

Implementing Reforms in Public Sector Accounting

Susana Jorge
Editor



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CONSOLIDATED FINANCIAL REPORTS IN LOCAL GOVERNMENT: A COMPARATIVE ANALYSIS OF IPSASB AND SCMA

Introduction

During the last few decades public sector organisations in many countries have introduced accrual accounting including consolidated accounting (e.g. Lüder and Jones, 2003; Stalebrink and Sacco, 2006). In many countries also international auditing and consulting firms have played a crucial role in the process of implementing accrual accounting in the public sector (Lüder and Jones, 2003; Christensen, 2005). Methods and practices from the private sector have been copied and introduced in the public sector without any thorough analysis of the objectives and characteristics of the latter (Christiaens, 2002). According to Christiaens, the uncritical introduction of private sector accounting methods and the apparent lack of a conceptual framework for governmental accounting creates problems rather than resolving them.

The shift from cash to accrual reporting represents a major development in public sector financial reporting. Broadbent and Guthrie (1992) described this paradigm shift as *new accounting* and associated it with a move in the public sector towards *managerialism*. Hopwood (1984) associated the use of accrual accounting with government decisions to induce efficiencies into public institutions. Aiken and McCrae (1992), however, cautioned about the potential risk of welfare or other policy distortions that might be caused by the inappropriate application of accrual accounting outside competitive markets.

Changing from a cash basis to an accrual basis of accounting has implications for many features of public sector accounting and financial reporting, one of which is the use of accrual-based consolidated financial reporting. While the simple aggregation of cash-based data of individual entities will result in a form of consolidated report, the accrual-based method of consolidated financial reporting includes adjustments designed to eliminate double-counting of data where inter-entity transactions have occurred (Wise, 2004).

The development of municipal corporations has led to the observation that annual accounts of local governments disclose only a partial view of their economic and financial

activities. This is because the financial consequences of subsidiaries, joint ventures and associates are not necessarily included in the annual reports of the local governments. Thus, the decentralisation process has resulted in a great lack of information (Walsh, 1994). Consequently, accountability and decision usefulness of local governments is no longer guaranteed by their annual accounts. Internal users and external users of financial information are not able to base their decisions on reliable and relevant information about the financial position, financial performance and cash flows of the local government entity (Hughes, 1994). Consolidation is a necessary step to overcome this information gap (Lande, 1998; Grossi, 2001 and 2004; Srocke, 2004; Wise, 2004 and 2006).

In the private sector, consolidated financial statements are useful accounting instruments that improve accountability and provide an overall true and fair view of assets/liabilities and financial results (profit/loss) of the group (Childs, 1949; Walker, 1978). In the public sector, the consolidated financial statement is a useful instrument for governments that deal with a large number of publicly-owned companies because it presents a clear picture of the current economic status and functioning of the municipal corporate group (Lande, 1998; Grossi, 2001 and 2004; Srocke, 2004; Wise, 2004 and 2006; Grossi and Srocke, 2005). Such information is not ascertainable just by reading and analysing the single annual reports published by each company. However, this does not mean that the accounting documents drafted by local governments or by the companies that are a part of the municipal corporate group (which have their own objectives in terms of information and data) are any less important. The methodology used to gather information for the consolidated financial statement is still accrual accounting and thus must be implemented in a uniform way in all entities belonging to the municipal corporate group, as well as in local government itself. Group results are determined by LGs and their companies (Grossi, 2001). In this case we are dealing with results that have been achieved through economic processes carried out by LGs, in addition to those carried out by companies under the financial control of the LGs. The technical methodology used to calculate group results consists of consolidated accounts that include both the consolidated Balance Sheet and the consolidated Income Statement (Grossi, 2004; Srocke, 2004; Grossi and Srocke, 2005; Wise, 2006).

This financial tool of the municipality, together with a new conglomerate culture, takes on the fundamental role of an instrument in the hands of the city council and executive board that plan and control the activities of the publicly-owned corporations. Without a doubt, an aggregate accounting system promotes and improves the relations between the municipalities and the publicly-owned companies that are interested in understanding the real opportunities of debt retirements. The following users are interested in the overall information of the municipal group's consolidated report: creditors of the LG and the publicly-owned corporations, the mayor and the city executive board, and the city council and the citizens that are the clients of all the municipal activities. Moreover, the consolidated report assumes a special informative value for the internal and external stakeholders of the municipal group (such as the suppliers, the other creditors, the employees of the municipality and the publicly-owned corporations).

