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INNOVATION IN PUBLIC SECTOR ACCOUNTING: A NEW ROLE FOR LOCAL GOVERNMENTS?

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Innovation in Public Sector Accounting: a New Role for Local Governments?

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Abstract

The research aims to analyze how local governments can adopt accounting innovations to reinvent their role. This report attempts to define the importance of reducing information asymmetry among citizens, policy-makers, and public managers, as well as how accounting system reform can support the process. This paper makes use of a case study based on the realization of a medium-sized Italian municipality's consolidated financial statements, exploiting the action research method. The analysis outlines that, on one hand, the development of new accounting tools can enhance organizational awareness, while on the other hand, there are some possible limits regarding internal and external accountability.

KEYWORDS: Accounting innovations, Consolidated financial statements, Accountability

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1. Introduction

In the last two decades, there have been many relevant changes in local governments' accounting systems to adhere to public sector reform[4]. More specifically, the accounting reform starts from the idea of supporting decision-making processes to improve public accountability[5]. At the European level, the integration and harmonization of public accounts became crucial to foster common financial policies[6]. To this end, there has been an increasing demand to compare value and financial statements among all countries in a common accounting language (SEC10). In Italy, the process started with Law n. 42/2009, on fiscal federalism, but the first legislative initiative for accounting harmonization came in the form of Law n. 196/2009 on Central Government accounting reform, based on the reform of the traditional cash accounting system[7]. Later came the Legislative Decree n. 118/2011, with its subsequent ministerial decree to implement procedures and forms (Legislative Decree n. 126/2014). Accounting and financial statement reform involves local governments, from municipalities and other authorities to local utility and general service companies[8]. The reforms led to local governments seeking control of all the entities included in a sort of Public Corporation, with a common aim to create public value[9] and increase responsibility and accountability toward stakeholders.

This paper provides an accessible overview of the opportunities and challenges that come with public accounting system innovations, focusing primarily on two research questions:

a) *What are the possible effects of these innovations for a local authority from an internal and external point of view?*
b) *What are the possible impacts of innovation in public sector accounting on the relationships between managers, politicians and the community from an accountability perspective?*

This paper consists of two parts: the first concentrates on the origins of accounting system reform and its international context through a literature review. The second section develops a case study to verify the possible benefits of innovation in local government accounting through an exploratory research method. By examining the presence of critical issues, this research will highlight the opportunities and risks of recent accounting reforms in Italy, with specific attention to the aspects of transparency and responsibility in political decision-making processes. This article analyzes the potential for applying accountability practices to stakeholders in addition to politicians and public servants too.

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[4] Pollitt, C., & Bouckaert, G., *Public management reform: a comparative analysis,* Oxford University Press, 2004.
[5] Sinclair, A., *The chameleon of accountability: Forms and discourses,* Accounting, Organizations and Society, 20(2), 219–237, 1995.
[6] Rossi, F. M., Cohen, S., Caperchione, E., & Brusca, I., *Harmonizing public sector accounting in Europe: thinking out of the box*, Public Money and Management, 36(3), 189–196, 2016.
[7] Hyndman, N., Liguori, M., Meyer, R. E., Polzer, T., Rota, S., & Seiwald, J., *The translation and sedimentation of accounting reforms. A comparison of the UK, Austrian and Italian experiences*, Critical Perspectives on Accounting, 25(4–5), 388–408, 2014.
[8] Ezzamel, M., Hyndman, N., Johnsen, A., & Lapsley, I., *Reforming central government: An evaluation of an accounting innovation*, Critical Perspectives on Accounting, 25(4), 409–422, 2014.
[9] Moore, M., *Public value as the focus of strategy*. Australian Journal of Public Administration, 53(3), 296–303, 1994.

