

Research Article

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Accounting Rules for the European Communities: A Theoretical Analysis

Abstract: In the last decade, the European Union (EU) has reformed its accounting system, issuing its own conceptual framework and 18 accounting standards that draw upon the International Public Sector Accounting Standards (IPSAS) issued by the IPSAS Board. The aim of this article is to analyse this renewed EU accounting system that frames and shapes financial accounting and reporting of the European Communities (EC), in order to assess its capacity to “truly and fairly” represent EC economic activity as a non-business entity.

The EU accounting rules are analysed from a theoretical perspective that disentangles three different accrual-based accounting representations focusing respectively on wealth (static accounting), cash flow and economic flow (dynamic accounting). Our analysis retains a modified dynamic accounting representation that fits the specific economy of public administration. This modified dynamic accounting representation is then applied to assess the representational quality of the EU accounting system. This legal-economic, normative analysis of consistency with our theoretical model is complemented and somehow corroborated by documental analysis, financial analysis and few semi-structured interviews with EU officials.

Generally speaking, our analysis shows that the EU accounting system provides a consistent representation of the EC economic and financial activities, although the reference to the IPSAS has somewhat involved the application of a balance sheet accounting approach that is inconsistent with this representation. In particular, the new EU accounting system has improved on some objectives of financial accounting and reporting, such as: the economic function of redistribution related to the economic solidarity between its constituencies (Member States); the prevention of frauds concerned with transfers and financial operations; the accomplishment of intergenerational

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and transnational equity, through the recovery of incurred expenditures by constituencies (Member States and, indirectly, taxpayers) located in different places at different times.

These findings seem relevant not only to assess the quality of accounting representation provided by the EU accounting system but also in the view of its possible influence on the European Public Sector Accounting Standards – making process launched since 2013. This process is expected to reframe and reshape EU Member States' accounting systems in the near future.

Keywords: governmental financial accounting, public sector accountability, accounting model, European Commission, accounting and economics of supra-national organizations, European public sector accounting standards (EPSAS), International public sector accounting standards (IPSAS)

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1 Introduction

Recent decades have been characterized by major public sector reforms that purport to improve on its efficiency, effectiveness, transparency and accountability all around the world (Aucoin, 1990; Pollitt & Bouckaert, 2004; Kettl, 2005). In this context, reforms of financial accounting and reporting systems have been considered to be a key dimension to improve on management and control of public finances, as well as on public sector accountability (Olson, Guthrie, & Humphrey, 1998; Kioko et al., 2011). National governments and supranational organizations do collect and spend huge amounts of financial resources through organizational processes that are accounted for under some specific accounting regulation. Every regulation implies relevant accounting choices concerning the model of reference for the representation of these economic and financial activities to decision-makers and to the ultimate constituencies that are involved in those activities. Analysing how these governmental organizations do account and report for their economic and financial activities is then an essential task in assessing their overall capacity to fulfil financial accountability to these constituencies (Mack & Ryan, 2006).

One of the common drivers of recent government accounting reforms is the introduction of accrual-based accounting systems. Public administration has been recording public spending when cash movements occur, under the so-called cash-basis of accounting. Under an accrual-basis of accounting, costs (revenues) are imputed to the period in which (or the activities for which) they are incurred (earned), substituting or complementing the traditional cash accounting system.

The adoption of an accrual-basis of accounting is quite controversial. According to some studies, accrual accounting is expected to provide better information for both internal use (cost and tariff calculation, make-or-buy decisions and outsourcing) and external use (reporting), thus improving public administration's transparency, accountability and performance evaluation (Parker & Guthrie, 1990; Brorström, 1998; Perrin, 1998; Chan, 2003; IFAC-PSC, 2003; FEE, 2007). The expected advantages with accrual-basis do actually correspond to the missing points that are attributed to cash-based accounting. The latter is accused to prevent accounting for the matching between absorbed resources¹ and achieved results; it is consequently accused to mislead public management control and accountability. However, other studies raise issues regarding the application of an accrual-based accounting to the public sector, arguing that cash accounting is more suitable for the kind of activities run by the public sector, since the latter is primarily concerned with collection and allocation of financial resources (that are cash flows and funds). These studies claim that, as far as the public sector's ultimate purpose is not profit-generation, the financial performance represented on an accrual-basis of accounting cannot be consistent, relevant and useful. Generally speaking, these studies show that a consistent conceptual framework has not been developed and applied by ongoing reforms that adopt an accrual-basis of accounting. This has resulted into a misleading and dysfunctional transfer of business practices to the public sector (Mautz, 1981; Stewart & Walsh, 1994; Olson, Humphrey, & Guthrie, 2001; Hodges & Mellett, 2003; Guthrie, Humphrey, Jones, & Olson, 2005).

In this context, the European Union (EU) has engaged its own modernization effort devoted to better its functioning and enhance its accountability towards Member States and the European citizenship (European Commission, 2000; Soverchia, 2010). The reform of its financial accounting and reporting system constitutes an integral part of this overall effort. The renewed accounting system organizes consolidated accounts of the European Communities (EC). Eighteen accounting rules stand at the core of this reformed system: they draw upon the International Public Sector Accounting Standards (IPSAS) and introduce an accrual-basis of accounting that is combined with a cash-basis of accounting under an integrated accounting process.

This article applies a theoretical approach that disentangles different accrual-based accounting representations focusing respectively on wealth (static accounting), cash flow or economic flow (dynamic accounting). We assume that

¹ Here and thereafter, we shall use the term "resource" in its usual generic meaning, as the provision of something (such as money) that the entity has, control, generate and can use when it is needed. In the case of the EC, the main resources are the financial inflows and promises provided by the Member States.

the EC constitutes an economic organization which processes resources, mainly financial resources, committed by its constituencies (the Member States). This economic organization can then be understood as an ongoing entity that evolves over time, achieving ongoing economic and financial activities that jointly intent to fulfil specific missions and purposes over time. In this context, its accounting system constitutes an institutional device designed to control this entity and make it accountable. In fact, not all resources are included in its accounting process, while not all accounts represent a resource committed by one constituency. Specific sets of accounting rules are usually adopted to resume all the accounting choices that are required to define and represent this ongoing entity and its ongoing process to its decision-makers and constituencies. In this context, a static accounting representation shall focalize the definition and representation of the ongoing entity on the net worth resulting from balance between assets and liabilities at an arbitrary instant of time. In contrast, a dynamic accounting representation shall focalize on the progressive achievement of entity activity through inflow and outflows of resources period after period of reference. Our analysis retains a modified dynamic accounting approach as preferred representation that is consistent with the specific economy of a non-business entity. By taking this representation as accounting model of reference, we analyse the set of the EC accounting concepts and rules, in order to assess the capacity of this EC accounting system to “truly and fairly” represent its economic activity as a “non-business entity”.

A modified dynamic accounting representation of the specific economy of public administration excludes the application of fair value notions and methods to public sector accounting; furthermore, it applies a flow accounting method to determine past, present and future expenditures that have to be matched against recovering revenues over time. The matching process is then based upon successive periods of reference, combining financial (cash-based) and economic (accrual-based) accounting bases. This article applies this modified dynamic accounting representation to the EU accounting system through a two-step analysis. First, we apply our theoretical model to all the EU accounting rules, one after another, assessing the standards, their scope and requirements, as well as their consistency with the specific economy and finances of the EC. In case of inconsistency, we further assess the relevance and materiality of each inappropriate accounting representation of economy and finances of the EC. This legal-economic, normative analysis of consistency is complemented and somewhat corroborated by a literature review and a documental analysis concerned with EC financial statements and some primary sources that are not publicly available, such as accounting guidelines and other working documents produced by the EC offices.

The rest of the paper is organized as follows. Section 2 introduces the EC, its functioning and its accounting system under reform. Section 3 summarizes the theoretical framework of analysis that Section 4 applies to all the EC accounting rules one after another. Section 5 provides a synthesis and some conclusive remarks.

