Implementing Reforms in Public Sector Accounting

Susana Jorge
Editor

IMPRENSA DA UNIVERSIDADE DE COIMBRA
COIMBRA UNIVERSITY PRESS

(Página deixada propositadamente em branco)

Implementing Reforms in Public Sector Accounting

Comparative
International
Governmental
Accounting
Research

Susana Jorge
Editor

IMPRENSA DA UNIVERSIDADE DE COIMBRA
COIMBRA UNIVERSITY PRESS

COIMBRA • PORTUGAL 2008

COORDENAÇÃO EDITORIAL
Imprensa da Universidade de Coimbra
Email: imprensauc@ci.uc.pt
URL: http://www.uc.pt/imprensa_uc

CONCEPÇÃO GRÁFICA
António Barros

PAGINAÇÃO
Simões & Linhares, Lda.

EXECUÇÃO GRÁFICA
Simões & Linhares, Lda.

ISBN
978-989-8074-39-3

DEPÓSITO LEGAL
281657/08

OBRA PUBLICADA COM O APOIO DE:

Helge Mauland

Ailin Aastvedt

MISSION IMPOSSIBLE OR AN OBVIOUS OPTION – PROVISIONS AND CONTINGENT LIABILITIES IN NORWEGIAN LOCAL GOVERNMENT ACCOUNTING

Introduction

Accounting is information. The main task of accounting is to produce relevant and reliable information about earnings, financial position and development of the organization during the accounting period. Originally accounting information was dedicated to owners and creditors. Gradually the target group has widened. In public sector organisations the traditional notion of an owner is a meaningless one. We are all owners of central and local governmental institutions, agencies and utilities. Information about resource allocation and use is of major interest in this class of organisations and to inform whether the use of resources corresponds to the political intentions. For many years this was equivalent of controlling whether the activities were within the boundaries of political decisions. Focus has changed during the last decades. Since the introduction of New Public Management (NPM) it has been acceptable focusing on efficiency, effectiveness and performance measurement[1]. Change in focus has necessitated a reorientation of management systems. The budgeting and accounting system is a vital part of the management system. In public sector organisations the budgeting system has been considered the main pillar in the management toolbox while much less attention has been paid to the accounting system.

In earlier days the control of financial allocations was the universal one with respect to economic and financial management challenges. But relevant cost data is required in modern public sector organisations. Meaningful measurement of efficiency and effectiveness requires cost data that are relevant and reliable (Horngren *et al.*, 2002). Cost measurement where essential cost elements are omitted, for instance depreciation, is of little or no use. In public sector organisations this is a real management challenge.

[1] Probably the introduction of NPM is more correctly described as a revival of a management orientation in public sector organisations.

In many countries the foundation of public sector budgeting and accounting systems is still the cash and modified cash principle. So is the case in Norway. The main budgeting and accounting system in Norwegian Central Government[2] uses the cash principle, while a modified cash principle is used in Local Government systems. The cash or modified cash principle causes no problems in organisations with main focus on control of financial grants. Norwegian municipalities utilise a financial oriented system with focus on changes in working capital[3]. Whether the system is to be considered a modified cash system or a modified accrual system is not easily decided on and is a matter of minor interest in this context. For the time being the system is usually considered a modified accrual accounting system[4].

In this paper we are interested in relevant costs and liabilities in the accounting reports of Norwegian local government (municipalities and counties). We are particularly preoccupied with provisions and contingent liabilities. Provisions and contingent liabilities may occur in Norwegian local government. Insufficient or failure in the production of services (school and health services for instance) may give rise to claim for damages. Insufficient and polluted water supplies may also trigger lawsuits. In other cases the liabilities are self-inflicted. The local councils may decide to refund to the citizens charges (water charges for instance) in excess of full cost accounting principles even if there are no legal or formal obligations to do so. Cleaning up and dismantling (removal) costs are other examples of contingent liabilities in IPSAS 19. Many municipalities run waste disposal sites that represent considerable contingent liabilities.

From an informational viewpoint the accounting document should reflect all the liabilities of the agency whether certain or uncertain. Some criteria must be at hand, however, when to enter items of expenditure, income, assets and liabilities into the accounts and when not. In IPSAS 19 the accounting criteria is the inclusion of all likely events, and the value can be estimated reliably. Other accounting regimes have similar criteria for recording.

The problem at hand may be illustrated by an example. Imagine a municipality running an activity, a waste deposit for instance, with known and well-defined expenses today. When the deposit is filled up, it is closed down. Thereafter the owner, i.e. the municipality, has to tidy up. The day the deposit is put to use the exact closure-date is unknown. The closure date depends on how fast the deposit is filled up, which in turn depends on the general economic development. Neither the cost of tidying up/removal cost will be known with accuracy. The certain event is the decommissioning of the installation - the uncertain or probabilistic event is the date of closure. Even if there is uncertainty connected with the date of closure it is possible estimating the closure date with some accuracy. The same argument is valid for the cost of tidying up. The unanswered question is when the cost of tidying up is going to enter the accounts. In this context an uncertain liability has emerged.

---

[2] In 2003 a pilot project based on accrual accounting principles was introduced in ten government agencies. The pilot project is still under assessment.

[3] Working capital is defined in the traditional way as the difference between currents assets and short-term liabilities.

[4] For further information about modified accrual accounting see e.g. Van Der Hoek (2005).

It is a challenge how to incorporate this class of liabilities into the accounts. Is the future expense of cleaning up that we know will occur with a probability identical to one going to be recorded as a cost today? Or is the recording going to be deferred until the start-up of the cleaning process? The last alternative, which is in accordance with the cash principle, means in reality to hand over to the next generation costs caused by the activities of today. In this paper we are concerned with this kind of problems.