The mayor and the city executive board can consider the consolidated reports as a useful tool for steering and controlling the direct and indirect provision of public services. It is an indispensable tool for public decision-making in programming and controlling the different political choices.

The city council uses these financial tools, (mainly the consolidated reports) to guide and direct the management of the municipal ownerships. The political majority and the opposition are the principal users of LG's consolidated reports. The political majority in the assembly can use the consolidated reports to have an overall true picture of municipal operations, which helps in the activities of guidance and control. The political minority of the municipal assembly can use this accounting tool to give an opinion about the whole administration, to underline the possible limits and to suggest alternative solutions.

The consolidated reports are also very useful for external stakeholders. Since the compilation of the consolidated reports helps to give a true and fair view of the whole situation of the LG and its publicly-owned corporations, the transparency between the citizen and the public administration is improved. The increasing need for financial and social results renders even more important the requirement to also use new financial tools (such as consolidated reports) in the LGs; the consolidated report becomes the real tool of communication and evaluation" between the municipal group and the citizens.

The other public organisations (State and Regions) are interested in expanding their financial information by using the consolidated balance sheet and income statement to understand the real potential of the municipal group in reaching and keeping, long-term, dynamic financial equilibrium.

The banks are undoubtedly interested in the consolidated reports of the municipal groups as a means to understand the real and effective opportunities of debt retirement. Moreover, the consolidated report could be a useful, informative tool for determining the solvency of the entire municipal group. Within the different tasks of the consolidated balance sheet are included the measure of risk and the analysis of the capital structure of the municipal group.

Other external subjects (such as employees, clients, suppliers) are interested in having useful information about the size and future potential of local governments and the companies they own.

Such information is not ascertainable just by reading and analysing the single annual accounts published by each company. However, this does not mean that the accounting documents drafted by LGs, or the companies that are a part of the municipal group (that have their own objectives in terms of information and data), are any less important. On the contrary, every company's own documents are complementary to the consolidated financial statement. The methodology used to gather information for the consolidated financial statement is still accrual accounting and thus must be implemented in a uniform way in all companies belonging to the municipal corporate group, as well as in LG.

However, the stimuli behind these accounting reforms and the key factors in the reform process have varied among different countries (e.g. Lüder and Jones, 2003). In Sweden, an early adopter of both accrual accounting and consolidated accounting in the municipal sector, the Swedish Federation of Local Authorities and representatives from the academy played a critical role in the introduction and shaping of the reform process (e.g. Bergevärn *et al.*, 1995; Mattisson *et al.*, 2003). Academics played a particularly crucial role in the introduction and implementation of consolidated reporting (Svenska Kommunförbundet, 1989; Bergevärn *et al.*, 1995).

The aim of this study is to critically analyse similarities and differences in the approach to consolidated financial statements in standards issued by the International Public Sector Accounting Standards Board (IPSASB) and the Swedish Council for Municipal Accounting (SCMA). Sweden, as an early adopter, is an interesting case since the regulation of consolidated reporting in municipalities took place even before accounting in the private sector began significantly to be influenced and harmonised with international accounting standards.

The paper is organized in four main sections. Section 1 introduces the theoretical framework, while Section 2 describes the process of data collection. The paper continues presenting consolidated reporting for both the SCMA and the IPSASB, finalising with a comparative analysis.

1. Theoretical framework

The identification and definition of the accounting entity is dependent on the area of economic interest to identified stakeholders (Eriksson, 2002). Stakeholders might have different needs and uses for accounting information. Hence, a stakeholder identified as a primary user of accounting information can be expected to influence not only accounting issues such as valuation and reporting, but also the determination and definition of the accounting entity and methods of consolidating group accounts. Clearly, in order to determine the accounting goals, stakeholders' needs and uses of accounting information must be understood (e.g. Daniels and Daniels, 1991).