2 Research context: European Communities as an economic entity and the reform of its accounting system

The EC is not only a public administration with no-profit motive but also a supranational organization comprising different supranational institutions (such as European Commission and European Parliament) and some other bodies (such as European agencies). Furthermore, the EC activities are often realized with the operational support of NGOs, no-profit organizations and other private independent entities, which receive EC grants and EC fund transfers, carry-out programs and deliver services through European territories and abroad.

Since the end of the twentieth century, the EU has entered a modernization effort devoted to better its functioning and enhance its accountability towards Member States and the European citizenship. In fact, this effort was triggered by a major institutional crisis occurred at the end of the nineties (Harlow, 2002), as well as by the enlargement process that led EU Member States to increase from six to twenty-eight over time. This effort aimed to address two main shortcomings: a “democratic deficit” concerning the European government (Tsakatika, 2007) and a “management deficit” related to the inadequacy of management tools employed to assign performance responsibilities at different EU political and administrative levels (Metcalf, 2000). The European Commission launched the reform process in 2000 with the White Book publication (European Commission, 2000); the reform planned to base upon the principles of accountability, efficiency and effectiveness of actions put in place, assuring transparency over them for both the Commission itself and the external stakeholders (Levy, 2004).

The “modernization” of the EU accounting and financial reporting system, comprising the introduction of EU consolidated financial statements, is an integral part of this overall reform effort, realized by the European Commission through the “ABAC” project (Accrual-Based Accounting). Why did the Commission decide to reform its accounting system?

This choice took place in the context of the general rise of “New Public Management” and the related critique of cash-based accounting. As an

interviewed EU official states, one important stimulus came from the European Court of Auditors and from the European Parliament. In particular, the European Court of Auditors, through its annual DAS (Déclaration d'Assurance), had repeatedly stressed the limited reliability of the EU accounts, due to an accounting system exclusively based on cash accounting. This pressure has pushed the Commission to undertake a change in its accounting system, in order to provide additional financial information. Moreover, there was further indirect pressure from recent developments in public sector accounting, as many national governments (including some EU Member States) and other international organizations (such as OECD and NATO) have moved towards accrual accounting, starting general reforms of their financial management processes. In this context, being one of the most important institutions in Europe, the Commission wanted to prepare and provide financial statements that were “transparent,” that are, in line with international public sector developments. This “indirect pressure” from European national governments does not imply that the EC accounting reform took inspiration from them. An interview with another official has revealed that the process and the content of the EC accounting reform was not based on the experience of specific EU Member States, because of the specific features of a supranational organization relative to national governments, which actually are very different by structure and organization (centralized Member States vs decentralized Member States).

Started in 2002 (European Commission, 2002), the “ABAC” reform project is now completed, although the EC is permanently working on improvements, especially regarding IT infrastructure and accounting rules. One of the major objectives of this reform was the preparation and publication of the annual accounts of 2005, based on accrual accounting driven by the new Financial Regulation and Implementing Rules (Grossi & Soverchia, 2011; Soverchia 2012). According to one of the interviewed officials, this accounting reform was especially designed to cope with financial management issues, requiring better financial information and monitoring. Therefore, an exhaustive recognition and tracking of assets, liabilities and equities was introduced to complement the budget information (still on cash-basis), leading to better transparency, more reliable financial and accounting information and eventually better governance. The renewed accounting system is then a dual system that integrates accrual and cash accounting, the latter being still employed to manage budget appropriations. As for budgetary accounting, expenses are recorded under a modified cash-basis, while revenues are under a cash-basis. Instead, financial accounting is accrual-based and recorded under double-entry bookkeeping. The coexistence of the two accounting systems is possible thank to specific software integration (European Commission, 2008).

At the core of this accounting reform lays the new Financial Regulation² and Rules of Application³, approved by the Parliament and the Commission, making the explicit choice to introduce an accrual-basis of accounting in line with the IPSAS (Gray, 2006):

adopting accounting rules and methods, the Commission's accounting officer shall be guided by the internationally accepted accounting standards for the public sector, but may depart from them where justified by the specific nature of the Communities.

(article. 133, par. 2, Financial Regulation)

The interest of the EC for the IPSAS is confirmed by the presence of an EC observer within the IPSAS Board, in order to follow the IPSAS development and share the EC experience and practice with the IPSAS Board members. According to one of the interviewed officials, the IPSAS were chosen as reference since these accounting rules are specifically dedicated to the public sector, meaning that they are expected to be more appropriate for the EU than the IAS/IFRS. The latter are the international accounting standards designed for the business sector by the IASB. According to the interviewee, the IASB's rules have an investor orientation, while their focus on future economic benefits (future cash inflows) does not reflect the "business model" of the Commission; it does not generally provide the addressees (i.e. members of the European Parliament and the public in general) with the information they require. Furthermore, the notion of "service potential", as implemented by the IPSAS, does better reflect the informational needs of addressees of public sector financial statements, showing donations, grants and similar specific transactions that characterize the Commission's activity.

The economic role played by the European Commission deserves special consideration from the viewpoint of its accounting representation. It is a European institution that embodies the supranational spirit of the EU, defending the general communitarian interests beyond the particular interests of each Member State. In particular, it holds executive powers to ensure the proper implementation of European legislation, budget and communitarian programs. Therefore, the Commission is not only a public administration but also a supranational organization that is accountable to other public entities that are EU institutions and national Member States. By receiving financial resources from the latter, it plays a key economic role redistributing resources through the

² Regulation No 966/2012 of the European Parliament and of the Council of 25 October 2012 on the financial rules applicable to the general budget of the Union and repealing Council Regulation No 1605/2002.

³ Commissione Delegated Regulation No 1268/2012 of 29 October 2012 on the rules of application of Regulation No 966/2012 of the European Parliament and of the Council on the financial rules applicable to the general budget of the Union.

provision of public services and direct transfers or grants throughout the European territories. The EC can then be understood and represented as an ongoing accounting entity that receives committed (financial) resources by Member States and is accountable for their use in line with intended purposes and missions. In this context, the EU accounting model plays a role of utmost importance, defining accounting principles and rules to be applied by EU institutions, including provision of consolidated financial statements of the various EU entities.

According to the new Financial Regulation, financial statements are established in accordance with generally accepted accounting principles: going concern basis, prudence, consistent accounting methods, comparability of information, materiality, no-netting, reality over appearance and accrual-based accounting. Under these general principles, the Commission Accounting Officer, assisted by an Accounting Standards Committee, has issued 18 accounting rules to date (Table 1).⁴

Table 1: EU accounting rules

	Issued/ revised
Introduction	
1. Group accounting	12/2009
2. Financial statements	12/2009
3. Expenses and payables	10/2006
4. Revenue from exchange transactions	12/2008
5. Pre-financing	01/2012
6. Intangible assets	12/2011
7. Property, plant and equipment	12/2011
8. Leases	12/2011
9. Inventories	12/2011
10. Provisions, contingent liabilities and contingent assets	12/2009
11. Financial instruments	12/2011
12. Employee benefits	12/2008
13. The effects of changes in foreign exchange rates	12/2009
14. Accounting policies, changes in accounting estimates and errors	12/2009
15. Related party disclosure	12/2009
16. Presentation of budget information in annual accounts	12/2008
17. Revenue from non-exchange transactions (taxes and transfers)	10/2011
18. Impairment of assets	12/2011

⁴ Full text of all the accounting rules is nowadays available at http://ec.europa.eu/budget/biblio/documents/management/management_en.cfm#accounting.