The normal set of activities in Norwegian municipalities and counties includes problems like the ones listed above. The accounting practice in this context varies somewhat. For the time being there is no systematic and common practice in the field. Most likely accounting practise will be changed in the forthcoming years. The Norwegian Local Government Accounting Standards Board (NLGASB) has issued a temporary standard concerning provisions, contingent liabilities and events after the balance sheet date – Norwegian Local Government Accounting Standard (NLGAS) 7. The standard is clearly inspired by the corresponding standard for the private sector and the temporary standard for the Norwegian accrual accounting project in Central Government agencies – Norwegian Governmental Accounting Standard (NGAS) 19. This standard is in turn a translation and adoption of IPSAS 19 – Provisions, Contingent Liabilities and Contingent Assets. Both of NGAS 19 and IPSAS 19 are based on full accrual accounting principles, while the Norwegian municipal accounting regime has its origin in a modified cash accounting system. Even if there is an intention of incorporating uncertain and contingent liabilities into this regime, implementation is troublesome if the basic relations in the system are to be taken care of.

The further presentation is organised as follows. First we will discuss shortly some basic and principal considerations about the Norwegian municipal accounting system. Secondly we account for provisions[5] (uncertain liabilities) connected to municipal activities. The rationale for including provisions in the Norwegian municipal accounting system is explained. Some principal problems arising in this context are pointed out. Our conclusion is that long-term uncertain liabilities cannot meaningfully be included into a modified accrual accounting regime. In the last section main findings are reported and topics for further research discussed.

1. The accounting system - a government control instrument or a tool for management decisions?

The balance sheet and the profit and loss account are per se historic documents reporting events in the near and remote past. In most organisations the accounting system will be an important, perhaps the most important, part of the information system. Who is writing and how to write history has always been a subject for discussion and involvement[6]. Financial statements may be considered as storytelling.

[5] Provisions are defined in accordance with Weetman (2006: 289).

[6] See e.g. Jones and Pendlebury (2000), Chapter 1.

Accounting reports are always prepared in accordance with predetermined models and standards. Whether these models are appropriate is a matter of discussion. The accounting debate is to a large extent about this question.

Norwegian counties and municipalities are independent legal units. In principle they can decide upon and do whatever they want within the boundaries of Norwegian legislation. They are instructed to deliver services in primary and secondary education, health care and social services in accordance with national standards, but beyond that they can make an initiative and use resources in whatever area they want. The natural starting point will be to develop an accounting system designed for one's own decision and control purposes.

The Norwegian public sector comprises central government and two levels of local government. The Central Government is on the top of the organisational hierarchy. In many contexts municipalities are instructed by Central Government. From this point of view local government may be regarded as Central Government agents. Primary and secondary education illustrates this phenomenon. Primary health and social services is another area with comprising and detailed instructions and standards. Somewhat below 75% of total expenses in Local Government are spent for educational, health and social purposes. In this setting it is a relevant question whether the municipal accounting system primarily may be considered as a tool for governmental control.

Norwegian Local Government agencies are important producers of services. During the last years this is underlined in a significant way by the introduction of management systems emphasising performance measures and user orientation. The municipalities are, however, important democratic arenas in the Norwegian society. It is not easy to design an accounting system that includes both modern management and democratic considerations.

The production of goods and services in municipalities has no economic end. Income generation caused by own activities is modest. The bottom line in an income and loss account has no meaningful interpretation in a municipal context. In principle resources are allocated to local government by political decisions in the Norwegian parliament (*'Stortinget'*). Controlling the activities to be within the boundaries of budgetary decisions and political intentions is considered extremely important, the so-called budgetary control. Normally this implies focus on cash flows.

2. The financially oriented system with focus on changes in working capital[7]

According to the Ministry of local government the Norwegian municipal accounting system rests on a principle of financial orientation. The principle implies that the difference between grants and allocations (income) on the one side and the use of resources (expenses) on the other hand, is reported. This means that the consolidated statement of operational and investing activities reports the financing of total expenses the actual budget year. In this report depreciation costs are eliminated for obvious

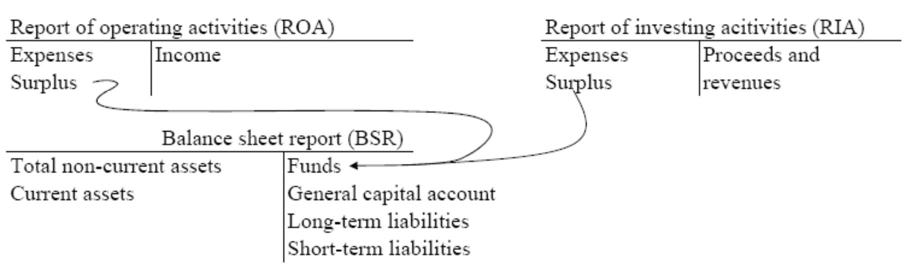
[7] For an introduction to the Norwegian system, see Mellemvik (1998) in Olson *et al.,* (1998).

reasons. Depreciations costs do not imply the usage of financial resources and have to be omitted when 'net income' is fixed.

Originally the main focus of the municipal accounting system was cash flows. Gradually the cash flows have been replaced by partly accruals. In an accounting regime originally constructed for budgetary control purposes focus is no doubt on operating expenses and expenses for the acquisition of non-current assets. For several decades the balance sheet only served as an instrument for a formally closure of the books of accounting. Except for cash and bank deposits the figures themselves had little or no value from an informational point of view. As the years go by focus has changed. Especially after the 1993 modernisation of the municipal accounting regulations there has been a revitalisation of the interest for balance sheet figures. The consequence of this reorientation is a focus on working capital flows in a modified accrual system (report of operating activities and investing activities). Loan instalments are expensed in the operating report, depreciation numbers are charged as an expense and recorded as income with identical amount, fresh loans are income numbers in the investing activities report, the acquisition of non-current assets are put into the balance sheet and charged as an expense in the report of investing activities. In the municipal accounting system balance sheet numbers are to be expressed in accordance with the regulations in the Norwegian Act of Accounting (NAA). As in other civilised nations, NAA is based on full accrual principles. Apparently there is an inconsistency in this context. In which way can a system reporting working capital flows meaningfully report fully accrued balance sheet numbers? The answer is of substantial interest handling uncertain and contingent liabilities.

