The European Process of Accounting Harmonization: Current Status and Future Developments. The Case of Italy

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Abstract

Purpose **–** *The aim of the research is to examine the accounting systems of the EU Member States in order to assess the feasibility of an accounting harmonization process in the European Union, whose final objective is the preparation of a consolidated financial statement of the European Union, which will be useful in controlling the European public debt and European finance.*

In particular, the study will focus on:

- *firstly, the evolution of the accounting practices of Italian state-owned enterprises, following a recent major reform that introduced an accrual accounting system;*
- *secondly, the accounting systems of the EU Member States in order to classify them as:*
  1) *countries that adopt a financial accounting system;*
  2) *countries that adopt a basic accrual accounting system ("Local GAAP based" accounting systems);*
  3) *countries that adopt an advanced accrual accounting system ("IPSAS based" accounting system).*

Design/methodology/approach **–** *We propose the following approach:*

- *presentation of the accounting system of the European Union.*
- *presentation of the Italian "public" accounting system and its recent reform.*
- *examination of the accounting systems of the EU Member States: current status and evolutionary processes.*
- *classification of the EU Member States into groups, depending on the accounting system adopted.*
- *identification of costs and benefits of moving to an advanced accrual "IPSAS based" accounting system.*
- *assessment of the time spent by the EU Member States to complete the transition to an advanced accrual "IPSAS based" accounting system.*
- *estimation of the time needed to implement an advanced accrual "IPSAS based" accounting system in all the EU Member States.*

Originality/value **–***This methodology will try to highlight the costs and benefits of moving to an advanced "IPSAS based" accounting system and the time it took these countries to accomplish this step. The final goal is estimating the time needed for implementing the "IPSAS based" accounting system in all the EU Member States.*

Keywords – International Public Sector Accounting Standard, Accounting Harmonization, Federalism, Consolidated Financial Statements, Control of Public Finance

Introduction

The evolving sovereign debt crisis has demonstrated that there is an urgent need for change in the way public sector financial information is collected and presented in Europe. For the monetary union to function properly it is necessary to have high quality and comparable information about balance sheet items (especially liabilities) and the true annual costs for items that do not currently require cash resources (such as public sector pension obligations) for all Member States. The costs of not acting and thus not having reliable financial information available for internal decision-making and the potentially protracted loss of the markets' and investors' trust as a result could be considerable. The benefits would still outweigh costs in the medium and long term.Implementation of IPSAS in EU Member States would provide a uniform accounting framework and accounting standards for determining deficit and debt levels that would enhance the consistency, transparency and comparability of public sector financial statements. This would help to prevent a situation where negative performance, in breach of the Stability and Growth Pact, was concealed in order to avoid an excessive deficit procedure. Whether full implementation of IPSAS is necessary to achieve this remains unclear.

An accruals basis such as that of IPSAS would provide a more meaningful picture of a government's financial position and performance, thus reducing uncertainty for ratings agencies and other users of financial statements. Opportunities for misrepresentation of financial positions and performance (i.e. by making payments in subsequent years) arereduced. It would enhance stewardship and financial management by identifying entities' assets and liabilities, facilitating a long-term perspective in financial management by identifying current liabilities that will need to be met in future (e.g. borrowings, guarantees, pension liabilities, social contribution, etc.), and better facilitate inter-generational fairness by identifying assets and liabilities. The recognition, measurement and reporting of liabilities, especially those of a long-term and uncertain nature, would be the main advantage of any future implementation of IPSAS in the EU Member States.A single set of public accounting standards such as IPSAS would reinforce the free movement of capital in the internal market and help investors to compare the financial activities of governments and consequently permit Member States to compete on an equal footing for financial resources available in EU markets and in world capital markets

Discussion

There are two principle methods of accounting – cash and accruals –which differ as to the time at which a transaction is recorded. Cash-based accounts record transactions when the amount is received or paid. Accruals-based accounts record when the transaction occurs, regardless of when the payment is actually received or made. Financial management, whether at the macro level (general government) or at the micro level (the government entity) should be based on the principle of accruals accounting. It is important, nevertheless, to note that moving to accruals-based accounts need not mean that the cash basis is abandoned. Cash data remain important, and in many Member States they are used as the basis for government budgeting.

