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ACCA Think Ahead

What accounting standards should be used for public organizations? Emerging frameworks and practices among Italian public care providers

Abstract

The financial pressures of the last decades and the requests for modernization of the public sector have often resulted in an increased focus on performance information and in the adoption of new accounting techniques, such as cost and accrual accounting. These new frameworks and standards can supplement or replace more traditional cash- and commitment-based budgetary accounting systems.

In some instances, public organizations were given the choice to adopt a harmonized system or to leap-frog to pure accrual accounting. This article explores what is advisable according to current regulations and financial managers for Italian public care providers.

Introduction

In the last twenty years the public sector has faced an increasing demand for public services, a mounting weight of entitlements and a growing regulatory demand from international institutions while facing fiscal and economic crises which have led to pressures to cut back expenditures, ensure balanced budgets and reduce public debt. This has led to a search for greater efficiency, flexibility and sustainability of public administration in the implementation of its mission.

Public sector accounting results have traditionally indicated whether there is a budgetary surplus or deficit and how much cash is available at the end of a financial year, while most attention is focused on the budgetary process, that is on the legitimacy of and the comparison between actual and estimated expenditure and on ensuring sufficient funding and revenues. Since the end of the last century, New Public Management (NPM) approaches (Hood, 1991) have introduced innovative processes in the public sector which, with different modes and intensity, have affected most Western countries and are now spreading globally. NPM practices have introduced private-like logics and tools with an emphasis on efficiency, effectiveness and results. Managers have been made more accountable for the results attained, while the accounting focus has gradually shifted from spending and budget allocations to costs and revenues, assets and liabilities.

Within this reformist process, a fundamental role has been played by changes in measurement and accounting systems, what is often referred to as “New Public Financial Management” (Guthrie et al., 1998). This is the gradual transition from traditional arrangements built on cash accounting paired with a commitment-based system to control and cap expenditure, to a cost and accrual-based framework typical of the for-profit sector and aimed at overcoming bureaucratic obstacles and at infusing efficiency, responsibility and results orientated approaches within the complex public realm. These new techniques can be in addition to or in replacement of more traditional cash- and commitment-based accounting.

In the early 2000s NPM accounting techniques had often failed to replace traditional cash- and commitment-based accounting as the main accounting system in the public sector (Lapsley et al., 2009). Moreover, their control mechanisms, which focused on individual managers’ goals and on an efficient use of resources rather than effectiveness and outcomes, had led to little attention for the attainment of longer-term objectives for organizations and for society at large. There is considerable literature on this topic (Bruno and Lapsley, 2016) which has steered the debate about the merits and the critical issues of introducing accrual accounting in the public sector in academic as well as practitioners' circles.

The research: purpose and methodology

Given that "the implementation of accrual accounting in the public sector can be conceived of as a dynamic and controversial process" (Bruno and Lapsley, 2016: 5), the purpose of this article is to offer further insight on such developments in the Italian public care sector in order to contribute to the debate about the pros and cons of introducing accrual accounting in the public sector and to present some practical implications of switching from traditional public accounting systems to accrual accounting.

Italy has been depicted as a hesitant adopter of NPM reforms, because of its entrenched bureaucracy with a legalistic system where public administration has been embedded in politics (Arnaboldi et al., 2016). The public accounting reform introduced in 2011, that prescribed the harmonization of cost and accrual accounting with cash and commitment-based accounting for regional and local authorities, has attracted skepticism and opposition. These circumstances make the Italian setting an interesting one for further investigating the development of public accounting.

Furthermore, the social and healthcare sectors are particularly worthy areas of inquiry, because they are extremely important intervention areas, both because of the social role they play given demographic and social trends as well as in terms of public spending. Indeed, they have registered an increasing demand for services, which has translated into an increasing importance for public budgets. Moreover, care providers operate in a quasi-market context with accounting information also suitable for cost and accrual frameworks. Indeed, public care providers decide autonomously the fees for their services, which are borne in large part by users since the value of public contributions is less than half. In Italy they also face the competition of private providers who can get their services accredited by public authorities, so that people are free to choose between public and private providers while still benefiting from similar allowances.

Therefore, this article considers 1) whether it is advisable for public care providers to adopt a pure accrual or a harmonized accounting system and 2) which, if any, further accounting standards should be developed to better suit their public nature.

Such an investigation was carried out through documentary analysis of both the relevant literature and current norms and regulations, and an empirical study testing the opinions and preferences of financial managers in public care providers in the Italian region of Friuli Venezia Giulia (north Italy). 21 financial managers were invited to a training session on accrual accounting which explained the details of balance-sheets and profit and loss accounts and the differences with more traditional financial statements based on cash and commitment accounting. The training was followed by a 6-day participatory workshop to discuss in detail the most recent laws and the implications of adopting various accounting solutions.

