Convenience Translation

of the IDW letter dated 1 December 2017 sent (in German) to Mr. Kay Scheller, President of the Supreme Audit Institution [Bundesrechnungshof], Adenauerallee 81, 53113 Bonn, Germany

Special Report dated 15 November 2017 – Intended implementation of harmonised European Public Sector Accounting Standards (EPSAS) in the Member States of the European Union

Dear Mr. Scheller

From press coverage we learned of the Special Report addressed to the Parliament, the Federal Government and the general public pursuant to Article 99 of the Federal Budget Code [Bundeshaushaltsordnung] in which the German Supreme Audit Institution is highly critical of the harmonisation of accounting in the EU and especially of any introduction of accrual accounting for the German federal government.

The Special Report and the Press Release have caused astonishment and incomprehension not just within the auditing profession in Germany. We would appreciate the chance to have a discussion with you in order to understand the Supreme Audit Institution's position and the reasons behind this action.

In particular, we are unable to comprehend the following points in the Supreme Audit Institution's Report:

- The Report disclaims the benefits of accrual accounting, although these have been clearly recognised in both the academia and in practice. In comparison to cash accounting, that basically only depicts cash receipts and payments, accrual accounting reflects the intergenerational impact of government policies and decisions and provides increased transparency and accountability. Only accrual accounting is able to provide a complete picture of assets and liabilities and how resources have been consumed.
- The Report does not distinguish between costs related directly to the implementation of accrual accounting and additional costs for IT maintenance and administrative improvement costs that are already overdue.
- Contrary to what is suggested in the Report, representatives from the public sector provide very significant input to the development of IPSASs. The International Public Sector Accounting Standards Board (IPSASB) has a

majority of such members. Only 2 of the 18 members are from professional auditing firms.

- It is generally common practice and indeed essential to draw on the knowledge and expertise of external parties in drafting laws and regulations. It is therefore illogical for the Supreme Audit Institution to demand not to make use – of all things – of the expertise of the auditing and accounting profession, particularly given that in undertaking their statutorily mandated role, private sector auditors have specific expertise.
- The Report equates IPSASs with International Financial Reporting Standards (IFRSs). This ignores the fact that IPSASs address the informational needs of a broad range of financial statements' users, from taxpayers through to members of parliament. It is for this very reason that the IPSASs do not reflect the IFRSs one-to-one without change, but are instead specifically formulated to take due account of the differences arising from public sector specific requirements.
- In view of the fragmented public sector accounting landscape in Germany, it is, in our opinion, inappropriate to criticise international accounting frameworks for including accounting options or allowing scope for judgement. Indeed adoption in the European Union could ensure harmonisation of certain options allowed under IPSASs, and thereby achieve greater comparability within Europe. On this basis, the existence of accounting options is not an appropriate argument against accrual accounting. Furthermore, there is no (accrual) accounting system that does not involve some degree of judgement, but this does not call into question the fundamental benefit of accrual accounting.
- A historical presentation of cash movements does not require any judgement, as it merely reflects past events. In contrast, accrual accounting also includes future settlement obligations resulting from economic events already present in the reporting period, which may have to be estimated. There are – also in private sector accounting pursuant to the German Commercial Code [Handelsgesetzbuch] – decades of experience in making estimations and many approaches, methods and conventions. Additional information included within disclosures as to the method selected ensures a basic degree of comparability.
- The relative importance of the prudence concept is indeed a fundamental issue for accounting. Accounting in the private sector serves a variety of objectives, including the provision of information and the determination of distributable profit for e.g. limited liability companies. There is a certain degree of conflict between these two objectives, which can be addressed by adapting the degree to which the prudence concept applies to reflect the particular objective. In applying accrual accounting for the federal

government and the federal states such a convention would also be necessary: For example, for the protection of future generations, the prudence exercised in determining state benefit obligations would tend to result in a higher provision. Irrespective of the degree of prudence applied, reporting under accrual accounting will always result in the presentation of higher obligations than financial reporting under cash accounting. Arguing in favour of cash-based accounting, where no liabilities are shown, that accrual-based standards do not apply prudence stringently enough and thus would lead to an understatement of liabilities, is contradictory.