In summary, the implications of not having robust and transparent accruals accounting for financial reporting and financial management may include an increased risk that government services are being delivered ineffectively or inefficiently, and that investment decisions do not take full account of the potential costs and benefits, for example because they are made with a short-term focus, without paying due regard to their full future costs and benefits. Robust accounting standards are important to ensure that, in difficult financial times, the reported financial information remains both reliable and credible (i.e. trustworthy and accepted as such). Strong standards reduce the scope and the temptation to manipulate information in order to hide problems. The sooner a problem is recognised the sooner it can be addressed. Having early warning of problems often means that their impact is much less than otherwise.

The last two tables show that a majority of European States have public sector accounting practices that can be characterised as accruals or modified accruals accounting across all levels of governement. Although accruals or modified accruals public accounting data is available in these Member States, in many cases. The countries that reported having mixed public sector accounting systems were Austria, Cyprus, Denmark, Germany, Hungary, Ireland, Italy, Luxembourg, Portugal, Netherland and Slovenia. These Member States either use different public sector accounting practices for different levels or sub-sectors of government, or, for example, in the case of Slovenia and Hungary, different financial statements are prepared on different accounting bases.
In **Austria**, the new accounting system implements accruals accounting for the federal government, but the states and municipalities operate cash-based systems.

In **Cyprus, Ireland, Portugal and the Netherlands,** central government applies cash or modified cash accounting, while local government uses accruals accounting. In Portugal and Ireland, accounting reform, moving to accruals accounting, is underway for central government, and in Cyprus, reform is in the planning phase.
In **Germany**, current reforms focus on the modernisation of the cash-based system at central and state levels. A minority of the federal states, and most of the municipalities, have introduced accruals accounting.

In **Denmark**, the central government and regional accounting systems are accruals based, whereas for the municipalities, accounting is mainly cash based.

In **Luxembourg**, central and local government entities, with the exception of public establishments (e.g. research centres, state foundations) and public corporations follow cash accounting principles. Similarly, social funds also use accruals accounting rules based on the general accounting principles following the national GAAP.

In **Hungary** and **Slovenia,** a cash/modified cash accounting system applies for all sub-sectors of government, although accruals/modified accruals accounting is also used when financial statements are prepared.

The results are clearly heterogeneous. No two countries have the same system or apply the same standards. Moreover, within many Member States, different accounting regimes may apply for different types of government entities.Member States with a state government sector tend to have the most complex accounting arrangements, since state governments usually follow their own accounting standards, which may differ from one state to another. More of the newer Member States follow an accruals accounting model than is the case for older Member States. In particular, the Baltic countries seem to have accruals-based standards close to IPSAS. Local governments are more likely to have an accruals accounting model than central governments.

	Federal Government			
	Statement of financial position (balance sheet)	**Statement of financial performance**	**Statement of changes in net asset**	**Cash flow statement**
Austria	Accruals accounting	Accruals accounting	Modified cash accounting	cash accounting
Belgium	Accruals accounting	Accruals accounting	Accruals accounting	Not applicable
Bulgaria	Accruals Accounting	Not applicable	Not applicable	Modified cash accounting
Cyprus	Modified cash accounting	Cash accounting	Modified cash accounting	Not applicable
Czech Republic	Accruals accounting	Accruals accounting	Accruals accounting	Cash accounting
Denmark	Accruals accounting	Accruals accounting	Not applicable	Not applicable
Estonia	-	-	-	-
Finland	Accruals Accounting	Accruals Accounting	Accruals Accounting	Accruals Accounting
France	Accruals acconting	Accruals acconting	Accruals acconting	Accruals acconting
Germany	Not applicable	Cash accounting	Not applicable	Not applicable
Hungary	Accruals accounting	Cash accounting	Not applicable	Cash accounting
Ireland	Cash accounting	Cash accounting	Not applicable	Not applicable
Latvia	-	-	-	-
Lussemburgo	Not applicable	Not applicable	Not applicable	Not applicable
Malta	Modified accruals accounting	Accruals accounting	Not applicable	Accruals accounting
Netherlands	Cash accounting	Cash accounting	Not applicable	Cash accounting
Poland	Accruals accounting	Accruals accounting	Accruals accounting	Not applicable
Portugal	Not applicable	Not applicable	Not applicable	Cash accounting
Romania	-	-	-	-
Slovakia	Modified accruals accounting	Modified accruals accounting	Not applicable	Not applicable
Slovenia	Modified accruals accounting	Modified accruals accounting	Modified accruals accounting	Cash accounting
Spain	Accruals accounting	Accruals accounting	Accruals accounting	Cash accounting
Sweden	Accruals accounting	Accruals accounting	Not applicable	Accruals accounting
UK	-	-	-	-