In detail, this paper examines the Municipality of Ferrara decision-making process through a qualitative research method: Action Research combined with Case Study exploration. This methodology was possible because a member of this study's research team was directly involved in Ferrara's decision-making processes and acted as accounting officer. Furthermore, a semi-structured interview has been submitted to two different profiles—one political and another managerial—to explore the Ferrara Municipality case study in terms of internal structure and organization. The objective of these interviews was to identify how new legislation and innovative accounting tools can support the decision-making process, improve internal and external accountability, and reduce information asymmetry between citizens, management and policy-makers.
This paper is structured as follows. The next section will explore public accounting reforms implemented in the last two decades in an international context, with special focus paid to their inspiring principles. The third section will examine the Italian context, with the bulk of analysis concerning recent reforms that have introduced elements of innovation in local government accounting systems. In the fourth section, the case study and its findings will be presented and analyzed. These findings will be discussed further in the last section, which also contains closing remarks.

2. The inspiring principles of the public sector accounting reforms

Public sector accounting reform arose from the need for harmonization, convergence, compliance and accounting internationalization.
Accounting harmonization can be interpreted differently depending on its process of implementation, meaning it can fall into one of three possible categories[10]:

1. Political accounting harmonization, which is dominated by State intervention, as is especially the case in France and Germany;
2. Pragmatic accounting harmonization, which is dominated by the contribution of professional in the field, as mainly found in the United Kingdom (UK);
3. Joint accounting harmonization, where the rules are jointly determined by the accounting professional and the State; the most relevant example being the United States (US), where the accounting rules are developed by the Financial Accounting Standards Board (FASB), and their implementation is put into practice by the Securities and Exchange Commission (SEC).

The public sector has always undertaken broad reforms in its own accounting. There has been a progressive movement away from traditional public administration systems in favor of new public management-type accounting tools inspired by the private sector[11].
Government accounting and financial statements aim to protect and manage public money to maintain accountability. There are two different accounting principles—accrual approach and cash approach. Simplified bookkeeping is characteristic of the cash approach. Its main feature is the recording of transactions only in the presence of received or paid cash. This accounting principle had previously been more prevalent in the field of local government accounting until the introduction of reforms in accounting

[10] Bebeşelea, M., *Accounting Reform in Romania*, Procedia - Social and Behavioral Sciences, 116, 4689–4694, 2014.
[11] Hyndman, N., Liguori, M., Meyer, R. E., Polzer, T., Rota, S., & Seiwald, J., *The translation and sedimentation of accounting reforms. A comparison of the UK, Austrian and Italian experiences*, op.cit..

practices. Cash accounting, however, is largely considered outdated by today's standards[12].

Accrual accounting, previously only thought suitable in the private sector, has actually been seen as a better alternative for reporting government activities[13]. In an international context, accrual accounting often appears as a kind of integrated management accounting system that includes budgeting, reporting, financial accounting, management accounting, and performance measurement systems. Some models of this accounting system can be found in initiatives like Accrual Output Based Budgeting (AOBB), fostered by Australia and New Zealand[14], and Resource Accounting Budgeting (RAB), developed in the United Kingdom[15]. The main reason behind the transition to accrual accounting is the growing need to obtain comparable and reliable information on the economic and financial situations of the accounting entities included in a whole Public Corporation. Applying this perspective can reveal more detailed information about external stakeholders and contribute to a reduction of information asymmetries at multiple levels[16]. Through the wider use of accrual accounting all the entities could be included in consolidated local government accounts.

These changes in accounting systems could also have an effect on the severe socioeconomic crisis. The ambitious goals of these processes support policy decisions, improve fiscal transparency and accountability, and assign mandatory rules and recommendations in support of the public value creation process. Accounting policies and accountability are the basis of the current phenomena of public sector innovation. A wide range of factors have influenced reforms in the public sector, and each one has played a strategic role in defining requirements for new accountability mechanisms[17]. Today, public governments have to take the interests of multiple stakeholders, which may have compatible rather than competing interests, into account.

In this respect, the problem appears to be the level of accountability, the importance of organizational structure and processes, and how multiple agents interact in the new scenario outlined by accounting reforms[18]. Accountability is necessary for local governments to obtain political legitimacy and stakeholders' trust and support. In agency theory, accountability may be considered the ability of a person or organization to clarify the usage of what it receives from its stakeholders. In the public sector, the stakeholders are the mandators, through the legitimacy of government, while local government is the mandated, which must provide an account of managerial and political

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[12] Young, E. & All, *Overview and Comparison of Public Accounting and Auditing Practices in the 27 EU Member States*, Prepared for Eurostat. Final Statement, 2012.

