A discussion series:

SUSTAINABLE PUBLIC FINANCES – EU PERSPECTIVES

REGIONAL AND CENTRAL GOVERNMENT PERSPECTIVES

Synopsis of discussion on 23 April 2013, Brussels

INTRODUCTION

The global financial and economic crisis is bringing about profound changes in international, financial and government institutions. In Europe, the crisis has also drawn particular attention to the poor quality of financial management, reporting and governance within much of the public sector, highlighting the need for greater action to address these interconnected shortcomings. At this critical stage in policy development, ICAEW is bringing together key decision-makers and experts with a wide range of perspectives to help advance discussion on how to promote better financial management, transparency and accountability in the public sector throughout Europe.

On 23 April 2013, a senior group of policy-makers and stakeholders came together to exchange views on such issues. The meeting was the second in a series of informal discussions being organised by ICAEW in 2013 with support from PwC.

This brief synopsis seeks to capture the key elements of the second discussion to encourage feedback and further development of the ideas raised during the dinner. It also aims to inform other stakeholders who have an interest in the overarching theme of sustainable public finances in Europe and who may wish to contribute to the subsequent discussions taking place in Brussels in 2013.

We would be delighted to receive comments on the synopsis, to be addressed to:

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NEXT DISCUSSIONS

During the course of 2013, four discussions are being organised to encourage an informed exchange of views on reforms to enhance financial management, transparency and accountability in the public sector throughout Europe. Each specific discussion provides an opportunity to comment on the overarching theme of sustainable public finances in Europe. Equally, in order to provide fresh input into the debate, each discussion also explores a particular aspect in greater detail.

Public sector finances – EU perspectives
22 January 2013
(synopsis available)

Views from international institutions
24 September 2013

Democratic accountability and fiscal sustainability
13 November 2013

SYNOPSIS OF DISCUSSION

‘Regional and Central Government Perspectives’

A common language of financial information across different tiers and branches of the state is essential. Without reliable and comparable information, the inter-relationship and accountability between central, regional and local levels of government risks becoming unmanageable.

The second discussion in the series on 23 April 2013 provided an opportunity to deepen the understanding of the inter-relationship between central, regional and local tiers of government in relation to financial management, accountability and transparency, focusing on the reasons why reform is critical to the EU’s long-term future and how this reform can best be achieved.

The discussion took place against the backdrop of important developments in EU economic governance, including the growing interactions between member states’ public internal control systems and the recently published Eurostat report setting out options to improve the reliability of data provided by member states by improving and harmonising public sector financial reporting across the EU.

In order to stimulate the discussion, brief presentations were given by the representatives from the European Commission’s Directorate-General for Budget responsible for the coordination of member state practice in relation to public internal control, and from Eurostat.

The discussion was wide ranging but evolved around two main focus areas within which a number of key questions were explored:

EU reforms: priorities, opportunities and challenges

- What particular challenges relating to local and regional government perspectives can be foreseen in the upcoming debate on improving and harmonising public sector financial reporting across the EU?
- To what extent do they stem from a reluctance to provide more open and transparent reporting of assets and liabilities?
- Are there particular challenges arising from public entities and other public initiatives which also need to be considered?
- What is the experience to date of public sector internal control systems at member state level and how can best practice be extended and improved?
- To what extent do these issues command sufficient attention in the European Parliament and should they be given greater priority at EU level as a whole?

Member states: current picture, lessons from reform and drivers of change

- How effective and reliable are the accountability mechanisms between central and regional / local governments across EU member states today?
- What lessons can be drawn from different experiences of accounting and public sector management reforms at local and regional level across EU member states, also covering public entities and other public sector initiatives?
- How can the need and benefits of reforms be better communicated and understood across different tiers of government in the EU?
- To what degree will the market drive reform in public sector financial management?

EU reforms: priorities, opportunities and challenges

> Moving from cash to accruals accounting is like moving from the Stone Ages into the Middle Ages.

Accruals accounting: an essential change for Europe

The current crisis in Europe has led to clear commitment by member states to consolidate public finances. The fiscal compact, the Two-Pack, measures to reinforce surveillance – including as of next year control of national budgets by the Commission ahead of national parliaments – are important tools to ensure compliance with targets. Within this framework, the accounting systems of member states assume critical importance.