- For years, at least in essence and not solely in the formal sense, the Federal Minister of Finance has not respected the first paragraph of Article 144 of the German Constitution [Grundgesetz], which requires the government to report on all assets and obligations. There are several material items not included in the federal government's Statement of Account of Assets and Liabilities [Vermögensrechnung], including fixed assets such as infrastructure assets and many (accrued) liabilities. Therefore, it is surprising that, rather than insisting that complete information be provided in the Statement of Account of Assets and Liabilities, the Supreme Audit Institution is questioning the validity of accrual accounting and consequently is also questioning the complete presentation of information on assets and liabilities.
- It should not be forgotten that it is cash accounting that has led to suboptimal management. Accounting that focuses solely on cash out-goings and in-goings does not deter the deferral of urgently needed measures to preserve national infrastructure. Indeed, the current dilapidation of infrastructure – whether motorways and bridges or at local level schools and kindergartens – has arisen solely because such failure to act is not made visible under cash accounting.
- The Supreme Audit Institution has in the past itself denounced the federal government's sale of assets such as land and buildings and investments, since they represent a stealthy erosion of wealth that will burden future generations. The cause of this change of view is unclear, as is why today the Supreme Audit Institution is resistant to the systematic recording and transparency of intergenerational wealth erosion that accrual accounting would facilitate.
- Since, due to demographical developments, it is evident that increasingly fewer citizens will have to pay for ever higher obligations that are not reflected in the financial statements, there is no alternative to accrual accounting. Only then will the price of those political decisions that limit the scope to manoeuvre in future be visible. Looking back in the mirror through cash accounting will not help.

The appendix to this letter includes a detailed discussion of these issues.

We would be pleased to meet with you to discuss our respective views and to explain our position in a personal discussion.

With kind regards

Prof. Dr. Naumann

Dr. Eulner, WP StB
Technical Manager

Appendix

Appendix

Advantages of Accrual Accounting

Germany is one of the few States that has not changed the core of its government accounting from cash accounting to accrual accounting at federal level. It is generally accepted that accounting for commercial businesses using accrual accounting provides better information than cash accounting alone, since it can give an appropriate presentation of assets and liabilities as well as how resources have been consumed. This is why the German legislator generally requires private businesses, up to and including larger business enterprises and groups to use accrual accounting for accounting in the public domain. Given this backdrop, it is hard to understand why the federal government with tax income in excess of 300 billion Euros should – as is the case for the smallest of Germany's business entities – make do with a statement of cash receipts and payments. Not only private sector entities have to manage with limited resources. State activities are aimed at meeting public needs. The federal government, federal states and municipalities therefore need to make fundamental decisions in order to optimize the use of limited resources. An uneconomical use of resources in the public sector is – in contrast to the private sector – not or not directly subject to market-related sanctions (insolvency or liquidation), but it does result (at least) in an undesirable increase in debt. Even when the economy is in good shape, there is an unquestionable need to manage the budget in an optimal manner. Dealing with public monies requires a special duty of care in shaping political decisions, independent of the entity's actual economical position, and certainly with a view to any future deterioration.

It is for these reasons that academic circles both nationally and internationally view accrual accounting as the accounting concept best suited to public sector administration for the future. Of course, accrual accounting does not guarantee economic success, but it can support decision-making and support resource preservation when used in conjunction with economic management techniques – on the premise that accounting information is actually used as a basis for political decisions that have financial implications. It is however questionable whether accrual accounting can influence political decisions, if the budget continues to be based on cash out-goings and in-goings rather than on expenses and income streams.

In a cash accounting world, it is (systematically) far easier to defer the cost to burden future generations. Thus today's political decisions do not impact the current cash-based financial statements of a State, because they do not become actually payable for until later. In contrast, a balanced budget on the basis of an accrual-based statement of financial performance could avoid false incentives, because the generation making a decision would already have to contribute to generating the resources needed.

Accrual accounting makes it far easier to manage ageing infrastructure and avoid infrastructure obsolescence: The breakdown of fixed assets (i.e., disclosure requirement) shows the age of each class of asset and by means of depreciation the reduction in value. In addition, there is a clear differentiation in terms of presentation between expenditure investing in new or improved infrastructure on the one hand and on maintenance of existing infrastructure assets on the other hand. Today's accounting means that this cannot be discerned from information currently available, even by experienced politicians in the transport sector.

A (cash-based) debt level that only includes capital market debts (in public sector budgetary terminology "explicit debt"), but excludes further obligations such as pension obligations, obligations that result from lack of maintenance, risks arising from liability mechanisms such as loan and other guarantees and social benefits (in public sector budgetary terminology "implicit debt"), does not provide useful information. State finances are sustainable if the State can repay debt as a whole over the longer term. Determination of the actual public debt level is a decisive factor in this regard. Classic cash accounting is insufficient for such a determination of total obligations.

The differentiation in the public administration's terminology between "explicit debt" and "implicit debt" is a smoke screen, since even the so-called implicit debts concern actual debts or clear burdens to be settled in the future. In addition, when comparison is drawn between the federal government's (cash accounting) debt and municipalities' (accrual accounting) debt citizens are denied useful and transparent information.

