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<th>Generally unacceptable accounting principles : the Irish public finance accounts</th>
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Policy Discussion Forum

This section of the Quarterly Economic Commentary (QEC) hopes to foster debate on topics of contemporary relevance and importance for the Irish economy. Articles or comments on the topics put forward and recommendations for topics to be addressed can be set to the Editor of the QEC. The opinions expressed in this forum are not necessarily those held by the Editor or the ESRI. Indeed contrary views are most welcome to enhance the policy discussion this section hopes to engender.

Policy Discussion Topics

1. How Can Wage Bargaining Within Social Partnership be Best Modified?

2. Economic Adjustment in European Monetary Union: The Irish Experience

3. Are There Better Ways to Manage the Public Finances? (in this issue).
ARE THERE BETTER WAYS TO MANAGE THE PUBLIC FINANCES?

The Irish public finances have oscillated over the last thirty years from periods of large budget deficits, with accompanying unsustainably high national debt levels, to soaring budget surpluses in more recent periods resulting in a debt to GDP ratios among the lowest in the world’s industrialised economies. The system of public finance accounts in Ireland is made up two principal sets of accounts.

The first set is the accounts of the central government, or the Exchequer, and this has been the traditional focus of debate on the public finances particularly in the context of the annual Budget. The second is a set of broader general government accounts, which incorporate the Exchequer accounts along with those of local government and the state sponsored bodies. The general government definition is becoming increasingly more important since it is used for international purposes, most significantly in assessment of criteria for European Monetary Union membership and subsequently in relation to the EU Stability and Growth Pact.

Both the exchequer and general government balances have been in surplus since 1998. The general government surplus peaked at over €4.6 billion, or 4.5 per cent of GDP, in 2000. This surplus had declined to under €2 billion, or 1.7 per cent of GDP, in 2001 and the deterioration in the public finances has continued into the first half of 2002 with taxation revenues coming in below forecast and public expenditure growing at unsustainably large rates.

The aim of this discussion forum is to consider different ways in which the system of public finances can be managed in Ireland. The two articles that follow consider how the process of public finance management might be altered to provide greater clarity and relevance for fiscal policy making. Colm McCarthy assesses how the accounting conventions used in the present system could be altered to provide a more transparent set of financial statements. This could be achieved by a proposal involving full consolidation for the accounts set on an accruals basis. Jim Power addresses the issue of control of public expenditure and assesses how fiscal rules might provide an effective remedy to the problem of overshooting targets. The objective of any fiscal regime should be to control the quality of public expenditure as much as controlling the quantity it is argued.
GENERALLY UNACCEPTABLE ACCOUNTING PRINCIPLES: THE IRISH PUBLIC FINANCE ACCOUNTS

COLM MCCARTHY*

The Irish public finance accounts, familiar principally through the annual Book of Estimates, Finance and Appropriation accounts, are prepared in compliance with requirements which have been laid down over the years in various statutes. The Department of Finance periodically updates its manual on procedures, which contains an outline of the constitutional and statutory base for the current system of accounts.¹

The Irish Government accounts, of which the most widely cited is the Exchequer account, are prepared and published on a basis which is not consistent with the GAAP (Generally Accepted Accounting Principles) enunciated by the professional accounting institutes and the accounting standards bodies internationally. In more recent years, the Government has also prepared accounts on the “General Government” basis, in line with the requirements of the EU’s ESA 95 system. This system addresses some, but not all, of the weaknesses in the traditional accounts. The principal weaknesses in the Irish Government accounts are:

- They do not properly consolidate, and so ignore financial relations within the State sector. Thus revenues can be remitted to organs of the State, for example, which are not automatically credited to the Exchequer account.
- They are largely cash based, and ignore the accrual of revenues and of several categories of expenditure. Thus revenues earned, but not actually received, may not be credited. Expenditures incurred but not paid may be ignored.
- They do not normally include balance sheets, and thus fail to allow for depreciation and generally for the consumption of capital, and they do not systematically quantify certain types of Government liabilities or the annual increase therein.