The role of accounting in providing investors with information for decision making has a long history in accounting theory. For instance, Moonitz (1961) stated that accounting information had to be useful for investors. This idea was the basis of the decision-making approach (AICPA, 1973) which is the foundation of the conceptual frameworks of both FASB and, later, IASB. However, investors are not the only possible stakeholders and accounting is more than an instrument for decision making. In the public sector, accounting plays a crucial role in demonstrating accountability (Pallot, 1992; Coy *et al.*, 2001; Chan, 2003; Mack and Ryan, 2006). According to the accountability approach (e.g. Ijiri, 1975), accounting is central in the control and balance of interest between agents and principals. Stanton *et al.* (1998) demonstrate how accounting information varies depending on whether accountability or decision making is emphasised. According to Demski *et al.* (2002), there is a tension between decision making and control "... because the data and processes that help to establish control are not necessarily the best for decision making, and the same is true in reverse". Ijiri (1975) applies a completely different meaning to the concepts of relevance and reliability than FASB does (Artsberg, 1992).

So, simply put, different stakeholders may emphasise different aspects of accounting. Thus, the substance and form of the accounting could be expected to differ, depending on which group of individuals and stakeholders has the strongest influence and interest in the various aspects.

Financing, legal form and purpose of the organisation are all aspects that influence the conditions and need for accounting information. In the preparatory work for the Swedish Municipal Accounting Act, the legislators outlined some specific aspects that they saw

as influencing the accounting model and motivating particular piece of legislation for municipal accounting. Brorström *et al.* (2005) summarise these arguments as follows:

- Municipalities run operations in the public interest which are mainly financed by taxes and grants from central government. Production means such as fixed assets normally have the character of a public utility, which means that they are not realizable on a market.
- All obligations are secured by the municipalities' power of taxation.
- The activities of municipalities are regulated by legislation. The activities are supposed to be in the public interest. Hence, municipalities are generally prevented from running operations for the purpose of profit.
- Municipal revenues are not assignable to a consumer market; consequently, in the short-term perspective they are relatively unaffected by changes in expenses.
- A municipality cannot go bankrupt, since its position is guaranteed by the Swedish Constitution.
- The form of government is built upon the principles of representative democracy, including the political responsibilities of the elected representatives. The form of government is established on the principle of openness, that is, all documents and the bases for decisions are public records.
- The budget plays a crucial role in the formulation of goals, priorities and resource allocation. Budgetary decisions are central parts of the management of municipalities, as they are politically governed organisations.

These aspects are not specific only to the Swedish situation. Similar arguments are emphasised by Pallot (1992) in her argument for an accountability-based framework for public sector accounting. Jones and Pendlebury (2004) also stress that the obligations are secured by the power of taxation. Many authors point to the fact that public sector activities are budget-controlled and that the accounting information principally is used in the follow-up of the budget (Daniels and Daniels, 1991; Brusca, 1997; Dittenhofer, 2001; Chan, 2003).

According to the Governmental Accounting Standards Board, the objective of governmental financial accounting is to provide financial information "...that is useful for economic, social and political decisions" (GASB, 1987). Thus, the objectives of governmental accounting are different from and broader than the objectives of private sector accounting. Surplus and earnings are not even long-term goals in the public sector; the goal is rather to offer services to the citizens (Jones and Pendlebury, 2000; Dittenhofer, 2001). Moreover, large financial surpluses are considered 'bad'; they signal political irresponsibility and imposition of too high taxes (Anthony, 1985; Gosling, 1992).

It is not only objectives that differ between public and private sectors. Another characteristic of public sector accounting is the diversity and heterogeneity of the principals (Stalebrink and Sacco, 2006). A resident in a municipality is not only an 'owner' but also a 'customer' (Grönlund *et al.*, 2005). Besides residents and voters, there are other principals such as central government, creditors/investors (GASB, 1999), sister organizations such as other municipalities (Coy *et al.*, 1997; Mack and Ryan, 2006) and internal users such as officials and politicians (Mack and Ryan, 2006).