As mentioned above the municipal accounting system consists of three main elements: the Report of Operating Activities (ROA), the Report of Investing Activities (RIA) and the Balance Sheet Report (BSR). If the credit side of ROA sums up with a bigger amount than the debit side, there is a net operating surplus (profit is a meaningless expression in this context). The operating surplus is included in the equity (funds) of the municipality in the BSR. The procedure is the same in RIA. Figure 1 illustrates the main parts of the Norwegian municipal accounting system.

Figure 1 - The three main parts of the Norwegian municipal accounting system



§ 7 in the municipal accounting regulations (Local Government Act – LGA) read as follows: "All supplies and use of resources during the year which relate to the activities of the municipality or county shall be reported either in the ROA or

RIA. Items cannot be accounted for directly in balance sheet accounts" [authors' translation]. The implication of this is that instalment of a loan has to be accounted for as an expense (debited) in the ROA. Likewise the acquisition of non-current assets (machinery, buildings, long-term loans, inventory, etc.) has to be accounted for as expenses (debited) in the RIA. All the magnitudes listed will affect the measurement of surplus in ROA and RIA respectively. The equity effect caused by the non-equity items has to be eliminated. Take the acquisition of non-currents assets. The acquisitions are expenses in the RIA and accounted as an asset in the balance sheet at the same time. The counterpart for this formal and cumbersome accounting exercise is the General Capital Account (GCA). The GCA is credited when the non-current assets are acquired. At the end there is no influence on the measurement of the total municipal equity. The reduction in equity takes place when the non-current assets are depreciated, as in private companies. The accounting technology in the Norwegian municipal accounting system is very complicated indeed. Why is it so? The answer is due to the gradually evolution of the accounting system. Originally the system was cash-based. During WWII the German occupants introduced some kind of accrual accounting in the Norwegian local government (principle of *'anordnung'*). The German legacy was mainly eradicated and abolished during the post-war years, but surprisingly enough the introduction of the accounting system of the war-years survived.

3. Principal considerations on uncertain liabilities in the Norwegian local government accounting system

In a financially oriented accounting system balance items will often be a residual. The economic interpretation of such items may be somewhat obscure. In many ways provisions are inconsistent with cash or modified cash accounting system. This is in fact the case for all short-term liabilities.

Until recently uncertain provisions have not been formally regulated. A preliminary draft on the subject was issued by the NLGASB in December 2007, NLGAS 7 (Povisions, contingent assets and events after the balance sheet date). The standard is clearly inspired by IPSAS 19 and NGAS 19.

IPSAS 19 and NGAS 19 apply for fully accrued systems, while the Norwegian municipal accounting system is far from fully accrued. The preliminary draft was substituted by NLGAS 7, temporary version in October 2006. The temporary version is far from a blueprint of the previous draft. NLGAS 7 contains the following definition of provisions:

> "A municipality has a liability if obliged to submit economic resources to another part in a future point of time. An uncertain obligation has unknown or uncertain outcome and/or uncertain moment of realisation. If it is uncertain whether a liability will be realised in the future, and this event depends on specific events triggered by occurrences not fully controlled by the municipality, it is characterised as a contingent liability. (….) A liability always originates from an occurrence, which means an occurrence before the end of the accounting period". [authors' translation]

From some quarters of accounting professionals it is asserted that cost connected with uncertain liabilities is inconsistent with the basic municipal accrual principle, the principle of '*anordnung*' (all known income and expenses). This point of view is mainly connected with the interpretation of the word *known*. For the last years the question is thoroughly discussed in the Norwegian public sector accounting surroundings. The introduction and implementation of pension costs and pension liabilities in the municipal accounts triggered the debate. For the time being the combatants have made a compromise an entered an armistice. Pension costs are true examples of costs of today but with uncertain time of realisation, if realised at all. If the employee passes away before the point of retirement, there will be no future disbursements.

Pension costs and pension provisions illustrates that uncertain liabilities have entered the municipal accounts. These costs and obligations were incorporated into the municipal accounting system by governmental command (minister of local government). The realisation point of time is unknown, the same is the amount to be realised. They cannot be exactly fixed. In that case the best estimate has to be used. The necessary complicated calculations are normally produced by outside actuaries.

A subgroup of uncertain liabilities is contingent liabilities. In the exposure draft of NLGAS 7 the intention was to account for this kind of liabilities. The temporary standard (NLGAS 7, October 2006) does not allow this solution. The argument is that only known expenses are to be recorded. If an amount is contingent, it is not known whether there will be a future disbursement or not. For other kinds of uncertain liabilities the uncertainty is connected to the realisation point of time and the magnitude of the future amount. A contingent liability is characterised by a probability majority that the liability will be realised. It can hardly be argued that these liabilities are known.