These accounting rules define the general purpose and objectives of the EC financial accounting and reporting, its financial statements and the modes of recognition, measurement and disclosure of main accounting elements. The Commission has established these rules after having observed communitarian features and specificities. This has implied a process of adjustment drawing upon the IPSAS. This adjustment process has identified when the IPSAS were directly applicable, without change; or when they had to be modified and adapted to the EC context; this process has also created some “new” standards regarding areas that were left uncovered by the IPSAS. As a result of this process, each rule is organized in several sections (objective, scope, definitions, recognition, measurement, disclosure and effective date), making this internal structure very similar to the IPSAS.

The following section shall summarize the theoretical perspective that is applied to the assessment of the quality of accounting representation provided by the EC accounting system based upon this set of concepts and rules.

3 Disentangling a theoretical perspective of accounting for public sector entities

This section aims at introducing an accounting theoretical synthesis that moves the dialectics between cash and accrual accounting bases a step upwards. From advocates of the accrual-basis, we accept the focus on determination of consumed resources, while we also accept caution with specificities of the public sector economic functioning which are stressed by its critics. Furthermore, we disagree with the alleged idea that a cash-basis cannot impute outflows and inflows to the period or activity of reference. The main difference between cash-basis and accrual-basis stands on the different recognition and measurement of assets and liabilities, including the timing of these accounting operations, not with the imputation process. On this basis, we purport to develop a comprehensive conceptual framework to assess the capacity of the EC accounting system to report a “true and fair”⁵ representation of its specific economic activity.

The EC economy is featured by the absence of “profit motive” that is typical of governments. As a supranational organization that embeds different institutions and other bodies, the EC economy is further characterized by the special

⁵ We utilize here the expression “true and fair” as a normative notion concerned with the quality of accounting system. It obviously depends on the purpose, scope and principles of reference for that system.

economic role played on behalf of the Member States that are the constituencies of its organization. The EC receives financial resources from those Member States that enable it to redistribute resources through the provision of public services, transfers and grants throughout the European territories. As stated by the accounting rule no. 17 devoted to non-exchange revenues, “the Community budget is an expenditure budget in the sense that expenditure is estimated prior to the calculation of the revenue needed to finance it. [...] In short, the residual GNI resource offsets the difference between total expenditure and all other revenue” (p. 18). This means that the EC entity is accountable for incurred expenditure that Member States must recover. This expenditure-sharing purpose adds to the usual no-profit motive that belongs to every public administration. In sum, the EC receives financial resources from those Member States and redistributes resources among them through the provision of public services, transfers and grants throughout the European territories. The “own resource revenue” that accrues automatically to the EC (in 2008, it constitutes 92% of total revenue⁶) and that enables it to finance its budget “is determined by total expenditure less other revenue” (EU, 2008, p. 7) and is limited to 1.24% of the gross national income (GNI) of the Member States. The revenue based on GNI corresponds to the 70% of the total own resource⁷ revenue and is “used to balance budget revenue and expenditure, i.e. to finance the part of the budget not covered by any other sources of revenue” (EU, 2008, p. 8).

Following Anthony (1978) and Biondi (2008 and 2012), these features require a specific accounting framework to be accounted for. The accounting system shall first establish expenses that correspond to the period of reference and then match revenues that accrued to that period, covering those expenses over time. This period-based matching avoids difficulties related to determining the imputation of expenses to the activities accomplished during the period, in order to match all the corresponding contributions to the same activities (Anthony, 1978). In our framework, contributions and expenses can be matched by taking the occurrence period as a reference. In this way, expenses are considered to be independent of contributions. Contributions are then matched not only with expenses and corresponding activities but also with the period of reference (this is usually done for taxes and assimilated inflows). This latter method appears to fit the accounting system for EC that has an annual basis of reporting to Member States. Furthermore, the EC revenue is expected not only to pay for

6 The remaining 8% consists of “sundry revenue” arising from the activities of the EC such as competition fines and recovery orders to private and public debtors other than Member States.

7 The remaining 30% consists of shares of value added tax levies, customs duties, agricultural duties and sugar levies collected by the Member States on behalf of the EU.

consumed resources (cost absorbed) but also to finance their acquisition for the EC activities (cash outflow). The accounting system is then a joint mode of accounting for the EC activities. It aims at making the EC governing bodies accountable for incurred expenditure and matching revenue that has to be levied on the Member States. It enables control and accountability towards the Member States themselves.

Under the overall no-profit motive and the expenditure-sharing purpose, the EC accounting system requires determining both incurred expenditure and matching revenue. Accrual accounting should be adapted to fit with these specific accounting needs. Following Biondi (2008 and 2012), three main families of accrual accounting exist and provide distinctive definitions of the accounting objectives and elements, including expenditures (Table 2):

- a static representation (patrimonial), focusing on the net worth of the entity and its valuation at a specific moment in time;
- a financial representation (cash flow), focusing on the financial inflows and outflows of the entity and representing the resources available at a particular time to meet the needs or purposes of its activities;
- a dynamic representation (economic), focusing on the resource inflows and outflows of the entity and representing the resources mobilized (and utilized) by its activities during a particular period.

Table 2: Accounting representation of the non-business firm

	Static view	Financial view	Dynamic view
Orientation	Wealth	Cash flows	Net result
Focus	Net worth	Resources available	Resources mobilized (and utilized)
Basis of reference	Properties and claims	Cash outflows and inflows	Matching of costs and revenues
Timing	Moment in time; changes between moments	Time period	Time period
Recovery of ...	Values conferred	Cash outflows	Costs absorbed

These three different representations complement each other within any given accounting system; however, as overall guides for representation and interpretation, they provide alternative models of reference. In particular, under Republican institutional orders, the static model is at odds with the usual understanding and the legal basis of tax levy, which imply the redistribution of collected resources by either transfers or non-business furnishing of goods and services. Furthermore, it is also at odds with public spending, which implies

recovery of actual expenditures, while unrealized losses and changes of value are excluded by this recovery. Already Holder (1980), Robinson (1998) and Stanton and Stanton (1998) provide critiques of the accounting and economic view implied by static accounting, arguing that the use of the economic concepts of value are inadequate and unreliable for the public sector. Accordingly, a static accounting view would result in a representation that does not reflect either the financial or the economic position of the reporting public entity. In particular, McCrae and Aiken (2000) develop a “flow of obligations” perspective of accounting for the public sector. This perspective refers to a flow (or matching) concept of service provision rather than to a “stock” (or “valuation”) concept (see Biondi, 2008 and 2012 for further details).

Concerning the EC economy, the featuring purpose of expenditure-sharing requires a specific definition of the expenditure that has been recovered. This definition should exclude the application of the static representation, which does not fit with the “true and fair view” of the underlying economy. For the static representation focalizes on the net worth and related changes in value, which do not represent incurred expenditure that is allowed to be recovered over time. This purpose further implies a combination of financial and economic representations, that is, the integration between budgetary accounting (related to the financial view) and dynamic accrual accounting (the dynamic view). Both flow-based accounting representations are required to obtain the “true and fair” representation of the EC activities. While the budgetary accounting may represent the resources that are made available to different projects and programs (cash outflows, under a financial view), the dynamic accrual accounting may represent the resources absorbed by them and by the whole EC economy (costs absorbed, under a dynamic view). Financial and economic flow accounting views are then allied to recognize and measure the resources that have been acquired (contributions) and consumed (expenditures). This consumption must be recovered to assure the continuity and fairness of the EC economy over time. Let us label this combined accounting system as a “modified” dynamic accounting view thereafter.

In sum, the suitable accounting representation of the EC economy is driven by the featuring absence of “profit motive” and by the supranational coordination role accomplished by the EC activity. While the wealth basis refers to fair value accounting and results to be at odds with these specificities, a modified dynamic view of the accrual-basis can be consistently applied to the assessment of EC accounting concepts and rules. This latter basis of accounting results to fit the economic sharing and redistribution functions performed by the EC among its constituencies. The next section shall apply this view as frame of analysis to assess the quality of accounting representation provided by the EC accounting system.

