step at a time. The first step was taken at agency level. The agencies implemented accrual accounting either in 1991, 1992 or 1993. The second step was taken when consolidated accounts were presented on an accrual basis. The first accounts were produced for the financial year 1993/1994.

Accounting regulations in central government follow the laws and standards in the private sector very closely, with due consideration given to the special characteristics of the public sector (ESV, 2001). The central government accounting rules found in the Ordinance on Annual Report and Budget Documentation (FÅB) and the Bookkeeping Ordinance (FBF) are mainly based on accounting rules for the private sector (ESV, 2013). As private sector accounting principles in Sweden are, to a great extent, similar to the IFRS, government accounting standards in Sweden are consequently quite close to the IFRS (ESV, 2001).

The Ordinance on Annual Report and Budget Documentation (SFS, 2000: 605) stipulated the reporting documents that each agency must draw up and submit to the government (an annual report, an interim report and budgetary documentation). A large part of the ordinance is focused on valuation rules of different assets (i.e. fixed and current assets, work-in-progress, stock values and foreign currencies). The Bookkeeping Ordinance (SFS, 2000: 605) includes principles concerning the definition of generally accepted accounting principles (GAAP), current recording of transactions, accounting vouchers, the closing of the books, and reporting requirements for consolidation purposes (ESV, 2001).

13.3.3 Financial reporting

The central government accounts are compiled once a year on an accrual basis and fully consolidated, with internal transactions eliminated. According to the new Budget Act (Budgetlag, 2011: 203) the annual report of the State must include: (a) a follow-up of the parliamentary decision on general government net lending (plus surplus target), expenditure ceiling and other broad budget targets; (b) the outcome of budget income headings and appropriations and the government's borrowing requirement; (c) an account of how the government has used the authorizations it has received pursuant to the legislation; (d) a statement of financial performance, a statement of financial position, a statement of cash and notes; (e) a report on the development of the central government debt; (f) information on expected losses and significant risks associated with central government lending and guarantees; (g) presentation of the measures taken by the government in response to the observations made by the National Audit; (h) a statement of financial performance and a statement of financial position for EU funds and a cash-based account for appropriations and incomes heading concerning payments to and from the EU; (i) a statement from the government concerning whether the previous accounts (as in h) have been drawn up in accordance with the generally accepted accounting principles (GAAP) and give a true and fair view and whether rules and systems exist that create satisfactory internal governance and control of EU funds; and finally (j), the government should explain significant differences between the budget and reported outcome.

The consolidated statements are based on the agencies' annual accounts that, according to the Ordinance on Annual Report and Budget Documentation (2011: 231), consist of the following reports and statements: (a) statement of financial position; (b) statement of financial performance; (c) cash flow statement; (d) an appropriation report and (e) a performance report.

In the central government financial statement and at agency level wholly or partially owned companies are consolidated according to the equity method (ESV, 2013).

13.3.4 Auditing

The Swedish National Audit Office (SNAO) is an independent organization reporting to the *Riksdag*. The establishment of the SNAO in July 2003 was the result of a merger between two predecessors: *Riksrevisionsverket* and the Parliamentary Auditors (Grönlund et al., 2011). The SNAO controls what state money goes to and how effectively it is used by the government and independent organizations. They also make recommendations for improvements when finding gaps in the audit. The work contributes to a more transparent democracy and strengthens both the use of resources and the management of the state. Parliament, by passing laws, decides the direction of the audit and the amount of audit that SNAO should do. It is also parliament that elects the management of the SNAO, which consists of three auditors.

The SNAO performs both financial and performance audits. The financial audit is performed annually and is quite similar to an audit in the private sector. In this case, the auditors control whether the organization's annual reports are reliable and correct. They also control whether the accounts are true and give a fair view and they confirm that organizations are following current rules and observing decisions. Each year, the SNAO examines about 250 annual reports. For example, they audit the state, the government and organizations under the government. When it is mandatory for organizations to provide interim reports the SNAO also examines them.

In a performance audit, the SNAO mainly focuses on efficiency. It looks at how well organizations are achieving their goals. It also makes sure that organizations work to give the state good results with regard to the interests of the general public. The performance audit examines the government's operation, management, monitoring and reporting to the *Riksdag*. The SNAO also audits organizations' operations and their reporting to the *Riksdag*.

According to Grönlund et al. (2011), SNAO combines different types of extended value for money audits with compliance audits. On the one hand, it audits how the government and/or central agencies fulfil their mandates (from good to bad). On the other hand, they audit how the government and/or central agencies adhere to legislation, rules and policies (right or wrong).

13.4 Local government

As mentioned in Section 13.1, the Swedish local government sector is divided into two different administrative systems: county councils and municipalities. The county councils' main responsibility is health care, but they also deal with other matters, such as regional transportation, culture, and so on. The county councils consume approximately 7 per cent of GNP. The municipalities are responsible for a wide variety of activities including nursery, primary school, secondary school, elderly care, waste management, water and sewage. The municipalities consume approximately 13 per cent of GNP. Even though the geographical boundaries and duties differ between the two administrative systems, the same administrative legislation is applicable to both systems. The two most important acts in this respect are the Municipal Act which, among other things, regulates budgeting and auditing, and the Municipal Accounting Act, which is a combination of bookkeeping and accounting legislation for the local government sector. In addition to this administrative legislation, many local government duties are regulated by special legislation. Local governments, however, have the prerogative to decide how the duties should be executed and funded. Both municipalities and county councils have the right to levy their own taxes. Differences in taxable capacity and demographic conditions are levelled out by an equalization system where funds are reallocated between local governments with different conditions (e.g. Tagesson et al., 2013). However, both in terms of execution and financing local governments are relatively autonomous from central government (see Mattisson et al., 2003; Argento et al., 2010). Neither county councils nor municipalities have any legislative power.

13.4.1 Budgeting

According to the Municipal Act, the executive committee of the municipality or county council must present a draft budget for the next calendar year before the end of October. The budget should then be adopted by the assembly before the end of November. The budget drafted by the executive committee is to be made available to the general public from the announcement of the assembly meeting at which the budget is to be adopted.

The budget must contain a plan for activities and economic management during the fiscal year and indicate the rate of taxation and funding allocations. The plan must also show how expenditure is to be financed and what the economic status is expected to be at the end of the fiscal year. According to legislation, budgeted income must exceed expenditure unless an exceptionally strong financial position is invoked by the assembly (the local government must then have a positive equity ratio, including all pension obligations). If expenditure for a particular financial year exceeds income, and no exception has been made with reference to a strong financial position, the deficit must be adjusted and the net equity as entered in the balance sheet must be restored during the three succeeding years. A decision concerning such an adjustment must be made in the budget no later than the third year after the year in which the deficit occurred. In exceptional cases, the assembly may resolve that no such adjustment shall be made. Such a decision by the assembly cannot be appealed. The monitoring and follow-up of the budget is based on the financial accounting, after specific adjustments for countercyclical measures and capital gains and losses. A special report on the outcome of income and expenditure, including the adjustments, should be presented in the income statement.

13.4.2 Accounting

All municipalities and county councils have to apply the same legislation and accounting standards. Thus, *de jure*, local government accounting is harmonized. As a consequence, all municipalities and county councils apply accrual accounting to financial statements and budgets.

Municipal accounting act

Accounting and bookkeeping for local governments are regulated by the Municipal Accounting Act, which is a framework legislation.

In addition to the fact that the legislation stipulates the content of the annual reports, it also states that the accounts, with few exceptions, must be made on an accruals basis. Exceptions to accrual basis apply to (i) pension obligations attributable to pre-1998, which are reported on a cash basis and (ii) grants to central government for specific infrastructure investments, which can be paid for gradually (up to a maximum of a 25-year period).

Other important issues regulated by the law are:

- Historical cost accounting and the lowest value principle should be applied.
- Revaluation that increases the value of tangible and intangible assets is not permitted.
- The management report must, *inter alia*, include an explanation of how the outcome relates to the budget and include an overall account of investments.

A key paragraph in the introductory chapter of the act deals with generally accepted accounting principles. The paragraph states that accounting and reporting are to be performed in a manner consistent with GAAP. If a municipality or county council deviates from an accounting standard issued by SCMA, the reasons for the deviation are disclosed in the notes. According to SCMA, deviations can only be accepted in very exceptional cases where it is necessary in order to achieve a true and fair view of the financial result and position. Municipalities and county councils applying the standards issued by SCMA normally meet the requirement for a true and fair view. However, if it is not considered sufficient to apply the standards, it can usually be remedied with additional disclosures. Thus, the SCMA has a key role in the content and design of local government accounting. The Municipal Accounting Act sets the frame and limits of SCMA's work, but within this limit, the conceptual framework provides guidance.

13.4.3 Conceptual framework

The conceptual framework was issued by SCMA in February 2011. The purpose of the framework is not only to provide guidance for SCMA in its work, but also to guide the accountants and those to whom they are accountable in their work. The conceptual framework consists of eight chapters, structured as follows:

Chapter 1 deals with the SCMA's role as standard-setting body for local government accounting in Sweden. In Chapter 2 there is a discussion about the specific conditions that apply to local government accounting in Sweden due to legal and institutional prerequisites. The purpose of financial reporting in local governments in Sweden is established in Chapter 3. The conceptual framework stipulates that the objective of financial reporting in local governments is to provide information that gives a true and fair view of financial results and position and, together with other information, can be the basis for political accountability and an evaluation of how available resources have been used. The conceptual framework also states that the information can be used for future-oriented [management] decision-making by politicians and officials regarding resource allocation and financing. Chapter 4 deals with the users of local government financial statements. Even if the financial statements are important as sources of information for politicians and officials in local government, the conceptual framework stipulates that external stakeholders, such as residents, voters, providers and representatives of central government, should be regarded as the primary users of local government financial reports.

Chapter 5 highlights five qualitative characteristics:

- *Understandability*
  - Even if understandability is important, this characteristic stipulates that one must assume the user is knowledgeable and informed. Important information should not be disregarded simply because it may be difficult to understand.
  - The characteristics of understandability also imply that the financial statements must be supplemented with notes and disclosures clarifying the estimates and judgments that the financial statements are based upon.
- *Comparability* means that the financial statements must be prepared in such a way that comparability between reporting entities, as well as over time for a single unit, is possible. The ability to make comparisons is of particular importance to local governments whose goods and services are not typically priced on a market.
- *Relevance* means that the financial statements should be designed so that the information can be used to monitor and evaluate how the resources have been used and the decisions implemented. Thus, for local governments the financial reporting emphasizes follow-up and accountability rather than forward-looking decision-making. However, timeliness must still be considered. In order to provide relevant information, financial statements may not be presented too long after the accounting period.
- *Reliability* means that financial reports should reflect the activities carried out within the accounting entity in a reliable and neutral way. The information in the financial statements must give an objective view of financial results and position. A fundamental assumption is substance over form.
- *Openness and transparency* means that all major economic events and essential aspects necessary for the evaluation of the entity's results and financial position, should be included and considered in the financial statements.

Chapter 6 states that the accounting should be based on the accrual assumption.

Chapter 7 deals with valuation and measurement methods. The essence of this chapter is that valuation is important in order to achieve a fair allocation and proper matching of revenues and expenses. The valuation of assets is normally based on historical cost accounting. However, fair value should be used in situations when it is available and more conservative and prudent than historical costs. Thus, in local government accounting, the income statement is the primary report, while the balance sheet has a subordinate role.

Chapter 8 completes the conceptual framework by discussing the definition and determination of the accounting entity or reporting unit. The crucial characteristic of a reporting unit is that there are users who need financial information for accountability purposes or decision-making. In line with the arguments in Chapter 4 of the framework, the conclusion is that there are multiple users of local government financial reporting information for whom the primary reporting entity and the requirements for reporting content may vary. Thus, an entity may be some special regulated activity (e.g. water and sewage, waste management), a committee, a municipal association, an individual municipality/county council or the entire consolidated group.

From the central government point of view and the legal requirements of the Municipal Act, the budgeted income must exceed expenditure. The municipality or county council is the primary reporting entity. However, from the citizen's point of view, the overall municipal operations are the decision unit for which the elected and accountable politicians have the political and economic responsibility. The consolidated group will therefore be the primary reporting entity and the joint management report with specific information and consolidated accounts, the most important reports for the interested citizen.

Accounting standards issued by SCMA

SCMA has now published 22 standards, of which 19 are still applicable. Considering the coordination between SASB and SCMA, many of the standards are broadly in line with IFRS (and thus also International Public Sector Accounting Standards Boards (IPSASB)). However, some important differences are worth mentioning:

- Provisions may only be made for legal obligations.
- Impairments may only be made in very specific cases, to the lowest of sales value and value in use.
- Financial current assets should be valued at the lower of historical cost and fair value.
- All consolidated reporting should use the proportional method.

13.4.4 Financial reporting

The content and structure of the financial statements are regulated by the Municipal Accounting Act. The financial statements should include a management report (including a reconciliation of how the outcome relates to the budget and effectiveness in relation to goals), balance sheet, income statement, cash flow statement and notes.

According to the Municipal Accounting Act, the *management report* should include an overall description of the activities carried out by the municipality or county council. Disclosures should also provide information about:

1. Information not shown in the income statement or balance sheet but which is important for the evaluation of financial results and position.
2. Significant events during and after the balance sheet date.
3. Forecast regarding future development.
4. Human resources (including sick leave).
5. Other conditions that are of importance for the control and monitoring of operations.

The management report should also include information about cost per activity (related to budget), effectiveness in relation to goals, a special report on the outcome of expenditure and income related to regulation in the Municipal Act, information on pension obligations and pension plans, and information on group structure and key suppliers.

– The *income statement*, which is the primary accounting report, should include revenues and expenses from operations, depreciation, tax revenues, general grants from central government and net effect of the equalization system followed by financial revenues and expenses. If extraordinary items exist, they should be specified at the end of the report.
– The *balance sheet statement* discloses the assets and liabilities of the entity and also shows the equity. Assets are presented according to their liquidity, the least liquid being shown first. Liabilities are also ranked from long- to short-term liabilities.
– The *statement of cash flows* discloses the origin and use of monetary assets representing cash and cash equivalents. The statement shows cash flows classified into four types: *(a) cash flows from operating activities, shown using the indirect method; (b) cash flows from investing activities; (c) cash flows from financing activities; (d) payment of grants to central government for national infrastructure.*
– The *notes to financial statements* disclose additional information and statements to complete the information provided in the income statement, balance sheet and cash flow statement.