Within its limits the accounting system shall reflect the economic reality in the actual organisation. Consequently the accounting system ought to inform about the activity of the accounting period. Accounting users need information about use of resources, the kind of activities performed and how effectively and efficiently allocated resources are employed. This implies an accrual accounting principle based on the activity of the period. The accounting system should reflect the actual activity of the period (Aastvedt and Mauland, 2006b). This principle is implemented in the legislation for Norwegian non-profit or ideal organisations. The activity principle can be formulated as follows: ***expenses are matched against the actual activity of the period.***

Accounting of provisions can be justified by the activity principle[8]. An example of this is environmental costs that are incurred because of the activities of the municipality. In this context pre-cost accounting can be justified by the argument that cost ought to be matched by the relevant activity. Environmental costs should be reflected in

[8] Statskonsult, a Norwegian state owned company specializing in public management issues, has assessed the ongoing pilot accrual accounting project in ten government agencies. A main conclusion in the report is that the agencies have got a more precise and relevant accounting system because costs elements (capital costs, for instance) now are linked up with the actual activity and costs are transparent in the accounts at an earlier stage.

the accounts in the period of polluting the environment. Standard Norwegian public sector accounting practise is to defer accounting until the period of tidying up. The period of tidying up may deviate essentially from the period of pollution. The relevant activity in this context is not the cleaning up but the polluting activities at an earlier stage. If the activities are already carried out when the cleaning up responsibility is acknowledged and accepted, correct procedure is to incorporate the current cost immediately. Otherwise this cost will be the burden of future generations. The accounting system should give information about this burden through information about liabilities in the balance sheet.

If cost accounting is deferred until the cleaning up period, the accounts do not reflect true cost figures and is not a relevant mirror of today's activities. A Norwegian parliamentary report (Ot.prp. 43, 1999-2000) states that local government activities shall be in accordance with the financial responsibility principle. The principle implies that the generation of today cannot burden future generations with costs due to the consumption and activities of today. Deference of cleaning up costs is in reality burdening future generations with today's costs. Matching costs of today with today's activities are within the ideas set forth in the parliamentary report.

4. How the accounting system collapses

In an accrual accounting system provisions (uncertain liabilities) will be debited a profit and loss account while the counter-post is credited a liability account (debt) in the balance sheet. It has to be considered individually whether the uncertain liability is most properly classified as a short-term or a long-term liability. ROA is the municipal accounting statement that in many ways parallels the profit and loss account. But there is one salient distinction between the two accounting systems; the ROA includes accounting figures that are not a part of the municipal equity. This is due to the working capital orientation. ROA shows change in working capital, not in equity. Accrued items (current assets and liabilities) not affecting the working capital is recorded as balance sheet items only. The following accrued items are recorded as pure balance transactions:

- Depreciation of fixed assets
- Write-downs of fixed assets
- Pension costs

As a consequence of the working capital principle provisions (long-term liabilities) not affecting the working capital are in fact pure balance transactions (credit entry provisions and debit entry equity). Now we will explain how pension cost is worked into the accounting system of Norwegian municipalities. Pension cost may be considered a provision.

Post-employment benefits, such as pensions entered the municipal accounting system fully in 2003. The accounting solution is not concurrent with the private sector one, but it is influenced by the commandments in the NAA in a significant way.

The cost concept does not exist in the local government accounting terminology. An exception is pension cost. The municipal accounting regulations state "pension cost of the year is the present value of pension earnings plus interest on pension liabilities minus interest on pension fund." This amount has to be displayed among the accounting notes.

Pension cost and pension liabilities are often considered a black box containing mysterious numbers delivered by very distant actuaries. Actuarial calculations ignored the problem is a well defined one in the accounting and financial literature. A parallel is depreciation values calculated as a reduction in net present value of fixed assets. The value of a fixed asset depends on future cash flows. Theoretically depreciation should be calculated as the difference between net present value at the beginning and the end of the year. The cash flow can be divided in an interest component and a residual value that is the depreciation value or the liquidation value[9]. The pension cost of the municipality may be compared with the cash flow for a single year adjusted for interest. The paid pension premium is recorded in the ROA, however. This is due to the financial orientation of the accounting system. The pension premium has to be adjusted for the deviation between the calculated pension cost and the paid premium.

We will illustrate the problem by an example. An imaginary municipal organisation presents the following figures:

Pension liability 01.01.X1	100
Pension liability 31.12.X1	200
Premium paid in year X1	60
Pension fund 01.01.X1 (bank deposit)	0
Premium deviation	40

The premium deviation is the difference between pension cost and paid premium.

Table 1 - Illustration of municipal accounting report

Report of operating activities (ROA)	**Year X1**
Net operating income ex. pension cost	0
Pension cost	-100
Operating deficit	-100

Balance sheet report (BSR) 31.12	**Year X0**	**Year X1**
General bank deposit	100	40
Pension fund (bank dep. non-current asset)	0	60
Total assets	100	100
General equity	0	-140
Pension liability (provision - long-term liability)	100	200
Premium deviation (short-term liability)	0	40
Equity and liabilities	100	100

[9] A well-known exercise is to construct the cash flow when depreciation is locked at a constant yearly amount based on historic cost and given interest rate.

Some comments:

- Reduction in working capital corresponds to operating deficit (-100);
- Reduction in equity (-140) corresponds to pension cost plus change in net pension cost;
- Reduction in equity deviates from operating deficit, equity is debited full pension costs plus change in net pension costs;
- The balance sheet items are more or less residuals. Main focus is on cost measurement.

It is not easy, indeed, to trace the logic of the system. The construction shows signs of an ad hoc solution in an accounting system not designed for handling this kind of problem.

The uncertain pension liability is recorded as a provision (long-term) in the municipal balance sheet. The commandments of the LGA state that loans (long-term liabilities) can only be used financing the acquisition of fixed assets with the exception of long-term financial assets. It is a matter of discussion whether the NAA authorises this accounting solution.

All technical accounting technicalities thrown away, the reality is that the increase in pension liability is recorded as a long-term liability in the balance sheet. The counter entry (debit) is another balance account, the general capital account. According to the municipal accounting regulations this solution is not authorised. All transactions must be recorded in either the ROA or the RIA. Solely transactions not affecting the working capital can be recorded balance to balance.