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A consequence of these weaknesses is that the annual Budget process has regularly been accompanied by accusations that the Government has “cooked the books”, and that once-off accounting tricks have been used to disguise what is actually happening, and to impair the comparability of one year’s accounts with the next. The December 2001 Budget (for the year 2002) was an example. Four discretionary measures were criticised by economic and financial commentators as being one-off in nature and hence distortionary. These were:

(i) Corporation Tax receipts were accelerated, through an upfronting of payment dates. This would not be possible with proper accrual procedures.

(ii) A receipt from the Social Insurance Fund, in which a surplus had been allowed to build up, was taken into the Exchequer. This would not be possible if proper consolidation procedures were in place, which, in this instance, would count all social insurance taxes as current budgetary receipts regardless of whether or not they were actually transferred to the Exchequer account. The surplus or deficit of the Social Insurance Fund would simply be added on to the budgeted Exchequer total automatically, as happens when there is a deficit, but not when there is a surplus.

(iii) A once-off payment was taken from the Central Bank, to correspond with the profits the Bank was deemed to have made through the loss or destruction of currency in issue. This need no longer be shown as a Central Bank liability, since it will never be presented for payment. There is a mixture of accrual and consolidation issues here. The Central Bank surplus should in any event be consolidated, and the particular surplus arising in this instance has arguably accumulated over decades, and should have been accrued as it was earned. It was taken in this year to coincide with the replacement of currency in issue consequent on the introduction of the Euro, an event which may have fortuitously drawn attention to these profits but which certainly did not give rise to them all at once.

(iv) A further once-off item of budgetary “income” from the Capital Services Redemption Account, a sinking fund for Irish Government Debt. This is both a consolidation and an accrual issue. The Government owns the sinking funds just as it does the Social Insurance Fund or the Central Bank. In standard accounting practice, interest costs expensed annually, but not the build-up of funds designed to liquidate debt.

Note that some of these items could serve to understate the surplus (or overstate the deficit) in a particular year, in the absence of discretionary action, so the departures from GAAP do not always work to flatter the figures. In addition to these explicit measures, there has also been a pattern of massaging the previous year’s deficit (or surplus) through cash manoeuvres at year’s end, designed to make year-on-year comparisons look more flattering, an accruals issue. Prior to the emergence of the short-lived Exchequer surplus, this usually took the form of inflating the deficit for the year just gone, through the acceleration of cash disbursements, the better to downplay the size of deficit emerging for the year to come. In sum, the figures given in Irish Budgets over the years have at times shown a better, and at others a worse, fiscal balance than was actually the case.
had recognised accounting procedures been used. The accounts can be massaged annually, in either direction, at the discretion of the Government.

It would not be possible for an auditor bound by GAAP to certify these accounts as giving a “true and fair view” of the financial condition of the Irish Government. The same is true of public finance accounts in many countries, but some Finance Ministries have made substantial progress towards the production of State accounts on a reformed basis. These reformed accounts are designed to provide a regular annual assessment of the State’s financial condition on a consistent basis comparable to that required by law from companies and organisations outside the State sector. Important ancillary objectives are to measure capital consumption by Government, to quantify the State’s deferred and contingent liabilities, and simply to provide a consistent basis for comparing the fiscal position in one year with the previous or subsequent years.

Aside from the unsatisfactory condition of the accounts themselves, the prevalence of these once-off accounting stunts, and the latitude which they afford to the creative instincts of both Government and opposition parties, have become a political distraction. In the recent General Election, the early phase of the campaign was taken up with exchanges between the parties on the credibility of their fiscal projections, including a futile attempt to have the figures independently checked by a committee of economists. The controversy fizzled out, but would never have arisen in the first place if a solid platform of credible fiscal information had been available from official sources.

In Ireland, the Companies’ Acts require that companies keep proper accounts, that these be independently audited and that the auditor certify that they give a “true and fair view”. A new State office (the Office of the Director of Corporate Enforcement) was established under statute in 2001 in order to improve compliance with these and other statutory requirements. Were the Irish Government’s own accounts covered by this new oversight body, the application of the accounting norms of the Companies’ Acts would prove embarrassing.