In addition, the use of cash accounting means it is impossible to perform an (accrual-based) consolidation. However, consolidation is becoming increasingly important in the light of the outsourcing of tasks, assets or debts to other entities. Consolidation is becoming increasingly important in order to obtain an appropriate and complete picture on the actual financial position and financial performance of the local authority or public sector as a whole. Foregoing consolidated financial statements carries the risk that asset consumption (for the time being) is not transparent and will occur without being sanctioned, leading to violations of the principle of intergenerational equity being recognized too late. Numerous examples in the economy prove the dangers resulting from foregoing of consolidated data.

Pursuant to paragraph 1 of Article 114 of the German Constitution [Grundgesetz], the Federal Minister of Finance is required to account for the assets and debts – as the basis for discharging the Federal Government. Fulfilling this requirement completely can only be achieved with an accrual accounting system. Accordingly, the Statement of Account of Assets and Liabilities prepared by the federal government is incomplete (see, for example, the 2016 Statement of Account of Assets and Liabilities on page 8 and the items reported there with EUR 0.0* million and the footnote that items marked with * are currently not measured and recognised). Not included are inter alia material items such as intangible and tangible fixed assets. The real estate of the federal government is missing completely, also federal motorways and roads as well as shipping lanes (according to page 11 of the Statement of Account of Assets and Liabilities, the basic assets are recorded only in terms of area).

The federal government's Statement of Account of Assets and Liabilities (Article 86 of the Federal Budget Code) has the character of a rudimentary balance sheet, as it neither presents a complete reflection of the assets nor of the liabilities and the totals are unbalanced. Recognition of debt under cash accounting takes only capital market funding, bonds and loans into account. In contrast recognition of debt under accrual accounting takes all obligations entered into in the past into account. Although the federal government's Statement of Account of Assets and Liabilities contains in addition isolated provisions and, since 2009, includes provisions for civil service pensions and benefits, it does not include all obligations.

If consolidated financial statements were prepared at federal level, besides the core administration, legally dependent and independent entities would also have to be included. Then, by means of the consolidation of subsidiary entities, e.g., the rail network would be reported as infrastructure assets.

The failure to fully enforce the rules of the preventive and corrective arm of the Stability and Growth Pact is indeed regrettable. This is, however in essence a sign that politics and administration ought to be monitored. Accrual accounting provides a better basis for this than cash accounting.

Advantages of Harmonization in Germany

Besides the obvious advantages of international comparability, harmonization within Europe could have a positive impact, especially for Germany. Because there are numerous separate frameworks each with different regulations of individual details, public sector accounting in Germany is extremely heterogeneous; Germany is therefore in an exceptional position, detrimental to its reputation. At the local (municipal) level, the reform to introduce the accrual accounting has been largely completed, but due to the federal structure, the regulations differ greatly between the individual federal states.

These differences between the federal states, but also between the various entities (core administration, municipal enterprises without legal capacity, and various legal entities organized under either public law or private law) within a federal state are hardly straightforward for the citizens and other addressees, especially since it is difficult to understand the underlying reasons for the differences. In many cases they cannot be justified as public sector-specifics.

In this respect, one positive side-effect of the Eurostat project can be to counter the fragmentation of accounting in Germany, and thus increase transparency and comparability.

Cost-benefit considerations

In view of these advantages, it is hard to comprehend that the expected costs of the reform should be weighed against "in fact of no use" (page 24 of the Special Report). The potential benefits are manifold, if not always capable of being precisely quantified. It was right for the Supreme Audit Institution, at least in the past – unlike today – to repeatedly plead for the introduction of accrual accounting (e.g. published as parliamentary document 16/2400).

The (implementation) costs are relatively high for Germany because the federal government can be assumed as having a relatively low maturity level of financial reporting and IT infrastructure in comparison with other EU countries. In providing an estimate of the costs, the amount attributable to the change itself and the amount due to a (in any case overdue) modernization of administration, processes, software or infrastructure such as computers or networks should also be disclosed. The latter is likely to constitute the larger part of the total cost.

In addition, in a cost-benefit consideration, the opportunity costs of not introducing accrual accounting must also be taken into account.

The Report also criticizes the fact that the Eurostat project would result in a parallel system within Germany (page 3 and section 8). However, this is due to a conscious decision; it is not compulsory. Since 2010, the Law modernizing the Budgetary Principles Act [Haushaltsgrundsätzemodernisierungsgesetz (HGrGMoG)] has introduced the option to design the budget either on a cash accounting basis or alternatively according to the principles of the government double-entry bookkeeping system under section 7a of the Budgetary Principles Act (i.e., accrual accounting).