Being considered a long-term liability the consequence is that the liability has to be recorded as a pure balance adjustment. This has a parallel in the reduction of historic cost for non-current assets. This phenomenon is treated as a balance adjustment because the write-down of values does not represent the acquisition and use of resources. Recording provisions for uncertain liabilities in the ROA can only be done when the balance counter entry is a short-term liability. In normal circumstances and regimes liabilities like these will normally be classified as long-term.

A parallel case is the borrowing in foreign currency. According to earlier practice unrealised gains or losses on foreign currency were recorded as a balance adjustment (long-term debt and the general capital account). A realised gain or loss was to be recorded in the ROA classified as a financial item. In a newly published paper the NLGASB suggests that instalments are to be recorded in the ROA at current value without specifying gains or losses. Simultaneously instalments are debited long-term debt and credited the general capital account at historic (original) values. It is referred to the accounting treatment of fixed assets. The superior argument from NLGASB is that the logical relations in the financial oriented system will fail if gains or losses are to be reported in the ROA.

In the Norwegian municipal accounting regime long-term uncertain liabilities have to be handled as pure balance sheet adjustments. The liability has to be credited balance account long-term debt and debited the general capital account (equity). This procedure satisfies the basics described in the 2004 NLGASB paper. The challenge is the interpretation of LGA § 50. Long-term debt increases even if there is no counter entry in the RIA. According to LGA § 50 increases in long-term debt has to be recorded as an income (credit entry) in the RIA. Increase in long-term debt is equivalent to increase in a long-term loan and is considered as acquisition of resources. In the case of uncertain pension liabilities the problem is avoided by using the premium deviation account. The premium deviation is classified either as a current asset or a short-term liability. It can hardly be explained away, however, that pension cost is financed by long-term debt. This is an example of financing current cost in the ROA with long-term debt. Financing current costs with long-term debt is in conflict with the intentions of LGA § 50. The summing up so far is that an application of the Norwegian financially oriented accounting model excludes recording of unrealised losses on long-term liabilities or assets in the ROA.

We cannot find any discussion of this problem in the temporary NLGAS 7. The document does not include any kind of instruction how to classify uncertain liabilities in the balance sheet report. Are long-term liabilities to be classified as short-term liabilities because of the basic relations of the financial oriented system? Alternatively long-term liabilities may be handled in the same way as pension provisions. Principally pension provisions are long-term liabilities. It seems peculiar when accounting items due 30-40 years ahead have to be classified as short-term liabilities in order to avoid the technical collapse of the accounting system. Another technical possible solution is classifying the provision as equity. The professional supporters of this solution are presumed to be non-existent.

As a summing up we can list three alternatives for accounting:

- Provisions and contingent liabilities classified as equity;
- All provisions and contingent liabilities classified as short-term liabilities;
- Provisions and contingent liabilities classified as both long- and short-term liabilities.

Today all these solutions are chosen for different types of unrealised losses in the Norwegian local government accounting system.

It is obvious to us that the goals are too numerous compared to the means at hand in today's Norwegian accounting regime. Some goals may also be characterised as inconsistent. In the financially oriented system it is impossible to present correct values for all items in the ROA and the balance sheet at the same time. The supreme goals have to be decided upon. When decided some items are doomed to be residuals. Main focus on the ROA will inevitably leave some balance items as residuals without meaningful economic interpretations. In our opinion this underlines the need for developing a conceptual framework for the Norwegian local government accounting. Uniting the existing financially oriented system of today and an accrual system prescribed in the IPSASs regulations has to be regarded as mission impossible. Rightfully one can ask whether information given in the today's balance sheet is relevant for the accounting user.

5. Classes of uncertain liabilities in the local governments accounts

Approximately 75% of the resource allocation in Norwegian municipalities is dedicated primary education, health care and social welfare. The first years of our lives the municipalities provide kindergarten services while welfare services and geriatric care are delivered in our last living years. The production of services regulated by law is the basic principle, i.e. the primary education law (1998). Often the various laws define quality and quantity standards of production and the rights of the citizens. The production is also stimulated and destimulated by a variety of grants and contributions from central government. Ignoring signals and expressed intentions by central government is equivalent with abstaining from economic relief from central government. In contexts like these municipalities are in fact central government agents. But failure in service production is solely the responsibility of the municipalities. Illiteracy among adult persons may result in lawsuits against the municipality because of failure in the offer of primary education in earlier years.

We have researched headlines in some selected newspapers for the last three years in an attempt to form a picture of what cases imply uncertain liabilities. After scanning approximately 300 headlines about cases (potential, ongoing and settled) involving damage compensation in the period 2003-06, we reached the conclusion that 63 of them were relevant. We classified the various categories as in Table 2.

Table 2 - Cases involving damage compensation (2003-2006)

Categories	2003	2004	2005	2006	Sum	Relatively
Pollution and waste handling	4	3	4	1	12	19,0 %
Failure in child care	1	3	8	10	22	34,9 %
Failure in primary education		1	1	2	4	6,3 %
Labour disputes	3	2	2	1	8	12,7 %
Other municipal service production		1	3	2	6	9,5 %
Political decisions	2	3	5	1	11	17,5 %
Sum headlines	10	13	23	17	63	100,0 %

The category conspicuous by its absence is elderly care, maybe for natural reasons. From the table one can read that about 1/3 of the cases is about failure in child-care and protection.

The municipalities have responsibility of child-care and protection. When someone observes parental deficit care, the child-care authorities of the municipality is to be alarmed. In this area, as in many other social care areas, there is a role mix of various actors and ambiguous responsibility. Central government has taken over child-care institutions and is running them, while the municipality has the rest responsibility. The last years there have been several newspaper headlines concerning the running of child care institutions and sex misuse in those institutions. The lawsuits following in the wake of misuse and mishandling some twenty years ago have been costly for the municipalities in question.

