



# PUBLIC SECTOR FINANCIAL REPORTING

IDW POSITION PAPER ON **ACCRUAL ACCOUNTING IN GERMANY AND  
HARMONIZATION IN EUROPE THROUGH EPSAS (GERMAN LANGUAGE)**  
(DATED 25.03.2019)

AN OVERVIEW  
IN ENGLISH

The Position Paper was developed by the IDW's Public Sector and Trendwatch Committees.

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The IDW position paper dated 25 March 2019 explains the IDW's views on the need for Germany to move to accrual accounting and ultimately to embrace the European public sector accounting standards (EPSAS) as an inevitable step to improving and harmonizing public sector financial reporting throughout Europe.

**THE FIRST SECTION** purports that accrual accounting is superior to cash accounting, because an entity records its assets and liabilities as well as increases in the resources at its disposal and resources expended. According to the IDW, a decision on a future accounting system does not simply mean an “either or” choice between cash or accrual accounting, because moving to accrual accounting does not mean foregoing the information on liquidity and cash flows that cash accounting delivers.

Experience shows that a move to accrual accounting often prompts modernization initiatives. There are numerous examples in Germany, including e.g., municipalities, colleges and universities, churches etc. which have taken a pragmatic approach to adopting accrual accounting and seen various improvements as a result. However, these experiences are not currently being reflected in the discussion on EPSAS, as Germany's contribution to the development is limited to technical work and – as yet – there has been no political commitment to EPSAS. The IDW believes that this situation needs to change and calls upon the German Federal Parliament and Federal Council to be proactive in addressing this issue, so that it will have a say on the design of EPSAS, ensuring they are user-friendly and relatively simple to apply. Pragmatic discussions on accrual accounting in Germany are needed – decisions that should focus on the ability to deliver added accounting information to supplement information already available from cash accounting.

**THE SECOND SECTION** describes the EU Commission and Eurostat initiative, started in 2011, aimed at harmonizing financial reporting within the public sector in Europe. According to this initiative, IPSAS (International Public Sector Accounting Standards) should form a basis for the development of EPSAS, taking account of European public sector specifics. In May 2018, Eurostat published a draft Conceptual Framework for EPSAS, developed by a working group mainly comprising representatives from each of the European finance ministries.

Eurostat proposes a two-step implementation approach, whereby, in the short to medium term, EU Member States voluntarily either adopt national accrual accounting or move to IPSASs. In the longer term (second step), they would move to EPSAS. According to Eurostat, EPSAS could be adopted by 2025.

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Currently all EU Member States – except for Germany and the Netherlands – have either adopted, or plan to adopt, accrual accounting. Consequently, there is already quite a high degree of similarity in public sector accounting between most of the EU Member States.

In 2010, the German Law on Budgetary Principles (Haushaltsgrundsätze-gesetz) allowed accrual accounting in the public sector, and specific standards were developed based on Germany's commercial accounting (HGB: Handelsgesetzbuch – German Commercial Code).

Nevertheless, Germany's Federal Government has still not moved from single entry cash accounting, and there has also been little take up amongst the 16 Federal States. Hamburg moved completely to accrual accounting in 2006 and to an accruals budget in 2015. Hesse, which is one of the larger Federal States, moved to accrual accounting in 2009. Bremen has published (in part) financial statements based on accrual accounting since 2010, but, as there are no accruals-based accounting records available, remains unable to include Bremerhaven. North Rhine-Westphalia has been leading the way at the level of municipalities and is currently in the process of transitioning at Federal State level. In the 12 other Federal States, even though considerable progress has been made at municipality level, there are differences between the standards applied.

**SECTION THREE** explains why the IDW believes that accrual accounting is relevant for public sector entities. The paper points out that whilst a failure to optimize the use of limited resources would, in the case of a privately-owned entity, be sanctioned in the form of insolvency etc., in the public sector such failure is undesirable (only) in terms of growing levels of debt. Nonetheless, management of public monies demands political decisions be made with a particular degree of due care, irrespective of the specific economic situation.