4 Research findings from theoretical assessment of the EC accounting framework and rules

According to the EC accounting framework, EC financial reporting must demonstrate the accountability of the EC for the financial affairs and resources entrusted to it. This principle makes the mentioned reconciliation even more important, since the EU entity operates as a collective device whose financing pertains to the Member States, which must share it fairly.

In particular, the accrual accounting basis that is retained by the EC accounting system requires matching both revenue and expense to the period of reference (the financial year). This period-based imputation helps the reconciliation with the budget accounting, facilitating the accounting work, which is not expected then to match every revenue item (which generally does not have a constrained use) to the corresponding expenses (rule nos 3 and 4):

Generally, expenses are recognized in the economic outturn account on the basis of a direct association between costs incurred and the earning of specific items of revenue. But the European Communities' main revenues include both taxes and contributions from Member States. Moreover, the payment of taxes or contributions does not entitle a taxpayer to an equivalent value of services or benefits, as there is no direct exchange relationship between paying the tax or the contribution and receiving European Communities services or transfers. Consequently, matching revenues and expenses is not a concept that is readily applicable to the European Communities.⁸

(EU rule no. 3—expenses and payables, p. 10)

4.1 Connection between budget and general accounts

Virtually all EC accounting rules mention the difference between budget and general accounting at the beginning, while insisting that both “are monitored in a single integrated process which allows the two set of accounts to be reconciled” (EU, 2004). However, this reconciliation is neither reported nor disclosed by the financial statements until 2008, when a new accounting rule (no. 16, issued in December 2008) makes this reconciliation compulsory. This reconciliation and its disclosure are fundamental under a modified dynamic basis of accounting, drawing upon Anthony (1978) and Biondi (2008 and 2012) among others. The scheme of reconciliation adopted in the 2011 annual accounts consists of different adjustments, as given in Table 3.

This scheme and the related comments (European Commission, 2012, pp. 135–136) are merely technical. They do not provide an understanding of

⁸ Cf. also EU rule no. 4—revenues and receivables, p. 2.

Table 3: Reconciliation: economic outturn–budget outturn

Economic outturn for the year**Revenues**

Entitlements established in current year but not yet collected

Entitlements established in previous years and collected in current year

Accrued revenue (net)

Expenditure

Accrued expenses (net)

Expenses prior year paid in current year

Net-effect pre-financing

Payment appropriations carried over to next year

Payments made from carry-overs and cancellation unused payment appropriations

Movement in provisions

Other

Economic outturn agencies and ECSC (European Community of Steel and Coal)**Budget outturn for the year**

the reconciliation that may be useful to external users or decision-makers. This lack undermines the actual capacity of the accounting representation to improve on accountability for public finances and financial management.

A reconciliation scheme is actually provided by the EC (European Union, 2004, p. 3) itself:

$$\begin{aligned}
 &= \text{Budget accounting year } N \\
 &+ \text{Revenue receivable} \\
 &- \text{Expenses payable} \\
 &+ \text{Budget commitments for delivery in } N + 1 \\
 &\pm \text{Budget operations recorded in the balance sheet (e.g. investments, asset disposals, etc.)} \\
 &\pm \text{Operations relating to pensions} \\
 &+ \text{Pre-financing} \\
 &- \text{Eligible expenses giving rise to pre-financing} \\
 &= \text{General accounts year } N
 \end{aligned}$$

This scheme of reconciliation consists of different adjustments: the timing of inflow and outflow, including future commitments; the operations related to investing and financing, and pensions; and the operations related to pre-financing. This reconciliation is in line with the general accounting principles defined by the accounting framework: “The economic result (from the economic outturn) is expected to make the link between cash-based budget accounts and the general accounts, which are moving towards accrual

accounting”. In particular, it “reveals the impact on the balance sheet of expenditure and revenue not originating from budget accounting” (EU, 2004, p. 2).

The US Government Accountability Office (GAO) provides another scheme of reconciliation. Accordingly, “while cash and accrual measures each serve different purposes, they present complementary information and can be used together to provide a more comprehensive picture of the government’s fiscal condition today and over time” (GAO, 2006, p. 2). As for the case of EC accounting, US government revenue is primarily recognized on modified cash-basis, and there is little difference between cash receipts and accrued revenue. The differences are almost entirely on the spending side and arise when a cost is accrued (and affects the accrual deficit) in one fiscal year but paid (and affects the cash deficit) in another fiscal year. The largest differences are accounted for by employees’ benefits, veterans’ compensation, environmental liabilities, insurance programs, depreciation expenses and capital assets. The “crosswalk between accrual and cash deficit” follows this scheme (GAO, 2006, pp. 14–15):

= Net operating cost (i.e. accrual deficit)

Components of accrual deficit not part of the cash budget deficit:

- + Changes in employees’ benefits
- + Changes in veterans’ compensation
- + Changes in environmental liabilities
- + Depreciation expense
- + Changes in insurance liabilities
- + Other

Components of cash budget deficit not part of the accrual deficit:

- Outlays for capitalized fixed assets
- Other (e.g. principal repayments on pre-credit reform loans)

All other reconciling differences:

- + Net amount (i.e. the “plug” needed to force the statement to balance)
- = Unified budget surplus/deficit (i.e. cash surplus/deficit)
-

This US government scheme allows to better identify the main factors of difference between the two surpluses/deficits and to group them according to their sign. But it has the disadvantage to start from the accrual balance, while preparers and readers are supposed to know better the cash-basis at the present.⁹

⁹ According to IFAC-PSC (2003), cash accounting has been maintained to gradually introduce major accounting changes, to match the development of incurred costs’ recognition and to adjust with historical tradition and habits of administrative staff in dealing with cash accounting. However, according to our analysis, the EU choice of integrating accrual and cash bases of accounting does not appear to be transitory.

4.2 Rule no. 1–Group accounting

The first rule is devoted to the consolidation of the whole of entities that constitute the EC economic organization. This consolidation is critical to the true and fair representation of its economy. Following the IPSAS, the rule applies the “control concept” to the decision of including an entity in the scope of consolidation and to the choice of the related method. In fact, “the most common indicator of control – the majority of voting rights – is in most of the cases not applicable for the EC as there are normally no capitalistic links between the entities” (rule no. 1, p. 5). Generally speaking, these entities have been created through their founding treaties that establish also modifications of their structure and statutes. These entities “represent the basis of the organizational structure of the European Communities and contribute incontestably to the European Communities objectives” (rule no. 1, p. 5). This specific mode of organization implies a double definition of control: from one side, control is defined through “a power element such as the power to govern the financial and operating policies of another entity”; from another side, control is defined through “a benefit (and loss) element, which represents the ability of the controlling entity to benefit from the activities of the other entity” (p. 4) and/or “be liable for certain obligations of the other entity” (p. 21). This composite definition is further articulated on three decreasing degrees of control, as given in Table 4.

Table 4: Decreasing degrees of control for consolidation purpose

	EC framework	EC retained method	IPSAS
Controlled entities	Control	Global consolidation	Exclusive control
Joint ventures	Joint control	Proportionate consolidation	Joint control
Associated entities	Influence	Equity method	Significant influence

Although the definition of control is based on substantial (not formal) economic control, regulatory power and economic dependence are reasonably excluded by its application (rule no. 1, p. 6). A list of indicators of control is provided (rule no. 1, p. 21) that is based on distinctive conditions of power and benefit/loss (Grossi & Soverchia, 2011).

4.3 Rule no. 2–Financial statements

EU financial reporting comprises several documents and annexes concerned with consolidated accounts. All European institutions and bodies must then

prepare financial statements based on the EC accounting rules, in addition to budget accounts.

The “balance sheet” is established as a list where both assets and liabilities are divided between current and non-current: their algebraic sum determines net assets. This latter item includes, in addition to the economic outturn of the year, some reserves – including the reserve due to fair value measurements – and the amounts to be called from Member States.