Links between the budget and financial accounting

As stated earlier in this chapter, there is a strong link between the budget and financial accounting. The crucial role of the budget in the political system was pointed out as one of the fundamental conditions and starting points in the preparatory work to the Municipal Accounting Act (see Grossi and Tagesson, 2008). Thus, in Sweden both systems are accrual-based, and one of the important objectives, according to the legislation, is to control and monitor the budget. This is obviously one of the reasons why the income statement is considered the primary accounting report. However, there are additional reasons for focusing on revenues and expenses, as in the income statement. Although local governments have a range of legal responsibilities, citizens have the right to choose other private providers in a number of areas such as elderly care and school. These private providers will receive a compensation based on local government costs. In some situations, a citizen can turn to another local government, such as for care or schooling, but at the expense of the local government where the person resides. Thus, this system means that the focus in the accounting must be on the use of resources rather than on the wealth of the local government. The right to levy taxes also implies that it is probably tax capacity rather than the reported wealth of the local government that determines its solvency. Besides, according to the Swedish constitution, a municipality or county council cannot go bankrupt, for their financial obligations are ultimately guaranteed by the Swedish state.

Accounting standards for consolidated statements

In Sweden, consolidated reporting has been mandatory for local governments since 1992. According to SCMA standard 8.2, proportional consolidation according to the purchase method should be used in all situations. Although the general rule is that all companies where benefit or economic risk is significant should be included in the consolidated accounting, the standard provides some exemptions for smaller companies, companies where there are significant or lasting barriers to exercise influence, and companies that will be divested within a year. A rule of thumb is that if the local government controls 20 per cent of the votes, a company should be included in the consolidated accounts. Thus, it is benefits and economic risk, rather than control, that determine whether or not a company should be included in the consolidated accounts (see Tagesson, 2009; Tagesson and Grossi, 2012).

Whole-of-government accounting, where different administrative systems and levels of government are consolidated, does not exist, and would hardly be possible, given all the transactions that occur between, not only central and local governments, but also between local governments and corporations owned by other local governments. The problem of eliminations would be insurmountable.

13.4.5 Auditing

Audits in local governments are regulated by the Municipal Act. After an election, the new assembly must elect a minimum of five auditors for the next four-year term. The auditors are political appointees and elected from the various political parties. Even though the legislation stipulates that each auditor performs the audit independently, it is a rule rather than an exception that the auditors provide a common audit report. The auditors must inspect all activities carried out within the committee's sphere of activities, including municipal corporations. The auditors are responsible for inspecting whether the activities have been carried out in an appropriate and financially satisfactory way, whether the accounts are true and fair, and whether internal control within the committees is sufficient. In order to ensure professionalism in the audit, the auditors must be assisted by experts (professional auditors) in their inspection. The professional auditors, who are hired directly by the political auditors, must have experience of local government activities. Every year the auditors submit an audit report to the assembly, which then formally decides whether discharge should be given or not. The professional auditors' report must be enclosed with the formal audit report. This system of auditing is strongly criticized and questioned because of the political auditors' lack of independence (Cassel, 2000), the professional auditors' competence (Tagesson and Eriksson, 2011) and the auditors' role regarding accountability and liability (Nyman et al., 2007; Lundin, 2010). Even if the professional auditors' inspection reports are submitted to the council, the professional auditors are still formally agents, working for the politically appointed auditors who are responsible for the audit and the official audit report (Tagesson and Eriksson, 2011).

13.5 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

According to PwC (2014) Sweden is ranked among the most mature countries in terms of IPSAS compliance. However, even if accounting standards for the public sector in Sweden are comparatively close to IPSAS (Christiaens et al., 2010), some fundamental differences remain. These differences are not a coincidence. Both SCMA and SNFMA make systematic comparisons between their own standards and the standards of IPSASB. Thus, the differences that exist are because the Swedish national standard-setters have come to different conclusions from those of the IPSASB. Sweden has a long tradition of a revenue-expense approach based on historical cost accounting, and much of the special legislation regulating pricing and reimbursement systems in the public sector is based on this accounting approach. Thus, the accounting focuses more on measuring costs than valuating assets and liabilities (e.g. PwC, 2014).

13.6 Main challenges: problems identified

Embedded structures and traditions have a tendency to prevent and resist institutional reforms (e.g. Oulasvirta, 2014). Given that Sweden has different standard-setters for national and local government sectors, one may also question why Sweden would suddenly consider a common set of standards as appropriate for the entire public sector. One example is consolidation methods, where central level applies the equity method and local levels apply proportional consolidation. Consequently, consolidation methods in Sweden differ both between central and local levels and from the IPSAS approach to consolidation.

In its response to the public consultation paper from Eurostat regarding the assessment of the suitability of IPSAS for member states (2012), SMCA raises the following obstacles and problems:

- Contextual, legal, and institutional differences make it difficult to use a common set of standards.
- In order to be accepted and implemented, the accounting standards must be better adapted to public sector conditions and information needs.
- A common regulatory framework also needs to have common rules for auditing and monitoring.

SNFMA also observed that if a rule were introduced on valuation of fixed assets at replacement cost, this would affect budgets that are still on a cash basis at central level. Thus this would affect the requirements of appropriations, the expenditure ceiling and cash correction items (ESV, 2013).

Thus, a *de jure* harmonization is not enough. Questions regarding competence, training and monitoring are key issues that have to be considered in conjunction with an implementation of joint accounting standards. SNFMA also points out that the full implementation of IPSAS would imply comparably extensive costs (ESV, 2013).

References

D. Argento, G. Grossi, T. Tagesson and S.O. Collin (2010), "The 'Externalisation' of Local Public Service Delivery: Experience in Italy and Sweden", *International Journal of Public Policy*, 5, 41–56.

L-E. Bergevärn, F. Mellemvik and O. Olson (1995), "Institutionalization of Municipal Accounting: A Comparative Study between Sweden and Norway", *Scandinavian Journal of Management*, 11, 25–41.

F. Cassel (2000), *Behovet av kommunal externrevision* [The Need for External Audit in the Municipal Sector]. Stockholm: SNS.

J. Christiaens, B. Reyniers and C. Rollé (2010), "Impact of IPSAS on Reforming Governmental Financial Information Systems: A Comparative Study", *International Review of Administrative Sciences*, 76 (3), 537–554.

ESV [Swedish National Financial Management Authority] (2001), "Accrual Accounting in Swedish Central Government", ESV 2001:8.

ESV [Swedish National Financial Management Authority] (2003), "Performance Management in the Swedish Central Government", ESV 2003:22.

ESV [Swedish National Financial Management Authority] (2013), "Report to the Swedish Government. Comparison with the International Accounting Standards", ESV 2013:21.

P. Falkman and T. Tagesson (2008), "Accounting does not Necessarily Mean Accrual Accounting: Factors that Counteract Compliance with Accounting Standards in Swedish Municipal Accounting", *Scandinavian Journal of Management*, 24, 271–283.

A. Grönlund, F. Svärdsten and P. Öhman (2011), "Value for Money and the Rule of Law: The (New) Performance Auditing in Sweden", *International Journal of Public Sector Management*, 24 (2), 107–121.

G. Grossi and T. Tagesson (2008), "Consolidated Financial Reports in Local Governments: A Comparative Analysis of IPSASB and SCMA", in S. Jorge (ed.), *Implementing Reforms in Public Sector Accounting: Problems, Changes and Results*. Coimbra: Impress ad Universidad de Coimbra, 337–349.

H. Knutsson, O. Mattisson, U. Ramberg and T. Tagesson (2008), "Do Strategy and Management Matter in Municipal Organisations?" *Financial Accountability and Management*, 24 (3), 295–319.

T. Küchen and P. Nordman (2008), "Performance Budgeting in Sweden", *OECD Journal on Budgeting*, 8 (1), 1–11.

O. Lundin (2010), "Revisionen reviderad: en rapport om en kommunal. Angelägenhet [The Audit Revised: A Report of a Municipal Affair]", Expertgruppen för studier i offentlig ekonomi (ESO). Rapport 2010:6, *Regeringskansliet*, Stockholm.

O. Mattisson, G. Paulsson and T. Tagesson (2003), "Sweden", in K. Lüder and R. Jones (eds), *Reforming Governmental Accounting and Budgeting in Europe*. Frankfurt: Fachverlag Moderne Wirtschaft, 755–852.

C. Nyman, F. Nilsson and B. Rapp (2007), "Ansvarsprövning med förhinder [Obstructed Accountability]", *Kommunal Ekonomi och Politik*, 11, 29–46.

L. Oulasvirta (2014), "The Reluctance of a Developed Country to Choose International Public Sector Accounting Standards of the IFAC. A Critical Case Study", *Critical Perspectives on Accounting*, 25 (3), 272–285.

G. Paulsson (2006), "Accrual Accounting in the Public Sector: Experiences from the Central Government in Sweden", *Financial Accountability and Management*, 22 (1), 47–62.

PwC (2014), Collection of Information Related to the Potential Impact, Including Costs, of Implementing Accrual Accounting in the Public Sector and Technical Analysis of the Suitability of Individual IPSAS Standards 2013/S 107-182395, downloadable at http://ec.europa.eu/eurostat/documents/1015035/4261806/EPSAS-study-final-PwC-report.pdf, last download 23 January 2015.

Rådet för kommunal redovisning [The Swedish Council for Municipal Accounting] (2011), *Konceptuellt ramverk* [Conceptual Framework]. Stockholm: Rådet för kommunal redovisning.

M. Sterk (2007), "The Impact of Performance Budgeting on the Role of the Legislature: A Four-Country Study", *International Review of Administrative Sciences*, 73 (2), 189–203.

Swedish Government Offices (2014), *Facts and Figures 2013: Swedish Government Offices Yearbook*. Stockholm: Government Offices of Sweden.

T. Tagesson (2009), "Arguments for Proportional Consolidation: The Case of Swedish Local Government", *Public Money and Management*, 29 (4), 215–216.

T. Tagesson and O. Eriksson (2011), "What Do Auditors Do? Obviously They do not Scrutinize the Accounting and Reporting", *Financial Accountability and Management*, 27 (3), 272–285.

T. Tagesson and G. Grossi (2012), "The Materiality of Consolidated Reporting: An Alternative Approach to IPSASB", *International Journal of Public Sector Performance Management*, 2, 81–95.

T. Tagesson, M. Klugman and M. Lindvall (2013), "What Explains the Extent and Content of Social Disclosures in Swedish Municipalities' Annual Reports?" *Journal of Management and Governance*, 17, 217–235.

Useful sites

http://www.government.se/
http://www.esv.se/
http://www.rkr.se/
http://www.riksrevisionen.se/sv/

Legislature

Budgetlag (2011:203) [The Budget Act].
Kommunallag (1991:900) [The Municipal Act].
Lagen om kommunal redovisning (1997:617) [The Municipal Accounting Act].

14

Public Sector Accounting and Auditing in Switzerland

Sandro Fuchs, Andreas Bergmann, Iris Rauskala and Anna Schmitt

14.1 Introduction

In the following chapter, the state and government architecture in Switzerland and its political system is discussed, as this is the basis for the understanding of public financial management in Switzerland. Both, the federal organizational structure of Switzerland and its leading political principle, direct democracy, significantly influence public sector accounting, budgeting and auditing.

14.1.1 Three levels of state and government

Swiss public administration is organized on three levels: federal government, state government (26, so-called, cantons) and local government (around 2,350 municipalities). Swiss state structure is characterized by two fundamental principles, namely a pronounced federalism and the principle of subsidiarity, which are to be observed at each governmental level.

The first principle, federalism, refers to the federal state structure of Switzerland and the fact that both states and municipalities enjoy a substantial degree of autonomy. In fact, the constitutional sovereignty of the states may only be limited by other constitutional provisions and not, for instance, by laws or decrees without an explicit constitutional basis.

The second principle, subsidiarity, refers to the responsibilities and power sharing between the three levels of government. The main idea is to transfer power and responsibilities to smaller and less centralized authorities on a sub-national level, wherever possible. Therefore, federal authorities should perform only those tasks which cannot be performed more effectively at a more immediate or local level. Hence the authority of the federal government is strictly confined to a few but essential rights and tasks, for example, national defence or foreign affairs.

14.1.2 Direct democracy

Direct democracy constitutes the most important pillar of the Swiss political system. It allows people to directly participate in the political decision-making process or to veto parliamentary decisions.

An important instrument at federal level is the mandatory referendum for changes to the constitution, which means that every constitutional change requires a binding popular vote (Wolf, 2010). In contrast to the referendum, the citizens' initiative is an instrument to launch a new political debate which might change or amend existing constitutional law. Although relatively few initiatives are adopted, popular initiatives influence the shaping of policy in the sense that minority groups have a powerful instrument to put proposals into parliament's political agenda (Wolf, 2010).

While budget approval is in the hands of parliament at federal and state levels, and in larger cities, smaller municipalities generally approve their budget by popular vote, usually in an assembly of voters. This means that even budget decisions are quite often subject to direct democracy, although not at the two top levels of government.

14.1.3 Fiscal federalism in Switzerland

The federal state architecture of Switzerland directly influences its fiscal policy. Due to their sovereignty both states and municipalities enjoy a high degree of financial autonomy. Based on their autonomy cantons determine their tax rates freely, leading to tax competition (Wolf, 2010).

All three government levels raise significant amounts of direct taxes, namely income taxes. Hence all three state levels possess direct resources to fulfil their legislative tasks and to provide goods and services according to their responsibility (Rauskala et al., 2012). However states and municipalities differ with regard to their resource potential, number of inhabitants and other structural indicators. To mitigate these effects, an elaborate system of fiscal equalization with the goal of compensating for differences in financial resources is in place, contributing to and ensuring the federal architecture of Switzerland (Wolf, 2010). The fiscal equalization system consists of two main components, a horizontal component, as in resources transferred between "richer" and "poorer" municipalities or states at the same level, and a vertical component, as in resources transferred between the federal government and the states or municipalities (Rauskala et al., 2012).