Role of Private Sector Auditors

The Report and the Press Release are misleading in respect of the role of private sector auditors. For example, the Report fails to recognize that the professional organization Accountancy Europe includes on the one hand preparers as well as auditors and on the other hand public sector representatives in addition to private sector representatives. Such facts – also, incidentally, the composition of the IPSASB – are publically available and could easily have been determined through careful research. Since the Report has nevertheless elected to provide a different representation, the question arises as to whether there was a deliberate intention to mislead public perception.

The Report suggests that the International Public Sector Accounting Standards are written by the private sector auditors in their self-interest (see section 6.1, footnote 37). It is correct that the IPSASB is formally (still) under the auspices of IFAC. IFAC is the international professional organization for the accountancy profession – i.e., preparers and auditors. However, the Report disregards the fact that restructuring during the last fifteen years has resulted in the IPSASB acting to a large extent organizationally and financially independent of IFAC. The Special Report also ignores the fact, with regard to a balanced composition of the IPSASB, that several years ago not only were three public members introduced, but currently only two of the 18 members of the IPSASB are private sector auditors (thus a minority of representatives have in-depth knowledge of international private sector accounting).

Moreover, the profession is firmly convinced that only sustainable and universally convincing principles can serve the interests of the profession as well as the public interest in the long-term. For this reason alone, we have no interest in unnecessary increases in complexity.

The Special Report criticizes Eurostat for including private sector auditors in the deliberations (see page 1, point 3 and section 4.4). Notwithstanding that there are undoubtedly several professions with expertise in accounting, it is indisputable that private sector auditors have experience of specific relevance, not least because of their legal mandate in respect of the statutory audit. It has been common practice for decades to involve private sector auditors as experts in a wide variety of accounting issues. If it is not disputed, that subject-matter expertise should be included in the development of laws (see e.g. the Federal Government's response to a Kleine Anfrage (minor query) from 2012, published as parliamentary document 17/9266), it must also be appropriate to draw on the expertise of the profession as part of the harmonization initiatives.

According to the Report, the Supreme Audit Institution clearly sees a conflict of interest, when private sector auditors advise on the interpretation or adaptation of established accrual accounting principles for application in the public sector and later insist on compliance with them. In contrast, the Supreme Audit Institution obviously does not see any conflict of interest in the fact that the preparers of public sector financial statements set the rules themselves, by which they must prepare financial statements. A key distinction between private sector auditors and state institutions is that auditors can never give legal effect to the regulations compliance with which they are required to audit.

Design/Content of EPSAS

a) Suitability of the IPSASs as Reference Model

The Supreme Audit Institution's Report makes the sweeping presumption that EPSAS will likely be based on Anglo-American and capital market-oriented standards, rejecting them by arguing that they are tailored towards private sector companies and that the principles are geared towards the needs of capital market investors (see page 2 and section 6).

This view does not take account of the fact that IPSASs — unlike IFRSs — are drafted to take account of the specifics of the public sector and that IFRSs are not just adopted on a one-to-one basis. In any case, orientation to IFRSs only relates to the general principles. In contrast, the majority of projects deal with public sector specific issues, for which there are no corresponding IFRS standards available.

In its Conceptual Framework the IPSASB focuses on the information needs of the users of financial reporting and defines this community of users very broadly. According to the IPSASB, the IPSASs are therefore written for a large and heterogeneous group: individuals and legal persons who provide resources to the public sector (taxpayers, purchasers of government bonds, other creditors, employees), recipients of public services (residents) and their representatives (parliaments). The objectives of accounting according to IPSASs include accountability and transparency in the provision of services and use of resources, respectively reporting (for example, for creditors), as well as the provision of an information base for political policy-making processes.

Incidentally, in the case of accrual accounting, the information about cash flows is not lost, but is an explicit and differentiated component of the cash flow statement.

b) Accounting Options and Scope for Judgement

In addition, the Special Report criticizes the fact that EPSAS would introduce additional accounting options and allow scope for judgment. This could be countered if the EU were to decide on the use of the options when adopting the IPSASs and uniformly prescribe a single alternative for all preparers in order to create greater comparability. This argument cannot be used as an argument against an accrual accounting framework.

The exercise of an accounting option in taking an IPSAS standard as a reference point for an EPSAS standard is not merely a possibility, but it is one of the European Commission's stated objectives. In this context, a (publicly available) Issues Paper on "Options" deals with the identification of such options.