Even though citizens and other stakeholders often lack direct interest in municipal accounting matters (Zimmerman, 1977; Brusca, 1997; Coy *et al.*, 1997; Bouckaert

and Dooren, 2003), municipal accounting is an important part of the democratic system (GASB, 1987; Edström *et al.*, 2004). Voters and taxpayers have a ‘right to know’ (GASB, 1987) and must be regarded as the primary stakeholders of municipal accounting (Daniels and Daniels, 1991). Therefore, accounting is an important tool to create political accountability in the democratic system:

“The accounting system can be highly useful to the accountant and the accountee even if no one reads the accounting reports. Like insurance, what is ultimately of use here is the assurance provided by an accounting system of records and reports that things can be accounted for whenever necessary.” (Ijiri, 1983:78)

In sum, compared to the private sector, the public sector differs in organisational goals, financing, ownership, recipients of accounting information, etc. Considering these aspects, the decision-making approach does not seem to be so relevant for public sector accounting. We argue that an accountability approach (e.g. Ijiri, 1975 and 1983) would much better serve the objectives and needs of public sector accounting (Pallot, 1992; Mack and Ryan, 2006). This will be an important theme as we proceed to analyse the approach of consolidated financial statements in standards issued by the IPSASB and the Swedish Council for Municipal Accounting (SCMA).

2. Data collection

The analysis is primarily based on documentary studies. Besides the accounting standards on consolidated reporting issued by the IPSASB and SCMA, we also analysed statements, discussion papers, instruction manuals, annual reports and other documents regarding accrual accounting and consolidated reporting in municipalities and local government. In addition to the study of documents we had the opportunity to participate and observe the meetings of the SCMA’s expert committee over a period of three years; these observations particularly helped us to better understand and interpret the data from the documents.

3. The concept of control and method of consolidation according to IPSASB and SCMA

3.1 Consolidated reporting in Swedish municipalities

Consolidated reporting was introduced on a voluntary basis in the late 1980s. The Swedish Federation of Local Authorities encouraged the introduction of consolidated reporting and in 1989 published a booklet with instructions and ideas about objectives and techniques for consolidated reporting in a municipal context. This booklet was prepared in co-operation with Dr. Lennart Eriksson from Gothenburg University, one of the leading scholars in the field of consolidated reporting. The basic ideas in this booklet still dominate praxis as well as standards in the field of consolidated reporting

within the municipal sector. The Municipal Act of 1992 introduced a requirement that municipalities' annual reports should include a consolidated financial statement. In connection with the statutory requirement of consolidated reporting, the standard-setter of that time, the Swedish Federation of Local Authorities' Reference Group in Accounting Issues [*Referensgruppen i redovisningsfrågor*], issued Standard 7 on consolidated reporting.

From 1998 municipal sector accounting has been regulated by a special law, the Municipal Accounting Act. According to this act, municipalities should establish a consolidated accounting report including a balance sheet and an income statement. The legislation refers to GAAP and standard-setters in the more detailed issues about consolidation methods and concept of control. The SCMA, which took over the power of standard-setting for the municipal sector when the Municipal Accounting Act was introduced, issued a standard (RKR 8.1) which is essentially built upon the same fundamental presumptions as earlier standards and GAAP.

In the municipal consolidated group, wholly-owned companies are included as well as companies with joint ownership. Companies should be included in the consolidated reporting if the municipality directly or indirectly has a material/significant influence. A rule of thumb is that the municipality should control 20% of the number of votes. However, according to the standard, there are situations when the numbers of votes comes short of 20% but the ownership involves a materially economic commitment for the municipality. In these cases the company should be included in the consolidated accounting. Hence, it is the economic concept rather than the legal concept that decides whether a company should be consolidated or not (Lefebvre and Lin, 1991). But this approach is from the municipalities' point of view. The standard also states that, besides the criteria of significant influence, the municipality should also consider whether a consolidation of a wholly- or jointly-owned company provides any material information, compared with the information that the municipality's annual report give.

The accounting principles of the municipality should guide the preparation of the consolidated accounting reports. As a general rule, the proportional method should be used when consolidating the companies. The standpoint is based on the fact that a full consolidation method may imply that a company that is jointly owned by (for example) two municipalities can only be included in the consolidated reporting of one of the municipalities. Considering the specific aspects of municipal operations (Brorström *et al.*, 2005) this would, according to the standard-setter, not give a true and fair view of the consolidated accounting. As profit is not a goal for municipalities, the need for information in order to estimate ROA or similar earning measurements is not of importance. Instead, it is information about the costs for service delivery and the obligations for the municipality that is of importance for the consolidated financial statements.