Switzerland has sound public finances, also due to its distinct financial solidarity between federal, state and local governments. Compared to the federal level, state and local governments show remarkably low levels of debt. One reason for the federal government's larger debt burden might be that states and municipalities made an early move to modern, accrual based accounting systems, which in turn shifted the focus from a purely cash perspective towards full financial statements (Rauskala et al., 2012). The Swiss federal government followed in 2007 when it introduced an accruals based accounting system. This might be part of the explanation why the federal government has been able to substantially and constantly reduce its debt burden, even during the global financial crises years.

14.2 Public sector accounting standards in Switzerland

Due to the federal state structure of Switzerland, all three governmental levels, but particularly state and local governments, also enjoy a high degree of autonomy with respect to their budget and accounting law. The divergent legal environment leads to the use of different accounting practices and models. For the sake of a quick overview, the three relevant accounting models will be briefly described and then discussed in more detail. The *new accounting model (NAM)* was introduced at federal level for the 2007 budget and the 2008–2010 mid-term financial plan. The NAM contains two main elements. First, a fiscal policy model. For the macro-economic fiscal policy, the cash or financing perspective is the focus. However, for operational management, accrual budgeting and the performance aspect, as in the statement of performance, are important. Second, the NAM is a fully accrual accounting model based on IPSAS, however, at least initially, not fully compliant with respect to a few, but substantial, issues.

The *Harmonized Accounting Model (HAM)* was the first attempt towards a uniform accrual accounting model (by the underlying chart of accounts) for state and local governments and is still in use, mostly at local and partially at state level. However, it is successively being replaced by HAM2. HAM includes some basic recognition and measurement requirements, but falls short of comprehensive disclosure requirements (FDK-CDF, 1981). All in all, HAM does not fit in with the definition of a modern accounting model oriented towards a true and fair perspective as it allows for treatments and practices which are clearly more in line with fiscal policy considerations. However, HAM introduced accrual budgeting and accounting at state and local levels back in the 1980s.

HAM2 has been widely implemented at state government level and partly at local government level. HAM2 is focused on accrual accounting but, as its main harmonization feature is the underlying chart of accounts, it also encompasses budgeting elements. The unified chart of accounts is also a critical success factor for the preparation of the Government Financial Statistics. HAM2 shows clear references to IPSAS. It includes all presentation techniques despite the statement of equity and many of the recognition requirements known by the IPSAS. However, HAM2 allows for alternative treatments, especially in respect of measurement, of which some clearly deviate from the IPSAS, and fall explicitly short with respect to disclosure requirements (FDK-CDF, 2007).

14.3 Central government

Central government consists of the following entities:

a) Central government administration (e.g. ministries, FLAG[1] agencies).
b) Decentralized non-independent entities depending on government budget (e.g. special purpose funds).
c) Decentralized autonomous public entities to which the performance of public tasks have been entrusted by central government (e.g. Swiss Financial Market Supervisory Authority).
d) Undertakings in whose registered, nominal or share capital the confederation holds a participation of over 50 per cent.

As budgeting, accounting or auditing practices and requirements differ between the above mentioned entities, the following sections will focus particularly on central government administration, which consists of seven ministries, parliament, federal council, federal courts and public sector agencies governed through performance mandates and global budgets, the, so-called, FLAG agencies.

14.3.1 Budgeting

The Federal Finance Administration (FFA) is responsible for preparing on an annual basis the federal budget for discussion and approval by parliament in the second semester of the year (August to December). The federal budget is prepared on an accrual basis consistent with the accounting principles as stated in the NAM (Section 14.2) and includes the following six components:

- Overall federal budget and explanatory comments (volume 1);
- Budget appropriations to federal entities (volume 2A);
- Explanatory comments to the budget appropriations to federal entities (volume 2B);
- In-depth discussion of individual budgetary items (volume 3);
- Budget appropriations to special accounts (volume 4);
- Financial plan for the following three years, excluding current budgeting period (mid-term planning framework) (volume 5).

The budgeting process consists of the following five stages (FFA, 2014):

1. *Preparation stage* (*December to February*). Analysis of the overall fiscal conditions and macroeconomic indicators and determination of general budgeting parameters by the Federal Council.
2. *Budgeting stage* (*February to April*). Decentralized budgeting and financial planning according to budgeting principles and parameters set by the Federal Council.

3. *Adjustment stage* (*April to June*). The Ministry of Finance adjusts the budgetary and financial plan together with the budgeting entity. Announcement of budget cuts by the Federal Council.
4. *Finalization stage* (*June to August*). Finalization of the federal budget by the Federal Finance Administration and submission to parliament.
5. *Parliamentary discussion and approval stage* (*August to December*). Discussion of the federal budget and financial plan by the finance committee and approval by parliament.

With the introduction of the NAM and the FLAG management model, the traditional principles of budget management have been expanded with some new elements, such as performance contracts, product groups and respective performance (i.e. global) budgets (FFA, 2008). FLAG agencies are managed through performance contracts, which specify the amount and quality of services rendered. Taking into account output and outcome targets, each FLAG agency receives a global budget, which is basically a block grant of which the FLAG agency freely disposes (FFA, 2013b). An expansion of FLAG principles to all entities is currently under consideration.

14.3.2 Accounting

The NAM of the Swiss Confederation is applicable to entities that belong to the central government administration. It is based on IPSAS and will be discussed in greater detail in the following section. All other entities (e.g. decentralized public sector entities or private corporations controlled by the government) are not legally required to follow the NAM. However, agencies that are included in the consolidated financial statements need to follow comparable sector specific standards (e.g. IFRS or IPSAS) in order to facilitate the consolidation process and to gain a comprehensive and meaningful view of the reporting entity.

NAM was introduced for the 2007 budgeting period and the 2008–2010 financial planning period. It takes a dual perspective in presenting the federal macro- and micro-economic financial situations (FFA, 2008):

(1) With regard to overall fiscal policy management and the debt containment rule – which requires balanced expenditure and revenue – the cash perspective is still important. Hence under the NAM, a financing or cash flow statement still exists.
(2) With regard to operations, the performance aspect is increasingly important. As in the private sector, the income statement – supplemented by management accounting – gives more detailed information about the performance of public sector entities or goods and services provided.

The Federal Budget Act (2005; status as of 2011) requires that federal government apply IPSAS. Hence the NAM, by which accounting law is implemented, follows mainly the same definitions and principles as under IPSAS (e.g. accounting and bookkeeping principles, definition of assets, liabilities and equity or recognition, measurement and disclosure of assets and liabilities). Thus derived from the definitions and principles of IPSAS, the NAM aims to present a true and fair view and to improve comparability of financial statements to the private sector (FFA, 2008). However, there are a few substantial deviations with regard to some IPSAS, as for example, with respect to the recognition of some asset classes (e.g. military assets) or the accrued recognition of some revenue items (e.g. federal tax, value added tax). Furthermore, the newer standards, as for example, IPSAS 28–30, have not been introduced yet. All in all, though, it can be stated that the NAM shows a high degree of compliance with IPSAS, with a few, but substantial, exceptions. However, a number of deviations were eliminated over time and there are plans to eliminate the remaining differences described in Section 14.3.3 by 2016.

14.3.3 Financial reporting

Government financial statements (*Staatsrechnung*) under the NAM comprise (FFA, 2008):

- Income statement
- Balance sheet
- Financing and cash flow statement
- Statement of investments
- Changes in net assets/equity
- Notes to the financial statements

The four fundamental components of the model are the income statement, the balance sheet, the financing and cash flow statement and the statement of investment, a Swiss public sector peculiarity (FFA, 2008).

The *income statement* presents expenses and revenues (i.e. values and not just cash flows) and shows the annual result. Hence it takes the profit and loss view, which is an elementary achievement for operational management issues. Revenue particularly consist of income from taxes, duties and fees, whereas expenses show operating expenses, including depreciation, expenses for subsidies and contributions to other budgets and expenses for earmarked funds in liabilities.

The income statement is divided in three parts, which can be found at all levels of the federal administration:

(1) *Operating result*: increase or decrease in assets from operations and services delivered. Income is differentiated into fiscal income and income from royalties and concessions, and payment for individual services provided by the confederation.

(2) *Financial result*: compares financial income with financial expenses, and together with the operating result, gives the ordinary result.
(3) *Extraordinary result*: records extraordinary transactions as specified in the debt containment rule and enters the federal balance sheet as an increase or decrease in assets.

The *balance sheet* shows the size and structure of assets and liabilities and positive or negative equity. In compliance with the IPSAS and the new business accounting principles, the balance sheet provides better and comprehensive information on federal assets, liabilities and equity, as it follows private sector oriented recognition and valuation principles with a clear focus on the economic substance of the transaction.

The structure of the balance sheet follows IPSAS in principle. It shows the assets, liabilities and equity. However, there is one substantial difference with regard to asset classification with a differentiation made between financial assets (items used for asset management) and operating assets (items used for service generation) with respect to budget law and different decision-making powers. Hence the asset side of the balance sheet follows a different classification from that proposed by IPSAS.

The *financing and cash flow statement* follows IPSAS, disclosing all cash flows within the reporting entity. It is of major importance, as the central information and management control instrument for overall budget execution and management in terms of fiscal policy. It discloses the cash balance between expenditure and revenue, which is the main focus of the debt brake regime.

The *statement of investment* discloses the inflows and outflows from investments or de-investments. It is the basis for credit appropriation, which needs to be approved by parliament. It is a traditional but peculiar instrument of Swiss public sector financial management and not explicitly required by IPSAS. Hence the private sector records such transactions directly as an increase or decrease in assets and liabilities in the balance sheet.

The statement of investment presents a revenue side (e.g. de-investment in tangible/intangible assets, loans repayments, disposal of financial participations) and an expenditure side (e.g. investments in tangible assets, financial participation, granting of loans). Hence the statement of investment conveys the, so-called, credit view thus providing the necessary information for overall fiscal policy management and a basis to set financial objectives for the operational management of administrative units.

Consolidated financial statements

Consolidated financial statements (CFS) have been prepared since 2009 according to IPSAS, with a few, but substantial, differences particularly with regard to the scope and method of consolidation. CFS are rather informative, which means that they are not explicitly approved by parliament and not subject to external audit.

The CFS of the federal administration mainly follow an organizational (legal) perspective with the full consolidation of the following entities (FFA, 2013a):

a) Central government administration (e.g. ministries, FLAG agencies);
b) Decentralized non-independent entities depending on governmental budget (e.g. special purpose funds);
c) Decentralized autonomous public entities to which the performance of public tasks have been entrusted by the confederation (e.g. Swiss Financial Market Supervisory Authority).

However, private or special-law corporations, which are controlled by the government (entities in which the state holds more than 50 per cent of the equity, e.g. Swiss Post, Swiss Federal Railways) are not fully consolidated but recorded according to the equity method (FFA, 2013a). This is in clear contrast to IPSAS, which requires the line-by-line consolidation of all controlled entities. However, there currently exist plans to fully adopt the IPSAS principles, hence taking an economic perspective while fully consolidating all controlled entities.

14.3.4 Auditing

The financial supervision system of the federal administration consists of three main actors, namely the Finance Committee, the Swiss Federal Audit Office (SFAO) and the financial inspectorates.

The Finance Committee is a parliamentary body appointed by members of the Federal Assembly. It is the supreme financial supervisory body of the federal administration and is supported by the SFAO in fulfilling its duties as the supreme supervision authority.

The Federal Auditing Act (FAOA 1967; status as of 2012) is the legal basis for the SFAO and its auditing activities, in which it is bound only by the federal constitution and the law. The SFAO is independent and autonomous within the scope of its legal provisions (FAOA, Art. 1f.). The scope of audit is substantial, including central and decentralized federal administrations, parliamentary services, recipients of subsidies and financial aid and other controlled entities.

According to the Federal Auditing Act, there exist two main elements of audit, namely internal and external. The *external audit* not only includes traditional accountability elements, like compliance and financial audits, but also performance elements, for example, efficiency or effectiveness assessments. In fulfilling its external auditing tasks, the SFAO mainly follows Swiss auditing standards, which are also applied in the private sector.

The second element, *internal audit,* is more decentralized. The financial inspectorates of the federal administration are responsible for internal audits. The inspectorates are directly assigned to the executive management in their audit function and supervised by the SFAO. The current sixteen established financial inspectorates are autonomous and independent in the fulfillment of their internal audit duties (FAOA, Art. 11). The scope and execution of internal audit is less regulated compared to external audit, giving the financial inspectorates a high degree of autonomy with regard to their support and control activities.

14.4 State governments

The Swiss confederation consists of 26 cantons. Due to the federal state architecture, the cantons enjoy a high degree of autonomy with regard to their budget and accounting legislation. However, there are substantial efforts to harmonize accounting practice horizontally between state governments and vertically between state and local governments.

14.4.1 Budgeting

Switzerland enjoys a long tradition of harmonized budgeting and accounting at all three levels of government. Particularly with the introduction of the HAM in the 1970s and 1980s and with the further developed HAM2 in 2007 (a more detailed discussion of HAM and HAM2 follow in the next section), accrual budgeting and accrual accounting have been improved or enhanced and closely linked together at both state and local levels (Bergmann, 2012, 2008). In fact, there was no controversy about introducing accrual budgeting, even back in the 1970s and 1980s, since it was assumed that accounting and budgeting should correspond and be on the same basis (Bergmann, 2012, 2009).

Since all states have implemented HAM at least, or even a more comprehensive accounting model like HAM2 or IPSAS (SRS-CSPCP, 2012), it can be stated that accrual budgeting has been fully introduced at state government level with a close linkage between accounting and budgeting. All cantons present annually a parliamentary approved accrual budget which is legally binding. Sometimes the annual budget is presented in combination with a mid-term planning framework integrating tasks and finances, which usually covers a period of four years.

However, detailed budgeting practices and processes do differ between the states, also due to the implementation of performance budgets in some cantons from the 1990s. Currently 15 out of 26 cantons have fully or partially adopted performance budgets, covering nearly three-quarters of the financial volume of all cantons. Hence all NPM cantons do present budgets together with information on respective tasks, objectives and indicators. It might be assumed that more cantons will abandon traditional budgeting practices and turn towards performance budgeting over the next years.