[13] Chan, J. L., *Government accounting: An assessment of theory, purposes and standards,* Public Money and Management, 23(1), 13–20, 2003.

[14] Becker, S. D., Jagalla, T., & Skærbæk, P., *The translation of accrual accounting and budgeting and the reconfiguration of public sector accountants' identities*, Critical Perspectives on Accounting, 25(4–5), 324–338, 2014.

[15] Van Helden, J., & Uddin, S., *Public sector management accounting in emerging economies: A literature review,* Critical Perspectives on Accounting, 41, 34–62, 2016.

[16] Pernica, M., & Hanušová, H., *Certain Aspects of the Use of Accounting Principles in the Accounting of Public Corporations,* Procedia - Social and Behavioral Sciences, 213, 345–350, 2015.

[17] Almquist, R., Grossi, G., van Helden, G. J., & Reichard, C., *Public sector governance and accountability,* Critical Perspectives on Accounting, 24(7–8), 2013.

[18] Collier, P. M., *Stakeholder accountability. Accounting*, Auditing & Accountability Journal, 21(7), 933–954, 2008.

activities[19]. In this sense, we can identify two directions of accountability: from politicians toward citizens and from public managers toward politicians. In terms of diffusion theory, accounting reform can also be interpreted as a mechanism for enhancing democratic accountability and reducing information asymmetry through wider use of new accounting tools, like consolidated financial statements for local authorities.

However, implementing these tools can be problematic when they are not connected with the politicians' strategic vision[20]. Their introduction seems to depend more on managerial agendas rather than democratic accountability[21]. Imposing managerial controls is less likely to be effective than informing the process by which public managers construct and enact a sense of being accountable[22]. The root problem is the permanent information asymmetry between politicians and public managers, not to mention consistently low citizen engagement in the decision-making process. Another complication is the considerable investment in financial and human resources. Making positive reforms that improve performance requires high-level capabilities and skills. Local authorities have to restructure and redefine their internal and external responsibilities if they want to harmonize and reform their accounting processes.

Accounting standards also play an important role in the reform and innovation process. The most influential initiative at present is the IPSAS (International Public Sector Accounting Standards) issued by the IPSASB (the IPAS Board). This initiative's primary objectives are to increase transparency and develop high-quality global financial reporting standards for public sector entities' application. IPSAS represents the most representative international standard for public sector accounting. More and more governments are adopting the accrual-based IPSAS as a basis for their accounting and financial reporting. IPSAS also represents a global standard for providing optimal accounting practices in the public sector.

In addition, the European Commission is developing European Public Sector Accounting Standards (EPSAS) to standardize public sector accounting practices within the European Union[23]. Some authors[24] propose a way forward for policy-makers and standard-setters, in which the benefits of harmonization can be obtained without obliging EU member countries to abandon their current public sector accounting systems.

After an in-depth study of select European countries' experiences in accounting reform implementation, some scholars highlight that reforms are not isolated events[25]. Rather, they are embedded in more global discourses concerning the modernization of public administration and further influenced by institutional pressures.

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[19] Broadbent, J., & Laughlin, R., *Control and legitimation in government accountability processes: the private finance initiative in the UK,* Critical Perspectives on Accounting, 14(1–2), 23–48, 2003.

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[24] Rossi, F. M., Cohen, S., Caperchione, E., & Brusca, I., *Harmonizing public sector accounting in Europe: thinking out of the box,* op. cit..

[25] Hyndman, N., Liguori, M., Meyer, R. E., Polzer, T., Rota, S., & Seiwald, J., *The translation and sedimentation of accounting reforms. A comparison of the UK, Austrian and Italian experiences,* op.cit..

3. The public sector accounting reform in the Italian context

The accounting and fiscal system in Italy is ruled by different laws for central public administrations and local authorities. At the central level, the annual budget includes a report recording total government revenues and another recording total government spending broken down by ministry. The budgets of autonomous enterprises and agencies are also enclosed. Each spending report includes preliminary notes and a technical annex. The national annual budget is drawn upon both an accrual and cash basis. The Italian Parliament ratifies by law both the accrual-based and cash-based estimates.