The European Union has introduced a new standard for the macroeconomic and public finance accounts which addresses these issues only in part. Governments in the EU must now present, as well as the traditional Exchequer-type accounts, an estimate of the General Government deficit (or surplus). The ceiling of 3 per cent for State borrowing under the EU’s Stability and Growth Pact is specified in terms of the deficit of General Government. As its name implies, this new standard specifies a particular definition of Government, and is thus concerned principally with the consolidation issue. It is not unfortunately the case that the EU standard, called ESA 95, deals fully with consolidation issues, nor does it address adequately the accruals and other areas of deficiency in State accounts.

The Government made provision, as far back as the 1994 Appropriation Act, for the preparation of accruals-based accounts, and a pilot report on accruals-based accounting in one of the Departments (the then Department of Transport and Communications) was released in 1996. The Appropriation Accounts now contain accruals adjustments on the expenditure side for all Government departments, but this
requirement does not descend to the ultimate spending units. Thus any unpaid bills at the Department of Health at year’s end, including amounts due to Health Boards and other “subsidiaries”. In addition to the expenditure accounts of Government departments, the key area in which accruals adjustment is required is of course revenue, but the current strategy statement of the Revenue Commissioners does indicate that any milestones have been set in this regard.

At present, the Irish Government produces two principal sets of accounts, the traditional Exchequer-based accounts and the General Government figures in accordance with ESA 95. It seems to me that there ought to be a new set of accounts, which I will call GAAP accounts for want of a better term. The Exchequer accounts, which have become increasingly meaningless, would be abolished and replaced with the cash-flow statement corresponding to these GAAP accounts, and the ESA 95 accounts would still have to be produced to meet EU obligations. While the design of these GAAP accounts would need to be quite detailed, four key questions would need to be addressed in order to overcome the main shortcomings of the present system. These relate to accruals, consolidation, capital consumption and provision for liabilities.

ACCOUNTING FOR ACCRUALS

The notion that meaningful accounts cannot be just cash accounts does not need to be laboured. Tricks involving revenue acceleration are familiar to Irish economy-watchers, and arose when VAT was imposed on imports at point of entry in the 1980s, and on several intervening occasions when payment schedules for Advance Corporation Tax (as it then was) or Corporation Tax were modified. The Government has also frequently juggled the prior-year Exchequer figures on the expenditure side, through the timing of once-off cash payments to agencies and to underfunded State company pension schemes for example, and through end-of-year massaging of cash management generally.

Companies governed by the Companies Acts and the professional bodies’ accounting standards have no incentive to resort to these manoeuvres for profit enhancement because the accruals adjustments will negate their effect, although they may well pursue early payment for other reasons, including credit risk and minimisation of working capital costs. ESA-95 requires that State revenue be accounted for on an accruals basis, but permits benefit to be taken for a permanent acceleration of due payment dates. As a result, the Corporation Tax acceleration in 2002 is allowed to benefit the deficit calculation on the General Government definition, and will presumably continue to do so in the years ahead. Whether this would be acceptable in a GAAP framework is at least debatable.

CONSOLIDATING THE GOVERNMENT SECTOR

Those familiar with ESA 95 will know that it achieves consolidation of central and local Government, for example, and it seeks to ensure that no significant pockets of extra-budgetary spending or revenue are left uncounted in social security funds or in hypothecated taxes for specific
purposes. It also lays down rules about the treatment of financial transactions between Government and State-owned commercial enterprises. There are four main consolidation issues raised by recent and proposed Budgetary measures in Ireland. These are the treatment of the Social Insurance Fund; of transactions with the Central Bank; with the National Pensions Reserve Fund; and finally with the new National Development Finance Agency proposed in the Programme for Government of the incoming Fianna Fáil/PD administration.