14.4.2 Accounting

As there were no uniform accounting practices between the states before the 1970s, the Conference of Cantonal Ministers of Finance (FDK-CDF) introduced the HAM in a provisional version in 1977 and a final version in 1981. The core harmonization element was the chart of accounts. Therefore, it is often characterized as a formal harmonization. HAM is not a law but only a consensual recommendation by FDK-CDF, which is a particular reason why the implementation of HAM took almost two decades, from the late 1970s until the 1990s (Bergmann, 2009).

HAM includes a statement of financial position, a statement of performance and a statement of investments. It also gives some guidance in respect of recognition and measurement under the accrual principle, but in a much less rigorous way than the international accounting standards (Bergmann, 2009). However, most importantly, HAM is not a financial reporting standard aiming for a fair presentation (Bergmann, 2008).

The lack of fair presentation, ongoing NPM style reforms and the introduction of accrual accounting based standards (IPSAS) at federal level, and in some states, led particularly to the development and introduction of HAM2. Similarly to HAM it is not more than a consensual recommendation and hence only achieves legal character by transforming its recommendations into cantonal law. HAM2 makes explicit reference to IPSAS and NPM style reforms (Bergmann, 2008). In fact HAM2 was designed to allow the adoption of the IPSAS, an option which is currently used by five large cantons (Geneva, Zurich, Basel-Stadt, Lucerne and, from 2015, Berne), which account for more than 50 per cent of Swiss GDP. HAM2 has already been implemented by a majority of cantons. However there are still a few states that are to change to HAM2 in the next years.

When HAM2 was issued in 2008, the FDK-CDF also created a permanent standard-setting body, the SRS-CSPCP, with the mandate to assist in the implementation of HAM2 and to develop it permanently, rather than carry out large scale reforms every 20 or so years. SRS-CSPCP is also responsible for the maintenance of the unified chart of accounts, which is not only used by all states and municipalities, but also by federal government.

14.4.3 Financial reporting

HAM2 includes a statement of financial position, a statement of performance, a statement of investments, a cash flow statement and the notes (FDK-CDF, 2007). Therefore, HAM2 includes all IPSAS presentation requirements except for the statement of equity. Also, with respect to recognition and measurement requirements, it generally takes IPSAS as a benchmark but it allows alternatives. The disclosure requirements are much reduced, but still with the option to be fully compliant with IPSAS (Bergmann, 2012).

Despite the orientation towards IPSAS and its allowance for opting out, HAM2 is generally reluctant to present a true and fair view (Bergmann, 2008). For example, it still allows the accumulation of hidden reserves and does not require the consolidation of controlled entities. The latter might be a particular risk, namely within the context of NPM style reforms and the latest trends towards decentralization of public sector entities. The bottom line is that HAM2 is a substantially updated guide for accrual accounting and budgeting since it still focuses strongly on elements rather than on achieving formal harmonization (like the unified chart of accounts), it falls short of a more principles based, true and fair approach. Therefore, the rule based elements of an accounting model outweigh the principle oriented elements of accounting standards like IPSAS.

14.4.4 Auditing

Due to the high degree of autonomy, audit practice still varies across the cantons. At least one similar element might be observed throughout the cantons. The finance committees, which are parliamentary organs, are primarily responsible for the financial supervision of federal states.

With regard to external audit, different practices can be observed and the degree of independence and functions of the audit offices still differ significantly (Bergmann, 2009). Therefore, the Professional Association of Financial Audit created a sample auditing act to increase the alignment of state audit practice, which is, however, not legally binding. Hence, states are still free to define and follow their own audit practice but have a possible reference point. Besides, a growing proportion of cantons, around two thirds, constitutionally guarantee the independence of their audit office and clarify its functions at the highest legislative level (Grüter, 2013). The remaining cantons might do so in the medium term. The dominant system within the states is the monistic system, which means that audit offices support both parliament and government in their supervising functions (Grüter, 2013). A few cantons, such as Geneva or Vaud, have turned towards a dualistic system, with a strong, independent auditor general office.

14.5 Local governments

Just like the cantons, local governments had formally harmonized their budgeting and accounting law and practices with the introduction of HAM and are now in the process of further developing and modernizing their budgeting and accounting with the implementation of HAM2. It can be observed that the cantons, which are responsible for setting the overall financial framework for their municipalities, adopt "lighter" versions of HRM2 or – if there are alternative treatments – chose the technically easier alternative. Whether or not municipalities are allowed to opt out and use IPSAS, depends on state legislation. Some of the larger cities especially, which issue bonds on the capital market, have shown interest in using full IPSAS, but states tend to be reluctant as they prefer a harmonized implementation of HAM2, rather than have different versions of it within the same state.

14.5.1 Budgeting

Along with the implementation of HAM by the states from the late 1970s, they required their local governments to switch to the newly developed harmonized accounting model, leading to a comprehensive and nationwide introduction of HAM at local level (Bergmann, 2008). Therefore, accrual budgeting has been completely implemented at local level and some states, particularly their municipalities, have started the implementation of HAM2 (SRS-CSPCP, 2012). However a majority of municipalities will only start the implementation process of HAM2 in the near future. Fully integrated accrual budgeting remains state-of-the-art as HRM2 uses exactly the same guidance for budgeting and accounting, leading to a straight-forward comparison (Bergmann, 2012).

In the wake of NPM reforms, some larger municipalities switched to performance budgeting, taking into account early experiences of some states. Compared to the total number of municipalities, only a limited number of communities have switched to performance budgeting (Flick et al., 2012).

14.5.2 Accounting

Despite a few early movers, which have already introduced HAM2, a majority of municipalities still apply HAM. However local governments are also required to introduce HAM2 by their respective states (SRS-CSPCP, 2012). It is expected that the largest share of municipalities will apply HAM2 by the end of 2017. Though there have been numerous experiments with the introduction of IPSAS at local level, up until now, no municipality has switched to IPSAS.

14.5.3 Financial reporting

Because financial reporting practices differ within states and local governments and depend particularly on the applied accounting model (e.g. HAM or HAM2 in their various implementation alternatives), it is difficult to sum up financial reporting practices at local level in a few lines. At a minimum level, all communities are on accrual budgeting and accrual accounting. All present a statement of financial position, a statement of investment and a statement of financial performance. Some governments additionally present their financial information through a cash flow statement and explanatory notes, following HAM2.

14.5.4 Auditing

Due to the high degree of autonomy, financial audit and supervision varies across states and local governments. As at the federal and state levels, finance committees, which are parliamentary organs, also have a prominent and important role in supervising the financial affairs of their local administration. External audit differs between local governments. Some municipalities, particularly small and medium sized ones, are either audited by the state body, for example, through municipal offices, or via mandates given to private audit companies. Other municipalities, particularly larger cities, have their own independent audit offices which perform both external and internal audits.

14.6 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

As major budgeting and accounting reforms have recently taken place at federal level (introduction of the NAM) or are currently taking place at both state and local governmental levels (introduction of the HAM2), it might not be assumed that any other major budgeting and accounting reform is about to happen. The federal level is, despite a few exceptions, already in compliance with IPSAS. Yet there exist plans to further harmonize the NAM with IPSAS to achieve full compliance in the mid-term future. State and local governments find themselves in a transition period, working on the implementation of HAM2, an elements based accrual accounting model. Although HAM2 contains some basic IPSAS principles with respect to recognition and measurement and could allow for a complete opting out to IPSAS, HAM2 is still generally reluctant to present a true and fair view. However, with the creation of a permanent standard-setting body at state and local levels, the SRS-CSPCP, there is a strong tendency to continue the gradual alignment with IPSAS in the mid-term future.

In the area of auditing, however, there still exists room for improvement at all three government levels. One substantial area of reform at federal level might occur through the revision and modernization of the Finance Auditing Act. State and local governments will increasingly focus on the constitutional anchorage of independent institutional audits in the near future.

14.7 Main challenges: problems identified

Current and past reforms on all three state levels revealed different types of challenges which can be briefly described as:

- *Change management*: reform projects of this magnitude cannot be solely treated as mere accounting projects. It is a comprehensive, organization-wide change management process, which needs the support of all relevant management and political authorities and requires the early involvement of all parties concerned.
- *Resources vs. benefits*: budgeting and accounting reform projects bind a substantial amount of resources for design, implementation, education

and training. As project costs might appear more salient in a first stage, one should particularly emphasize and focus on tangible reform benefits in order to gain the necessary (political) acceptance.

- *Know*-how: public sector entities may lack sufficient knowledge to successfully introduce and operate accrual accounting and budgeting systems. Both the early involvement of outside experts and the constant education and training of project and staff members is a key point for a successful project.
- *Cost awareness and economic thinking*: the implementation of accrual based accounting and budgeting is not a mere revision of accounting law, policies and manuals but mutually affects internal procedures, structures and organizational culture. It particularly fosters and requires an increased cost awareness and economic thinking of all organizational units.
- *Restatement and political desires*: the move towards true and fair financial statements frequently triggers the necessity to restate assets and/or liabilities, which might lead to a situation where a public sector entity ends up with increased equity. This in turn might arouse political desires, for example, claims to increase public spending. It is therefore crucial to explain clearly the basic purpose and interpretation of restated assets and liabilities to proactively stop an increased spending appetite.

Note

1. German acronym for managed by performance mandates and global budget (*Führen mit Leistungsauftrag und Globlabudget*).

References

A. Bergmann (2008), "Local Governments Accounting Models: Switzerland", in S. Pozzoli (ed.), *Local Authorities Accounting and Financial Reporting. Trends and Techniques in Multinational Perspective*. Milano: Franco Angeli.

A. Bergmann (2009), *Public Sector Financial Management*. London: Prentice Hall.

A. Bergmann (2012), "The Influence of the Nature of Government Accounting and Reporting in Decision-making: Evidence from Switzerland", *Public Money and Management*, 32 (1), 15–20.

Federal Finance Administration FFA (2008), "The New Accounting Model of the Swiss Confederation", *OECD Journal on Budgeting*, 8, 1–37.

Federal Finance Administration FFA (2013a), "Consolidated Financial Statements of the Central Government", http://www.efv.admin.ch/d/dokumentation/finanzberichterstattung/konsolid_rechnung_bund.php, date accessed 11 August 2014.

Federal Finance Administration FFA (2013b), "Swiss Public Finances Compared Internationally", http://www.efv.admin.ch/e/downloads/finanzstatistik/Kennzahlen/Int_Vergleich_e.pdf, date accessed 11 August 2014.

Federal Finance Administration FFA (2014), "Budget 2014", http://www.efv.admin.ch/d/dokumentation/finanzberichterstattung/budget.php, date accessed 11 August 2014.

M. Flick, A. Mannsky and B. Stoelker (2012), "New Public Management – Tendenzen in ZürcherGemeinden", in Swiss Society of Administrative Sciences (eds), *Yearbook 2012 of Swiss Administrative Sciences*, 63–67.
K. Grüter (2013), "Finanzkontrolle", in A. Ladner et al. (ed.), *Handbuch der öffentlichen Verwaltung der Schweiz*. Zurich: NZZ.
I. Rauskala, A. Bergmann and S. Fuchs (2012), "30 Jahre Doppik in der Schweiz – eine Bilanz", *Verwaltung und Management*, 18 (3), 127–130.
Swiss Public Sector Financial Reporting Advisory Committee SRS-CSPCP (2012), "Einführung von HRM2", http://www.srs-cspcp.ch/srscspcp.nsf/vwBaseDocuments/HOSRS01?OpenDocument&lng=de, date accessed 11 August 2014.
L. Wolf (2010), *Swiss Democracy – Possible Solutions to Conflict in Multicultural Societies*. Bern: Federal Department of Foreign Affairs.

Useful sites

The Swiss Finance Administration, http://www.efv.admin.ch/e/
The International Federation of Accountants, http://www.ifac.org/
The International Public Sector Accounting Standards Board, http://www.ifac.org/public-sector

Legislature

Conference of State Ministers of Finance FDK-CDF (1981), *Harmonized Accounting Model HAM*. Bern: Paul Haupt.
Conference of State Ministers of Finance FDK-CDF (2008), *Harmonized Accounting Model HAM 2*. Solothurn: Conference of State Ministers of Finance.
Federal Auditing Act (2012), "Federal Council", http://www.admin.ch/opc/de/classified-compilation/19670112/index.html, date accessed 11 August 2014.
Federal Budget Act (2011), "Federal Council", http://www.admin.ch/opc/de/classified-compilation/20041212/index.html, date accessed 11 August 2014.

15

Public Sector Accounting and Auditing in the United Kingdom

Rowan Jones and Josette Caruana

15.1 Introduction

The Treasury dominates budgeting and accounting for the revenues, expenses, assets, liabilities and cash flows of central government. Its powers and responsibilities for central government money extend to the economy as a whole, covering fiscal and monetary policy for the UK's currency (although the operational responsibility for this is with the central bank). The political heads of the Treasury are the Prime Minister and the Chancellor of the Exchequer.

The renowned accrual accounting reform by the UK *central* government was begun in the 1990s and is known by its brand name of Resource Accounting and Budgeting. This reform produced two distinct sets of financial statements (Jones, 2003; Chow et al., 2007, 2008; Jones et al., 2013). The first stage introduced, for the financial year ended in 2000, accrual accounting into central government departments and produced a set of financial statements for each department. The second part invented a completely new set of audited financial statements (accrual-based, of course) for the whole-of-government; the first financial statements published by the Treasury were for the financial year ended in 2010 (Jones, 2012).

These latter financial statements now cover not only central government but also what can be termed the whole of the public sector, including local government. They have changed the nature of public sector accounting in the UK and have given the Treasury much greater direct influence over accounting, especially in local government and the health service, than it has ever had. Until the very end of the last century, central government accounting was almost wholly cash-based, with little relationship to the accounting profession (whether for the public or private sectors). In the health service and local government, some form of accrual accounting had long been the norm, and for many decades there had been a closer relationship with the accounting profession. The lead in linking public sector accounting with the accounting profession is now taken by the Treasury.

The "government" of government accounting is defined by accounting (more specifically by financial reporting) not by legal or administrative definitions of government. The definition has the force of statute law and associated regulations but it is determined by the Treasury. It is given in the whole-of-government accounts (WGA) prepared by the Treasury, by listing the entities whose annual financial statements have been consolidated in them (and by listing some entities whose annual financial statements have not) (Treasury, 2013b).