The “economic outturn account” is established as a list which contains operating revenues and expenses. In particular, revenues are split between: own resource, contribution revenues and other operating revenues; while expenses between: administrative expenses and operating expenses. On this basis, the economic outturn of the year is calculated adding-up the following elements: (i) the surplus from operating activities; (ii) balance between financial revenues and expenses; (iii) movements in employee benefits liability and (iv) share of net surplus (deficit) of associates and joint ventures.

The “statement of changes in net assets” is in line with IPSAS’ requirements. In fact, the EC cash-flow table is established according to the indirect method, while the IPSAS recommend the direct method. The EC rule classifies operations in three areas: operating activities, investing activities and financing activities.

Moreover, the “notes to the financial statements” provide further details on and explanation of accounting items included in all these statements, including additional information prescribed by internationally accepted accounting practices, when such information is relevant to the EC activities (Financial Regulation, par. 126.2).

Contrary to the budget outturn account, the accrual-based economic outturn account is very aggregate and does not assist users to understand its economic meaning and significance. No reconciliation is provided with the budget outturn and the budget classification of expenditures among 31 policy areas. Only segment reporting splits operating revenue and expense by policy areas, which are then classified in three larger headings: (i) “Activities within the EU” comprising the many policy areas; (ii) “Activities outside the EU” concerning trade and aid and (iii) services and other tasks that concern the internal and horizontal activities necessary to the functioning of the EC institutions and bodies (EU, 2008, pp. 83–89).

Furthermore, although the definition of expense applies the critical distinction among exchange and non-exchange expenses, the financial statements do not exploit this distinction for reporting and disclosure, but a somewhat obscure distinction between operational and administrative expenses that does not help to understand the EC activities.

Interestingly, the “net assets” item of the balance sheet is not directly explained by cumulated surplus/deficit and other reserve movements, but it is

connected to the “amounts to be called from Member States”, further distinguished among “employee benefits” and “other amounts”. The connection with cumulated surplus/deficit is made only by the “statement of changes in net assets”. This choice seems in line with the EC purpose of sharing expenditure among Member States that remain then responsible for cumulated deficits. It makes also clear that the impact of future employees benefit has not the same meaning as the remaining deficit, since the former shall be covered when it is due, from both the economic and the financial viewpoints.

4.4 Rule no. 3—Expenses and payables

This rule applies a critical distinction between exchange expenses that are related to commercial transactions and non-exchange expenses that are related to transfers, provision of public services and other non-reciprocal transactions. This distinction is in line with our modified dynamic accounting view drawing upon Anthony (1978) and Biondi (2008 and 2012) among others.

The main criterion of measurement for expenses is their historical cost, that is, “the amount of the original invoice”, improperly called “fair value” (rule no. 3, p. 10). This is in line with the purpose of “expenditure-sharing” that stands at the core of the EC accounting system and of the EC economy to be represented.

Nevertheless, this purpose is not properly applied to commitments for future payments. The latter “should not be recognized as liabilities and, subsequently, as expenses” (rule no. 3, p. 14). Only some contingent liability – related to possible losses – should be disclosed in the notes to the financial statements. This exclusion of commitments mainly depends on the peculiar definition that is retained. A commitment is then defined as a voluntary act that may change, while it is a virtually certain obligation whose amount is not yet due. From the economic viewpoint, committed obligations represent a potential expenditure for the constituents (i.e. the Member States) that have to recover it in the next future. In some cases, it may derive from a contractual obligation to pay, as for operating leases. Accordingly, a modified dynamic accounting system may recognize it first in the balance sheet and later in the economic outturn account, once the payment becomes payable to the beneficiaries. If the commitment results from the acquisition of an asset that is not on the balance sheet, the asset and the related commitment may then be recognized on the balance sheet according to the treatment for finance leases (see rule no. 8). If the commitment results from the acquisition of an asset that is on the balance sheet, additional costs due to the commitment may then be capitalized according to the treatment for the estimated cost of dismantling the asset and restoring the site (see rule no. 7).

4.5 Rule nos 4 and 17—Revenues from exchange and non-exchange (taxes and transfers) transactions

As for the case of expenses, the revenues of EC economy are mainly non-exchange revenues. Both definitions (exchange and non-exchange) adopt an inconsistent stock (static) basis of accounting. In addition, the rule seems to confound the economic substance of the occurrence of revenue with its accounting formulation as “an increase in net assets” (rule no. 17, p. 5 and 11). Notwithstanding, accrued revenue is properly recognized when the generating event or transaction occur, not when it is actually received. The stock basis involves a further distinction of “increases relating to contributions from owners” that is misleading in the public administration context. The accepted method of measurement is improperly called “fair value” and generally refers to the “best estimate” of net assets acquired. This method involves then subjective interpretation of complex contracts to distinguish between exchange and non-exchange, asset and liability components, involving a misleading reference to the “present value” of the liability (rule no. 17, p. 12). In addition, the stock basis excludes from revenues all “amounts collected as an agent of the government or another government organization or other third parties” (rule no. 17, p. 5) resulting in lack of disclosure for relevant activities managed on behalf of third parties.

Furthermore, following a stock basis of accounting, even the cancellation of a borrowing from a third party corresponds to revenue, since it is equivalent to receiving a grant or a donation from that third party. This treatment is questionable: this kind of extraordinary transactions should deserve a specific treatment and disclosure as capital transactions, especially when they refer to borrowing from Member States.

As recognized by Biondi (2008 and 2012), taxes on employees’ salaries and pensions raise a serious accounting trouble since the reporting public administration results to pay taxes to itself. In line with the purpose of expenditure-sharing, the EC accounting rule no. 17 establishes a meaningful accounting reporting that overcomes that paradox (rule no. 17, p. 24). These taxes are then included in the “revenue from administrative operations”: In this way, only the net salaries and pensions are accounted for as expenses in the economic outturn account that properly reports then the net annual expense to be recovered.

Even staff contributions to their pension scheme are accounted for as “revenue from administrative operations”. In this case, the change in the pension liability – that is included among the annual expenses – is made net of annual contributions to the pension fund that is held on behalf of employees. Therefore, the final balance includes only the remaining part of the total

pension liability that is incurred (is expected to be covered) during the year of reference.

4.6 Rule no. 5—Pre-financing

Pre-financing constitutes a specific and material financial operation related to the EC purpose to redistribute resources through grants and transfers. The transfer process constitutes the main economic activity of the EC and is then represented by the economic outturn account. The pre-financing phase constitutes a financial step of that process, i.e. the cash advance that provides the beneficiary with a float (rule no. 5, p. 1). This financial step is then properly represented by the balance sheet, until the transfers are actually accrued:

In the general accounts, pre-financing is a sum of money paid to a beneficiary and constitutes a simple cash movement with no impact on the European Communities' outturn account. No expense is booked to the outturn account as the generating event (delivery of good, performance of service or acceptance of eligible expenditure) has not yet occurred.

(rule no. 5, p. 1)

Nevertheless, specific reporting and disclosure of pre-financing operations should be developed to better account for this material financial activity by the EC.

4.7 Rule no. 6—Intangible assets

The recognition of intangibles and the capitalization of related investments are strictly justified by the “existence of future economic benefits [for the EC] attributable to the asset purchased or developed by the European Communities” (rule no. 6, p. 1 and 5). The rule introduces the distinction among research and development expenses, allowing a transitional period of five years to start applying this criterion with improved information systems. The restatement of previous research expenses is explicitly forbidden, making the separation even more stringent (rule no. 6, p. 6).

