



DISCUSSION PAPER

THE FUTURE OF EU PUBLIC SECTOR ACCOUNTING IN A GLOBAL CONTEXT

An ICAEW discussion paper to generate broad consensus on the reform of public sector accounting in the EU by 2025

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EXECUTIVE SUMMARY

This paper addresses an area of acute public interest on which ICAEW is seeking to generate a sense of urgency and prioritisation on the part of EU policy-makers. Modern and transparent public sector accounting matters because economic sustainability cannot be successfully pursued without it. It is recognised that there are serious shortcomings in public sector accounting in the majority of EU member states, with inevitable consequences on the management of the public purse. Despite this, reform of public sector accounting is not an EU priority.

This paper aims to generate a broad consensus in favour of comprehensive and mandatory reform of public sector accounting across the EU by 2025 to secure public trust through greater comparability, transparency and accountability leading to enhanced financial management. It does so by inviting views from as wide a range as possible of public and private sector stakeholders on three broad policy recommendations.

We have developed these recommendations with a view to the public interest benefit we believe they will bring, not only for the EU, its member states and citizens, but through its example in a global context too. EU policy-making can galvanise a dynamic process around the world in the drive towards better public sector financial management and global comparability in public sector reporting. For this reason we invite stakeholders in and beyond the EU to give us their feedback.

Our recommendations:

1. Require true and fair public sector reporting by 2025

EU legislation should be adopted before the end of the current EU legislature in 2019 stipulating a requirement, expressed through key principles which can be implemented through international and / or national standards, for the annual disclosure on a true and fair basis of the public sector financial position of all member states by 31 December 2025, beginning with the 2024 financial position.

2. Recognise the need for proportionate and tailored member state implementation

Member states should develop tailored roadmaps with clearly defined milestones to implement accounting reform. This will enable the application of subsidiarity on the basis of materiality, thereby maintaining existing accounting traditions. The reporting of a financial position can be through consolidated or combined financial statements, to suit individual member states' constitutional arrangements while respecting EU comparability.

3. Build effective institutions and governance for global influence, EU oversight and enforcement

EU legislation should establish the required institutional structures and governance processes to influence international standard-setting through the International Public Sector Accounting Standards Board (IPSASB), to ensure appropriate EU oversight and accountability for international standards and to enforce member state implementation of the EU key principles for true and fair public sector reporting through international and / or national standards.

We welcome all comments and suggestions on our recommendations, in any form.

We aim to reflect on all feedback received in order to foster a wide stakeholder debate on the merits of adopting an EU legislative proposal before the end of the current legislative term in 2019, in order to meet the suggested 2025 deadline for the reform of public sector accounting in the EU.

INTRODUCTION

Public sector accounting is, in the most immediate sense, a matter of good government and democratic accountability to citizens. It has a critical inter-generational dimension given the need for long-term planning to meet societal demands. It is of major relevance to global financial stability and to international financial markets, given the volume of government bond issuance. The financial crisis led to widespread acknowledgement of deficiencies in the financial information reported by EU governments, which were deemed insufficient to make a fair assessment of risk. Today government securities, whether in the EU or around the world, are no longer perceived as risk-free but their proper rating and valuation is hampered by the opaqueness of public sector reporting.

Against this background, this paper aims to generate a wide consensus for an EU requirement for public sector accounting and reporting on a consistent and comparable true and fair basis across all EU member states by 2025. We set out three policy recommendations to achieve this and invite all interested stakeholders to provide feedback. In particular, we hope to generate broad momentum in favour of EU policy-makers prioritising reform during the current legislative term in order to achieve change by 2025. A sense of urgency is needed. Despite an initiative launched by Eurostat in 2011 to draw a positive legacy from the financial crisis by improving the quality of public sector financial information, mandatory accounting reform has slipped far down the priority list of the EU institutions. We recognise Eurostat's continuing efforts to make progress on technical issues but now call on the EU institutions to prioritise reform in light of the acute public interest.

Our three recommendations consider what an EU framework should look like to achieve comprehensive reform, encompassing legal and practical implementation issues as well as institutional and governance aspects. Our recommendations also address how the EU framework can lead and strengthen the global agenda for public sector transparency and accountability.