Normative changes

Since the early 2000s the Public Service Committee of the International Federation of Accountants has encouraged public organizations to move to accrual accounting and adopt International Public Sector Accounting Standards (IPSASs). The Committee maintains that accrual-based statements, rather than cash-based financial reports, provide the most relevant, reliable, comparable and useful information. In 2011 the European Union with Directive n. 85 required all European public sector entities to have “uniform requirements as regards the rules and procedures forming the budgetary frameworks of the Member States”. In order to facilitate the harmonization and consolidation of public budgets and thus further control public accounts, “complete and reliable public accounting practices for all sub-sectors of general government” should be reconciled with ESA (European System of Integrated Economic Accounts) which relies on information provided on an accrual basis. This pushed those European countries, that had not already done so, to enact new laws and regulations providing for either the harmonization of accrual accounting and traditional public accounting systems or for implementing a full accrual accounting system. In general, Italian legislators favored the former solution. Law 42/2009 and the related Legislative Decree 118/2011 established that regions, provinces, local authorities as well as their instrumental bodies should follow a harmonized accounting system with the new accrual-based and the old cash and commitment-based accounting systems running in parallel.

Focusing on public care providers, Italian “Aziende di Servizi alla Persona” (ASPs, care service organizations) are public care homes that provide residential and home-delivered social and healthcare services for the elderly, frail and disabled. ASPs were born at the beginning of the century when the Italian government with Law 328/2000 and Legislative Decree 2017/2001 decided that the “Istituzioni Pubbliche di Assistenza e Beneficenza” (IPAB, public welfare and charity institutions) should be converted into proper and independent legal entities. IPAB provided residential services to non-self-sufficient elderly people, but over time with the reorganization of healthcare services, the rationalization of public health structures and the reduction of hospitalization times, ASPs have increased their range of services to include day-centers, residential services for the critically ill and disabled people, palliative care and home-delivered services such as hot meals, transportation and therapy implementation. With the constitutional reform of 2001, the Regions were given more legislative competence in the social and healthcare sector and could decide whether IPAB should be converted into public ASPs or into private associations or foundations or should be left free to choose. In Friuli Venezia Giulia Regional Law 19/2003 regulated the transformation of IPAB in public ASP or into private associations and foundations: out of 46 IPAB, 21 turned into ASPs, 20 were privatized and 5 were shut down as they did not have the prerequisites to become public entities nor enough interest was gathered to turn them into private organizations. Hence, half remained in the public realm, even though their services are only partly subsidized by public funds and private contributions are significant and prevailing. They continued with a traditional public accounting framework, while those IPAB who converted into private associations and foundations had to immediately adopt an accrual accounting system.

In 2016 Regional Law 24/2016 established that by the end of 2018 ASPs should follow local authorities and implement harmonized accounting systems with accrual accounting supporting cash- and commitment-based accounting and thus reap the benefits of both worlds. However, in 2017 the Regional Executive Committee decided to suspend the application of such a norm and to leave ASPs free to choose between implementing full accrual or harmonized accounting procedures (“Delibera di generalità”, general deliberation, n.14/54, 28.07.2017). Most Italian Regions have taken a similar approach since budget harmonization and consolidation for social and healthcare providers does not appear to be necessary in the Italian system, since their public funding is already accounted for in regional and municipal budgets and hence it is de facto included into budgetary consolidation procedures. Consequently, the impact of the social and healthcare system on national public expenditure is already accounted for and there is no need to force a public care provider to adopt a harmonized accounting system.

What financial managers suggest: results from the workshop

ASPs' financial managers were asked to deliberate what accounting rules they would establish for their organizations. They were initially divided into 7 groups according to the size of their organizations: one group consisted of financial managers from small ASPs with a turnover of less than 2 million euros; two groups included financial managers from ASPs with a turnover between 2 and 4 million euros; one group consisted of financial managers from ASPs with a turnover between 4 and 10 million euros; three groups were comprised by financial managers from large ASPs with a turnover of over 10 million euros. This was done to ensure that issues could be discussed among people from organizations of similar dimensions, since size can influence their work, their responsibilities, their experiences, their perceptions and their risk aversion. Then the groups reconvened to discuss the regulations they had drafted in smaller teams.

Overall, during the workshop all financial managers favored the adoption of a pure accrual accounting system, because they found it more straightforward. Abandoning cash accounting would be feasible since, on the one hand, their public funding is already accounted for in regional and municipal budgets and, on the other, according to ESA these entities do not need to be included in the consolidation of public accounts because they are considered a market producer, that is an organization where sales cover at least 50% of their costs over a sustained multi-year period (ESA 2010).