No matter how organising the production of services and their quality assurance some groups will probably be dropouts and will not receive the services they are entitled to. The consequence is that municipalities may expect liabilities with payouts several years ahead. The parallel to the pension cost illustration is obvious. In accordance with the activity principle explained earlier, the cost of the activities in question should be recorded in the accounts the period the activities takes place, and not in the period the municipality has to compensate for damage. When the activities take place the liability emerges, and should be entered into the books. A necessary requirement is that a reliable estimate can be worked out. Recorded as a short-term entry this will cause no methodological problems in the Norwegian local government accounting regime. The drawback is that the notion of short-term becomes meaningless. Classified as a long-term liability the accounting challenges become identical to the ones in the case of pension liabilities and foreign currency.

With an eye to the vast resource use in the fields of health care and education it was to be expected that NLGAS 7 should enter deeply into the accounting challenges of the fields in question. This is not the case. NLGASB 7 excludes provisions or contingency arising from a social benefit from the scope of the Standard. The exclusion will encompass liabilities arising in the wake of production of services and societal goods not paid for by the recipients at a value approximately equal to the production value of the goods and services. By societal goods and services are meant education, health care and elderly services. The notion may also include other advantages as direct payments to persons in financial trouble. In practice this implies that NLGAS 7 is not valid for approx. 75% of the municipal activity area. The explanation is most probably found in IPSAS 19. NLGAS 7 and NGAS 19 are obviously influenced by the international standard. According to IPSAS 19 the explanation is primarily that it has been extremely difficult to agree on a recommendation in these essential areas. The proposition of a recommendation and standard in these areas have until recently been put on ice until further investigations and discussions are made. The problem at hand is not rejected for principal reasons. IPSASB have now issued an exposure draft[10] on employee benefits and an exposure draft dealing with social policy obligations, including social security pensions.

From our point of view all liabilities ought to have been worked into the local government accounts according to the activity principle. A prerequisite for cost accounting is reliable cost measurement. If so, the cost should be recorded. Within the fields of education and production of social services the municipalities must be in possession of a vast experience material. We are not informed whether systematic statistics are produced locally in the areas in question. Statistics Norway, however, have some material available. Table 3 illustrates resources use for child protection and welfare relatively to total operating expenses (the number of municipalities is 412 out of a total population of 433).

[10] Proposed International Public Sector Accounting Standard.

Table 3 - Grouping of damage compensation cases

Child Welfare/Total Operating Expenses	Relatively of total population 2004	Relatively of total population 2005
0 % < MG1 < 1 %	21,4 %	17,5 %
1 % < MG2 < 2 %	38,8 %	40,8 %
2 % < MG3 < 3 %	34,5 %	33,7 %
3 % < MG4 < 4 %	4,6 %	6,6 %
MG5 > 4 %	0,7 %	1,5 %
Totally	100,0 %	100,0 %

MG: Municipality group

The table is made on the basis of reported figures to Statistics Norway. You will see that a relatively small part of Norwegian municipalities use more than 3% of total expenses for child welfare and protection (6,6 + 1,5) = 8,3%. In 2005 (33,7+ 6,6 + 1,5) = 41,8% use more than 2% of total operating expenses for child welfare purposes.

According to the standard of today (NLGAS 7) current costs related to service production failure of today cannot be recorded in the accounts of today. The amount in question will be recorded when a legally valid sentence is at hand.

If a municipality is sued because of service failure production, it may be considered to inform about the lawsuit in the accounting notes. The liability cannot be considered known (cf. LGA § 48) until a valid sentence exists.

Waste management has called for much attention in the newspapers during the last years. The following press cutting illustrates this:

> "Tidying up old sins, closed waste deposits included, demands the understanding that this is a complex cost matter. In my period as mayor more than ten years ago, I was confronted with the fact that tidying up costs for one of our historic waste deposits amounted to more than 10 million NOK. By the tidying up standards of today this amount has most probably risen to more than 25 million NOK. Viewed at the background of Holmestrand's 10.000 citizens, total national tidying up costs linked up to historic municipal waste deposits should be about 6 billion NOK."
>
> (Kommunal Rapport, August 31, 2005)

The running of waste deposits entails the certain event tidying up at a future point of time. When this point of time occurs, is an uncertain event. The same is true for the tidying up costs. But there is no doubt at all that it is the current activities of today that cause the tidying up costs. According to the activity cost principle and the principle of financial responsibility formulated by Ministry of Local Government and Regional Development, the tidying up costs should be accounted for in the ROA as a cost and a liability in the balance sheet (pre-cost accounting and deferred payment). Deferring cost accounting until the moment of payment will in our opinion obscure the actual use of resources today. An argument put forward against pre cost accounting is the municipal freedom of action. Advancing tidying up that which will be paid for in a distant future is said to confine the freedom of action. Our view is that this freedom is exerted at the expense of future generations. The LGA § 1 states that municipal management and activities shall be in accordance with the principles of sustainable development. Shifting the costs onto future generations has to be considered in conflict with the intent of § 1.

The discussion above is also valid for the management and running of harbours. In Norway this is a responsibility of the municipalities. There are several examples indicating that harbour activities have caused considerable tidying up costs.

6. Financial instruments and provisions

Pushed by banking and financing companies many municipalities have entered the realm of financial instruments. A municipality can accomplish any economic disposition within the limits of the LGA and the underlying regulations. There is no general or formal prohibition involving in transactions with considerable uncertainty. More and more municipalities choose increasing the risk profile in their financial operations, see e.g. Jørgensen (2005). The intention is to increase yield on their financial assets. This in turn will in increase the production of services and welfare goods. New kinds of financial dispositions bring along new accounting challenges. In this context we will discuss swaps and options. These financial instruments illustrate some important problems linked up to uncertain liabilities and financial instruments. We will shortly discuss zero-coupon swaps and swaptions. For more information about financial instruments see e.g. Deloitte (2007) guidance.