Internationally, both academia and practice recognize the value of accrual accounting in terms of its superior delivery of information for the public sector in comparison with cash accounting. Indeed, the IDW asks why German legislation requires the presentation and publication of financial information using accrual accounting for most entities in the private sector – but not for itself? It is difficult to comprehend why the German Federal Government with over € 300 billion taxation receipts should account for its income and expenditure akin to the very smallest of entities in the private sector. A modern government competing at an international level needs recourse to information deliverable by modern accounting.

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The paper explains the three components of financial reporting under an accrual accounting system (cash flow statement, statement of financial position and statement of financial performance, (supplemented by note disclosures)) and compares this to the relatively sparse information on cash received and cash expended during the reporting period available under cash accounting. Cash accounting provides no information about the developments of assets and liabilities and, where applicable, the consumption of assets over time. Consequently, the information delivered is not sufficient for the decision-making needs of a range of interested parties, including citizens, taxpayers, capital market participants, holders of government bonds, other creditors, state employees and recipients of social benefits. The overall level of government indebtedness is an issue, since government bonds can no longer be regarded as risk free per se. An incomplete portrayal of the level of indebtedness risks creating a lack of trust in the capital markets in general.

For fiscal management purposes, one of the advantages of accrual accounting is the recognition of assets and liabilities, which go unrecorded under pure cash accounting. A move to accrual accounting necessitates an initial stock-take of assets and liabilities, often revealing items of which there may have been little awareness previously. The appropriate assignment of management responsibilities to these items – ranging from intangible assets to heritage assets and a country's infrastructure – is just one of the benefits for fiscal management within the reporting entity.

There are commonly different understandings between public sector managers, government statistical offices and the general public as to what constitutes a liability. For example, within the cash-based accounting system, the public sector in Germany differentiates between “explicit debt” and “implicit debt”; the former being credit titles, such as debentures, bonds and other loans. This doctrine does not recognize “implicit debt”, i.e., liabilities arising from past decisions and events that will have to be financed from cash flows in the future. Experience has shown that such “implicit debts” are often higher than those termed “explicit”. For example, for Hamburg or Hesse, the move to accrual accounting revealed liabilities that were more than triple those included in the liability statistics of the Federal Statistical Office.

The recognition of how certain resources should be capitalized and their use over time recorded (by means of depreciation) is a further key difference between accrual and cash accounting. In the context of current discussions in Germany concerning the undeniable deterioration of key infrastructure assets (e.g., road and

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rail), the IDW explains that, whilst the use of accrual accounting by Deutsche Bahn (German Rail) cannot prevent deficient maintenance, it does allow the impact thereof to be reflected in the financial statements. In contrast, cash accounting records only an expense – in full – at the time infrastructure is acquired, constructed or repaired, but does not reflect degeneration as the physical substance of infrastructure deteriorates through use.

Accrual accounting reveals the (financial) impact of present policies and past decisions on future generations. For example, by selling assets today or letting them deteriorate through deficient maintenance programs or long-term use, it will be future generations who face the cost of remedial action later on. This applies to all current policies and past decisions that commit the public sector to specific expenditure. Not identifying such matters risks today's generation increasingly living at the expense of future generations. The paper asks how the government should ensure equality between generations if it neglects to account for all the things it has committed to in the past.

According to the IDW, accrual accounting is a key prerequisite for generational fairness, whereas, cash accounting makes it far easier to defer debts to future generations. Current political decisions are often not reflected in financial reporting prepared under cash accounting until a later point in time.

The paper discusses two illustrative examples:

**EXAMPLE 1:** Under accrual accounting, provisions for the future payment of civil service pensions are recorded during the period of employment, showing the cost of pensions to be met in future, thereby revealing the extent of commitments made on future public sector income e.g., tax receipts. A political decision to e.g. reduce the pensionable age for civil servants would have no immediate impact under cash accounting but its financial impact (pay longer for less active service) would be easily identifiable as an increase in the provision and immediate recognition of a corresponding expense under accrual accounting.