At the same time, most participants agreed on the need to develop specific regulations to accommodate the accounting specificities of public entities such as ASPs. In particular, they discussed exemptions and dispensations from specific International Financial Reporting Standards, such as booking public grants for multiyear investments as capital reserve, as normally done with commitment-based accounting, rather than as multiyear revenues, as done for accrual accounting. This issue is not set by any national or regional law, but it is left to be determined by own regulations if need be.

Moreover, financial managers recommended adopting a break-even constraint defined a priori in order to help guarantee a positive cash flow and avoid losses, that is budget deficits and overspending, even under accrual accounting. However, financial managers suggested that such a constraint should be set only for the overall budget and not for individual business or organizational units, so that the system would enjoy more flexibility than under a traditional commitment-based system. Yet, there was less agreement among managers on who should authorize budget changes: most suggested that the managing director should be able to authorize them across business units, while some maintained that the board of directors should approve those variations too. These uncertainties reveal that some financial managers were still skeptical about the benefits of accrual accounting and feared the increased responsibility they would face. At the same time, managers in large organizations appeared less attached to traditional practices and somewhat readier to embrace new frameworks.

In keeping with traditional public accounting rules, most financial managers agreed on the need for more precautionary constraints on specific issues such as indebtedness: new debts should be contracted exclusively for investment purposes according to all managers except those in small organizations, who would use new debts also to pay back old ones. This is indicative of the comparatively limited funds available in smaller organizations, where debt repayment can become a crucial limitation to spending.

As far as assets are concerned, most financial managers suggested implementing some preventive asset restrictions. They argued assets should be monitored and their use restrained through indicators such as the proportion of own funds to third party funding, the ratio between current assets and current liabilities or between own funds and net fixed assets. This would help monitor capital strength and the solidity of the organization's assets.

Lastly, financial managers maintained that shifting to accrual accounting would diminish paperwork and bureaucratic procedures. However, they did not wish to give away all formal documents used to allocate budget resources under commitment-based accounting. In particular, they claimed they could not operate without payment orders and collection vouchers without significantly changing the modus operandi and habits within their organizations. In some cases, they suggested keeping these documents at least for a transitional phase during the adoption of the new frameworks. Their awareness of their limited understanding of the technicalities of the accounting changes often made them suggest cautious solutions and doubt the rationale for implementing new practices.

Final remarks and implications

The implementation of accounting reforms in Italy as in many other countries aimed at introducing accruals reporting in the traditional budgetary accounting system to enhance efficiency, accountability and sustainability in an overall modernization of public administration processes. In some cases such as care providers, public entities can choose whether to apply pure private sector accounting practices or run them in parallel to traditional cash- and commitment-based systems.

As we have seen, accrual-based reporting is no longer marginal or as strongly opposed as at the beginning of the reform process. Yet, even when they are free to choose which system to adopt, public managers are still anchored to cash accounting frameworks and standards. An imprint of cash- and commitment-based accounting is still evident and more needs to be done to make managers appreciate the advantages of reforms which also increase their accountability. Moreover, while accrual accounting is seen as useful, specific public sector needs and managerial control systems suggest maintaining some of the prescriptions of commitment-based accounting. Authorization remains the prevailing strategy in public accounting. This may also be because Italian public financial managers have often perceived budgeting reforms not so much as rational and part of a modernization of public administration needed to improve the management of financial resources, but rather as legitimized by authority, that is as imposed by law, the EU or fiscal stress.

Findings confirm that in contexts with a strong legalistic culture such as Italy, some aspects of the traditional bureaucratic mentality persist and have simply been adapted to accommodate new requirements. In order to overcome this limitation, previous studies have highlighted the importance of the presence in public organizations of financial managers with some professional and private-sector experience, who are viewed as "privileged communities" able to understand the new systems and who would embrace the shift to accrual accounting and NPM reforms more easily (Hyndman et al., 2018). In Italy instead, managers often have a general management or law background and such credentials may hinder attempts at implementing changes inspired on the private sector.

From a research perspective, it would be interesting and recommendable to investigate these issues further across countries and administrative cultures with different interpretations and implementations of accounting reforms. It would be important to understand to what extent, in countries other than Italy, the modernization discourse has been resisted to and merely grafted onto a predominantly bureaucratic structure that in some ways persists and encloses reforms. Further research could also delve deeper into the internal organizational dynamics of change processes related to accounting systems and consider multiple and conflicting logics at play and focus on the role of accounting in the interactions between an organization and its institutional environment.

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