This criterion prevents therefore the capitalization and amortization of various expenditures, including research expenditures, which are expected to generate benefits for Member States and the European citizenship over time. This choice is inconsistent with a modified dynamic accounting representation. Although these expenditures do not produce a reliable expectation of future benefits to the EU as an entity, the EU purpose of expenditure-sharing should require their capitalization in order to better share them among the Member States across future periods of reference, thus asking future Member States

contributions to cover for these expenditures of public interest. In this way, these capitalized expenditures would be better shared among present and future contributions through a modified dynamic accounting allocation over time, according to their useful life (Robinson, 1998; Biondi 2008 and 2012).

Furthermore, the gains on sales of intangibles are included in the operating revenue, although they are not part of the core operating activity (rule no. 6, p. 4). In fact, the impact of this misrepresentation of intangible assets is certainly not material, since they do not have either a material size or a key role in the EC economy.

4.8 Rule no. 7—Property, plant and equipment

Contrary to a modified dynamic accounting representation, gains on sales of tangibles are included in the operating revenue (rule no. 7, p. 5). Nevertheless, revenue related to tangible fixed assets is immaterial, accounting for 25 EUR millions in 2008, that is, the 0.020% of the gross operating revenue and the 0.197% of the economic result of the year.

Furthermore, the EC rule explicitly excludes to value tangible fixed assets at their market value (fair value), prescribing that they “should be carried at cost, less any accumulated depreciation and any accumulated impairment loss” (rule no. 7, p. 10). On this basis, the depreciation rule is theoretically sound, although improperly defined as a “loss in value” (rule no. 7, p. 10).

According to the rule, the estimated cost of dismantling the asset and restoring the site may be capitalized to the extent that it is recognized as a provision (rule no. 7, p. 7). In this way, from our modified dynamic accounting view endorsing an expenditure-sharing purpose, this dismantlement cost is passed twice through the economic outturn: once as part of the annual depreciation of the asset and another time as provision for future expenses.¹⁰ A modified dynamic accounting system should then compensate the depreciation and the provision charge on the economic outturn account and show the correspondence between the capitalized cost and the related provision in the balance sheet.

4.9 Rule no. 8—Leases

The rule applies a critical distinction among finance and operating leases based upon a “control concept”. Control is defined as the substantial transfer of “all the

¹⁰ Accounting for private sector entities applies this double counting to maintain financial capital, but this maintenance is not consistent with accounting for public sector entities.

risks and rewards incident to ownership to the lessee” (rule no. 8, p. 4). When they are substantially transferred, the lease is accounted for as a finance lease.

The operating lease is recognized as an expense in the economic outturn account. The related assets are regarded as rentals, and no liability is recognized. The total amount committed to the payment of future rents is disclosed only in the notes. However, according to a modified dynamic accounting representation that endorses a purpose of expenditure-sharing, this method generates a doubtful asymmetry between finance and operating leases, since even the latter involves a contractual commitment to pay for future rents over the lease term (Biondi et al., 2011). In fact, the “control concept” itself may allow its recognition as an asset, since the EC controls it: the leased asset is exploited by the EC as lessee entity and is contractually bounded to this exploitation. Therefore, its future service potential to the entity makes it accountable as an asset to the entity, although the naked ownership (and the related whole of risks and rewards) formally belongs to the lessor.

The finance lease is accounted for the same amount in both sides of the balance sheet, with the actuarial depreciation method allowing the symmetrical reduction of both amounts through the distinction between the rent charge (recognized as finance expense) and the capital installment (recognized as depreciation expense). “No subsequent measurement of the finance lease (i.e. change in the initial value of the asset) is allowed, as the value of the asset is determined once and for all in the contract” (rule no. 8, p. 11). This method assimilates the contractual cost for the leased asset, including future rent charges, to the original invoiced amount that is the basis of historical cost according to other accounting rules. Both leases may follow this accounting method, while a clear accounting and disclosure of future payments and obligations, including capital installments, should be provided.

4.10 Rule no. 9–Inventories

In line with historical cost basis and modified dynamic accrual accounting, the EC accounting rule applies the First In–First Out method or, in some exceptional cases, the weighted average cost formula (WAC), on the basis of periodic physical stocktaking. The rule further excludes Last In–First Out method and perpetual stocktaking. Each item is then valued at its acquisition cost and impaired at the lower of cost and net realizable value (rule no. 9, p. 10), which seems appropriate for turning-over stocks.

The definition of stock does not include agricultural stocks, which constitute a significant activity of the EC. The rule explains that “the

Communities do not buy in stocks and that the intervention stocks are held by the Member States” (rule no. 9, p. 16). Only the assistance in respect to these stocks must be recorded in the general accounts: it is then assimilated to grants (rule no. 9, p. 17). These grants are employed to regulate market prices. At least the notes should nevertheless disclose further information on the nature of these stocks and their evolution over time (wheat, barley, rice, etc.), to better represent and explain this main EC activity.

4.11 Rule no. 10—Provisions, contingent liabilities and contingent assets

Provisions are recognized by the general accounts and reported by the financial statements, while contingent assets and liabilities are only disclosed in the notes to those statements. The distinction between provision and contingent liability is based on the probability of the generating event and the reliability of the measurement of the related amount (rule no. 10, p. 8):

- If the event is provable and the measurement is reliable, the amount is recognized as a payable item by the general accounts;
- If the event is probable but the measurement remains uncertain, the estimated amount is recognized as a provision;
- If the event is uncertain, but the related outflow is probable in the near future, the estimated amount is disclosed as a contingent liability in the notes;
- If the event is uncertain and the outflow remains remote, no report or disclose is made.

Concerning its estimation, time value of money applies: values are then discounted (rule no. 10, p. 10). This method significantly reduces the amount that is accounted for during the current financial year. It results in postponing a large part of the recovery to future periods. According to a modified dynamic accounting system that endorses a purpose of expenditure-sharing, the security of this recovery is then weakened, while no information is disclosed in the notes on the planned timing of future payments and recoveries, period by period. Furthermore, the definition of provision excludes future charges and includes only the potential losses that do not depend on voluntary acts. The future payments incurred under a long-term (remote) obligation are not included unless the contract becomes “onerous”, that is, when it implies an economic loss (defined as an economic outflow that is not compensated by economic benefits: rule no. 10, p. 11). Finally, this measurement method and narrow definition are theoretically unsound, since it materially prevents to compute

provisions in view to facilitate the planned sharing of future expenditures among Member States.

4.12 Rule no. 11—Financial instruments

Problems with fair value accounting of financial assets and liabilities are well known for both business firms, and the non-business activities that are carried on by public administration (Biondi, 2008, 2012 and 2013). The EC “has no present intention to use the fair value option” that allows full fair value accounting for all financial elements (rule no. 11, preface, p. 1). Fair value accounting is then introduced only for either short-term financial assets and liabilities or available-for-sale financial assets (rule no. 11, p. 15). While fair value accounting is inconsistent with the purpose of expenditure-sharing and the no-profit motive, its impact shall not be material, since the EC utilizes financial operations only to compensate financial unbalances in the budget management. Debt financing is then very limited, and deficit spending is prohibited in principle.

4.13 Rule no. 12—Employee benefits

The main principle of this rule is that “the cost of providing employee benefits should be recognized in the period in which the benefit is earned by the employee, rather than when it is paid or payable” (rule no. 12, p. 4).

The preparer of the EU accounts is then expected to make complex calculations that are not further explained, comprising discounted values based on actuarial basis (for long-term benefit and defined-benefit plans) and present values (for short-term benefit and defined-contribution plans). The combined employee benefit liability is then accounted for among the non-current liabilities in the balance sheet. The annual change of this liability is accounted for as an expense in the economic outturn of the year.

While France and USA have excluded this liability from their general accounts, in order to avoid its impact on the net operating annual result (Biondi, 2008 and 2012), the EC introduces the liability and its change in order to share the related expenditure among the Member States that are responsible for its recovery. This factually includes potential and unrealized gains and losses (related to changes of value, expectations and estimations) among expenditures to be recovered, contrary to a modified dynamic accounting model of reference.