6.1. Zero-coupon swap

Zero-coupon swap is an exchange agreement where the parties swap future cash flows and present value. The cash flows in a zero-coupon swap can be compared with a loan. Compared with a traditional loan it is characterised by wider flexibility to satisfy the preferences of the parties. The cash flows swapped are connected to an underlying asset or value. Several municipalities have entered into arrangements like this and invested the released capital in financial assets as shares and redeemable bonds.

All financially motivated investments are to be classified as current assets in the municipal balance sheet report. The time horizon of the investment does not influence the classification. Classifying the investment as current asset implies that the zero-coupon swap has to be classified as a short-term liability. If not the consistency in the financially oriented system will fail. The present accounting regulations imply a current asset is activated even if the time horizon is long-term. On the other hand an item is credited as a short-term liability even if the loan is a long-term one. The accounting challenge is once again identical with the problem faced in connection with pensions and foreign currency.

6.2. Swaptions

A swaption is an option for an interest swap. A municipality entered in February 2006 into an agreement with a major Norwegian financing company. The agreement can illustrate the problem at hand. The municipality sold an option committing the municipality in five years to pay an interest of 4,05% per year for a ten-year swap. The basis for the swap is the loan portfolio of the municipality amounting to approximately 300 million NOK. The option implies that the municipality has a liability, but no opportunity. The municipality received the option premium of 7,7 million NOK when signing the agreement (a kind of sign-on-fee?). If the market interest rate in five years is above 4,05% the interest swap will not be effective. With a market interest rate above 4,05% the swap will not be profitable for the financing company. The financing company has an opportunity but not a liability. The municipality keeps the option premium whether the swap is realised or not.

The liability is contingent and shall not be recorded in the accounts. According to NLGAS 7 contingent liabilities are not to be recognised as known expenses, even if there is a major probability of realising the liability. If zero is a possible outcome for the realisation value of the liability, the expense is not recognised as known. This will be the case for this agreement. The consequence is that the municipality has to record the option premium as income (revenue) in 2006, but the liability linked up to the premium is not reflected in the accounts. Many financial instruments have a similar structure and construction.

The purpose of using financial instruments is to improve the liquidity of the municipalities and widen the municipal flexibility and freedom of action. Serving the liability is a complex and risky matter. Allowing the municipalities to employ financial instruments linked up with considerable uncertainty, we are somewhat wandering not presenting the risky instruments in the accounting reports. This holds especially when there is a major probability that the liability be realised.

These kinds of options are also used in the stock market and the market for foreign currency. An increasing number of municipalities have chosen to establish specific holding companies. The holding companies are the owners the stocks and manage the portfolio and pay dividends to the municipality. Even cash flows that are not affected by haphazard market fluctuations are secured. For a single year a limited liability company may display negative revenue and still pay out dividends. According to NAA it is the equity size that decides whether dividends can be paid or not. Received dividends will be recorded in the ROA as an income and ceteris paribus increase surplus and equity. From the viewpoint of many municipalities stable or constant cash flows are just as important as maximum dividends on investments. In the situation described one can imagine that the municipality enters into an agreement with the holding company that includes an obligation (but not a right) to swap the shares at a given price at a given point of time, i. e. five to ten years ahead. The holding company has a right but not an obligation sell the shares (sale option). This is a liability contingent on an uncertain future event. In this case the future event is the market share price.

According to LGA § 51 municipalities may furnish securities or guarantees except for business purposes. An option may be considered a kind of guarantee. It is an open question whether the options in question are in conflict with the regulations in the

LGA. The question is left unanswered by NLGASB. The Ministry of local government and regional development has expressed its opinion in a matter similar to the one described above. The case was whether a county was obliged to buy a fishing vessel at book value if the fishing company was to abandon fishing rights. The Ministry concluded that the agreement in fact was a guarantee. From an accounting point of view it is clarified that the options shall not be recorded into the accounts whether they are considered guarantees or not.

Guarantees are a well-known phenomenon in Norwegian municipalities. Some years ago it was common practice that municipalities in thinly populated distant areas furnished securities for business enterprises that promised employment for vacant hands. Businesses in question were fish farming enterprises and alpine skiing facilities. Many of them shortly faced liquidity problems. Consequently the securities were realised and the municipalities in question ran into financial trouble. Some of them were in fact placed under administration by central government. The ministerial reacted quickly. In 1992 a provision was included in the LGA that vetoed guarantees for business purposes outside the municipal organisation itself. This was an essential narrowing of the formerly practice in this area. In 2001 a new accounting regulation for county and municipal guarantees was launched. The basic principle is that all guarantees and securities have to be approved by central government. Neither the law nor the underlying regulations include formulations regulating the accounting of guarantees.

Guarantees are typical examples of contingent liabilities. The guarantee may be realised or it may not. If realised the realisation value is uncertain. NLGAS 7 states that liabilities with uncertain outcome and realisation value cannot be considered known figures. Consequently they are left outside the accounts. The municipal accounting regulations require information about the described liabilities to be given in the accounting notes. Several of the financial instruments have similar characteristics as guarantees. Several of the financial instruments are in reality an uncertain liability. The realisation value of an instrument may depend on the rise in and fall of market interests.

The Norwegian municipal accounting regulations are in many ways insufficient with respect to handling modern financial activities. This is a challenge since Norwegian municipalities have entered into the complex world of financial instruments with insufficient and unclear accounting regulations. Considerable liabilities may develop and are non-transparent in the accounts until the day of realisation. In some municipalities they were un-detonated loss bombs for several years. At realisation day the bomb detonated. The NLGSAB sees no need for a system revision and is of the opinion that the problem at hand can be taken care of by relevant equity provisions (fund provisions). The NLGASB is however rather vague about the calculation of relevant equity provisions. Any discussion of the mixing of debt capital and equity is omitted.