Since many of the annual financial statements included in the WGA are themselves consolidated financial statements, it is useful to call the WGA a meta-consolidation. It is this meta-consolidation that now defines government accounting in the UK, and can be said, colloquially, to define public sector accounting.

The "government" of government accounting, then, is an entity-based definition. This seems particularly appropriate since accounting, at least insofar as it is defined and practised by the accounting profession, is itself entity-based. Which entities are included in "government" is now significantly influenced by national accounting's definition of government, which is not an entity-based definition.

15.2 Public sector accounting standards in the United Kingdom

The accounting policies of the meta-consolidation are determined by the Treasury (*Financial Reporting Manual* [known as *FReM*]): these are based on EU-adopted IFRS but with modifications determined by the Treasury. In the meta-consolidation, the accounting policies of the consolidated entities should, of course, be the same. But this does not mean that the accounting policies of every entity included in the meta-consolidation are determined by the Treasury's *FReM*: they are not. For those entities that we would naturally include in a definition of central government (most obviously government departments), the accounting policies of each are the same as for the meta-consolidation, and are determined by *FReM*; it is important to note, however, that there are some financial statements of entities at the heart of central government (e.g. the consolidated fund) that remain cash-based.

For other groups of entities in the meta-consolidation, there are other sources of accounting policies than *FReM*, even if they are based on EU-adopted IFRS. Public corporations (of particular kinds) apply EU-adopted IFRS directly (meaning without interpretation by *FReM*). For the health service, there are two separate sets of accounting policies for different parts of it (*NHS Manual for Accounts*, and *NHS Foundation Trust Annual Reporting* for those parts that are deemed more like businesses), which are based on EU-adopted IFRS, with modifications. For local government, the accounting policies are determined by a professional accounting body, the Chartered Institute of Public Finance and Accountancy (CIPFA), and applied to all local authorities. These too are based on EU-adopted IFRS, with modifications. Almost all of the sets of public sector accounting policies are therefore accrual-based and, while there are differences in detail, could properly be called full accrual bases.

FReM is produced by the Treasury but follows consultation with the Financial Reporting Advisory Board (FRAB), which was given the statutory role of advising on the Treasury's accounting policies from the beginning of central government's accrual-based reform. FRAB is part of the Treasury and its responsibilities now include oversight of the accounting policies for local government and the health service.

The overarching difference between EU-adopted IFRS and the Treasury's *FReM* is in the policies on consolidation. The crucial difference this makes is in the definition of the reporting entity for the meta-consolidation, which in turn defines what government is and what it is not (Chow et al., 2008). *FReM* now uses the UK's central statistical office's interpretations of what government is, themselves based on the concepts of national accounting. Thus, while government accounting in the UK is fundamentally based on accounting (and indeed on business accounting) as the accounting profession defines it, there is now this direct link between government accounting and national accounting.

International Public Sector Accounting Standards (IPSAS) have no explicit role in government accounting in the UK, except for a minor role in local government.

15.2.1 Accounting systems in the UK public sector

In the UK context, it is not useful to refer to a general accounting plan. The fact that government accounting is primarily determined by financial reporting standards has clear requirements for accounting itself, as well as implications. But the way that government entities carry out their accounting is largely a matter for them. The meta-consolidation obviously requires a chart of accounts, in the narrow sense of a uniform set of account headings, but this chart does not necessarily determine the underlying accounting in each entity of the meta-consolidation.

There is no explicit conceptual framework for UK government accounting that is in any way comparable with the framework of the International Accounting Standards Board (IASB) (or the Financial Accounting Standards Board, or the Financial Accounting Standards Advisory Board of the US federal government, for example). The *FReM*, however, does acknowledge that the IASB's conceptual framework forms part of generally accepted accounting practice (GAAP), and the accounting policies contained in the *FReM* follow GAAP to the extent that it is meaningful and appropriate in the public sector context. GAAP is not defined in a legislation or regulation, but for the purposes of the *FReM* it is taken to mean the accounting and disclosure requirements of the Companies Act 2006, and all pronouncements issued by the IASB (including the conceptual framework); interpreted in the light of the body of accumulated knowledge built up over time through technical and academic research, journals and other publications. Besides the general principles underlying GAAP, the *FReM* refers to two additional principles: parliamentary accountability and regularity (Treasury, 2013a, para 2.1.3). The overarching aim of the *FReM* is to require financial statements to present a true and fair view of the results and state of affairs of an entity.

The objective of general purpose financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to it. The *FReM* adds that the financial information would permit an assessment of the stewardship and accountability of management for the resources entrusted to it (Treasury, 2013a, para 2.2.1).

General purpose financial statements would meet the requirements of the relevant authority and Parliament, identified as the main users; and of other users, including the entity's management board, the entity's audit committee, and the taxpayer (Treasury, 2013a, para 2.2.2).

Where required, departments prepare a statement on parliamentary accountability, which statement can be regarded as a special purpose report within the meaning of the conceptual framework (Treasury, 2013a, para 2.2.5).

15.2.2 Measurement and recognition of assets, liabilities, equity, revenues and expenses

There are no material differences between measurement and recognition under IFRS and under government accounting. The latter does choose current value options under IFRS so that the overall accounting policy is stated as:

> prepared under the historical cost convention, modified by the revaluation of non-current assets, and, where material, current asset investments and stocks to fair value as determined by the relevant accounting standard. (Treasury, 2013a, para 2.1.4)

In fact, the *FReM* does not give general definitions of the elements of financial statements, but simply draws the attention of the preparers to the IASB's conceptual framework (Treasury, 2013a, para 2.2.3). The same applies for the rules of recognition and measurement of elements. What the *FReM* does, however, is provide guidance on how IFRS are to be adapted and interpreted in the public sector context. In the *FReM* for 2014–2015, these adaptations and interpretations are very conveniently tabled (Treasury, 2014, para 6.2), with further guidance provided.

Further guidance on accounting for assets and liabilities

Basically, all non-current assets should be revalued, depreciated and subject to impairment review (according to IAS 16 *Property, Plant and Equipment* and

IAS 36 *Impairment of Assets*). A distinction is made between property and non-property. Property is required to be valued by a professional valuer. The depreciated replacement cost can be used as a proxy for fair value, where this is deemed to be more appropriate. Non-property should be carried at fair value, but an entity may select to adopt a depreciated historical cost basis for assets that have a low value and/or a short useful life.

Networked assets, donated assets and heritage assets are defined in the *FReM*, and further guidance given on their recognition and measurement. Networked assets (e.g. road network and sewer systems) should be held at depreciated replacement cost based on service potential. Donated assets should be valued at fair value. Operational heritage assets should be valued in the same way as other assets of that general type, while non-operational heritage assets should be recognized at fair value or, if not practicable, at historical cost, or if not available, they should not be valued at all but disclosed as a note. Heritage assets with indefinite lives are not depreciated but tested for impairment.

Intangible assets can be classified either as current or non-current assets. Such assets are initially measured at cost, and then revalued at fair value where there is evidence of an active market.

Non-current assets are tested for impairment. Impairment rules are in line with IAS 36 requirements, but departments need to establish whether any of the impairment loss is a result of consumption of economic benefit or of reduction in service potential or a change in market price. This distinction would determine whether the impairment loss is treated as an expense in the Statement of Comprehensive Net Expenditure (SoCNE), or offset against a revaluation reserve, or partly transferred to the general reserve. Further guidance is provided on the budgetary implications of accounting for impairment losses.

Public–private partnership arrangements, including private finance initiative contracts, are accounted for according to IFRIC 12 *Service Concession Arrangements*. The *FReM* provides further guidance on the applicable discount rate for investment appraisal purposes, and initial recognition and measurement of assets and liabilities arising from such arrangements, including assets that were held by the operator prior to entering into such arrangements (Treasury, 2014, paras 7.1.44–60).

Depending on the purpose for which a financial liability is acquired, it will be classified and accounted for either as a financial liability at fair value through profit or loss or as an other financial liability, which will be accounted for at amortized cost (Treasury, 2013b: 56). The Treasury determines the classification of a financial liability.

Further guidance on accounting for income and expenditure

The *FReM* requires all operating and non-operating income generated by an entity to be recognized in the SoCNE. However, it identifies the following sources of funds as financing, which should be recorded through the general fund and not accounted for as income:

- Parliamentary authorizations for expenditure (known as supply);
- Transfers and advances from the consolidated fund, the contingencies fund and the national insurance fund;
- Appropriations of tax revenue for the purpose of paying tax credits;
- Appropriations of national insurance contributions for the purpose of financing the NHS; and
- Grants and grants-in-aid to non-departmental public bodies.

Except for EU twinning projects receipts, all EU income should be accounted for gross in the SoCNE, distinguishing between receipts where the entity is acting as an agent and receipts to fund own expenditure. Otherwise, an entity does not recognize as revenue any receipts collected as an agent. This refers particularly to the collection of taxes, duties, fines and penalties. The majority of this income is required by statute to be paid into the consolidated fund and the collecting entity would be acting as an agent. The collecting entity can only record as revenue in its SoCNE any part of the revenue that it is allowed to retain by law. The collecting agency is required to report the collection of such income, and related expenditure, in a trust statement (in a form as directed by the Treasury).

Taxes and duties are recognized on an accrual basis and measured at the fair value of the consideration received or receivable, net of repayments. Revenue is recognized when a taxable event has occurred, the revenue can be measured reliably and it is more likely than not that the income will be received. In exceptional circumstances, and with the consent of the Treasury, taxes and duties can be recognized on a cash basis. Similar to IPSAS 23 *Revenue from non-Exchange Transactions (Taxes and Transfers)*, the *FReM* defines the tax gap but entities are not required to recognize or measure it (Treasury, 2014, para 8.2.4).

Fines and penalties are recognized at the time they are imposed and become receivable by the entity. If they prove to be not collectible, they are recorded as an expense.

Notional costs, for example, for cost of capital and insurance, which may be recorded in the management accounts of reporting entities, have to be excluded from their financial statements. Any expenditure relating to EU grants or subsidy claims are to be reported gross in the SoCNE. A distinction between administrative and programme expenditure is required.

15.2.3 Financial statements

The financial statements required by IFRS (unchanged, of course, by EU adoption) are:

- statement of comprehensive income;
- statement of financial position;

- statement of changes in equity;
- statement of cash flows; and
- notes to the accounts.

These are the required financial statements for public sector accounting, but in some cases with changes to reflect the public sector context. This is particularly so for operating statements that are not concerned with measuring profit, given that most departments have minimal or no income.

The formats of, and disclosures in, financial statements are according to the requirements of the Companies Act 2006 and IFRS, as interpreted for the public sector. For example, assets less liabilities in the statement of financial position is referred to as taxpayers' equity; and the statement of cash flows includes a footnote to highlight cash flows with the consolidated fund.

Besides the primary financial statements and the notes, the annual report of a reporting entity is to include:

- a strategic report, directors' report and remuneration report, as set out in the Companies Act 2006 and interpreted by *FReM* for the public sector (Treasury, 2014, para 5.2);
- a statement of accounting officer's responsibilities;
- a governance statement; and
- the audit opinion and report.

The auditor is required to review the contents of the annual report and express an opinion on consistency with other information in the financial statements. The strategic report is to include a reconciliation of the estimates, budgets and amounts shown in the accounts for net operating costs.

15.2.4 Links between the budget and financial accounting

The Treasury's budgeting system, on behalf of Parliament, is separate from, even if inextricably linked with, the financial accounting and reporting of central government. It is elaborated in *FReM*, as are the links with financial accounting and reporting.

For the entities in local government and the health service, the relationships between budgeting and financial accounting are more like those relationships in businesses. The budgets have constraints, of one sort and another, imposed on them by the Treasury, but the form and content of the budget of each entity is a matter for that entity, as is the link between its budget and the financial accounting and reporting. In local government, the financial reporting policies have retained some of the traditional practices of publishing budget and actual comparisons. In the health service, for example, it is now as likely for financial reports to have little reference to budgets, in the manner of business accounting.

From the various reconciliations provided in both the budget statements and the financial reports, perhaps the most obvious link between the two systems is the Statement of Parliamentary Supply required from departments financed through central budget funds in order to satisfy the parliamentary accountability principle. This statement reports to Parliament:

- a comparison of outturn against the supply estimate voted by Parliament in respect of each budgetary control limit;
- the net cash requirement, with a comparison of the outturn against voted supply estimate; and
- a statement of administration costs incurred, with a comparison of the administration costs limit.

The notes to the Statement of Parliamentary Supply then include a reconciliation between the net resource outturn to the net operating cost shown in the SoCNE; and a similar reconciliation for the administration budget. The notes also extend the disclosure of contingent liabilities to include quantifiable remote contingent liabilities, thus going beyond the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

It is interesting to note that the Statement of Parliamentary Supply follows the budgeting principles used in the Supply Estimates laid before Parliament; that is, they are compiled on a similar basis to the national accounts and comply with the European System of National and Regional Accounts (ESA), as adapted and interpreted in the consolidated budgeting guidance (Treasury, 2013a, para 3.2).

Annex 3 to *FReM* 2014–2015 consists of two tables identifying the main differences between the SoCNE and resource budgets; and capital budget and the movements in non-current assets and investments.

15.2.5 Accounting standards for consolidated statements

Consolidated statements are fundamental to the UK system, as explained above. The *FReM* applies to the preparation of consolidated accounts at various levels of reporting entities, and also to WGA. For the preparation of the latter, there are a few variations in the adaptation and interpretation of some reporting standards (Treasury, 2013a, para 14.2.1). The major adaptation concerns IAS 27 *Consolidated and Separate Financial Statements*. No parent company is disclosed since "no one body appears to have the ability to control all of the bodies within the consolidation" (Treasury, 2013a, para 14.2.10[a]). The WGA are prepared for the purposes of government and parliament as a whole and not as a requirement of any individual entity. More importantly:

> The requirement to include all subsidiaries of the parent is adapted in order that WGA shall conform to the statutory requirement in the Government Resources and Accounts Act 2000 that WGA comprise a consolidation of

> those bodies that appear to HM Treasury to exercise functions of a public nature or are entirely or substantially funded from public money. This will be based on the national accounts classification of bodies to the public sector, as independently determined by the Office of National Statistics at the reporting date. (Treasury, 2013a, para 14.2.10[b])

It does not appear that the adaptation of IFRS 10 *Consolidated Financial Statements* as from financial year ending 2015 will make any difference to this position taken by the Treasury (Treasury, 2014, para 10.2.3).