European government accounting arrangements in 2013 remain extremely heterogeneous. This is evident from the March 2013 Eurostat report (and accompanying papers) which assess the move towards harmonised public sector accounting standards and the suitability of International Public Sector Accounting Standards (IPSAS). At the present time, taking into account all tiers and branches of government and the public sector across EU member states, no two countries have the same system or apply the same standards. Similarly, a global survey of 100 countries undertaken by PwC highlights the diverse landscape when it comes to accounting practices in the public sector. Cash accounting is still very common.

Change is in the air and a move towards accruals accounting is becoming more visible not only within Europe but also globally, including by many non-OECD countries. The EU now has an opportunity to take a major step forward as part of wider moves towards stronger economic governance.

Since 2010, the European Commission has been promoting the need for accruals based accounting practices in the EU as a prerequisite for enhancing the quality of government statistics. These efforts have been stepped up further through Eurostat's recent consultation exercise and publication of its major report in March. The starting point is that moving to accruals accounting is a 'must': reliable government financial accounts are essential for the preparation of national accounts and thereby fiscal planning, coordination and supervision. Greater harmonisation in the preparation of financial information for decision-making is essential.

The Eurostat report states that while IPSAS cannot easily be applied directly in the EU today, the suite of standards remains the obvious point of reference for potential EU harmonised public sector accounts – or 'EPSAS'. A strong European governance structure will be a precondition for developing and adopting EPSAS. Moreover, accruals based data is used for EU budgetary coordination and surveillance processes via the European System of National and Regional Accounts (ESA), which provide the statistical accounting framework for EU government and non-government sectors. Yet even where accruals information is available, ESA data is derived by translating data from a cash basis to an accruals one. Is this really the best way to do it?

EU-level discussions will be focused on the Eurostat initiative. But there are also other drivers for reform, including external ones in cases where domestic pressures are currently insufficient. For example, the World Bank and IMF (as well as the EU) played an important role in encouraging recent and new EU member states to implement accruals accounting.

Where steps towards accruals accounting are not on the agenda, there is a need to 'spread the gospel' at all government levels and to bring together policy-makers and stakeholders to push for reform. This 'gospel' can refer to a number of significant benefits, including greater transparency, improved democratic accountability as well as the potential to rationalise financial management structures and bring about efficiency gains. To reap the full benefits a comprehensive change management and education process may be needed, drawing in key decision-makers, stakeholders and finance professionals.

Reforms take time and entail costs – often identified as an important obstacle. But the costs of inaction can also be significant: for instance, what are the consequences of not having financial information which accurately reflects the position of governments with all their assumed responsibilities across different tiers and branches of the public sector? And what are the consequences of not having comparable information across the in the EU for broader economic governance? The absence of such a key information source will make it harder to achieve sustainable EU public finances.

> No government would allow a listed company to not use accruals accounting because of the costs.

Accounting in the broader context

The current accruals debate needs to be seen in a broader context which acknowledges the 'modesty' of the proposed step. Moving from cash based to accruals based accounting is like moving from the Stone Ages to the Middle Ages. It is a first step. Other questions need to be asked, such as for whom are accounting systems useful? Are the right things being measured? And once information is produced, is it actually being used? What if decision-makers continue to make decision without reference to the available data? A particular challenge is that the focus within the public sector often tends to fall on budgets, not on financial reporting; the link between the two is insufficiently made.

Public sector accounting needs to provide the right information, without too much complexity or information overload. The debate on the way forward in the public sector sometimes draws on parallels in the private sector. There are some concerns that private sector accounting standards have become overly complex. It is also sometimes said that even specialist analysts do not read all the data in private sector financial statements. Equally, reluctance to introduce accruals based accounting in the public sector is sometimes expressed on the grounds of avoiding unnecessary complexity. Reference is also made to the fact that an external driver demanding more detailed information from the public sector has been largely lacking.

However, lessons can also be drawn from private experiences which could assist public sector reforms. There would also be benefit from encouraging the public sector in the direction of integrated reporting, particularly to ensure the inclusion of information on risk management.

A still broader perspective might also be taken to question the assumption of continuing economic growth and the implications for public sector accounting. By way of example, the assumption of growth has underpinned accounting for public finance initiatives in the UK (PFI) and the risk that PFIs could end up back under public sector control was not considered. Yet, it could be said that with the de facto state control of some major banks, the UK now has 'publicly financed private finance initiatives'.