Clearly the Irish Social Insurance Fund is a part of General Government on any practical definition. It collects what are in effect taxes, and disburses current spending. Its activities should be fully consolidated, regardless of whether any actual transactions flow between the Fund and the Exchequer, and this is what ESA 95 requires. Thus the annual surplus/deficit on the Social Insurance Fund is consolidated properly under ESA 95, and once-off transfers are ignored.

Transactions with the Central Bank have to date consisted of annual dividend payments and the once-off payment in 2002 already discussed. In the past the undistributed profits have been left to accumulate on the Central Bank’s books. These amounts are now substantial and the Bank can be expected to continue to earn substantial profit in the form of interest earnings in the years ahead. The original sources of the Irish Central Bank’s profitability were the normal seignoirage profit on the note issue, plus the payment of sub-market interest rates on certain categories of liquidity required of financial institutions, a kind of unlegislated indirect tax on financial intermediation.

The Central Bank of Ireland showed net assets of approx. €3 billion at December 31st, 2001, these being the sum of the item Capital and Reserves and the item Revaluation Accounts in the reported balance sheet. The assets include an amount of €429 million corresponding to Ireland’s contribution to the reserves of the European Central Bank, and it is conceivable that a further amount could arise under this heading. But the Euro floats against the dollar and yen, and it is unlikely that the ECB will need to add to its substantial intervention capability. Were the view to be taken that member State Central Banks no longer require to carry large net worth, given the diminution in their role since the establishment of the European Central Bank, then a portion, perhaps a very large portion, of the Irish Central Bank’s net worth could be transferred to the Exchequer over the next few years. Since the State already owns these amounts, a GAAP-based measure of fiscal balance would not be affected by any such transaction. ESA-95 would appear to leave open the possibility that credit could be taken for certain categories of Central Bank disbursements to the Government in computing the General Government deficit.

The once-off transfer in 2002 from the Central Bank was credited in the Budget statement to both the traditional Exchequer Borrowing definition and to the General Government (ESA 95) definition of fiscal balance, and thus ESA 95 does not appear to consolidate Central Banks in a manner which would accord with GAAP. Thus future transfers of accumulated Central Bank profits, which should have been accounted for in consolidated accounts as they arose, would appear to be available to “reduce” both the Exchequer Borrowing Requirement and the General Government Deficit. The amounts are potentially significant.
The National Pension Reserve Fund is currently being invested in a portfolio consisting principally of international equities. Under ESA 95 rules, it must be consolidated as part of General Government, and any changes to the contribution rate would not affect the deficit on the GGB definition, and thus would not help to keep the deficit below the 3 per cent limit of the Stability and Growth Pact. Interest and dividend earnings on the Fund are also treated as Government revenue under ESA 95. If a future Government were to raid the Fund, or indeed to wind it up, this would affect the Exchequer position as currently measured, but would not change the GGB position. An unresolved issue is what happens as the assets of the Fund are marked to market each year. Under a GAAP system, the gains or losses would have to be recognised at some stage, and there is a case for prompt recognition. Indeed under the accounting standard FRS 17, corporate defined-benefit pension funds are now required to recognise gains and losses and to show pension fund deficits in the accounts.

The National Development Finance Agency is proposed in the Programme for Government as a vehicle for raising finance for the State’s public investment programme. Unless its borrowing can be kept off the books on the GGB definition, it is difficult to see a rationale for this new Agency, which is to be managed, like the National Pension Reserve Fund, by the National Treasury Management Agency. It is clear that plain vanilla issues of Exchequer paper are likely to be the cheapest source of State funds. At this stage, it is not clear what financial instruments will be used by this new body, and accordingly it is difficult to see to what degree they will prove effective in taking some State financing outside the GGB definition. If they are effective in the context of Eurostat’s interpretation of ESA 95, it does not of course follow that a GAAP-based system would treat them in the same way. Network Rail, the new Government-sponsored successor to Railtrack, will be able to keep borrowings off the UK Government accounts while staying within ESA-95 rules, according to a determination already made by the UK’s Office for National Statistics. UK financial commentators have remarked that GAAP-type rules would prevent a private company from doing this, and the UK’s own ongoing public finance reforms could have the same effect.

