

The need for harmonised, accruals-based European Public Sector Accounting Standards from a German perspective

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Since the mid-90's, the majority of local governments in Germany reformed their budgeting and accounting system towards an output-oriented, accruals-based system. The accounting regulations were mainly based on the accounting regulations for the private sector. A recent empirical study (www.doppik-studie.de) revealed that in German local authorities, the majority (70%) of financial officers estimate that the benefits of the budgeting and accounting reform will in the medium to long term outweigh the costs, which implies that after having implemented the accounting reform, there is still a positive emotion that it was the right decision even if in the short run the costs clearly exceed the benefits, which are difficult to measure anyway. Benefits associated with the move from cash to accrual are:

- The possibility to prepare consolidated accounts,
- Ensuring intergenerational equity by focusing on revenues and expenses rather than cash flows,
- Improved information relevance,
- Improved transparency about the financial position and performance of a public sector entity,
- Benchmarking/Comparability, at least with other local authorities within the same state, and
- Improved management through performance measures.

As Germany is a federal state and the states ("Bundesländer") have the regulating power concerning the local budgeting and accounting system, the accounting regulations for local authorities are as a result not materially comparable. Differences between the states can be found regarding:¹

- Measurement of property in opening statement of financial position (Cost vs. fair value),
- Useful life of long-term assets,
- Definition of ordinary and extraordinary revenues and expenses and budget implications, e.g. revenues from the sale of assets which are in some states classified as ordinary and in others as extraordinary revenue. As the balanced budget rule is connected to either the ordinary result or

¹ See. www.doppikvergleich.de

the result for the period, the local authorities in some states are offered the possibility to balance their budget by selling assets;

- Structure of cash flow statement (direct vs. indirect method for cash flows from operating activities),
- Definitions and scope of consolidated accounts, deadlines for issue of consolidated accounts,
- Definition and subcategories of net assets/equity (e.g. with regard to special reserves to cover for an unbalanced budget which are allowed only in some states),
- Financial assumptions for calculation of pension provisions, e.g. discount rate, and
- Recognition criteria regarding provisions (especially pension provisions).

As none of the German states considered IPSASs as a basis or benchmark, and because in Germany there is some reluctance to use international standards, a project was set up which implemented IPSASs in a medium sized local authority (Gemeinde Hiddenhausen, around 20.000 inhabitants) to evaluate the additional workload as well as costs and benefits that might be associated with IPSASs compared to national regulations. The overall effects were the net assets/equity increased by 37% and the deficit for the period increased by about 20%.

From this project, which is of course not representative, the following conclusions can be drawn:

Fiscal transparency was improved by the classification of the entire statement of financial position into current and non-current elements, the measurement of certain types of assets at fair value (realisable assets, i.e. investment property and some financial instruments) as well as segment reporting in consolidated financial statements. All of the above mentioned points lead to the effect that users of financial statements are provided with information which is more relevant. From the perspective of users of financial statements, the comparability of financial information between different public sector entities will also be improved when using IPSASs as a basis, but only under the condition that options regarding the structure of components of financial statements and recognition as well as valuation options are eliminated or reduced to a minimum. The last point made is one of the main arguments for harmonizing public sector accounting standards in EU member states. As there is already an extensive set of IPSASs which took the IPSASB around 15 years to develop, there seems to be no alternative to using those as a basis for European Public Sector Accounting Standards (EPSASs).

As most of the IPSASs are based on IFRSs, e.g. alternative valuation treatments have also been approved for the public sector. In the private sector, there are a number of reasons to allow alternative valuation options as corporations are engaged in many different activities. This is different for the public sector, at least for core public sector entities. The same is true in regard to the structure of the elements of financial statements, which should be the same for every core

public sector entity to be able to achieve formal comparability between public sector entities.

The project also revealed some disadvantages of IPSASs-based accounting standards:

- Impairment rules as impairment is to be immediately recognised regardless of whether the impairment is considered lasting or not and impairment tests are to be applied to the whole group of assets,
- Substantial extent of notes (see e.g. [http://www.ey.com/Publication/vwLUAssets/IPSAS_Disclosure_Check_list/\\$FILE/IPSAS_DisclosureChecklist.pdf](http://www.ey.com/Publication/vwLUAssets/IPSAS_Disclosure_Check_list/$FILE/IPSAS_DisclosureChecklist.pdf) or <https://www.google.com/url?q=http://www.nao.org.uk/report/compliance-guide-for-entities-which-prepare-financial-statements-in-accordance-with-international-public-sector-accounting-standards-ipsas/&sa=U&ei=WE2wUYjLG4aAhQf7h4HoDg&ved=0CAcQFjAA&client=internal-uds-cse&usq=AFQjCNF1J4rhsyB9bzUOSpecSvfkAoo1KA>),
- Measurement of PPE at revalued amounts for administrative assets, which does not provide more relevant information for users compared with the valuation at costs for assets used in the production of goods or rendering of public services,
- Recognition of revenue from non-exchange transactions (especially taxes and transfers), and
- Budget information in consolidated financial statements on the basis of IPSAS 24.

In summary, it can be stated that for German local authorities that have already implemented an accrual accounting system, the change to IPSASs and therefore also presumably the change to EPSASs will not be overly high. The situation is different when regarding the majority of states and the central government which still have reservations as to why an accrual accounting system is superior compared to the alternative of adding accrual data to the data produced by a cash accounting system. While it is true that all the necessary data produced by an accrual accounting system can also be generated in separate systems when using a cash accounting basis, the main argument for the change from a cash to an accrual accounting system is that only with this prerequisite it is possible to prepare and present consolidated financial statements. In addition, from the experience of the reform on the German local level, it can be stated that about 80% of the costs associated with the change to accrual accounting will also apply when generating accrual data in addition to a cash based system. Furthermore, using separate systems to produce accounting data is highly error prone. In addition, two other aspects speak for shifting towards an accrual system:

- When regarding the objective of improving financial management, which is to a large extent based on information from management accounting systems, this is far easier when all accounting information produced is included in one system, and

- The prominent user groups (politicians, key management and citizens) are more likely forced to use accrual data if the basis of accounting is changed from cash to accrual; otherwise, there is the risk that the focus of some user groups will still remain mainly on the cash information.

Last but not least, empirical evidence from empirical studies on governmental budgeting and accounting reforms suggests that benefits of the reform will only be realized to their full extent if budgeting and accounting system are on the same basis.² While it is clear that the EU Commission does not have a mandate that extends to budgetary regulations, the EU should nevertheless encourage governments to simultaneously reform the budgeting system, and should take implications on budgetary accounting into account when developing EPSASs. Additional consideration should also be given to possible simplifications for small and medium sized public sector entities.

In summary, the harmonization of public sector accounting standards within the EU is long overdue. At the same time, harmonized accrual accounting rules are only a necessary requirement to achieve improved financial management within the member states as improving efficiency and effectiveness of financial management is largely dependent on the context in which reforms are implemented. One lesson that can be learned from the German experience for the process of approving EPSASs is that it is important when approving accounting regulations to always have in mind that there should be a balance between the benefit and cost: the benefit derived from producing accounting information should in all circumstances at least equal or exceed the costs associated with producing this information.

² See Lüder/Jones: Reforming governmental accounting and budgeting in Europe, 2004