**EXAMPLE 2** discusses this issue in the context of the state retirement pension. Due to the expected change in demographics, it is generally deemed likely that, in future, fewer citizens will have to finance the state pensions of an increasing number of pensioners. The IDW poses the question: shouldn't the accounting be able to reflect this situation as it exists today and quantify the extent of this gap? Even though citizens regularly receive an expected entitlement notification without any legal guarantee of the amount of their future pension due from the government, a factual liability could be perceived that could give rise to an accounting provision of the amount required to finance this gap.

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The paper discusses what the IDW sees as a key difference between the private and public sector. Under accrual accounting, the nature of equity (or negative equity) for a public sector entity is very different to that of an entity in the private sector and thus, in a public sector context, equity needs to be interpreted very differently. Specifically, although, the public sector's ability to levy future taxes and other contributions is significant, this ability cannot be reflected as an asset to offset those liabilities intended to be settled from future income (i.e., funded on an intergenerational basis). Only accrual accounting reveals the intergenerational impact of decisions made and events occurring during the reporting period as movements in net equity year-on-year.

For example, the construction of a bridge (or road, airport, school etc.) would be expensed in full when paid for under cash accounting, whereas under accrual accounting the total construction costs would initially be capitalized, and then spread over several periods by depreciating this total over the expected useful life. In direct contrast, a policy decision promising expenditure that is not related to a recognizable asset – an example given here is Germany's recent extension of state retirement pension eligibility to all mothers – would be reflected as an expense in the reporting period i.e., the estimated cost of the promises to eligible mothers at the date of the reporting period would be added to pensions paid during the period, so the impact of such a policy change would be clearly evident as a movement in equity. In contrast, cash accounting would not show the future impact of such a decision, but instead only account for payments made during the reporting period.

Just a brief look at the statement of financial position reveals the total indebtedness of a company in the private sector. In contrast, a citizen seeking this information for the public sector is confronted with various sources of information and, even then, may be uncertain as to whether the information gleaned is complete and accurate. There is a distinct lack of transparency, since fiscal managers and politicians will have access to sources of information during their day to day activities that are unavailable publicly. Financial statements prepared using accrual accounting can provide an overview of the most material information; as such accrual accounting constitutes an important communication medium between citizens and politicians. The President of the Court of Auditors in the Netherlands summarized this in January 2018 with: "better accounts, better democracy".

In Germany, the basic constitutional law (see Grundgesetz, Article 114, paragraph 1) requires the Federal Minister of Finance to present an account of the assets and liabilities to the Federal Parliament and Federal Council, as part of the annual



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discharge of the government. However, this account characterizes a rudimentary balance sheet that neither gives a complete picture of assets nor of liabilities; nor does it balance. Furthermore, as there is no transparency as to which provisions are included and which not, it fails entirely as an informative document.

The IDW asks whether the government ought not to be discharged based on complete information. An accruals-based statement of financial position would account for all assets and liabilities and thus be far more suitable for such purposes.

Cash accounting has no equivalent to a consolidated set of financial statements capable of providing a comprehensive view of all public sector activities. The more a public sector entity outsources its activities, the more relevant consolidated financial statements become. Consolidated financial statements at whole of government level would include all legally self-sufficient and non-self-sufficient entities comprising the public sector. In Germany at the national level, these include over 100 private sector entities in which the government has a controlling interest such as Deutsche Telekom, Deutsche Bahn as well as many small and medium-sized limited liability companies. The IDW points out that only if a consolidated set of financial statements were made available would such outsourced deficits and liabilities be included so as to provide a complete record of the public sector's financial management.