Finally the Programme for Government also contains proposals for a Transformation Fund into which future privatisation proceeds could be paid, the intention being that these could also be used to help finance the Public Capital Programme. ESA 95 appears however to be quite explicit on the treatment of State equity disposals, which could not be used to cut the deficit on the General Government definition.

**CAPITAL CONSUMPTION**

State expenditure programmes often consist largely of cash, as would be the case for disbursements of social security payments. But other programmes can include large elements of capital consumption. The Appropriation Accounts as currently published do not deal adequately with the consumption of capital through comprehensive depreciation provisions, even though many Departments consume large budgets for asset replacement via the Public Capital Programme. The consumption of capital is a current cost of service provision, and there is a danger that true
current costs are understated unless asset values are computed and adequately depreciated annually.

The Appropriation Accounts for 2000 for two large spending departments illustrate this point. The Department of the Environment and Local Government funds the bulk of the road maintenance and investment programme, the water services programme, and the provision of public housing. The scale of assets involved is illustrated by the maintenance and capital expenditure. The capital and maintenance spend for roads was €672 million in the year 2000, with €525 million for housing, and €425 million for water/sewerage. The total depreciation charge shown for the entire vote is under €1 million, since it relates only to the depreciation of assets at central department level. Nothing else is shown in the “balance sheet”, which lists only the very modest assets and liabilities of the department, when the operating assets used in delivering services are elsewhere. Similarly, for the Department of Health and Children, where €273 million was spent on hospital building alone, with a depreciation charge of under €1 million for the entire vote.

Consolidated balance sheets, including local authorities and Health Boards, with explicit treatment of maintenance expenditures and depreciation charges, are necessary in order to quantify the actual costs of the services being delivered by the programmes financed through these departments.

**PROVISION FOR LIABILITIES**

If a company’s accounts contain once-off “extraordinary” or “exceptional” items year after year, financial analysts will be tempted to conclude that these are not really once-off at all, but rather that there is a systematic tendency to under-provide for expenditures that keep on arising. The company auditors are required to certify that all reasonably foreseeable liabilities have been explicitly provided for, and that contingent liabilities are fully recorded. There are conventions governing the conversion of contingent liabilities into actual provisions.

This is an area in which the Irish Government accounts have long been deficient. Pay awards in the public sector are rarely provided for fully in the Estimates, and there is widespread failure to insure risks, or to build claims reserves where self-insurance is chosen. For example, bad weather regularly results in “once-off” compensation payments to farmers, but good weather does not result in flows in the opposite direction. Claims against the (now discontinued) Export Credit Guarantee scheme were never provided for, even though cash receipts for premium income were taken in as Exchequer revenue. A private insurance company which behaved in this manner would have had its license revoked. The cash cost of, for example, the Army deafness claims, or the payments arising from the Hepatitis affair, are simply added to current spending as they arise. A more recent example relates to the sexual abuse claims against the Catholic Church and various religious orders, where the State has capped the liability of the latter but has made no provision for its own liability which is uncapped.

The Irish Budget accounts now contain a general contingency provision, and the figures are very substantial. For 2003 and 2004, the figures are €1050 million and €1550 million respectively, as given in the 2002 Budget. The note accompanying the Table states simply:
This is a contingency provision against all budgetary costs which cannot be quantified at this stage.

A number of comments are in order. Such a large global contingency (averaging around 1 per cent of GDP) is surprising, as is the unexplained large jump from 2003 to 2004. But the failure to provide for specific individual liabilities is the feature which is most striking, and it is difficult to accept that not one of them is capable of explicit quantification.

The Irish State sector does not, as a rule, insure itself against risks. The exceptions are the commercial State companies, and the local authority/health board sector, which insures some but not all risks through a mutual insurer, Irish Public Bodies which is owned by its clients. The rest of the State sector pays no premiums, makes no provisions, has no claims reserves, and simply picks up the tab on a pay-as-you-go basis. A recent reform will see the National Treasury Management Agency assume responsibility for a new State Claims Agency, designed to administer claims centrally and hopefully to improve cost containment, but there are no plans to alter the accounting treatment for liabilities of this type.