It is unclear what the Special Report's criticism refers to exactly in regard to scope for judgment. Improvements can be made during the adoption phase, to address objections to individual requirements or phraseology in the IPSASs.

Inherently, an accrual-based set of annual financial statements (unlike a statement of cash receipts and payments) contains numerous estimates. This is in the nature of accounting and is not a fundamental flaw. Similarly, the fact that estimations are always associated (more or less) with uncertainties is not a flaw either. In any case, an estimated provision that is subject to uncertainty is superior for the fair presentation of financial position and financial performance rather than not including the provision (as is the case under cash accounting). Otherwise, each entity preparing financial statements could choose to omit financial statement items such as warranty provisions with the reference, that they can only be estimated on the basis of past experience. Of course, estimates must be reliable and verifiable. In order to increase the reliability, the audit of the financial statements serves to ensure that such estimates are based on reasonable assumptions and are appropriately derived from such assumptions, that estimates are not biased and that any estimation uncertainties are adequately described in the notes.

Cash receipts and payments are undisputedly more reliable than accounting estimates. However, for an appropriate presentation in the financial statements there needs to be an appropriate balance between (informative) relevance and reliability. Using only historically observable cash flows, because they are 100% reliable, and deliberately excluding less reliable but highly relevant information is not expedient for a fair presentation of the financial position and financial performance.

The examples given in the Special Report are unconvincing, as illustrated by the example of the pension liabilities (section 7.3): The advantage of accrual accounting lies precisely in the recognition of all liabilities, including the material position of pension provisions. An "option" not to recognize legal or de facto liabilities is incompatible with the transparency requirement and the notion of accountability. The choice of the discount rate as a typical exercise of judgement should not be used as an argument for the concealment of governmental debt. In addition, there are established procedures for determining the interest rate and its disclosure.

c) Specification of the Prudence Concept

The Report justifies the rejection of the European harmonization process with (amongst other things) the fact that the Eurostat working group is not following the German prudence concept (see section 6.3 in conjunction with section 2).

There are different views internationally regarding the degree of prudence. Regardless of the degree to which the prudence concept is followed, accrual accounting leads to a higher recognition of liabilities than the cash accounting. In this respect, it is contradictory to argue for cash accounting (without provisions) on the grounds that the desired accrual-based standards do not interpret the prudence concept strictly enough and therefore the provisions to be made are measured at an amount that is not sufficiently high.

The question of the significance of the principle of prudence in no way relates to a comparison of cash and accrual accounting. In contrast to accrual accounting, cash accounting makes no provision for the liabilities to be met by future generations that have arisen in the past. Even a less cautious and therefore more objective measurement of such provisions would always be far superior to the cash accounting approach.

Whether the accrual accounting of territorial authorities (i.e. public sector entities on national level, (federal) state level and local level) should be based on the traditional accounting principles of German commercial law or whether an Anglo-Saxon characterized prudence concept is sufficient, is indeed a fundamental question, ultimately impacting the measurement of liabilities recognized in the financial statements. The underlying objective is that the entity preparing its financial statements does not calculate itself to be richer than it is. However, an overemphasis on the prudence concept can lead to an asymmetrical depiction of the financial situation, as the entity preparing its financial statements calculates itself to be "too poor" instead.

The different calculation methods for financial performance depend on which function the accounting is intended to fulfill. In addition to the informational function, according to German commercial law, the function of annual financial statements is primarily the determination of distributable profit in the interest of creditor protection, i.e., it has to determine what can be distributed to the shareholders without jeopardizing the company's existence and the interests of other stakeholders (such as lenders, suppliers and employees). Therefore, the prudence concept has a greater significance for the annual financial statements of a commercial entity. The traditional German prudence concept leads to an unequal weighting of partly conflicting interests of creditors (preservation of capital) and corporate owners (distribution of earned profits) in favor of creditor protection. A transfer of the German prudence concept in commercial law to public sector accounting would thus be more likely to protect future generations and to the detriment of the current generation. However, when the profit distribution function is not applicable, the accounting could focus more on the presentation of accrual (short-term) performance and current liabilities and thus present a more neutral (as opposed to an asymmetric) reflection of financial position and performance.

Therefore, it is certainly understandable that internationally the prudence concept is applied to local authorities in a more objective form than as is prescribed by the German Commercial Code for limited liability companies in the private sector.

If, for reasons that are not easy to understand, Germany were to adhere to an interpretation of the prudence concept based on traditional private sector commercial law, or even abstains from this discussion, on the grounds it has decided on cash accounting, which itself uses no concept of prudence, Germany would forfeit the opportunity to participate in the further development of the accounting framework.