Even if the general rule is the proportional method of consolidation for each company, the standard-setter allows one exception. If an intra-group has been consolidated with a full consolidation method and, due to time and cost reasons, it is not justifiable to consolidate each company one by one, it is acceptable to proceed from the intra-group's annual accounts even if it is prepared according to the full consolidation method. This alternative to the general rule has been criticised because it could

mean that the consolidated annual accounts of the municipality become over- or underestimated depending on ownership structure (Falkman, 2005).

The main content of SCMA Standard 8.1 on consolidated reporting can be summarised as follows:

- It is the material information about the municipality's obligations rather than control that determines whether a company should be included in the consolidated reporting or not;
- The proportional method should be used when consolidating the companies.

3.2 Consolidated reporting according to IPSASB

In the private sector, the obligation to compile consolidated financial statements as well as the consolidation area itself will be defined according to the concept of control. If a company controls another company, the controlling organisation is obliged to present consolidated financial statements (IFRS 27). According to IAS 27, control is given if the parent is able to govern the financial and operating policies of another company. It does not matter if the parent actually uses the power to influence or if the parent benefits because of the influence, either in a positive or negative way. The ability to govern the financial and operating policies must be proved by a formal document like a statute, an agreement with the other investors or by reason of a majority of voting rights (IAS 27.12).

However, the definition of control used in the private sector does not satisfy the complexity of the public sector. This is because local governments aim to meet non-financial as well as financial objectives, whereas municipal corporate groups consist of heterogeneous, decentralised organisations. Therefore the definition of control must be changed in order to satisfy the special characteristics of the public sector.

The criteria that define control according to IPSAS 6 are the following:

- The local government benefits from the activities of the decentralised organisations;
- The local government has the power to govern the financial and operating policies of the decentralised organisations; and
- The power to govern the financial and operating policies is presently exercisable. (IPSAS 6.36).

If all three criteria are met, the local government controls the other decentralised organisation, and there is an obligation to prepare consolidated financial statements.

In contrast to the private sector's definition of control, these criteria fix two elements of the definition: the 'benefit element' and the 'power element' (IPSAS 6.26). Both elements have to be considered. The benefit element signifies that the controlling entity has to receive a financial or non-financial benefit from the activities of the decentralised organisation. This can also be a financial risk (IPSAS 6.27). The power element signifies that the government or the parent of a subgroup must be able to exercise the power to govern the financial and operational policies of the decentralised organisation. This does not require a majority of voting rights, but the power must be conferred by law or another formal agreement. The formal agreement must presently exist. If the ability to exercise the power requires changing law or renegotiating agreements,

the power is not presently exercisable. The existence of power to control does not mean that the controlling government or parent of a subgroup has to use this power. It is sufficient that the controlling entity is able to use it. It is possible that the controlling entity never gives any instruction to the decentralised organisations (IPSAS 6.28). Besides, the controlling entity is not required to have influence on the day-to-day business (IPSAS 6.29) (Grossi, 2004; Srocke, 2004).

Generally, every controlled entity should be consolidated (IPSAS 6.21). Only when “(a) control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its subsequent disposal in the near future; or (b) it operates under severe external long-term restrictions which prevent the controlling entity from benefiting from its activities” should the controlled entity be excluded from consolidation (IPSAS 6.22).

If control does not exist, it is necessary to investigate whether the decentralised organisation might be a joint venture or associate. According to IPSAS 8.5, a “joint venture is a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control”. That means that the controlling government or parent of a subgroup cannot decide about the decentralised entity on its own. The entity has joint control over the joint venture together with another venturer.

IPSAS 7 should be applied for accounting by local government for investments in associates (IPSAS 7.1). Associates are decentralised organisations “in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor” (IPSAS 7.6). Significant influence means the power to influence financial and operating policy decisions of the investee. An investor is supposed to have significant influence if it holds at least 20% voting power of the investee. If the voting power is about 20% and significant influence does not exist, it can be proven that the investee is not an associate according to IPSAS 7. If there are less than 20% voting rights, a significant influence still exists if the government or parent of a subgroup holds an ownership interest in the other decentralised organisation and the relationship between both organisations shows a significant influence of the investor.