At the local level, there are three tiers of local authorities: Regions, Provinces (and Metropolitan Cities), and Municipalities. Regions have their own regulations and may use unique public accounting systems, while Municipalities and Provinces must comply with a national statutory law in their accounting rules. They may, however, establish their own internal accounting regulations, adapting national rules to suit their own needs to a limited extent. Consequently, there are significant discrepancies not only between different local administrations, but also between local and central governments in terms of accounting arrangements. The system is very heterogeneous[26]. Many legislative interventions have been proposed in recent years to develop systematic regulations regarding local governments' harmonization. The legislative decree n. 267/2000 was the first consistent legislative measure about local governments' organization and accounting systems. This law, which has been subjected to several modifications during the years, still enforces the central role of financial statements in the management and decision-making process.

In 2001, a reform of the Italian constitution redefined the balance of powers between central and local governments. Central government held jurisdiction on the accounting harmonization process. As a result, local governments had only central impositions to follow in terms of accounting system structure and principles. Law n. 42/2009 gave more fiscal autonomy to local governments until Law n. 196/2011 completely changed the accounting and bookkeeping system at the central and local levels consequently. This resulted in the passing of Legislative Decree n. 118/2011, which introduced new principles and bookkeeping systems.

The most important challenge for local governments now is the mandatory introduction of a homogenous accounting system for Municipalities and their entities and companies. After the accounting reform, municipalities must take into account the following principles:

1. Planning a control cycle with the introduction of new strategic documents;
2. Expanded cash basis accounting, where payables and receivables are recorded upon their expiration, not their occurrence;
3. Development of a real accrual-based accounting process;
4. Consolidated financial statements.

The last principle is the most important to measure the effects of accounting reform, compare results and obtain more information about the municipality's structure, public services and activities provided for the community.

Recommendations before the Legislative Decree 118/2011 focused only on municipalities' financial aspects, not the management of public services. With the passing of Legislative Decree n. 126/2014, the consolidated financial statement has

[26] Young, E. &. All., *Overview and Comparison of Public Accounting and Auditing Practices in the 27 EU Member States,* op. cit..

become an official component of the financial statement system. The law established a three-year period of experimentation to be applied to some municipalities before it is to become a compulsory procedure for all local authorities.
The introduction of a consolidated financial statement for the local Public corporation, based on accrual-based accounting, should allow for the presentation of economic-financial assets and control of the outsourced activities. These innovative tools aim to reduce information asymmetries and evaluate every entities' results. The consolidated financial statement can be considered a fundamental document because it allows for a more effective monitoring process of public finance constraints, and it is based on uniform accounting rules that must be adopted by the "parent" authority and all entities included in the Public Corporation. Legislative Decree n. 126/2014 represents the most important reform thus far because it takes into account results from both public administrations and public sector companies, which provides a wider overview of local government activities.

4. The case of the Municipality of Ferrara

Methodology
The empirical analysis of this research is based on the use of a qualitative approach, specifically the case study approach combined with Action Research (AR). The adoption of the case study methodology ensures a solid foundation for the verification of assumptions of the theoretical framework[27], while the flexibility of Action Research provides a wide range of methods to analyze the variety of research outputs collected in the field. The empirical investigation aims to analyze one Italian municipality, which used consolidated financial statements in evaluating the actual profiles of its implementation process, especially with reference to the internal reorganization and internal and external stakeholders' engagement.
Ferrara's municipality was selected because it was particularly suitable for this analysis[28] and for two main reasons too. First, this municipality was not included in the pilot group for the experimentation process, but it began the harmonization and account consolidation process of its own volition, conforming a year in advance to the prescriptions and operational principles of the Legislative Decree 118/2011. Therefore, it can be considered a pioneer in the adoption of consolidated financial statements and new accounting principles. Consequently, it was potentially aware of the role of innovative principles in mobilizing internal consciousness and activating processes of legitimization and learning. Second, the Municipality of Ferrara represents a medium-sized local authority and, in this sense, offers a privileged perspective for analysis. It is sufficiently large enough to provide a complete perspective of the consolidation process and operates in a multi-level stakeholder context. This municipality has a fair number of entities, authorities, and companies where the majority shareholder holds relationships with the industrial sector, equity distribution, and a direct connection with citizens. At the same time, this modest dimension allows for a complete analysis of the whole process in its essence. It also permits the identification, through an exploratory approach, of possible relationships between the adoption of consolidated financial statements and a multi-level accountability process.