Our overall vision, within which the recommendations are framed, draws inspiration from the debate at EU level to date, including Eurostat's initiatives, as well as broader examples of effective international and EU policy-making. The latter includes lessons from the EU's successful harmonisation of listed company reporting where the capacity of the EU to lead global policy is now well recognised. We acknowledge that there are some important differences between public and private sector accounting, but this should not distract from the fact that a greater overall alignment between the two, based on providing a true and fair view, is in the public interest.

The paper is structured as follows:

Section 1 summarises the case for reform, setting out the critical importance of comparable accruals accounting and true and fair reporting, and explaining the relevance to broader EU financial stability measures based on the Maastricht criteria.

Section 2 outlines the broad challenges which have stalled the first initiatives to try to achieve EU-wide public sector accounting reform.

Section 3 sets out our three key recommendations for a proposed EU framework, with due consideration to the global public sector agenda.

Section 4 draws together the overall benefits of our recommendations in relation to the concerns aired to date and to the EU's capacity to galvanise global reform.

Section 5 includes a short list of questions on our proposed vision and recommendations to encourage feedback from as wide a range of stakeholders as possible.

THE CASE FOR REFORM

Public sector financial management, transparency and accountability are critical to maintaining the EU's high living standards. This is an issue for all governments, irrespective of their political colour. The efficient management of public resources and improved planning for future needs are imperative to ensure governments' continuing capacity to fund, for example, advances in healthcare while also meeting pension obligations. Governments also need to invest in the infrastructure and skills used by European businesses to retain international competitiveness. Economic growth is unsustainable without sustainable public finances.

High quality accounting standards and reporting assume crucial importance in this context, within an overall framework encompassing internal control and external audit. The urgent need for EU reform is made stark by the conclusions of the European Commission in 2013 following a comprehensive study: 'the overview of Member States' public sector accounting practices shows that they are very 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'¹.

In fact, a number of key member states still apply cash accounting, while only a handful publish an annual statement of government financial position which includes a balance sheet. Cash accounting provides a very partial picture of a member state's financial position, as it records only cash transactions. Financial statements give a more complete view by recording assets as well as liabilities which refer to known commitments or expected future outcomes for which income needs to be raised. Accruals accounting, as it is referred to, has long been required of private sector companies through EU legislation, in the interest of transparency and accountability for investors and other stakeholders. However, in the majority of EU member states public sector accounting is some way between cash accounting and accruals accounting. In the main, therefore, asymmetric reporting continues to exist between the public and private sectors.

There are significant public interest consequences arising from the shortcomings evident in public sector accounting across the EU. In the first place, accruals accounting and the preparation of statements of financial position constitute key stewardship mechanisms for governments and a source of accurate information for democratic accountability, as well as providing greater transparency for financial markets as investors in government bonds. Secondly, the lack of comparability arising from the significant variations raises questions in relation to EU fiscal discipline and financial stability.

Terminology in this debate can be confusing. Currently, EU member states are required under the Maastricht criteria to prepare national accounts which are drawn up on a statistical basis according to information requirements set out by Eurostat in the European System of Accounts (ESA 2010). They have a different purpose to financial accounts and do not provide a full picture of assets, revenues, expenses and liabilities. Financial accounts, so called as they are prepared according to the broad, internationally-accepted principles of accounting used for private companies, record this full picture.

National accounts and financial accounts can and should be mutually reinforcing; if done properly and on the basis of comparability, the combination of the two creates a whole which is greater than the sum of the individual parts. This can give the EU a new, more robust Maastricht Plus framework to underpin financial stability as well as improve government management of public finances and enhance democratic accountability. For example, financial accounts published by the

¹ European Commission (2013), Staff Working Document accompanying the 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, SWD(2013)57

UK (known as Whole of Government Accounts) reported total liabilities at 31 March 2014 of £3.2 trillion, or 177% of GDP, while the UK national account reported net liabilities of £1.4 trillion, or 78% of GDP, at the same date². The former will matter more when thinking about a government's ability to cope in the event of a future downturn. For this reason, greater institutional, stakeholder and media attention must be given to financial accounts as well as national accounts.