A number of countries around the world are engaged in a fundamental reform of public sector accounts, designed to bring them into line with Generally Accepted Accounting Principles. These include Australia, Canada, Sweden, the United States, as well as two whose progress we summarise below, the United Kingdom and New Zealand.

The motivation for these public sector accounting reforms is different from the perceived need to subject company accounts to the rigours of GAAP. Companies issue publicly-traded equity and debt securities, they borrow from banks and take credit from business counterparties. The public assessment of credit risk and the valuation of traded securities would be inhibited in the absence of accounts prepared to a high standard, as recent failures to meet required standards have dramatically demonstrated. The governments which have chosen to reform their public finance accounts to accord with GAAP are, however, mainly those rated AAA by Standard and Poors, and would doubtless command that rating regardless of the way they present their accounts. The motivation has been good housekeeping rather than the need to keep markets happy, as the UK and New Zealand examples demonstrate.

The United Kingdom Government has been engaged for a number of years in a progressive reform of the UK’s public finance accounts, a process described in detail in a series of documents available on HM Treasury’s website. These reforms go well beyond compliance with ESA 95 and the associated EU statistical directives, and the Treasury documentation makes it clear that the motivation for the reforms is the desire for more meaningful accounts rather than EU compliance.

The UK completed the transition to a full accruals basis (RAB, for “Resource Accounting and Budgeting”) for all Government accounts in April 2001, and the target for full consolidation of all public service accounts (“Whole of Government Accounts”) is the financial year 2005/06. This will be achieved for central Government in 2003/04. The entire process is statutory, in accordance with the Government Resources and Accounts Act 2000. The Treasury states the motivation for the reforms in the following terms:
The Code for Fiscal Stability commits the Government to producing accounts for the whole public sector on a consolidated basis where reasonably practicable. It also commits the Government to applying best-practice accounting methods – UK GAAP adapted for the public sector – in the production of its accounts. GAAP-based WGA will be fully auditable, yielding additional confidence in their reliability and will be based on established accounting practice providing a true and fair view of the Government’s financial performance. They will therefore provide better transparency and accountability to Parliament as well as greater certainty to fiscal planning.\(^2\)

The New Zealand Government commenced the move to GAAP-based accounts as far back as 1989, and the accounts have been fully accruals-adjusted since 1994. The statutory basis is in the Public Finance Act 1989 and the Fiscal Responsibility Act 1994. In explaining the grounds for the reforms, the New Zealand Treasury states:

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\text{In the past, the New Zealand Government used its own set of accounting rules. The accounting rules under GAAP are made by a body independent of the Government. This requirement therefore adds to the integrity and credibility of the Government’s statements. Furthermore, GAAP is the set of rules followed by businesses in New Zealand. This familiarity means government statements are easier to understand, adding to their transparency.}^3
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The adherence of Ireland to the ESA 95 rules in the preparation of national and government sector accounts does not bring the accounting standards for the public sector in line with GAAP, although the consolidation and accruals rules under ESA 95 eliminate some of the distortions possible under the old system. In order to fully modernise Irish Government accounting it would be necessary to legislate afresh, requiring compliance with GAAP, including full accruals adjustment and proper consolidation. The traditional Exchequer cash accounts would be abolished, to be replaced by a GAAP-based cash flow statement. A full balance sheet statement would facilitate better depreciation computations, as well as mark-to-market adjustments for State financial assets and liabilities. The Comptroller and Auditor General in this scheme of things would be required to certify annually that the accounts give a full and fair view, and that they are comparable with the out-turn for the prior year and with the budgeted figure for the year ahead. The Comptroller and Auditor General would be quite unable to so certify under current arrangements.

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2[www.wga.gov.uk/pages/faq](http://www.wga.gov.uk/pages/faq)