Even the disclosure requirements of IFRS 8 *Operating Segments* are interpreted in line with the sub-sector classification used by the Office for National Statistics according to the ESA, that is, central government, local government and public (financial and non-financial) corporations (Treasury, 2013a, para 10.2.2). Given that the UK Government does not publish financial statements consolidated at central government level (Heald and Georgiou, 2011), relevant data concerning the central government is only available from the disclosure note on segmental reporting in the WGA (Treasury, 2013b: 65–67).

15.3 Central government

According to the segmental analysis contained in the WGA, the central government sector comprises:

- central government departments;
- the devolved administrations of Scotland, Wales and Northern Ireland;
- non-departmental public bodies;
- entities in the national health service; and
- certain local government functions in Northern Ireland, such as police, education and social services, which are carried out by Northern Ireland departments, non-departmental public bodies and health and social care trusts.

But the information concerning central government stops at this disclosure note.

As stated above, the government of government accounting is defined by the meta-consolidation known as WGA. These provide a list of entities consolidated in the meta-consolidation. This list is sub-divided, first, into central government entities (further divided into those for England, Northern Ireland, Scotland and Wales); this list includes the entities within the health service. Then there is a list of public corporations and public financial corporations (e.g. the Bank of England and BBC entities), and then a list of local governments (again further divided into those for England, Northern Ireland, Scotland and Wales).

The WGA also provide a list of entities not consolidated (e.g. government audit offices, universities, some pension schemes, and many others). Broad explanations are given of why sets of entities are excluded; these explanations can amount merely to an assertion that they are not consolidated. There is explicit recognition that the "unconsolidated versus consolidated" status can change. This list includes some of the major banks that the government has bailed out since 2008.

15.3.1 Budgeting

In the Treasury's own words:

> The budgeting system is a set of HM Treasury rules for the control of public spending in support of the fiscal framework... Performance against the fiscal framework is measured using national accounts aggregates. National accounts are prepared by the Office for National Statistics in line with internationally agreed rules, which are different from IFRS. That is one of the reasons why transactions might score differently in budgets and in accounts. (2013a, paras 2.4.1–2)

This usefully puts government budgeting in its macro-economic framework. From this, we can turn to what might be termed micro-budgeting, or budgeting as an accountant would understand it.

In 1997 (just before the renowned accrual reform referred to above), there was a budgeting reform. There were two sets of budgetary control systems: firstly, a set of three-year budgets, with flexibility to carry budget underspendings from one year to the next within the three years; and secondly, the longstanding (and typical of most other governments) annual legislative budgetary control under the constitution, with no carry-forward of budget underspendings. The essence of the budgetary reform was to be the predominance of three-year budgets over the annual budget. The budgeting reform was not a matter of statute law, it was defined and implemented by the Treasury, with the agreement of Parliament.

From 2000 onwards, the Treasury fed the accrual-based accounting into this budgeting reform. The previous budgeting system had been almost purely cash-based. In the traditional, annual budget, the cash-based system has been retained, but with accrual-based additions. In contrast, in the three-year budgets – the ones that are used to manage the government – an accrual basis alone is used; the significance of this can be seen in the fact that the accruals are based on current values, of course include charges for depreciation, and did (until 2010) also include a charge for the opportunity cost of capital.

The combination of a medium-term budget (in this case for three years) and an annual budget would typically be seen, in a national government, as a non-binding medium-term planning document being overlaid on a binding annual law. Under this UK reform, however, the combination has rather the opposite effect. The binding document is the three-year budget, with the annual budget as the *ex post* rationalization, albeit that the rationalization takes place before the sovereign Parliament.

Both sets of budgeting include copious reconciliations between them and accounting against them:

> Departments send reports on a budgeting basis to HM Treasury on a regular basis through the Online System for Central Accounting and Reporting (OSCAR). HM Treasury publishes high level and detailed information in publications such as Public Expenditure Statistical Analyses. Departments publish budgetary information in Departmental Reports; they publish reconciliations to budgets in their Supply Estimates [the annual legislative budgets]; and they are required to report in…their annual report and accounts the outturn against Estimate and outturn against the Administration Budget…Departments are also required to provide in the Management Commentary a reconciliation of resource expenditure [that is, accrual-based] between Estimates, Accounts and Budgets. (Treasury, 2013a, paras 2.4.5–6)

15.3.2 Accounting

FReM defines the relevant entities that have to follow its policies (Treasury, 2013a, para 1.1.2). There is a lot of overlap between this definition and the definitions provided by the lists of entities consolidated and unconsolidated in the WGA. This overlap is not, however, complete. *FReM* does not apply to local government or to the entities of the health service, which have their own policy makers; it also does not apply to some public corporations.

15.3.3 Financial reporting

FReM requires the relevant entities to produce an annual report and accounts, which includes what are termed the primary financial statements. These financial statements for each government department are:

- statement of comprehensive net expenditure;
- statement of financial position;
- statement of changes in taxpayers' equity;
- statement of cash flows.

The first and last in this list take a different form when they are for government departments because of the effect of the government's budgeting system.

The financial statements for the WGA are:

- consolidated statement of revenue and expenditure;
- consolidated statement of comprehensive income;

- consolidated statement of financial position;
- consolidated statement of changes in taxpayers' equity;
- consolidated cash flow statement.

15.3.4 Auditing

The financial statements of central government are audited by the supreme auditor. There is one auditor for the UK as whole (Comptroller and Auditor General) and one each for Wales, Scotland and Northern Ireland. The auditors use the international standards on auditing (UK and Ireland) issued by the UK's Auditing Practices Board (a private sector body). In addition, for some of the financial statements within the central government, the law requires the auditor to give an opinion that, in its unqualified form, reads "I have no observations to make on these financial statements" (Treasury, 2013a, paras 5.5.2–5).

In addition to the audits of financial statements, the supreme auditors have, and have long had, formal responsibilities for auditing value for money.

The Treasury requires central government entities to have audit committees and internal audit. Internal auditors use the UK's public sector internal audit standards. These standards were first issued in 2013, for the whole of the public sector. They apply the, in some cases modified, standards of the Institute of Internal Auditors (the global, private sector body). The UK's standards were created by all of those bodies responsible for internal audit throughout the public sector, not only the Treasury.

Budgets are not audited. As stated in Section 15.2.3, the auditor is required to review and express an opinion on the consistency of the annual report with the financial statements; and the former would include a reconciliation of budget amounts and actual results. Since 2010, the Office for Budget Responsibility publishes comments on the assumptions underlying the UK Budget, but this is not an audit.

15.4 Local government

There is a very long tradition of decentralized local government, elements of which remain even as, particularly during the past generation, the encroachment of central government has shifted the emphasis to the centre. One obvious part of this shift is in the percentage of local government finance provided by or through central government in relation to the amount of local taxes levied, a percentage that has significantly increased; another is in the various controls on local budgets and on borrowing.

One element of decentralization that remains, to a greater or lesser degree, is the role of the professional accounting body, CIPFA.

15.4.1 Budgeting

In local governments, the form and content of their budgets is largely a matter for each of them. Accounting policies have retained some of their traditional influence over budgets, in that budget-to-actual comparisons have to be included in the financial statements. But otherwise the form and content of budgets is not prescribed.

15.4.2 Accounting

Accounting policies are formally defined by a code of practice issued by CIPFA, which has, however, the force of law throughout the UK. The code was produced under the oversight of the FRAB (of the Treasury). It is based on EU-adopted IFRS. It does, however, draw on IPSAS and the UK's Financial Reporting Standards (for businesses) for additional guidance. The policies include fair value for some non-current assets and financial instruments.

15.4.3 Financial reporting

The main financial statements are:

- comprehensive income and expenditure statement;
- movement in reserves statement;
- statement of financial position;
- cash flow statement.

In addition, there are statements and discussion of important funds, particularly in relation to council housing and capital.

15.4.4 Auditing

Audit of local governments is an audit of financial statements and of value for money. Budgets are not audited.

The audit regime for local government is in transition. From 1984, a central public body was created, known as the Audit Commission, to regulate local government audit. It had four major roles: first, it produced a code of practice for audit; second, it appointed each auditor to each local authority; third, it had its own body of auditors (who were, therefore, in the public sector), to which it allocated roughly 70 per cent of audits, with the remaining audits allocated to private sector firms; fourth, it carried out value for money studies that drew on the individual value for money aspects of each authority's audit.

In 2010, the new government announced that the Commission would be abolished. In 2012, the government announced that: first, the code of practice will be the responsibility of the National Audit Office, subject to parliamentary approval; second, that each local authority will appoint its own auditor and that the regulation of these auditors will take the same form as the regulation of auditors for the private sector; and that there will be a change in the value for money studies that are done for local government as a whole.

In this transition period, the Commission still exists but it no longer has its own body of auditors and, while the Commission still appoints each auditor, all local audits are now carried out by private sector auditors.

The nature of local audit, in being an audit of financial statements and a value for money audit, is not to be changed.

15.5 Readiness for change: technical facilitators, comparison of national accounting standards with IPSAS framework and readiness for adopting EPSAS

EU-adopted IFRS pervade public sector accounting, together with the Treasury's interpretations of them and, in the case of local government, the Treasury's oversight of them. The accrual-based accounting is also a part of central government's budgeting.

A change to using IPSAS as the basis instead of EU-adopted IFRS would presumably be, in the change's administrative detail, unwelcome but hardly radical. In itself, the change in policy making would represent a shift by the Treasury from referring to one international private sector body's policies (the IASB's modified at the margin by the EU) to another's (the IPSASB's); and since IPSAS are largely based on IFRS anyway, this could be judged a relatively minor technical matter. In itself, such a change would not affect the Treasury's sovereignty on behalf of the UK Parliament.

The same could be said of a change to whatever European Public Sector Accounting Standards (EPSAS) were to become, unless they were to be imposed on member states without the possibility of modification by each member state for its own accounting. It is hard to imagine the UK volunteering to give up this sovereignty.

We do not know what EPSAS will become but, from the published material of Eurostat, it would seem that they will be heavily influenced by the needs of national accounting (Jones, 2014; Jones and Caruana, 2015). Particularly in the light of the UK's annual meta-consolidations of public sector accounting, it is clear that the Treasury is similarly influenced now by national accounting (Jones and Caruana, 2014). It is at least possible that the UK's government accounting could remain largely unchanged and still provide the information that might be required by Eurostat.

15.6 Main challenges: problems identified

There are acknowledged challenges in the UK's current system (see, e.g. Heald, 2005; Chow et al., 2007, 2008; Heald and Georgiou, 2009, 2011; Biondi, 2013; Jones and Caruana, 2014). The meta-consolidations are not yet timely. The audit reports on the financial statements of the meta-consolidation are significantly qualified, as are some of the underlying financial statements.

Moreover, despite Treasury policies and its oversight of others' policies, there remain some significant differences between the policies of the consolidated entities. We would suggest that none of these matters could point to any fundamental change in the system.

It is not possible to identify challenges in the use of all of this accrual-based budgeting and accounting by the Treasury and departments, where it really matters, in the absence of empirical research into that use.

The biggest challenge that EPSAS might provide for the UK system, if EPSAS were to provide the policies for each member state's government accounting, we would judge to be political, and significantly so, given the UK's own currency and its current ambivalence even to the EU itself.

References

Y. Biondi (2013), "The HM Treasure's Island: A Theoretical Analysis of Central Government Accounting Standards in UK", 14th Biennial CIGAR Conference, Birmingham University, 2–3 September 2013. Available at SSRN: http://ssrn.com/abstract=2197656.

D. Chow, C. Humphrey and J. Moll (2007), "Developing Whole of Government Accounting in the UK: Grand Claims, Practical Complexities and a Suggested Future Research Agenda", *Financial Accountability and Management*, 23 (1), 27–54.

D. Chow, C. Humphrey and J. Moll (2008), *Whole of Government Accounting in the UK*. Project Report. London: Association of Chartered Certified Accountants.

D. Heald (2005), "The Implementation of Resource Accounting in UK Central Government", *Financial Accountability and Management*, 21 (2), 163–189.

D. Heald and G. Georgiou (2009), "Whole of Government Accounts Developments in the UK: Conceptual, Technical and Timetable Issues", *Public Money and Management*, 29 (4), 219–227.

D. Heald and G. Georgiou (2011), "The Macro-Fiscal Role of the UK Whole of Government Account", *Abacus*, 47 (4), 446–476.

R. Jones (2003), "United Kingdom", in K. Lüder and R. Jones (eds), *Reforming Governmental Accounting and Budgeting in Europe*. Frankfurt: Fachverlag Moderne Wirtschaft, 941–1017.

R. Jones (2012), "The UK has Whole of Government Accounts at Last. Phew!", *CIGAR Newsletter*, 3 (1), January, 1–3.

R. Jones (2014), "Management of Government within Two Different Exogenous Financial Metrics: An Unfamiliar Context for Research and Teaching", in A. Bourmistrov and O. Olson (eds), *Accounting, Management Control and Institutional Development*. Oslo: Cappelen Damm Akademisk, Chapter 4.

R. Jones and J. Caruana (2014), "A Perspective on the Proposal for European Public Sector Accounting Standards in the Context of Accruals in UK Government Accounting", *Accounting, Economics and Law*, 4 (3), 265–282.

R. Jones and J. Caruana (2015), "EPSAS – Worrying the Wrong End of the Stick?", *International Journal of Public Administration*, 38 (4), 240–252.

R. Jones, E. Lande, M. Portal and K. Lüder (2013), "A Comparison of Budgeting and Accounting Reforms in the National Governments of France, Germany, the UK and the US", *Financial Accountability and Management*, 29 (4), 419–441.

Treasury (of the UK) (2013a), *Financial Reporting Manual 2013–14*.