Actually, in practice, the outstanding liability accounts for a large part of the cumulated deficit of the EU on accrual-basis. The Member States are surely not

recovering it on accrual-basis, but only paying for it on cash-basis, thus postponing to future periods the recovery of charges that become payable (if ever) only in the future, as confirmed by the speech of Dr Manfred Kraff, Deputy-Director General, Accounting Officer of the Commission, DG for Budget (DG BUDG), at the EUROSTAT Conference on “Towards implementing European Public Sector Accounting Standards”, Brussels on 29–30 May 2013 (Kraff, 2013).

4.14 Rule no. 13–The effects of changes in foreign exchange rates

According to the EC rule, both realized and unrealized exchange differences are recorded as revenue or expense for the year in which they occurred (rule no. 13, p. 10). This method is at odds with both the purpose of expenditure-sharing, since it pretends to share non-realized expense, and the prudence principle, since it pretends to share non-realized revenue. In fact, this choice might suggest a peculiar accounting policy devoted to make the Member States responsible for exchange differences. In this way, the EU has not to cover these differences on their behalf but passes them through to the Member States.

The impact of this accounting misrepresentation should not be material, since “most of all financial assets and liabilities are denominated in Euro” (EU, 2008, p. 114) and so are most of all operating expense and revenue.

4.15 Rule no. 14–Accounting policies, changes in accounting estimates and errors

The rule requires the EC to “present the net surplus or deficit from ordinary activities of the period, with specific additional disclosures, including extraordinary items” (rule no. 14, p. 1).

According to our analysis of the accounting framework and rules, this principle is generally applied, since the impact of fair value accounting is very limited, and the inclusion of extraordinary revenue (such as gains from liquidated fixed assets, whether tangible or intangible) or the inclusion of non-realized revenue (such as positive exchange difference) is not material. In addition, the economic result is net of taxes paid by employees on their salaries and pensions, avoiding thus the overwhelming paradox of paying taxes to itself.

Therefore, the economic result of the year as reported by EC is in line with the purpose of expenditure-sharing among the Member States, under the overall

no-profit motive typical of every public administration. This result may nevertheless be more meaningful if it would integrate further information on economic sustainability over time. For the latter purpose, its coherence with annual and multiannual budget should be disclosed, providing that annual excess on budget must be refunded to (or called from) the Member States. Furthermore, this extension shall include commitments for future charges as liabilities in the balance sheet, even in case of operating leases or other certain commitments for future charges or contractual payments. The deferred expense on the asset side may then be recognized against the committed/contractual liability on the liability side. The deferred expense should be released as current expense through the economic outturn according to the underlying payment plan and the actual payment flow over time. In addition, the economic result of the year relates to the “amounts to be called from the Member States”, which are responsible for its eventual recovery. The complex procedure that makes these amounts recognizable by budget and general accounts should deserve further specific attention by this accounting rule.

4.16 Rule no. 15–Related party disclosure

This rule addresses two kinds of related party disclosures – control disclosure and key management personnel disclosure – by making reference to the concepts of transparency and materiality.

Control disclosure purports to reveal the existence of related party relationships “*where control exists*”. It applies only to general accounts on accrual-basis. When the related parties are within the frontiers of control, significant influence or common control of the reporting entity, the relationship must be disclosed irrespective of whether there have been transactions between the related parties. Nevertheless, only the transactions “other than transactions that would occur within a normal supplier or client/recipient relationship, on terms and conditions no more or less favourable than those which it is reasonable to expect the entity would have adopted if dealing with that individual or entity at arm’s length in the same circumstances” (rule no. 15, p. 5) should disclose: the nature of the relationship; broad terms and conditions of the (class of) transaction(s) and amounts or appropriate proportions of outstanding items. Aggregate disclosure is allowed for items of a similar nature.

Key management disclosure concerns remunerations, compensation and some loans to key management personnel and close members of their families. Actually, the rule regrets that “key management” is difficult to be reduced “to a limited number in the case of the European Communities”. Furthermore, in

order “to observe confidentiality as regards private data and to comply with the relevant legislation”, only aggregate “information on the top grade in the entity” is required (rule no. 15, p. 7).

These restrictions appear to potentially undermine the relevance of related party disclosure; they do not actually follow widespread practices for members of governing bodies in private companies. Concerned with related party disclosure in business affairs, the IFRS (24, BC4) rejected the “privacy issue” to justify exemption for the disclosure of management compensation. Expenditure-sharing Member States and their citizens deserve to know what their contributions are employed for, including related party and key management personnel disclosures.

4.17 Rule no. 16—Presentation of budget information in annual accounts

The need of meaningful coherence between budget accounting and financial accounting is reinforced by the rule no. 16, which requires nowadays “a reconciliation of actual amounts on a budget basis, with actual amounts presented in the financial statements when the accounting and the budget basis differ” (rule no. 16, p. 3). “The actual amounts presented on a comparable basis to the budget shall be reconciled to the actual amounts presented in the financial statements, identifying separately the major differences on both the revenue and the expenditure side” (rule no. 16, p. 8). In particular, revenue is primarily recognized on modified cash-basis with little difference between cash receipts and accrued revenue. The differences are almost entirely on the spending side: they arise when a cost accrues (and affects the accrual deficit) in one fiscal year, but paid (and affecting the cash deficit) in another fiscal year. The largest differences refer to employees’ benefits, veterans’ compensation, environmental liabilities, insurance programs, depreciation expenses and capital assets.

This reconciliation has been applied since the financial accounts of 2009, but its clarity and meaningfulness are still limited, as explained in a previous section. These limitations do not appear to be material in 2008. The total budgeted amount of revenue (121,385 EUR billions) is of the same order of the total accrued revenue (122,444 EUR billions). Nevertheless, the accumulated economic result (called economic surplus/(deficit) or outturn) is negative (47,424 EUR billions). This implies a continued unbalance between revenue and expenditure on accrual-basis, while the European budget is expected to be balanced every year, that is, “the budget revenue should always equal or

exceed budget expenditure and any excess of revenue is returned to Member States". This negative result represents "that part of the expenses already incurred by the Communities up to 31 December 2008 that must be funded by future budgets" (EU, 2008, p. 74). In 2008, some 25% of it is explained by recognized expenses in the year N (2008) that will be actually paid only in year $N + 1$ (2009) using the budget of the year $N + 1$. The remaining part is due to "employee benefits obligations of the Communities towards its staff" that are "guaranteed by the Member States". This surely means that, although EC has introduced accrual reporting for employee benefits, their funding is assured on cash-basis when it becomes payable to employees.

4.18 Rule no. 18—Impairment of assets

Impairment is an accounting method which theoretically belongs to a static accounting representation. It is then theoretically inconsistent with public sector, generally speaking. Impairment applies a general requirement to test and align the depreciated carrying amount of every asset with some ongoing value of reference, often estimated through sale price, market value or liquidation value. Every estimated impairment loss is then recognized as a non-cash expense though the comprehensive statement of financial performance, as if the entity should immediately recover it through current revenue. Moreover, every estimated impairment loss can be reversed through time, generating a non-cash revenue based upon values that are dependent upon managerial discretion, subjective estimation and erratic fluctuations of market quotations, forecasted variables, as well as interest and discount rates of reference.

According to a modified dynamic accounting representation, the EC accounting system should maintain the reference to not-impaired historical cost as measurement criterion of assets. The asset value in use should then be focused only on its specific criteria of continued useful life to the EC economy in the future, according to the going concern principle.

Impairment test used to be included under the EC rule no. 7. The old impairment test was based on the higher of the net selling price (liquidation value) and the value in use of the asset to be tested. The value in use was based on the identifiable active market value (whenever available) or on its replacement cost (rule no. 18, pp. 12–13). The impairment loss had to be material and not to be temporary; the reversal of it had not to exceed the not-impaired historical cost, which remained the benchmark measurement (rule no. 18, p. 14).