² Campbell, R., Hodgkinson, R. and Wheatcroft, M. (2016) 'Whole of Government Accounts: an ICAEW assessment', in Emmerson, C., Johnson, P. and Joyce, R. (eds) IFS Green Budget 2016

CHALLENGES IN THE EU DEBATE

The so called Six-Pack legislation, adopted in 2011, sought to strengthen economic governance in the EU and led, among other measures, to a concerted effort by Eurostat to promote harmonisation of public sector accounting.

Eurostat's initiative began with an assessment of the suitability of the existing International Public Sector Accounting Standards (IPSAS). It concluded that the suite of global standards presented an 'indisputable reference point', but was not suitable for direct implementation for a number of reasons on which further debate could usefully be pursued. Eurostat's attention began to focus on possible European Public Sector Accounting Standards (EPSAS) – with various connotations given to the actual meaning of EPSAS which have evolved over time. These have ranged from EPSAS as a set of standards developed by a still to-be-created European standard setter, to EPSAS as a European interpretation of IPSAS.

Although a Eurostat public consultation was held in 2013 on the governance principles and structures of an EPSAS standard setter, the results of the consultation were not published. An anticipated European Commission communication on the overall EU approach to public sector accounting reform was also not issued. More recently, Eurostat has encouraged and provided some funding to member states still operating on cash accounting to begin the introduction of accruals. This is with a view to returning to the overall vision of EU public sector accounting harmonisation at a later date.

While it is helpful that some individual member states are pursuing reform, it is clear that the overall momentum of an EU-wide accounting reform with a clear end-point in sight has stalled. In developing our three recommendations designed to reinvigorate momentum in the reform, we have considered the major challenges (listed below) which have stood in the way of such a consensus to date.

- Appropriate form, degree and timing of EU harmonisation of accounting standards which has generated conflicting views among member states. Some member states have concerns that they might have to retreat from existing use of standards and reduce their reporting to a lower European mean. Other member states have concerns about the process to achieve – and the implications of – enhanced accounting and reporting to a European mean which is higher than current practices. As part of this debate, the control boundary of public sector reporting is also important.
- Governance and control of accounting standard setting and enforcement, also in acknowledgement that accounting standards will result in reporting which is relevant for EU Growth and Stability Pact procedures and may, in turn, constrain national decision-making. The legal legitimacy, independence and suitability to European and national circumstances of accounting standards are all critical issues in the debate on the most appropriate governance framework for accounting standard setting and enforcement.
- Technical constraints arising from the fact that accounting standard setting requires significant technical expertise which is in short supply although not impossible to find. While it is recognised that international standard setting capacity is the most developed, important gaps within the suite of standards remain. Europe's support to address these gaps partly depends on a decision on the EU's reform path.
- Quantifying the benefits of a move to accrual accounting. It is important to consider the overall case for change as the full benefits of reformed public sector accounting might be difficult to quantify and only apparent over the mid to long term.
- Constitutional arrangements within some member states which raise specific accountability and reporting challenges, for example, in the relationship between federal and regional governments – especially where the accounting bases differ between tiers of government.

RECOMMENDATIONS

In this section, we set out our three recommendations designed to encourage a broad consensus in support of a comprehensive EU-wide reform of public sector accounting which also contributes to the global agenda for public sector transparency and accountability. Each recommendation has been developed with the aim of finding a route to overcome the specific challenges noted in Section 2 which have stalled progress to date. The overall benefits of the three recommendations, in relation to accounting reform both within the EU as well as the wider international context, are set out in Section 4.

1. Require true and fair public sector reporting by 2025

We call for EU legislation to be adopted before the end of the current legislative term in 2019 stipulating a requirement for the annual public disclosure on a true and fair basis of the public sector financial position of all member states by 31 December 2025, beginning with the 2024 financial position. This legal requirement could be either a regulation or a directive.

EU legislation should specify a high baseline of reporting requirements set around the key principles of accountability, transparency, comparability and reliability. It should explicitly recognise the need for accruals accounting and completeness. In doing so, it should also allow member states to implement the key principles through international or national public sector accounting standards, or a combination thereof, providing that all the standards meet the minimum EU requirements.