**SECTION FOUR** discusses the rationale for harmonizing public sector accounting in Germany, explaining the status quo whereby, rather than standardizing their legislation using example texts based on commercial accounting that were at their disposal in 2003, the Federal States opted to “reinvent the wheel” at the local level for municipalities. According to the IDW, this display of German federalism has led to a proliferation of differing accounting solutions, each with different detailed rules; not all of which are necessitated by public sector specifics. For example, provisions for civil servant pensions are measured according to different criteria from Federal State to Federal State, with some Federal States not requiring any provision at all. Consequently, there is a lack of comparability between the various levels of German public sector accounting, both horizontally and vertically, i.e.:

- between different levels (Federal Government, Federal State and municipalities),
- within each level (between municipalities situated in different Federal States),  
and
- between the different types of entities within a Federal State.

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Eurostat's initiative offers the chance to remedy this situation as well as to improve public sector accounting at the Federal State level.

Within Europe the statistical information needed for macroeconomic purposes can only be as reliable as the quality of the source from which it is derived. Accounting systems for financial reporting offers synergies in capturing data for both statistics and financial reporting purposes, fostering transparency and comparability. Cash-based accounting systems mean that data has to be collected from other sources, which therefore risks data being incomplete or subject to aggregation errors etc.

It is difficult to understand why – after EU harmonization of matters such as currency, banking, employment etc. – Germany should stop at – of all things – public sector financial reporting, even though a high degree of harmonization has been achieved in private sector financial reporting.

**THE FIFTH SECTION** explores which accrual accounting standards could be appropriate. The IDW suggests that, in terms of Germany's public sector "taking a step in the right direction", consistency in moving to accrual accounting is more important than which standards are applied (i.e., modified commercial accounting, the German public sector accrual accounting standards previously developed, IPSAS or the (still to be developed) EPSAS). However, from the perspective of European harmonization, applying IPSAS would currently be more appropriate than each EU Member State using its own national accounting standards.

The IDW notes that, through its involvement in the EPSAS technical working group, the Federal Ministry of Finance has already had some success in ensuring that the concept of prudence is reflected in the EPSAS conceptual Framework. However, Germany's continuing publicized reluctance to adopt accrual accounting may preclude German suggestions gaining acceptance as the development of the EPSAS standards progresses.

As the largest and most significant EU Member State, and especially in view of its heavy involvement in demanding economical and organizational reforms in other EU Member States (such as Greece), Germany should instead be perceived as a role model both in terms of its participation in the development of a homogeneous system for future financial reporting for the EU, and in pursuing financial reporting at home that will hold pace internationally.

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**IN ITS FINAL SECTION** the paper draws a conclusion and calls for action.

Eurostat has called for increased transparency and comparability in public sector financial reporting throughout the EU. The EPSAS, constituting financial reporting standards upon which the EU Member States agree, are essential to the achievement of both goals.

The majority of Member States already apply accrual accounting (national standards or IPSASs). In some cases, because international lenders have stipulated this as a specific prerequisite for advancing loans; in other cases, because of their own convictions that reforming financial reporting supports broader public finance management reforms as an integral part of modernization initiatives.

Germany on its own will not be able to halt this process.

Discussions have been ongoing in German for several years as to whether cash or accrual accounting is the best choice for the public sector. The answer is not “either ... or” but rather “as well as”. Both are important, since the receipts and expenditure in a cash accounting system form a central aspect of management in both public and private sector entities, but equally in both environments it is unable to deliver all relevant information.

Several key issues have become increasingly relevant in the public domain the last few years: How high is the burden associated with promises to pay for pensions and other longer-term services? What about the state of public assets, particularly infrastructure assets? How much risk is associated with public sector investment in e.g., state banks, airports or transport companies etc.?

Of course, a budgeting or accounting system that delivers relevant decision-making information cannot guarantee that negative developments will not be repeated. Even when comprehensive information is available, political necessity may demand economically questionable decisions. Nevertheless, relevant information and transparency remain a prerequisite for good decision-making and improved management.