Issued in December 2011, the new EC rule devoted to asset impairment provides no exception to the general inconsistency of impairment test when applied to the public sector. To be sure, required impairment method distinguishes between cash-generating assets, narrowly limited to “assets held to generate a commercial return,” and all the other assets, defined as non-cash-generating ones. Concerning the latter, recoverable amount does not only point to incurred permanent loss of service potential (a narrow definition that remains quite consistent with a dynamic accounting representation) but includes reference to the present value of that service potential (par. 3–13) and to asset’s market value (par. 4.1–3b; par 4.2; 4.3 9a). Required reference to environmental changes for impairment evaluation purpose is also disputable. On the one hand, inclusion of expected environmental changes (including technological and regulatory changes, par. 4.1–2b) may involve material impairment losses that might deter suitable reforms in policies and regulations. On the other hand, inclusion of changes in the planned budget for operating and maintaining the asset (4.1–4 and 4.2–12; 4.3 8a) seems to extend impairment test to the ongoing current use of the asset, involving dysfunctional pro-cyclical effects on the statement of financial performance. Similar effects are expected by impairment of cash-generating assets pointing to ongoing market values and including ongoing discount rates of reference (5.1–3), although double counting on inflation, time value of money and financial movements is avoided (5.2–11 and 20).

In sum, it is regrettable that this new impairment method was introduced, involving complex and subjective calculations that may obscure the faithfulness and usefulness of the statement of financial performance. Nevertheless, having scoped out (par. 2) financial instruments and construction contracts, as well as inventories (which do not anyway include agriculture stocks), the impact of impairment losses is not expected to be material on financial accounting and reporting of the EC economy.

5 Synthesis and conclusion

This article has analysed the choices made by the European Commission in terms of its own accounting system and financial reporting, with particular reference to the accounting concepts and rules issued by the European Commission itself in its recent process of reform. In particular, our theoretical analysis has assessed the capacity of the EC accounting system to “truly and fairly” represent its economic activity as a “non-business entity”. Our analysis has then verified the consistency

between the EC set of 18 accounting concepts and rules with our theoretical frame of analysis introduced by Section 3. This framework disentangles different accrual-based accounting representations respectively focused on wealth (static accounting), cash flow or economic flow (dynamic accounting). Accordingly, only a dynamic accounting representation – modified to fit the special needs and purposes of public administration – is appropriate to represent and govern public entities and their non-lucrative activities. To be sure, the EC economy is further featured by the purpose of expenditure-sharing among the Member States that ultimately are responsible for EC expenditure.

According to our analysis, deviations from this appropriate accounting representation prove to be limited and never material. For example, the definition of intangibles is limited to the interest of the EC entity and excludes then public interest purposes, but their size and role are not critical in the case of EC economy. In addition, the impact of inappropriate fair value accounting is very limited, and either the inclusion of extraordinary revenue (such as gains from liquidated fixed assets, whether tangible or intangible) or the inclusion of non-realized revenue (such as positive exchange difference) are not material. Furthermore, the economic result is net of taxes paid by employees on their salaries and pensions, thus avoiding the overwhelming paradox of paying taxes to itself. Therefore, in our opinion, the EC accounting system seems to have improved on the following EC financial accounting and reporting objectives:

- the economic function of redistribution, related to the economic solidarity between the Member States, through an improved representation of revenue and expense;
- the prevention of frauds concerned with transfers and related financial operations made by the EC;
- the accomplishment of intergenerational and transnational equity, through the recovery of incurred expenditures by Member States and then ultimately by various taxpayers located in different places at different times over the European territories.

An important element of the EC accounting modernization project is the “dual system” choice, characterized by the maintenance of the cash-based budget accounting along with accrual-based general accounting that serves preparing the consolidated financial statements. This choice is surely due to a need to gradually introduce accounting changes – dependent on transition costs and the incumbent habit of administrative staff in dealing with cash and budgetary accounting records (IFAC-PSC, 2003). But it is also consistent with the specific needs of EU activities, which do mostly deal with cash fund and flow

transactions while organizing public and private sector co-operation at different levels. According to Christiaens and Rommel (2008), accrual accounting should be used when government engages in business-like activities, while cash accounting should be applied when public entities provide public service without profit motive. These authors further argue for a combination of both systems when both kinds of activity coexist. The EC case appears to be in line with their view. It shows both the importance of accrual accounting for improving activities' cost measurement and the necessity of its integration with cash-based information, in consideration of the specific features of the EU activities. To date, the dual accounting system does not appear to be a temporary choice. All analysed documents comfort this choice as a distinctive move towards accrual accounting based upon a combined approach.

Another significant element of the reform concerns the reference to the IPSAS, including in the view of their possible role in the harmonization of government accounting standards among EU Member States. In Europe and abroad, private sector accounting standards have been increasingly submitted to a harmonization process: globalization and financialization have then been driving a transformation of accounting information and representation for business entities. It is well known that the EC has required the adoption of the IAS/IFRS for all listed corporate groups in EU Member States. What is likely to occur for the European Public Sector Accounting Standards (EPSAS) that are currently under review? How may the EC authority and experience reshape governmental accounting policies and practices of EU Member States?

As far as its own accounting system was concerned, the EC appears to have accommodated with the IPSAS, in line with actions developed by other international and supranational institutions (i.e. OECD, NATO and the UN). At the same time, the EC has maintained its ruling power upon the specific requirements of its public entity, since the EC did not have adopted the IPSAS, but it has instead issued its own set of accounting concepts and rules.

As far as the EPSAS are concerned, the EC has no political mandate or power to setting national government accounting standards, although it may exert influence over the EU Member States and their governments (Benito, Brusca, & Montesinos, 2002; Gray, 2006). At the present, in the aftermath of the sovereign debt crisis of some EU Member States, the EU powers and functions are evolving in matters of fiscal consolidation, financial management and fiscal accounting. In particular, the legislative package adopted by the Council of the EU on 8 November 2011 marks an important reinforcement of coordinated economic governance in the EU. On the basis of the Council Directive n. 85/2011 concerned with requirements for budgetary framework of the Member States, Eurostat launched at the beginning of 2012—on behalf of the European Commission – a

public consultation to assess the suitability of the IPSAS for governmental accounting of the EU Member States. Two main issues arose from this consultation. On the one hand, the IPSAS cannot be adopted by the EU Member States; on the other hand, the IPSAS represent a valid reference for establishing the EPSAS (European Commission, 2013). Furthermore, on March 2013, the European Commission started a relevant project with the intention to create harmonized EPSAS to be applied by all the Member States. At the end of 2013, a report and the public consultation on “towards implementing EPSAS for EU Member States” were launched, and the results are still unknown. How will EPSAS match with the accounting rules issued by the Commission for its own economic activity? The comparative analysis of both accounting models may offer an interesting way to go on applying our research approach.

In our opinion, this theoretical investigation is relevant for public administration, as accounting constitutes a neglected but driving political medium, a fundamental governance mechanism and a central accountability device. In this context, our theoretical perspective paves the way to two distinctive patterns of further research. On the one hand, we invite accounting students to look for *appropriate* accounting representations, disentangling and clarifying *existing* representations (developed by incumbent or alternative accounting regulatory bodies or proposals), while challenging them by comparative assessment and development of alternative *possible* models, in view to better represent specific needs, purposes and missions of public administration. On the other hand, having accepted the actual variety of accounting models and representations and their contingency over times, we suggest studying their emergence and evolution in their own contexts, situating them in relation with vested interests of reference (*cui prodest?*), as well as with their specific ideational frames of reference.

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- 13th Biennial CIGAR Conference “Bridging Public Sector and Non-Profit Sector Accounting” (Ghent, 9–10 June 2011).

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