EU legislation should also specifically provide for member state options, enabling them to progress through defined transitional periods to implement accounting reform. This will ensure an approach that meets the principles of proportionality and subsidiarity while achieving EU-wide comparability by 2025.

2. Recognise the need for proportionate and tailored member state implementation

We recommend that each member state develops a tailored roadmap to achieving true and fair reporting of its public sector financial position by the 2025 deadline, with clearly defined milestones to implement reform. Member state use of optional transitional periods could take into consideration different starting points in terms of accounting standards and systems as well as member state constitutional arrangements which have resulted in disparities to date in the application of accruals accounting. Reflecting diverse constitutional arrangements across the EU, the reporting of the public sector financial position could be achieved through either a consolidated whole of government financial statement or through the combination of the financial statements of different tiers of government. For the purpose of EU comparability the important point is that consistent methods of consolidation or combination are used.

Member state roadmaps, through the exercise of proportionality and subsidiarity, could allow the retention of some existing accounting traditions on the basis of materiality for different entities in the public sector while achieving overall EU comparability. It is important that reform takes into consideration that member states' need to meet their obligations for delivery of public services. The roadmaps should also set out the route to implement the key principles in EU legislation through international and / or national standards, with due consideration given to the anticipated interaction between the EU and the international standard-setting community.

3. Build effective institutions and governance for global influence, EU oversight and enforcement

We recommend that EU legislation should establish the appropriate institutional and governance structures to achieve member state implementation by 2025 while enhancing the EU's contribution to the global agenda for international public sector accounting standards. On the

one hand, the institutional and governance framework will be required to influence international standard setting and ensure appropriate legitimacy and accountability for the use of international standards with regard to member states, relevant EU institutions and stakeholders. On the other hand, it is needed to monitor member state roadmaps and enforce the annual reporting of the financial position through international and / or national standards. The new structures will need to work concurrently in these two spheres with optimal interaction.

EU legislation should foresee a growth in EU technical capacity in relation to accounting and financial reporting expertise. This is needed to review the compliance with standards used by member states to implement the key principles in the legislation and, in the case of international standards, to endorse their adoption. Technical capacity will also be necessary to undertake detailed monitoring of member state roadmaps and the reporting of their annual financial position. Particular attention will need to be paid to analysis of the use of transitional periods, materiality judgements and exercise of subsidiarity decisions by member states. Appropriate technical input will be needed to achieve effective upstream EU influence on the international standard-setting process. A comparable role is carried out for private sector accounting by the European Financial Reporting Advisory Group (EFRAG). This could provide initial inspiration for the public sector sphere, with appropriate modifications to composition and structure.

EU AND GLOBAL BENEFITS

In this section, we draw together overriding points on how the three recommendations can re-invigorate the debate and create a clear framework for a successful EU reform process. This would also deliver a positive impact on the global drive for transparency and accountability.

We are aware of the fact that in some quarters there is a strong reluctance to address public sector accounting reform and even more so to take an international standards route. By anchoring the member state reporting requirement, as well as the overall institutional and governance framework, directly in EU legislation, we believe it possible to address perhaps the most commonly cited reasons for such reluctance: insufficient EU legitimacy, control and oversight. If the EU has the will, the structures to achieve the desired legitimacy, control and oversight can be built. The specific inclusion in legislation of subsidiarity and proportionality provisions for member states should also help while ensuring necessary EU comparability. In addition, the proposed date for implementation by 2025 provides a timeframe allowing member states to generate the appropriate expertise and transition from existing practices with a manageable call on resources.

We believe that it would be in the best interests of all member states to work towards the use of international standards, as endorsed by the EU, and to plan to continue to report against these standards after 2025. We express this view on the basis of a number of factors. First, our recommendations foresee the EU achieving appropriate upstream influence on the development of international standards, while also building strong oversight. Together, this should prove effective in avoiding divergences between the key principles to be stipulated in the EU legal requirements and the international standards. Secondly, this approach would also ensure that member states which have introduced (or are moving towards) international standards, including towards a mixed IPSAS-International Financial Reporting Standards (IFRS) model, would not have to undo such reforms. It is essential that harmonisation is to the highest quality, not to the lowest common denominator: this consideration underpins our three recommendations.