[27] Yin, R. K., *Case study research : design and methods*, London: Sage Publication, (5th. ed.), 2015.
[28] Eisenhardt, K. M., *Building Theories from Case Study*, Academy of Management Review, 14(4), 532–550, 1989.

Consistent with research objectives, the empirical analysis has been realized through an investigation based on semi-structured research interviews with open-ended questions[29], combined with Action research method. Specifically, one politician and two managers involved in the account consolidation process were interviewed to determine whether they see the new regulation as a challenge or a threat. The action research portion of this study took into account all appropriate steps for consolidation, which included active collaboration with the municipality's politicians and managers. Furthermore, other sources of data were used, such as specific statements produced during the process of consolidation and public documents available on the Ferrara municipality's website.
The research interviews incorporated three profiles of investigation: (1) the process of implementing account consolidation; (2) the contribution of the account consolidation process to a more effective system of governance and internal accountability; (3) the role of consolidated financial statements in the pursuit of external accountability and civic engagement.
More specifically, the first investigative profile was designed to contextualize the account consolidation process and its internal results and benefits for the organization. Therefore, this aspect of the research interviews focused on the reasons for adopting consolidated financial statements, timing and process of their implementation (duration, use of internal resources or external consultants, emerging difficulties and application criticality, and prior or current co-existence of other competencies, skills, or voluntary accounting statement documents), and their organizational effects.
The second profile of analysis is primarily related to the contribution of consolidated financial statements to a more effective system of governance. With that goal in mind, this component of the research interviews focused on the real effects and benefits of producing such statements on the relationship between politicians and public managers in the decision-making process and planning and control cycle.
Finally, the third profile of analysis considered the level of civic engagement in a participatory decision-making process. In this case, accountability was interpreted in a broader sense, i.e. the general relationship between a municipality and its community. The interviews aimed to understand how a municipality could catalyze community development through effective accounting reform.

Results

This research aimed to analyze the effects of innovation produced by accounting system reform from a public corporation point of view. The results will be presented with reference to the three different profiles of investigation.
First profile of investigation. The first profile of investigation concerned the process of consolidating financial statements and the organizational effects on the municipality. While establishing the steps of this process, Ferrara municipality decided in December 2014 to defer the consolidated financial statement adoption to the 2016 fiscal year. Indeed, the first step was to harmonize the accounting and bookkeeping system in an aim to make comparable the results of different entities involved in the consolidation process. The Municipality of Ferrara began this process in its institutions and instrumental authorities in 2015. It represented an accounting innovation because, for the first time, the municipality had to revise its group of companies in order to match the new regulation.

[29] Qu, S. Q., & Dumay, J., *The qualitative research interview,* Qualitative Research in Accounting & Management, 8(3), 238–264, 2011.

During 2016, the municipality identified and divided the entities that owned a shareholding or direct control, into two categories:

a) Entities on which the municipalities exerted some form of influence or control;
b) Entities where this form of influence or control was relevant for inclusion in the scope of consolidation.

According to Italian law, the criteria for including the entities in the scope of consolidation were:

- Applicability, due to the relevance in the truthful and correct representation of patrimonial, financial, and economic results;
- Availability of financial information; if not available, the entities should be excluded.
- Ownership of a shareholding in the entity, which should be more than 1% of equity.

This work was completed at the end of 2016 and identified 18 entities belonging to the first category. From this list, 10 entities were also included in the second category.

The next step was to define a methodology to bring the entities together in the consolidated financial statement. According to the law, there were two different methodologies:

a) The "parent company method," by which all items from the municipality and its entities must be added and evidence of the items not related to the municipality must be provided;
b) The "proprietary method," by which the items' values are proportional to how many shares the municipality has in the entities' equity.

From the AR method, we know that the Municipality of Ferrara chose the "parent company method" to obtain a complete record of financial and economic results and measure the consolidated public corporation's final equity. Managers and directors of all entities participated in the meetings organized for the process' development and contributed to the decision-making process. Moreover, many training exercises in human resources were organized to implement a precise items consolidation process.