	Local Government			
	Statement of financial position (balance sheet)	**Statement of financial performance**	**Statement of changes in net asset**	**Cash flow statement**
Austria	Not applicable	Accruals accounting	Not applicable	cash accounting
Belgium	Accruals accounting	Accruals accounting	Modified accrual accounting	Not applicable
Bulgaria	Accruals Accounting	Accruals Accounting	Accruals Accounting	Accruals Accounting
Cyprus	Accruals accounting	Accruals accounting	Accruals accounting	Accruals accounting
Czech Republic	Modified accrual accounting	Modified accrual accounting	Not applicable	Not applicable
Denmark	Accruals accounting	Accruals accounting	Not applicable	Accruals accounting
Estonia	Accruals accounting	Accruals accounting	Accruals accounting	Accruals accounting
Finland	Accruals Accounting	Accruals Accounting	Accruals Accounting	Accruals Accounting
France	Accruals accounting	Accruals accounting	Accruals accounting	Accruals accounting
Germany	Accruals accounting	Accruals accounting	Not applicable	Cash accounting
Hungary	Accruals accounting	Accruals accounting	Accruals accounting	Accruals accounting
Ireland	Accruals accounting	Accruals accounting	Not applicable	Not applicable
Latvia	Accruals accounting	Modified accruals accounting	Modified accruals accounting	Accruals accounting and cash accounting
Lussemburgo	-	-	-	-
Malta	Accruals accounting	Accruals accounting	Accruals accounting	Accruals accounting
Netherlands	Accruals accounting	Accruals accounting	Accruals accounting	Not applicable
Poland	-	-	-	-
Portugal	Accruals accounting	Accruals accounting	Not applicable	Cash accounting
Romania	Modified accruals accounting	Modified accruals accounting	Modified accruals accounting	Cash accounting
Slovakia	-	-	-	-
Slovenia	-	-	-	-
Spain	Accruals accounting	Accruals accounting	Not applicable	Accruals accounting
Sweden	Accruals accounting	Accruals accounting	Not applicable	Accruals accounting
UK	Accruals accounting	Accruals accounting	Accruals accounting	Accruals accounting

As far as the Italy is concerned, IPSAS has not yet been implemented: accounting harmonization is being introduced with a change from a cash accounting to an accruals accounting system.

Central government uses a modified cash-based accounting system called the 'legal accruals' system, which assigns resources in the budget when the obligations with third parties arise. Accruals accounting is also used, but not as the primary accounting system for some components of the financial statement.

According to two recent legislative decrees, the principle for the cash-based 'legal accruals' has been modified for local government and a few other types of entity into the so-called 'enhanced legal accruals'. Under this principle, obligations are still recorded when the obligation arises, but the amount is imputed only in the year when payments are due. This innovation has been authorised for three years on an experimental basis. After this, a decision will be made concerning the basis on which harmonisation in public accounting will proceed.

	Italy	
Federal Government	Statement of financial position (balance sheet)	modified accruals/modified cash accounting
	Statement of financial performance	modified accruals/modified cash accounting
	Statement of changes in net asset	not applicable
	Cash flow statement	cash accounting
Local Government	Statement of financial position (balance sheet)	modified accruals/modified cash accounting
	Statement of financialperformance	modified accruals/modified cash accounting
	Statement of changes in net asset	not applicable
	Cash flow statement	cash accounting

Accruals accounting which conforms to robust accounting standards provides the transparency needed for markets to function properly, without which investors in government securities might enter into transactions without a proper understanding of the level of associated risk. This in turn could create a contagion risk, acting as a significant impediment to financial stability. Transparent financial reporting leads to greater market confidence and lower interest costs.