To re-invigorate the EU-wide reform process, our recommendations envisage that member states could potentially use national standards to implement the principles set out in the proposed EU legislation. Such a route would likely be more costly for the individual member state and also for the EU as a whole, given that it would generate the need for further technical reviews of comparability. But in the broader public interest, we believe it appropriate to incorporate this optionality into the proposed EU architecture to alleviate potential member state concerns. It is far preferable to allow for this possible additional cost rather than risk leaving the current EU reform project stalled as it is now.

It is also preferable to foresee the possibility of a member state developing national standards to implement EU legislation, instead of international standards endorsed at EU level, rather than to see the EU develop a European standard setter. The latter would risk a lowest-common denominator approach and would likely detract from, rather than drive forward, the case for internationally comparable standards. We believe that the international standards route would deliver the best return on investment for the EU, not least given the shortage of expertise. It should allow the IPSASB to continue developing a more complete and robust set of international standards, making efficient use of existing structures, processes and skills. There are critical advantages to using a model that has an existing infrastructure and expertise, allowing public money to be allocated most efficiently and generally reducing the financial burden on taxpayers.

Accounting reform – and standard setting – is an ongoing process. It is important that the EU legislation and framework is firmly established to ensure appropriate input into this process which has global relevance. In the increasingly global financial environment in which all countries operate, accounting standards need to be comparable at the international level. A clear and

legally-based commitment by the EU to implement reform, within a challenging but feasible timeframe, would significantly enhance the drive towards transparency and international comparability in public sector reporting across the world. We would also expect that, over time, the global financial markets would effectively encourage maximum comparability and remaining divergences are likely to attract growing pressure for additional disclosure and explanation.

As noted, there is already an important precedent in the accounting world for the EU to drive global progress: the decision by the EU to champion international standards for private companies. This led many countries around the world to take up IFRS. While retaining the right to adopt IFRS standard by standard, the EU gave these standards credibility and a critical mass to convince many other countries around the globe to move in the same direction. A comparable impact for public sector accounting on the world stage could be expected, in the first instance by raising the bar against which other countries and regions would necessarily be compared. An EU decision would undoubtedly strengthen the resolve of countries around the world which have already committed to international standards and strongly encourage those which are still to make such a commitment. For all, there would be much to learn from the EU's capacity to use legal instruments to achieve accounting reform and public sector comparability while respecting subsidiarity, different accounting traditions and constitutional arrangements. For this reason, we see that the EU reform debate has truly global relevance.

TURNING VISION INTO REALITY

Contribute to the reform of public sector accounting

We want to generate a compelling vision for public sector accounting reform in the EU. Turning this vision into reality involves the collective effort of EU and national policy-makers. The contribution of the wider stakeholder community is critical to emphasise the need for urgent action and to help shape reform. This combined effort will also benefit from engagement by all those interested around the world in seeking global progress in accountability, transparency and high quality public sector financial management.

We aim to distribute this discussion paper to a wide range of stakeholders with an interest in public finances. These could include: national, regional and local governments; the EU institutions; financial regulators and financial actors such as banks, investors and rating agencies; civil society groups and non-governmental organisations; standard setters; academics and think tanks; business representative groups at EU and national level; and accountancy and finance professionals working in both the public and private sectors.

We want to achieve the broadest consensus possible on how reform can be achieved by 2025. To this end, we welcome all comments and suggestions on how to improve and build on our proposed recommendations in order to achieve reform.

Here are some initial questions for discussion:

Strategic approach	How can we improve our suggested approach? What other elements do we need to consider?
Recommendation 1	What are the key principles to be considered? Do they need to be embedded in legislation?
Recommendation 2	How can reform be achieved in practice? Are other measures required?
Recommendation 3	How do we ensure that concerns are appropriately addressed? How else could these be tackled?

We welcome feedback in any form by 31 March 2017.

You can email us at reformpublicsector@icaew.com or call us on +32 (0)2 230 3272.

We will consider all feedback received, before pursuing further steps in 2017 to encourage a wide debate on the merits of adopting an EU legislative proposal before the end of the current European Parliament and European Commission terms in 2019, with a view to meeting our suggested 2025 deadline for reform of public sector accounting in the EU.

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