Summing up, conclusions and suggestions for further research

The accounting system is an essential carrier of information in all organisations. This means that information has to be reliable and relevant. In such a setting it is important to formally include provisions in the Norwegian municipal accounting system. This means that all kinds of uncertain liabilities that are likely ought to be incorporated into the accounts, like damage compensation and tidying up costs. Recording provisions in the accounts are done with reference to the notion of known or unknown. This widely used notion in the Norwegian municipal accounting terminology is very little precise and is interpreted on an ad hoc basis.

The newly published NLGAS 7 – inspired by IPSAS 19 – is an important document clarifying some cloudy and unsettled accounting questions. All the less many disputes are left un-discussed and unresolved by the publisher.

The Norwegian municipal accounting system is not founded on a superior accounting framework. This fact becomes evident when discussing accounting of provisions. There is no problem connected to short-term liabilities. In this case methods and procedures defined and settled in the NAA and its underlying regulations can be applied. Most provisions are long-term however. If long-term liabilities are worked into the system in a proper way, the financially oriented system formally collapses. There are two available technical solutions to the existing system: 1) Record the liability as an ordinary cost and a short-term liability. 2) Record the liability as provision in ROA with a credit entry in the balance sheet as equity (fund). In neither case the balance sheet can hardly be said to give relevant and correct information.

Answering the question raised in the heading of the paper is a mixed blessing. Clearly legal authorities have an ambition of including provisions in the accounting system. The problem is that the system origins from a cash based model. The consequence of bending and twisting provisions into the system results in a somewhat meaningless equity concept in the BSR.

In some accounting areas there seems to have been no discussion concerning which uncertain liabilities are to be included and which are to be left out. Excluding approx. 75% of the total activities without an exhaustive discussion seems a little bit strange. Several newspaper stories in the last years indicate some un-detonated bombs out there. The areas of child-care, kindergartens, primary education, care for elderly and disabled are regulated by laws and regulations securing national standards. The responsibility of running the activities is left to the municipalities. There is an increasing consciousness about citizens' rights. This consciousness may well result in an increased number of lawsuits. Some municipalities have established so-called guarantees for citizens. Implicitly it is understood that no-fulfilment of guarantee or contract entitles users to compensation.

It is somewhat strange that NLGAS 7 states that provisions for municipal liabilities may confine the municipal area of action. Our assessment is the opposite: Ignoring this type of important liabilities expands the action of the generation of today at the expense of future generations. This will conflict with the principle of sustainable economic development (LGA § 1).

There are still essential accounting challenges with respect to provisions. The challenges can be classified into two categories: 1) Classification of liabilities to be worked into the accounts. 2) Measurement methods and procedures for working the liabilities into the account. The professional foundation of uncertain liabilities is still somewhat unsettled. The need for a public sector accounting framework is obvious to us.

This paper is written with reference to Norwegian regulations and accounting practice. There is no reason to believe that Norwegian experiences in these fields are isolated Norwegian experiences. By international standards Norway has a peculiar set of regulations for local government accounting, however, and may be characterised as a slow adopter of international trends. Further research will be to compare accounting practice in various countries.

References

Aastvedt, A. and Mauland, H. (2006a), Kommuneregnskapet – rammeverk og prinsipper, Working report, n. 14/06, Telemark Research Institute

Aastvedt, A. and Mauland, H. (2006b), Hva bør styre periodiseringen i kommunene?, *Regnskap og revisjon,* n. 8, 17-25.

Alfredson, K.; Leo, K.; Picker, R.; Pacter, P. and Radford, J. (2006), *Applying International Accounting Standards*, John Wiley & Sons Australia, Ltd, Australia.

Bean, D. R.; Mead M. D.; Schermann, K. R. and Reese R. E. (2005), The Road to Accrual Accounting in the United States*,* IPSASB occasional paper.

Deloitte Touche Tohmatsu (2007), iGAAP 2007 Financial Instruments: IAS 32, IAS 39 and IFRS 7 Explained, Deloitte Touche Tohmatsu.

Fédération des Experts Comptables Européens (2007), Accrual Accounting in the Public Sector, FEE Public Sector Committee. Available at: http://www.fee.be/publications/default.asp?library_ref=4&content_ref=635.

Horngren C., Bhimani; Datar, S. and Foster, G. (2002), *Cost and Management Accounting*, Pearson Education, Prentice Hall.

Jones, R. and Pendlebury, M. (2000), *Public Sector Accounting,* Pearson Education, Prentice Hall, Harlow.

Jørgensen, J. P. (2005), *Kommunal finanshåndbok*, Kommunaløkonomisk forlag, Oslo.

Mellemvik, F. and Pettersen, I. J. (1998), Norway, a Hesitant Reformer?, *in* Olson, Guthrie and Humphrey (1998).

Olson, O.; J. Guthrie and C. Humphrey (eds.) (1998), *Global Warning – Debating International Developments in New Public Financial Management*, Cappelen Akademisk Forlag, Oslo.

Kommunal- og regionaldepartementet (1992), Ot.prp. nr. 43 (1999-2000): Om lov om endringer i lov av 25. september 1992 nr 107 om kommuner og fylkeskommuner.

Statskonsult (2006), Oppsummering og vurdering av erfaringer med periodiseringsprosjektet, Rapport. Available at: http://odin.dep.no/filarkiv/297752/statskonsult_periode.pdf.

Van Der Hoek, P. (2005), From cash to accrual budgeting and accounting in the Public Sector: The Dutch Experience, *Public Budgeting & Finance*, Spring 2005, 32-45.

Weetman, P. (2006), *Financial Accounting, an Introduction,* Fourth Edition, Prentice Hall, London.

• U C •