Depending whether control, a joint venture or an associate exists, the consolidation method is determined and therefore the effect of the decentralised organisation will be presented in the consolidated financial statements regarding the influence the local government is able to exercise.

The consolidation methods should represent the different influences the public sector entity has on its subsidiaries. If a public sector entity is under control of another public sector entity, it shall be fully consolidated (IPSAS 6.17). If it is a joint venture, the entity should be consolidated proportionally or by using the equity method (IPSAS 8.36). If a public sector entity has just a significant influence on another public sector entity, the equity method shall be used (IPSAS 7.18).

4. Comparative results

There are several differences between the standards issued by the IPSASB and the SCMA. One obvious difference between the two standard-setters concerns the methods of consolidation. In Table 1 we summarise these differences.

Table 1 – Differences in methods of consolidation

	IPSASB	SCMA
	Decision-making approach	Accountability approach
Controlled Entities	Purchase method Full consolidation	Purchase method Proportional consolidation
Associates	Equity method	Purchase method Proportional consolidation
Joint Ventures	Purchase method Proportional consolidation (Equity method)	Purchase method Proportional consolidation

In the IPSASB standards the concept of control is central. Companies are treated differently, depending on equity interest and the municipality's power to govern the financial and operating policies in the corporation. No corresponding division exists in the SCMA standard. Even if the SCMA standard implies significant influence, the concept of control is not so crucial in the SCMA's standard-setting as in the IPSASB's; instead, economic materiality and obligations are emphasised. In practice this means that according to the IPSASB, several different consolidation methods, full respectively proportional consolidation according to purchase method as well as the equity method, have to be used in the consolidated reporting. According to the SCMA standard, proportional consolidation according to the purchase method should be used, no matter what the equity interest.

Another obvious difference between the standard-setters is that the IPSASB standards are much more comprehensive and detailed than the SCMA standard.

Conclusions

The IPSASB standards are essentially based on standards issued for the private sector by the IASB (2004). This means that the fundamental feature of the standards is based on a decision-making approach that aims to produce information primarily for investors. A negative consequence of this is that the special focus and special needs of the public sector are not sufficiently considered (e.g. Gustavsson, 2004). However, since the majority of the daughter companies have the form of association based on the capitalistic principle of a joint stock company (e.g. Collin and Hansson, 1991), the decision-making approach can in one way seem to be rational and appropriate in the matter of consolidation. But still it is unsatisfactory that IPSASB standard-setting is not based on a comprehensive theoretical framework that explicitly considers the special conditions and needs of public sector accounting information.

The SCMA offers an alternative approach of consolidated reporting which, instead of focusing on future-oriented accounting information, focuses on accounting information useful for accountability relating to employment of resources and obligations. As a consequence, the SCMA standard not only considers consolidation methods and concept of control but also valuation, a topic that IPSASB does not consider in its

corresponding standards. However, the SCMA standard is very generally kept and allows scope for different estimates and judgements, something that can have a negative effect on comparability and reliability (e.g. Falkman, 2005). The exception rule that allows the municipality to proceed from the intra-group's annual accounts, even if it is prepared according to the full consolidation method, is a concession towards the accountant, which is not in line with the accountability approach and the interest of the accountee. In practice this exception rule in many cases overturns the fundamental ideas that the standard is based upon, as more and more municipalities organise their ownership and companies in a municipal business group with a 100%-owned parent company at the top of the group.

In sum, there are several differences between IPSASB and SCMA in their standards for consolidated reporting. The fundamental difference is that the IPSASB's standards are based on a decision-making approach while the SCMA's standard is based on an accountability approach. Considering organisational goals, financing, ownership and recipients of accounting, several arguments support an accountability approach in public sector accounting. However, theoretical arguments also have to be balanced against practical and economical matters. In this balancing act one must also consider national legislation and the scope, aim and direction of the public sector. This comparative study has shown that:

- There are alternative approaches other than the one offered by the international standard-setter.
- Accrual-based public sector accounting does not necessarily have to be based on the decision-making approach.
- The different approaches each have their strengths and limitations.

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