This process required high levels of commitment and cooperation to abide by the law's principles. In this sense, the account consolidation process improves the relationship between the municipality and its own entities.

From the interviews, some specific insights emerged:

- Internal competencies and human resource skills were suitable to implement the new process, even if the innovative accounting tools were not easily understood, correctly applied, or implemented in a timely manner; more practice still seems necessary to hone the consolidation process' effectiveness;
- The municipality appears to assume a new strategic role, favored by the compulsory adoption of these innovative accounting tools.

The first consolidated financial statement was approved by the Municipality Council in September 2017 and referred to the financial year 2016. However, the harmonization and consolidation processes are still in progress.

Second profile of investigation. With reference to a more effective system of governance and accountability, results indicate that politicians are not ready to embrace increased public access to the financial statements promoted by the reform. The managers of the municipalities play a central role in making the most important decisions about the consolidation process. Indeed, politicians still do not seem to understand the relevance of this accounting system reform and the positive effects it may have on local governments.

Third profile of investigation. The third profile of analysis investigated the role of external accountability as the central topic. For the first time, local governments could catalyze interest in multiple business and professional fields (including general services, finance and business markets, healthcare, and other public administrations) to improve public value for all. However, these are opportunities that have not been realized yet. External accountability, in this case study, has not been pursued. The interviewees have admitted that citizens do not understand public accounting, and they do not entirely comprehend the consolidation process that the municipality is trying to implement.

At the moment, alternative accounting tools have not been implemented, mainly because the financial and human resources departments are concentrating their efforts to the implementation process of the consolidated financial statement.

The results also reveal that there are still some technical incongruences and limitations. Accounting systems applied by different entities were not homogenous, and the internal accounting program must be constantly updated to accommodate legislative requests.

5. Discussion and conclusions

The paper provides an accessible overview of the opportunities and challenges presented by public accounting systems innovations, with additional discussion on two research questions.

The first research question concerned the possible effects these innovations may have on local authority from an internal and external point of view. The case study analyzed the innovation in accounting processes in relation to the realization of the consolidated financial statement for the municipality. The results indicate that, from an organizational point of view, this process yielded some benefits. First, the organizational benefits were internal in nature. The development of new accounting tools fueled organizational awareness and the technicians' result orientation. However, some technical difficulties emerged, and the human resources involved in the project–even if sufficiently able to implement the process–still need to accrue further experience. Another positive aspect of the process regarded its external effects, which include intra-organizational benefits. Promoting a new form of cooperation increased opportunity for dialogue among the public managers, municipality, and entities involved in the consolidation process.

The second research question aimed to clarify the possible impact of innovation in public sector accounting on the relationships between managers, politicians and the community from an accountability perspective. From this point of view, the results do not support improvements in accountability, neither internal nor external. Internal accountability, which refers to the relationship between public managers and politicians, did not experience any benefit from the development of this process. Many politicians do not understand accrual accounting and feel more confident with cash accounting, which has been the traditional system for years. In addition, the communication flow from the executive bodies to the deliberative body regarding the consolidation process appear weak, scarce, and not very incisive. Promotion of external accountability seems fragile, as well. The accounting tools currently used by local Italian authorities are not accessible to the local community. Efforts to make these instruments, like the consolidated balance statements, more interpretable to average citizens appears necessary.

The exploratory analysis developed in this work presents a few research limitations. First, the results of a single case study may not apply to the generality of the local authorities. These results can, however, form a starting point for future discussion of accounting innovation and its possible impacts. Moreover, expanding this study, which has considered only the implementation process of the first consolidated financial statement of the Municipality of Ferrara, could reveal more insight into the subsequent evolution of this process over time. Finally, this study is centered on Italy's specific situation. It is possible that the results of this research do not depend on the relationship between accounting innovation and public sector organizations, but are specifically influenced by the Italian legislative context, national culture, and organizational context of local authorities.

In conclusion, the first elements of innovation seem to most dramatically affect the municipalities' organizational aspects. However, meaningful change in the monitoring of relationships between politicians, public managers, and the community seems to require a longer application path.

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