Consideration of broader perspectives helps underline that that there are many issues which go beyond accounting and its essential function as an information system. This information system serves a critical purpose: in the public sector, accountants must 'stand behind politicians', providing a source of relevant information which is fair and accurate and on which politicians can base their decisions. Accruals accounting is the only generally accepted basis for the preparation of such information.

Timely, reliable and comparable information can improve the management of public finances. Financial information prepared on an accruals basis enables government authorities at all levels to take a longer-term perspective, to establish key performance indicators and to better measure outcomes. It is also expected that markets will over time become even more insistent on receiving such information when allocating capital. This interaction between the public sector and private markets will become more pronounced.

Enhancing internal control

Sound financial management is an integral part of good governance. Internal control, as well as internal and external audit, is an essential pillar in member state governance systems. A holistic approach is required. Just as accruals accounting alone is not sufficient to deliver sound financial management, internal control or internal audit alone can only achieve so much. There is still much work to be done across much of Europe in these spheres. For example, there are still some member states, albeit a handful, with no internal audit systems in place. In relation to internal control, there have been a number of concerted actions to promote reform in recent years.

DG Budget has been working together with member states to share knowledge on the need for adequate control and audit systems in the management of national budgets. This is an important step beyond the Commission's established cooperation with member states over the management of EU funds. In particular, the Commission has compiled a Compendium providing an overview of the public internal control systems currently applied across the EU. A group of member states are helping to steer the initiative forward, building also on the creation of a network of specialists across all EU27.

Reform that moves towards application of the COSO model and the International Professional Practices Framework (IPPF) guidance promulgated by the Institute of Internal Auditors could also be steps forward. Reform does not always benefit from widespread support: there are some vested interests that oppose or are not fully committed to change. Financial management inevitably relates to the wider environment and there is a need to secure broader buy-in and active support. Reform must be embedded in sound governance structures and proper risk management. Proper appreciation must be given to 'outside factors', whether it is the external economic environment or the impact of political decision-making.

Reform is simply essential. Europe cannot afford not to reform, given the debt crisis and the crisis of confidence among many citizens regarding the ability of their governments to uphold existing social welfare models. Ultimately, it comes down to the fact this is all about taxpayers' monies – and the fact that taxpayers want more for less.

Current picture: lessons from the crisis and drivers of change

> There is a lack of trust between different levels of government because there is a lack of transparency.

Accounting reform and economic governance

The picture is very varied across member states in relation to the accounting basis used in the public sector. While there is a discernible trend towards more accruals, the situation differs both across and within member states.

There are important examples of reform where considerable investment has been made over recent years, including in France and in the UK. However, in some other important member states, including for example the Netherlands, most of central government continues to operate on a cash accounting basis. Despite arguments in favour of accruals accounting by the Netherlands Court of Auditors, including better comparability, there is reluctance to move towards accruals accounting because of costs. In Germany, the *Bundesrechnungshof* (supreme audit institution) has initiated reform – but this has resulted in a hybrid, complementary cash based system.

It is possible for countries with good public sector systems of financial reporting, public internal control, and internal and external audit systems to still experience severe financial and economic crises.

For example, the UK is in an advanced position regarding accruals accounting and internal controls within the public sector but public finances have come under strain. This underlines the importance of the broader context of regulation and economic governance; better public sector accounting alone will not deliver sustainable public finances.

From another angle, the US situation demonstrates that the correlation between public sector accounting and overall economic sustainability is not necessarily straightforward: the US has major pension liabilities and debt levels higher than in the Eurozone. Still, the US 'doesn't think it has a sovereign debt crisis' and consequently it does not have one, or at least an acute crisis as in Europe.

Questions remain, however, over the longer term, as to whether the perception of markets and of the public can remain unchanged if the underlying financial position deteriorates? Economic growth can cover a lot of 'sins' in terms of public sector management and accounting. Like China, countries can live with all sorts of problems if there is economic growth.

'Might may make right' but shortcomings in public sector management cannot be overlooked forever. The dynamics at play between finance professionals – the 'reality-checkers' – and politicians are not always understood and inevitably there will always be tensions. But in order to get ahead of the curve both sides will need to understand each other better.

Central government, regions and localities

As a consequence of the strengthening of economic governance at EU level, central governments' relationship to and requirements of regional and local tiers of government are likely to change in many cases. This will give rise to many questions, not only about accounting, auditing and governance at regional and local level but also in many cases about the overall allocation of revenue and expenditure between central governments and regions and localities.