Treasury (of the UK) (2013b), *WGA Year Ended 31 March 2012*, HC 531.
Treasury (of the UK) (2014), *Financial Reporting Manual 2014–15*.

Useful sites

https://www.gov.uk/government/organisations/hm-treasury
http://www.nao.org.uk/
http://webarchive.nationalarchives.gov.uk/+/www.dh.gov.uk/en/Managing-yourorganisation/Financeandplanning/Allocations/DH_4000346
http://budgetresponsibility.org.uk
http://www.cipfa.org/
https://www.gov.uk/government/groups/financial-reporting-advisory-board-frab
http://www.ifrs.org/About-us/Pages/IFRS-Foundation-and-IASB.aspx

16
Comparing Accounting Systems in Europe

Isabel Brusca, Eugenio Caperchione, Sandra Cohen and Francesca Manes Rossi

16.1 Introduction

In the previous chapters a thorough discussion and presentation of public sector budgeting, accounting and auditing on a country level has been performed. Undoubtedly pluralism is evident. In this chapter we provide a summary of the main features of the systems and a synthesis of the main conclusions and trends. Harmonizing budgeting, accounting and auditing in Europe is definitely a challenge. In this chapter we break down this challenge into smaller ones dealing with the differences and similarities apparent in these systems across countries and within government levels.

16.2 Different government levels with different names and responsibilities

The public sector comprises public administrations and other organizations largely funded by public means, including enterprises and non-profit organizations that provide basic services, education, health care and social and cultural services. In the European Union, there are important differences in public sector profiles between countries and this is continuously changing. In some countries, education and health care are directly managed by central government, while in others regional government is responsible, and sometimes non-profit entities or other types of organization have been created to manage these services.

Belonging to the public sector implies an accountability for the use of resources, and accounting systems have been developed to allow these entities to report to stakeholders and upper level governmental bodies. However, not every entity in the public sector applies governmental accounting; in most countries governmental accounting only concerns the administrative or governmental part of the public sector, while public enterprises and non-profit entities apply the same accounting standards as private entities.

If we focus on public administration sub-sectors, that is, those who apply public sector accounting or governmental accounting, we can differentiate three levels of government: central, state or regional and local. The analysis of these levels of government in 14 European countries has revealed important differences (see, e.g. National Structures of Eurostat classification in http://epp.eurostat.ec.europa.eu). Not all countries have the same levels and differences appear mainly at the regional level. A feature of recent reforms in some countries has been a decentralization process. This is the case in Spain, Italy and France, where states or regions share the responsibility to provide services with central government. This level of government does not exist in Finland, the Netherlands, Portugal or Sweden. In other countries, regions do exist and are responsible for providing services but do not constitute a separate government level as they are included in the local level, as is the case in Greece.

This leads to differences in the importance of the public sector in the economy of each country and of the different levels of government within the public sector. These differences can be measured through the weight of the government expenditure and revenues over GDP of the country.

16.3 Diversity in budgeting systems

A review of the country chapters revealed that budgeting at central government level shows a significant heterogeneity. Out of the 14 countries covered, five use cash, four apply modified cash, two use modified accrual, while there are only three countries using full accruals for budgeting purposes (Austria, Switzerland and the United Kingdom). However, regardless of the standard used for budget preparation, statements including the actual budget amounts are always reported (i.e. budget execution reports). A reconciliation between budgeting numbers and financial statements is not always performed, as is evident in ten out of the 14 countries. Performance indicators are also frequently used in ten out of the 14 countries.

Budgeting systems at the regional level or in the regions are simpler compared to those at central government level. With the exception of Switzerland, which applies accrual budgeting at regional level, all the other countries are equally split between those applying either cash (four countries) or modified cash (four countries). Budgeting statements and the budget execution statement in particular are apparent in the majority of countries. Reconciliation with financial statements on the other hand is less common. Finally, in the nine countries with regions, performance indicators are presented in six countries.

Local government level shows high heterogeneity as well. A significant differentiation at this level is that local governments within the same country may apply different budgeting systems. This is the case in Germany and the

United Kingdom. Otherwise, in four countries local governments use cash for budgeting purposes, four apply modified cash, two modified accrual and two full accruals. A budget execution report is commonplace in all countries. Reconciliation between the budgeting and the financial statements is sometimes done and the presentation of performance indicators is evident in about half of the country cases.

It is interesting to note that in the majority of the countries under analysis (10 out of 14) the two or three existing levels of government follow the same budgeting system. There is therefore vertical homogeneity in budgeting systems within a given country. Summary information about budgeting systems in all three levels of government is reported in Table 16.1.

16.4 Diversity in accounting systems

The accounting systems in the countries covered in this book show significant heterogeneity among different government levels. At the time of writing, and in several countries neither accounting standards nor accounting frameworks are the same among different government levels. In only four countries, namely Finland, Italy, Portugal and Spain (with the exception of some regional governments), vertical accounting harmonization exists. The following sections discuss in more detail the accounting systems in these government levels.

16.4.1 Central governments

The review of accounting systems in central governments is shown in Table 16.2. At this government level it is noticeable that the existence of a national conceptual framework for public sector accounting is usually absent (9 out of 14 countries). The rules for governmental accounting, without exception, stem from governmental bodies. The accounting systems are rather sophisticated as they are already developed on the basis of accrual accounting (10 out of 14). While the majority of countries have moved to full accruals, there are only four countries (Germany, Greece, Italy and the Netherlands) still using modified cash basis. However, in Italy financial reports prepared in accordance with accruals are required to complement information provided under a modified cash basis. The existence of accrual accounting at central level would be a potential facilitator to introducing International Public Sector Accounting Standards (IPSAS) or European Public Sector Accounting Standards (EPSAS), which, in principle, are accrual based standards. The standardization of accounts used in public sector accounting is evident given the fact that 12 out of 14 countries have a mandatory chart of accounts, unlike in the private sector in most of these countries.

The most commonly reported financial statements are the balance sheet and income statement, followed by the cash flow statement. The statement

Table 16.1 Budgeting systems at three government levels

Gov. level	Issue	AUT	BEL	DEN	FIN	FRA	GER	GRE*	ITA	NED	POR	SPA	SWE	SWI	UK
CG	Budgeting system	Accrual	Cash basis	Cash based budgeting	Modified Accrual Basis	Modified cash basis + commitments	Cameral (cash)	Cash basis	Modified cash	Modified cash	Cash basis	Modified cash	Modified accrual	Accrual basis	Accrual basis
RG	Budgeting system	Modified cash basis	Cash basis	Cash basis	n/a	Modified cash + commitments	Annual (or biannual) cash based budgets	Cash	Modified cash	n/a	n/a	Modified cash	n/a	Accrual basis	n/a
LG	Budgeting system	Modified Cash basis	Cash basis	Cash basis	Accrual basis	Modified cash + commitments	Budget basis follows accounting system but not in all states; some local governments still apply cash basis of accounting	Cash	Modified cash	Modified accrual	Cash Basis	Modified cash	Modified accrual	Accrual	Not prescribed

Notes: Where CG, central government; RG, regional government; LG, local government (*in Greece RG refers to regions and LG to municipalities).

Countries: AUT, Austria; BEL, Belgium; DEN, Denmark; FIN, Finland; FRA, France; GER, Germany; GRE, Greece; ITA, Italy; NED, the Netherlands; POR, Portugal; SPA, Spain; SWE, Sweden; SWI, Switzerland; UK, United Kingdom.

Table 16.2 Accounting systems at central government level

Issue	**AUT**	**BEL**	**DEN**	**FIN**	**FRA**	**GER**	**GRE**	**ITA**	**NED**	**POR**	**SPA**	**SWE**	**SWI**	**UK**
Accounting	Accrual	Accrual	Accrual	Accrual	Accrual	Modified cash	Modified cash	Modified cash/ accruals	Modified cash	Accrual	Accrual	Accrual	Accrual	Accrual
Balance sheet	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Income statement	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Cash flow statement	Yes	No	No	Yes	Yes	No	Yes	No	No	Yes	Yes	Yes	Yes	Yes
Statement in changes in equity	Yes	No	No	No	No	No	Yes	No	No	Yes	Yes	No	Yes	Yes
Notes to financial statements	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

in changes in equity is less commonly disclosed. The financial statements are also accompanied by notes. Recognition and valuation of fixed assets is probably the most difficult and controversial issue in governmental reporting. The majority of countries recognize fixed assets in the balance sheet, although in some cases the presentation is only partial (Germany and Greece). Those that fully report fixed assets also register depreciation in their income statement. While historical cost is used for evaluating assets in all cases where fixed assets are valued, there are some countries that also permit valuation at fair value or revaluated cost (Finland, Portugal, Spain, Switzerland and the United Kingdom). The recognition and measurement of long-term obligations apart from public debt (e.g. pensions) is not commonly done in the balance sheet, with a few exceptions. Apart from those countries that include this information in the balance sheet, in full or partly, others provide such information in notes or other reports. Quite frequently, central governments also publish consolidated accounting statements in which the inclusion of governmental businesses or enterprises is usually made when specific conditions are met.

The extent to which IPSAS have influenced existing accounting systems at central government level is an interesting issue. The countries that still follow modified cash are excluded from this discussion as it is clear that their accounting systems are not adapted to either IPSAS or IFRS (International Financial Reporting Standards) with the exception of Greece where there are some IFRS and IPSAS inferences. There are only two clear cut cases, Austria and Spain, where IPSAS have been adopted, while Portugal is in the process of adopting them. The United Kingdom is a country where the accrual accounting system at central government level has no IPSAS inferences; the IFRS have been used there as a source of inspiration for governmental accounting standards. In Belgium and Finland the accounting systems seem totally distinct from IPSAS, while in Denmark, France and Sweden the national accounting standards have similarities to IPSAS.

16.4.2 Regional governments

The review of the accounting systems in regional governments and regions is shown in Table 16.3. In regional governments, with the exception of France, there is not a conceptual accounting framework in place. The accounting systems used cover all possible alternatives (cash, modified cash, modified accrual and accrual) while it also happens that different regions within the same country adapt different accounting paradigms, as in the case of Austria, Belgium and Germany. Regions, like central governments, use a mandatory chart of accounts, with the exception of Spain. Accounting regulation in regions comes more frequently from governmental bodies and less frequently from regional governments themselves.

The balance sheet and the income statement are commonly published by regional governments using modified cash, modified accrual or accrual

Table 16.3 Accounting systems in regional governments and regions

Issue	AUT	BEL	DEN	FIN	FRA	GER	GRE	ITA	NED	POR	SPA	SWE	SWI	UK
Accounting	Diverse	Differences by region	Accrual	n/a	Modified accrual basis	Most states are with cameral (cash) accounting, a few with accrual	Cash/ accrual in the near future	Modified cash/ accruals	n/a	n/a	Accrual	n/a	Accrual	n/a
Balance sheet	Most	Differences by region	Yes	n/a	Yes	No, but some states apply accrual accounting	Not yet	Yes	n/a	n/a	Yes	n/a	Yes	n/a
Income statement	Some	Differences by region	Yes	n/a	Yes	No, but some states apply accrual accounting	Not yet	Yes	n/a	n/a	Yes	n/a	Yes	n/a
Cash flow statement	One follows the logic of a cash flow statement, others do not	Differences by region	No	n/a	No	No, but some states apply accrual accounting	No	No	n/a	n/a	Yes	n/a	Yes	n/a
Notes to financial statements	Yes	Differences by region	Yes	n/a	No	No, but some states apply accrual accounting	No	Yes	n/a	n/a	Yes	n/a	Yes	n/a

accounting but the fact that regional governments within the same country use different systems makes the drawing of conclusions rather difficult. Notes usually accompany financial statements. In any case, cash flow statements are less frequently used while the statement of changes in equity is the least published report.

The majority of regions recognize fixed assets in the balance sheet. Fixed assets evaluation is done with historical cost, while in Spain and Switzerland fair value may also be used for evaluation purposes. Fixed assets depreciation is also included in the income statement. As regions within a country may apply different accounting bases, fixed assets evaluation takes different forms. The recognition and measurement of long-term obligations, apart from public debt (e.g. pensions), takes place only in some cases. Publication of full consolidation reports is unusual.

Finally, IPSAS do not seem to exert a significant influence on the accounting principles of regions. With the exception of Spain and Switzerland, where IPSAS are considered as references for regional accounting standards, in all other countries they have not been relevant in standard-setting development.

16.4.3 Local governments

The main features of local government accounting systems are shown in Table 16.4. At local government level there are four countries with a conceptual framework, namely France, the Netherlands, Spain and Sweden. In most cases all local governments within a country apply the same accounting basis (11 countries). More specifically, most of them use accrual accounting (eight countries) followed by modified accrual (two countries) and modified cash (one country). In Italy, the only country still using modified cash basis as a general practice, financial reports developed under accrual accounting complement the information provided. Nevertheless, in three countries (Austria, Denmark and Germany) not all local governments follow the same accounting principles and there is also heterogeneity in accounting standards selection. This might be explained by different systems followed by regional governments influencing local governments in turn. The majority of countries have a mandatory chart of accounts for local governments. Accounting regulation at this level is mainly the responsibility of governmental bodies. Less frequently, regional governments have a say in accounting regulation. Professional bodies decide on accounting regulation for local governments only in the United Kingdom. The majority of local governments publish a balance sheet and an income statement. Their financial statements are also frequently accompanied by notes. The next most common financial statement is a cash flow statement, while the issuance of a statement of changes in equity is unusual (found only in Spain, Sweden and the United Kingdom). In most countries, local governments recognize fixed assets in the financial statements by using historical cost for evaluation purposes and fixed assets depreciation is taken into account in the income statement.

Table 16.4 Accounting systems for local governments

Issue	AUT	BEL	DEN	FIN	FRA	GER	GRE*	ITA	NED	POR	SPA	SWE	SWI	UK
Accounting	Diverse	Accrual	Cash basis/ modified accrual basis	Accrual	Modified accrual accounting	Mainly accrual, but cash and modified cash still allowed	Accrual	Modified cash/ accruals	Modified accrual	Accrual	Accrual	Accrual	Accrual	Accrual basis
Balance sheet	Some	Yes	Yes	Yes	Yes	Yes, in those states where LGs apply accrual acc. (but LGs with cash system hardly comply)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Income statement	Some	Yes	Yes	Yes	Yes	Yes (see comment balance sheet)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Cash flow statement	Only one, the others not	Yes	No	Yes	No	Yes (see comment balance sheet)	No	No	No	Yes	Yes	yes	It depends	Yes
Notes to financial statements	Some	Yes	Yes	Yes	No	Yes (see comment balance sheet)	no	yes	Yes	Yes	Yes	yes	It depends	Yes

*In Greece local governments refer to municipalities.