The timeline and the process of implementing accruals is:

- first year: basic decision for implementation of accruals accounting
- second and third year: development of legal and technical implementation of accrual elements
- 4th and 5th years: simultaneous operation “old” and “new” IT system
- 6th: start of the new accrual budgeting and accounting system

IPSAS is currently the only internationally recognised set of public sector accounting standards. The standards are founded on the international financial reporting standards (IFRS), which are widely applied by the private sector. The main advantage of the current set of IPSAS is that it constitutes a formidable body of existing, harmonised, accruals-based standards for implementation by the public sector.

The costs of implementing accruals-based accounting standards are very significant, based on the information made available by countries which have moved to accruals accounting. Taking the estimated costs as a percentage of GDP, all of the cost estimates collected fall within the range of 0.02 %-0.1 % of GDP. Ongoing costs of running an IPSAS accounting system could also be significant. Moreover, the implementation of harmonised accruals accounting for the Member States would also have significant resource implications for the European Commission.

It is important to assist public sector entities in the process of adopting or considering the adoption of accruals basis IPSAS: one of the main obstacles to the future implementation of IPSAS or other harmonised accrual accounting standards is the high expected cost of implementation.

Costs are influenced by:

- the scale and pace of accrual implementation
- the size and complexity of the government sector
- the sophistication of existing system

In particular, the costs can be divided as follows:

- incidental costs: IT system, personnel, valuation of assets, change process;
- structural costs: personnel, maintenance of IT systems, valuation of assets.

In the last table the results of comparison of costs in some EU States, that have still quantified. The costs are compared to the Gross Domestic Product (GDP).

	Year	Costs (*)
France	2006-2015	1.500
Hamburg	2003-2007	4,6

(*) million Euro

It would be interesting to compare these costs with the GDP, as the European Commission tried to do in a recent study[1], which stated:

“For larger Member States, and, for example, for those with autonomous systems of regional government, those with more complex government systems, and those which have made least progress on accruals accounting, the costs could be much higher, especially if the transition to a harmonised accruals system is combined with wider reforms of accounting and financial reporting practices. For example, the cost of the accruals and budgeting reforms in France was very much higher. For a smaller Member State, which already has national systems of accruals accounting in place, the costs might be lower than 50 million euro. Taking the estimated costs as a percentage of GDP, all of the cost estimates collected and summarised here fall within the range of 0.02 to 0.1 % of GDP”.

[1]The suitability of Ipsas for The member States.

Nevertheless, this comparison is scientifically impossible, if the overall cost of introducing IPSAS refers to an undefined number of years for introduction and implementation.It is necessary to identify first of all the steps in the implementation, to attribute the costs relative to each year and only then to calculate the percentage of GDP. Undoubtedly, this is a calculation that must be made once the costs have been incurred.

In the case of Italy, therefore, it is not possible to identify and estimate the costs of implementation, since the premises for identification are not available. It is not possible to make a comparison with other European countries that are currently implementing the procedures, since the level of decentralisation of the local bodies differs from other countries and the various situations are consequently not scientifically comparable.From the experience of the other countries and the analysis of the type of process necessary for implmentation (summarised in the table above) it is only possible to determine which costs will increase, when IPSAS a implemented in the Italian system.

Conclusions

1) The identification of costs and benefits of moving to an “IPSAS based” accounting system is not possible in Italy .
2) The verification of the feasibility and estimation of the time needed to implement an accrual “IPSAS based” accounting system in all the EU Member States shows that a majority of Member States have public sector accounting practices that can be characterised as accruals or modified accruals accounting across all levels of governement.

Future tasks for the research:

1) monitor the process of implementation using comparative methods;
2) identify, during the process of implementation in Italy, whether European best practice can be applied, in order to carry out the process in an efficacious and efficient manner;
3) evaluate the impact of the implementation of IPSAS and the accounting harmonisaton on non-profit organisations and state affiliates, seen as public groups.

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