The situation regarding use of accruals accounting at regional and local government levels may be more positive than is the case at central level in some cases. However there are also significant challenges for local governments trying to harmonise standards and systems across an often vast number of public sector authorities and entities. Consolidation is and will remain a particular challenge. As identified in the Eurostat study, the current situation is that no two member states use the same standards when the regional and local tiers of government are considered.

There are examples, such as Finland, where accruals accounting and a high degree of transparency are in place. But this does not mean that the picture provided by local government is always accurate. For instance, local authorities appear to take different approaches to the depreciation of key assets such as property where major differences to private sector practice can be identified. This makes comparability of information very difficult.

Particular debate can arise over the difficult financial positions of regions and localities – which in turn raise broader questions about the structure of national budgets, with all the inevitable repercussions for broader political debate. For example, a number of Spanish regions (or autonomous communities) have high levels of public debt, coupled with high unemployment rates hovering over 25 percent. Regions such as Catalonia and Castile – La Mancha have significantly reduced their deficits in the last two years, drastically cutting spending. The scale of the challenge becomes particularly apparent when one considers that the majority of regional expenditure – 70 percent in the case of Catalonia – goes on health, education and social welfare.

In other member states, such as Italy, the strain on public finances is fostering further debate on fiscal federalism and the overall relationship between the centre and the regions from the perspective of income and expenditure. Measures to cut the Italian deficit have led to new demands on local authorities to make major contributions to fiscal consolidation at national level. It has spurred further consideration regarding the structure of the state itself, with some arguing that federal states tend to have lower running costs than centralised states – although fiscal federalism is about combining autonomy, responsibility and solidarity as much as it is a matter of taxation and expenditure.

Why were countries with good reporting and control systems in place still hit by the crisis?

Ultimately, there is a need for a more mature democratic exercise on how to achieve more healthy sustainable public finances and how central-regional relationships can function on sustainable economic grounds. Reliable information, drawn on the basis of accounting systems which recognise liabilities and assets, is essential to achieving this more mature debate.

A lack of transparency can lead to a lack of trust between levels of government. Accounting can provide a common language which all participants in the debate can understand. It is then for each individual member states to decide on the financial relationships between central, regional and local tiers of government. Within this picture, the position regarding public sector entities, whether owned directly by the state or by regional or local government, also has to be covered. A common language of financial information across these new different tiers and branches of the state is essential. The centralised versus decentralised arguments van be very heated so it is especially important that the debate takes place against a background of reliable and comparable information. Without it, the interrelationship and accountability between central, regional and local levels of government risks becoming unmanageable.

KEY OBSERVATIONS AND CONCLUSIONS

1 In a period of austerity, questions regarding the allocation of public resources and tax raising responsibilities between central, regional and local government generate intense debate. Reliable information, drawn on the basis of accounting systems which accurately recognise liabilities and assets, is essential to inform decision-making within member states regarding the appropriate relationships between central, regional and local government. Accounting information must act as a common language for participants to engage in the debate, recognising that the solutions pursued by member states can be different but that a common language is needed to achieve the common goal of sustainable public finances across the EU.

2 An accruals basis for the preparation of financial information within the public sector is the only appropriate and reliable basis for informed decision-making in the public sector. The current situation in the EU is characterised by major shortcoming within many member states, both with regard to central government and the relationship between different tiers of government and branches of the state. Critically, there are shortcomings in relation to the recognition of key liabilities due to the continuing use of cash accounting. Such shortcomings would not be tolerated by any member states in relation to the financial reporting of private sector and listed companies, so why are they tolerated in the public sector? The recent Eurostat report and ongoing initiatives provide a focal point for reform efforts in this regard.

3 Reform in Europe to embed accruals based accounting and having the right systems and processes in place are critical to achieving sustainable public finances. The EU simply cannot afford not to pursue reforms in these spheres: opposition to the introduction of accruals and establishing internal control systems on the basis of cost can be countered by asking: what are the costs of not pursuing reform? Reforms are central to improving the management of public resources in light of the current debt crisis and to instil confidence among citizens regarding the ability of their governments to meet existing commitments and plan for the future. For all economies, including those operating on larger scales outside of Europe, growth is not sufficient on its own to achieve sustainability in the longer term without appropriate public sector accounting and control.

> To reap the full benefits of reform a comprehensive change management and education process is required, drawing in a range of stakeholders and professionals as well as the key decision-makers. With such an inclusive engagement, the benefits could be significant.

APPENDIX: PARTICIPANTS

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