Cash accounting delivers information on liquidity, constituting an important part of this information. However, a depiction of the assets and liabilities, including those to be settled in future such as pensions (for the public sector this will generally be negative equity) is just as important. A third perspective, showing the results of the entity's economic activities provided by the accruals-based

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statement of financial performance completes the picture. This perspective provides information about developments in net equity from period to period.

It is not a question of which perspective is best, since basing fiscal management on only one perspective means suboptimal management. Cash accounting cannot deliver information on the intergenerational impacts needed for optimal management, so having information from more than one perspective is clearly superior.

Past attempts to supplement the information provided by cash accounting have not been very successful. Shadow accounting is not the way forward.

In view of this, accrual accounting offers opportunities, including:

- a modern conceptually-based system of recording cash-based information, as well as information on the financial position and performance
- consolidated information which can support the increasingly recent trend towards fiscal management on a consolidated basis, since this takes account of outsourced aspects of public sector activities. Given Germany's self-imposed debt limitation (Schuldenbremse) increasing debt in outsourced activities points to an increased need for such information, also for budgetary purposes.
- Introducing accrual accounting could also encourage wider-spread modernization of fiscal management.

From the start, German auditors (Wirtschaftsprüfer) have supported public sector municipalities in preparing their financial reports under accrual accounting, or by auditing them. Their experience shows that whilst there are advantages to be gained, accrual accounting does not always find ready acceptance amongst fiscal managers and politicians.

Such benefits they have observed include an increased awareness of the asset base with potential to raise cash through disposals and better perspectives for longer-term decisions. Awareness that investments are associated with opportunities but also risks is increasingly on the radar of many decision-makers. On the down side, besides some lack of acceptance, the increased complexity is also sometime problematical, resulting in the "new" information not being taken into account in the political decision-making process. As a result, some perceive the move to accrual accounting as a costly but unnecessary exercise.

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This is of significant concern to the German auditing profession. The IDW mentions the lack of a “healthy” ability to simplify matters within some public sector administration, noting that the perception that accrual accounting must, by nature, be minutely detailed and laborious is as misconceived as it is widespread. The paper points out that the concept of materiality is intended to address these very issues. The profession can provide support in applying this concept in practice such that accrual accounting can be applied efficiently, and complexity reduced. For example, not every (inexpensive) artwork or every (old) chair needs to be counted, nor would a provision always need to be calculated for non-material items such as employees’ holiday pay.

Experience has shown that the orientation of reported information to the reader is important, as it is key that they appreciate the informational value of the budgets, reports and financial statements made available to them. Initial uncertainties need to be addressed with practical implementation initiatives.

Municipalities that have moved to accrual accounting note that user-orientation, a strong focus on budgeting and using materiality to reduce complexity are key. Such experiences could be seen as “good practice” or a way to avoid pitfalls experienced in the past.

The mandatory application of EPSAS could be a medium-term solution for EU Member States. Politically speaking, Germany has placed itself on the outskirts of the EPSAS adoption discussions; thus, limiting Germany’s influence on this process. There are indications that, sooner or later the adoption of EPSAS will become inevitable, so it would be sensible for Germany to participate in shaping the seemingly-likely future. Indeed, there are good reasons for doing so, not least to address the pitfalls experienced, as described previously.

EPSAS should not become overly-complex. They must be capable of supplying financial reporting tailored to the readers – information that they can use for budgeting purposes and for other parliamentary processes. Given the various perspectives explained above, one possible solution might be budgeting on a cash basis and EPSAS’ financial reporting on an accruals basis.

Rather than becoming stuck in a discussion of “whether” in regard to EPSAS or “cash vs. accrual accounting”, it would be better to use the development potential on offer. Moving to EPSAS opens up a chance to use accrual accounting in an intelligent manner, retaining and supplementing cash-based budgeting familiar to the public sector in Germany.

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Achieving this would mean:

- working to ensure EPSAS provide information needed by users and are simple to apply, and
- being pragmatic in the discussion on accrual accounting, recognizing that this can be introduced “as well as”, rather than “instead of” current accounting.

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