The recognition and measurement of long-term obligations other than debt (e.g. pension, social benefits) in local governments is an uncommon process. More specifically, in eight countries local governments do not report these long-term obligations, in four countries they do, while in two other countries there is a variation in the treatment of this kind of obligation. As for the production of consolidated financial statements, the picture is mixed. In six countries, local governments produce (or will produce) consolidated financial statements, in another five countries they do not, while there are three countries in which there are differences among local governments on consolidation related issues. Where consolidation takes place, governmental businesses or enterprises are taken into consideration, albeit local governments within the same country may follow different procedures.

IPSAS adapted standards at local government level are used in Spain and Switzerland, and also for Belgian Flemish local entities. Moreover, in Portugal the project of developing IPSAS adapted standards for local governments is in progress. In the United Kingdom, IPSAS may be used as a reference point for further guidance, although local government accounting is inspired by IFRS. In all other countries the accounting standards used at local government level are not adapted to IPSAS.

16.5 Diversity in auditing systems

Public sector entities have an obligation to be responsible for the use of public resources and to achieve their objectives with economy, effectiveness and efficiency. Accountability and transparency try to guarantee these requirements, while auditing is a tool that serves the need for public managers to account for their use of resources.

In the European Union, Council Directive 2011/85/EU states that public accounting systems shall be subject to internal control and independent audits. In line with this, in all the countries analysed there are two types of audit: internal and external. Internal audits are carried out by public sector auditors belonging to the entity, while external audits are carried out by professionals outside the organization to be audited. Internal control includes the control of procedures, with legal intervention, financial control and, usually, the control of effectiveness.

In all the countries analysed the auditing regulation for external audit comes from a governmental body, usually passed through a legal document; normally, a law or decree is used to regulate central government audits. Professional auditors sometimes collaborate in the design of the auditing standards.

External audits try to ensure the organizational independence of the auditor, so that the audit can be carried out without interference from the entity under audit. Thus, one of the key aspects is the appointment of the auditor. In central government, budgetary statements are audited by public sector auditors belonging to the relevant supreme audit institution (SAI), a governmental or parliamentary body that is directly related to the government. The same body is in charge of the audit of financial statements, but in some countries certified auditors are also appointed to conduct a financial audit, as in the case of Portugal and Switzerland (see Table 16.5). Note that in Germany financial statements are not audited externally and only budgetary statements are under the control of the Federal Court of Audit.

Performance audit for central government is carried out in Austria, Denmark, Finland, France, the Netherlands, Sweden, Switzerland and the United Kingdom.

If we focus on the regional level, in most cases auditing regulations emanate from the national governments, but sometimes regional governments also have some power to regulate their control. In fact, there are many countries where the SAI shares its functions with regional audit offices, which are in charge of the control of public sector entities in the region. This is the case in Austria, France, Germany, Italy and Spain, where each region has autonomy to regulate external audits, although occasionally there is also national control and the functions are duplicated (e.g. in Italy and Spain).

The audit of regions is carried out mainly by public sector auditors belonging to the regional or supreme audit institutions and covers both budgetary statements and financial statements, with some exceptions, such as Greece, where audit of accrual financial statements is yet to be defined as the accounting reform is in process. In Denmark and Italy the budgetary and financial statements are audited by both the SAI and professionals. In Switzerland, certified auditors participate only in the audit of financial statements. Performance audit for regional governments is only applied in Denmark and France.

In most of the countries the central government is responsible for providing regulations about auditing for local government, but regional governments regulate local level audits in Belgium and Germany, so that there are important differences among entities of different regions. The auditors of budgetary statements are mainly public sector auditors belonging to SAIs and/or regional audit institutions. Therefore, public sector auditors predominate over private certified auditors. However, at this level of government certified auditors have more participation, especially for audits of financial statements, as can be seen in Table 16.5. In Finland, the audit of budgetary and financial statements is carried out by certified auditors and in Denmark, Italy and Portugal both public sector auditors and certified auditors are involved in the audit of budgetary and financial statements. In Italy, professional auditors are appointed by the Ministry of Interior, both for budgetary and financial statements.

The auditor of local government financial statements is a certified auditor in Greece, the Netherlands and the United Kingdom, while in Switzerland both types of auditors (public sector and certified) participate in the auditing

Table 16.5 Auditing in three levels of government

Gov. level	Issue	AUT	BEL	DEN	FIN	FRA	GER	GRE*	ITA	NED	POR	SPA	SWE	SWI	UK
CG	Auditor of budget statements	SAI	SAI	Parliament-elected state auditor in cooperation with SAI	SAI	SAI	SAI	SAI	SAI	SAI	SAI/ certified auditors	SAI	SAI	SAI	No
CG	Auditor of financial statements	SAI	SAI	SAI	SAI	SAI	Property account is not audited	SAI	SAI	SAI	SAI	SAI	SAI	SAI and financial inspectorates	SAI
RG	Auditor of budget statements	SAI and regional court of auditors	Difference by regions	SAI/certified auditors	n/a	Regional court of accounts	Regional audit office	SAI	SAI and board of certified auditors	n/a	n/a	Regional audit institutions and SAI	n/a	Regional audit office	n/a
RG	Auditor of financial statements	SAI and regional court of auditors	Difference by regions	SAI/certified auditors	n/a	Regional court of accounts	Regional audit office	Not yet defined	SAI and board of certified auditors	n/a	n/a	Regional audit institutions and SAI	n/a	Difference by regions	n/a
LG	Auditor of budget statements	Control units and SAI if +10,000 inhabitants	Difference by regions	SAI/certified auditors	Certified public auditors	Regional Court of Accounts	Difference by regions	Public sector audit	SAI and certified auditors	Public sector auditors	SAI and certified auditors	Regional audit institutions and SAI	SAI	Differences by entities	No
LG	Auditor of financial statements	Public sector auditors	Difference by regions	SAI/certified auditors	Certified public auditors	Regional court of accounts	Difference by regions	Certified auditors	SAI and certified auditors	Certified auditors	SAI and certified auditors	Regional audit institutions and SAI	SAI	Differences by entities	Certified auditors

Notes: Where CG, Central Government; RG, Regional Government and Regions and LG, Local Governments (* in Greece RG refers to regions and LG to municipalities).

of local government financial statements. In France, the Regional Court of Auditors is in charge of local government audits and in Spain both the National Supreme Audit Office and the Regional Audit Office have competences for the external control of local governments. In Germany, depending on the size of local governments, budget execution statements and financial statements of local governments are audited by an external or an internal auditor.

Performance audit is quite uncommon. Only in Denmark, France, the Netherlands, Sweden, Switzerland and the United Kingdom is this kind of audit implemented for local governments. In Finland an appointed audit committee, composed of non-professional auditors, carries out the performance audit.

In most cases the standards used for the audit have been developed by a governmental body with the collaboration of professionals and sometimes the International Auditing Standards of IFAC (International Federation of Accountants) or the International Standards of Supreme Audit Institutions of International Organisation of Supreme Audit Institutions (INTOSAI) have been taken as a reference. However, only in the Netherlands are the International Standards on Auditing (ISAs) applied.

To summarize, we can say that far from being harmonized, the auditing of the public sector offers a heterogeneous panorama. On occasions, only public sector auditors participate in the audit and in others certified accountants. The type of audit implemented also shows differences and the standards used have been developed nationally, although international standards have sometimes been considered as a reference.

16.6 Readiness for a change to a set of public sector accounting international standards

The situation reported in the countries examined above has highlighted a large variety of situations, where the possibility of moving towards a harmonized system at international level assumes different nuances. In 5 out of 14 countries (Austria, France, Portugal, Spain and Switzerland to some extent) a reform process to move towards IPSAS has been or is going to be undertaken in the public sector. Within the remaining nine, five are unlikely to follow IPSAS in the near future, since they have chosen a different approach to public sector accounting and do not see IPSAS as a suitable base for answering users' information needs (Denmark, Finland, Germany, Sweden, the Netherlands). In Belgium the situation differs within different regions but, generally speaking, there are several forces which can create a resistance to change. In Greece there is differentiation between different governmental levels and administration reforms are expected to take place in the future. In Italy a reform requiring internal harmonization is under trial, but cash accounting will be at its base; IPSAS have not been considered since Italy has declared its interest in EPSAS. Lastly, in the United Kingdom the public sector accounting system is already inspired by IAS/IFRS and there is no willingness to move to a different system. Table 16.6 illustrates the status quo.

The overall situation shows that there is a long way to go both before internal harmonization within the specific countries and from a widespread adoption – or willingness to adopt – of a common set of international accounting standards. Summarizing the situation depicted in the observed countries, the main challenges that must be taken into account in order to assess the readiness for the adoption of a common set of accounting principles through Europe can be identified as follows:

- *Accounting education level: training needs*

A limited knowledge of accrual accounting characterizes a number of countries both among politicians and civil servants (Greece and Italy), while in others (France, Portugal and Spain) progress has been achieved in the accounting culture thanks to the most recent reforms.

In other countries (Austria and Denmark) the situation differs between governmental levels, and in other cases also within the same governmental level (Belgium and Germany). In Finland, Switzerland and the United Kingdom it is possible to observe a high level of accounting education, mainly due to long experience in the adoption of accrual accounting in the public sector.

- *Information systems adequacy*

The implementation of new accounting systems often requires the adoption of new IT systems, which increases the difficulty of the change for all users and makes the reform process expensive. With regard to this point, most of the countries already have the support of IT tools, while in others some investment still needs to be done, although some differences occur between different governmental levels.

- *Maturity of accounting systems*

Accounting systems in Europe present, of course, different levels of readiness for change towards an accrual based system, like the one embedded in IPSAS. A very low level of accounting maturity emerges in Italy and Greece, while in other Mediterranean countries (France, Portugal and Spain) some progress has been brought about by recent reforms.

The situation is rather different in Finland, Sweden, Switzerland and the United Kingdom, where the adoption of accrual accounting in the public sector has strong roots, so that the adoption of a new set of accounting principles based on accruals would be easier. Nevertheless, it has to be taken

Table 16.6 The adoption of international accounting principles

Issue	AUT	BEL	DEN	FIN	FRA	GER	GRE	ITA	NED	POR	SPA	SWE	SWI	UK
There is a reform underway to adapt to IPSAS	Yes	Differences by regions	No	No	Yes	No	No	No	No	Yes	Yes	No	Yes, partly	No
There is a reform underway to obtain internal harmonization	Yes	Differences by regions	No	No, already realized	Yes	No	Yes	Yes	No	Yes	No	No	Yes	No
Reform underway inspired by IPSAS	Yes	Only Flemish local entities	No	No	Yes	No	No	No	No	Yes	Yes	To some extent	Yes	No
Reform underway inspired by IFRS	No	No	No	No	Yes	No	No	No	No	No	No	To some extent	No	No

into account that in some of the more "mature" countries the possibility of following IPSAS has been already denied, as these principles have not been considered suitable to satisfy the information needs of the public sector, or because the traditional use of historical cost for asset evaluation is still preferred to the fair value logic implied by IPSAS.

- *Political support*

A considerable number of the observed European countries demonstrate low political motivation for an accounting reform which includes the consideration of international accounting standards. This approach can be justified by two different kinds of motivation: in some of these countries politicians base their decisions mainly on budgetary accounting; in others the accrual system in place is already considered suitable for satisfying information needs, so there is no strong push for further change.

- *Legislation/clarity of rules*

Some of the examined European countries (Austria, Belgium and Germany) are currently characterized by a very complex legislative framework, which can cause divergences in the budgeting, accounting and reporting systems within different governmental levels. In Austria this complexity is undergoing a process of change. In other countries the approach followed so far is almost intended to satisfy a need to monitor how public resources are spent (i.e. Denmark). In others, moreover, a reform process is underway (i.e. France, Greece, Italy and Portugal) and new legislation is still under construction. This diversity could create further barriers that must be taken into account by supranational institutions if the willingness to adopt a common set of international accounting standards is to prevail in Europe.

- *Implementation costs*

Considering that the adoption of a different accounting system or a different set of accounting standards requires investment in both training and IT tools, the implementation of a new set of standards is generally considered an expensive operation. In a period of budget constraints this can create a further barrier to change in public sector accounting, especially in those countries with a low degree of maturity in accounting systems and where the need to train civil servants and adapt IT systems is high.

- *Consulting needs/technical support*

The implementation of a set of international accounting standards would require a high level of technical support, both related to the acquisition of professional expertise in the adoption of different rules and in the implementation of IT tools to support the adoption of a new accounting system. In several countries the need to obtain expert technical support is very high; this situation could create a high demand for professionals, causing a consequent increase in the related costs.

The challenge – as well as the potential – of the adoption of a common set of international accounting standards – like IPSAS or EPSAS – seems to lie in the possibility of creating a solution suitable for all countries, able to answer the information needs of both public decision makers and the public. Most countries have already implemented recent reform in their budgeting, accounting and reporting systems, even if in some (Austria, Belgium and Germany) the reform process has been differently implemented at different governmental levels, and different levels seem to be more sceptical about the adoption of an accrual-based system.

The situation within the different countries observed has also pointed to a strong role for the rules set out by the European Union: the need to comply with the Stability Pact requires an improvement in fiscal coordination between levels of government; committing to new fiscal rules; medium-term budget frameworks; reporting requirements. These all strengthen the need for accounting harmonization.

One point that still deserves great attention is a clearer role for budget execution. In those countries where budgeting and reporting follow different accounting bases this represents a challenging point.

The discussion has also highlighted that for some countries the approach followed by IPSAS gives room for discretion, while mitigating the use of options in financial reporting is more appropriate to the information needs of public entities. Moreover, the use of fair value would be difficult to apply, especially in those countries that, even if they have adopted an accrual basis, have been always devoted to prudence, the realization principle and historical costs.

Index