

Presentation of Accounts and Accountability

1. Modernisation of public-sector financial management and accounting

In August 2006, the Bundesrechnungshof reported to the German Parliament about the need for modernising public-sector financial management and accounting. In this report, the German SAI provided an overview of previous approaches towards the further development of federal budgetary law since 1998 and demanded further steps towards a comprehensive reform process. Details are given below:

Based on the Budgetary Law Reform Act, initial steps designed to modernise public-sector financial management and accounting system have been taken since 1998. The traditional cash-based budgeting and accounting system was supplemented by the (voluntary) introduction of cost and performance accounting. Increased cost transparency is to enhance the potential for steering the provision of public services and improving performance. Another legislative objective was to achieve greater financial management flexibility without diminishing the budget authority of Parliament. At the same time, more discretionary powers were to be given to the managers of public funds, thus enhancing their motivation and their self-interest in an efficient use of resources.

According to our findings, the modernisation objectives laid down in the Budgetary Law Reform Act for the federal administration have not been fully achieved. Budgeting and budget implementation in federal departments and agencies continue to be based on input and expenditure while too little attention is paid to managerial data. No thorough improvement of cost transparency and steering has been accomplished. What has been missing so far is a comprehensive approach that systematically focuses on the need, design and implementation of a reform of the public-sector financial management and accounting system. While important ground work has been laid for modernisation and impetus has been given, further efforts will be necessary to inform administrative planning and action with managerial thought.

Further reform approaches have emerged in Germany's constituent states and internationally. These range from an overall expansion of the existing cash-based accounting system to the

introduction of fully-fledged accrual accounting. Given the systemic weaknesses of cash-based accounting, a wide consensus has evolved in Germany that a fundamental reform of the public-sector budgeting and accounting system is needed. The ideas developed tend to be based on a concept of resource consumption that also discloses the losses of asset value which are not reflected in payments. Furthermore, many experts advocate a transformation of the input-oriented budgeting process into an output-oriented system of performance budgeting.

In the face of a wide variety of reform efforts in Germany's constituent states and local authorities as well as on the international and supranational level, of which some are far advanced, the Bundesrechnungshof perceives the danger that, in the long run, the results disclosed in the budgeting and accounting system are no longer comparable both nationally and internationally. Especially in the case of Germany's Federal Government and constituent states, budget structures should be similar to ensure the consistency and comparability of data. Retaining largely uniform budgeting and accounting systems at federal and state level is highly desirable for the sake of efficiency.

Therefore we asked the Federal Government to consider more extensive modernisation approaches to launch a comprehensive reform process. Based on a fundamental analysis taking into account the special features of the federal budget with its large volume of transfer payments, the pros and cons of the various options for designing an accounting system should be compared and evaluated.

We make available our experience and knowledge in the modernisation process also in order to make sure that the requirements of external government auditing will be taken into account right from the start.

The following aspects will be of major importance for us:

- safeguarding Parliament's authority over the budget including parliamentary oversight,
- taking more regard to intergenerational equity by allocating costs to the periods in which they have accrued,
- converting the traditional 'capital accounts' into a fully-fledged balance sheet,
- strengthening output orientation by defining products and objectives,
- bringing operational and financial responsibility together (flexible budgets),
- transparent presentation of government action (e.g. costs, performance, key figures),

- special features of the federal budget when compared to constituent states and local authorities.

The Federal Ministry of Finance concurs with our views. In October 2006, it established a task force which is to thoroughly consider a change of system towards performance-based budgeting and to explore the potential for introducing accrual accounting. In this endeavour, we cooperate closely with the Federal Ministry of Finance and will support the work of the task force by communicating information about the findings developed and lessons learnt by its auditors.

2. Transparency of budget risks

Long before the current considerations about a fundamental modernisation of the financial management and accounting system, we studied the problem of existing budget risks. In its 1998 annual report, it made thorough efforts to identify the burdens and risks for future budgets not stated in the appropriation and capital accounts. We reported to Parliament about the burdens on future federal budgets which were caused in previous financial years but will lead to actual expenditure only in future financial years. The biggest risks affecting federal budgets stem from indebtedness and the resulting debt service payments, the commitment of future years' funds and the contingent liabilities with respect to public service retirement benefits. Further risks are involved in the growing volume of sureties, guarantees and warranties assumed. These burdens considerably reduce the Federal Government's scope for fiscal policy decisions.

In our view, all payment commitments and the existing expenditure and revenue risks should be disclosed so as to informing the budget legislator as completely as possible about the potential burdens and risks which, while created in the past, affect future budgets. The budget legislator needs to be completely informed about these data in order to fully take into account the financial factors that affect the implementation of its policy objectives and to be aware of the potential outcomes of its decisions.

As a result of our efforts the financial plan to be submitted annually by the Federal Government includes an outlook on federal budget trends beyond the five-year financial planning horizon. E.g. the financial plan for FYs 2006-2013 includes an overview of potential burdens and risks to the federal budget which originated in the past and will in the future

materialise in the form of interest expenditure, pension payments, payments under warranties, commitment authorisations, private pre-financing of public works and payments from separate property funds. Based on statutory obligation, the Federal Government submitted a Pensions Report during each legislative period of the German Parliament. This report has to state and analyse pension payments of the past, present and future for the entire public service in Germany. This report provides initial evidence about constraints on future budgets that have originated in the past.

What the approaches considered so far have in common is that they provide additional information for fiscal policy in the form of supplementary reports. What is missing, however, is an integrated system that presents all relevant data in a straightforward and correlated way. A modernised budgeting and accounting system can make a substantial contribution towards a more transparent presentation of relevant information.

Especially since 2001, we have pressed for further development of the Federal Government's capital accounts. So far, the Federal Government has not had any complete oversight over its assets and liabilities. We feel that it is necessary to enrich the capital account with additional data and to convert it in the medium term to an informative and reliable information and steering tool for Parliament and the Federal Government. Apart from federal debt, the liabilities stated should include contingent liabilities (e.g. provisions for pension liabilities, warranties, omitted repairs and clean-up of contaminated sites). Ancillary budgets so far not included in the general federal budget should be integrated. A capital account enriched in this way would constitute an important contribution to the financial reporting of future financial constraints and budget risks originating from past action or omission.

Little progress has been made in complementing the federal capital account. We consider this as an important issue. It will take up this issue again in connection with the discussions about options to modernise the public-sector financial management and accounting system.

3. Fiscal consolidation

In our annual report, we also makes statements on the trend of federal public finance concerning the current annual federal budget, the planning of the next budget and federal medium-term financial planning. To do so, we analyse the fiscal situation and draw attention to particular budget risks and developments that give rise to concern.

In reporting on the fiscal trend delivered during recent years, we addressed the impact of the soaring public debt and recommended stronger budget consolidation. We repeatedly pointed out that the increasing public debt results in growing interest expenditure and thus continuously narrows the scope for fiscal policy decisions, especially with respect to future budgets. We highlighted the danger that the increasing borrowing for the purpose of repaying old debts due (follow-up financing) results in interest expenditure to become due in connection with loans that were used to fund assets which in fact no longer exist. The further increase in the interest burden causes a shortage of funds that can be used to incur capital expenditure in economically important fields (e.g. in infrastructure, research, education). The federal budget is stuck in the 'debt trap'.

In addition, we pointed out the structural problems in the federal budget that affect both expenditures and revenues. Growing social expenditure, above all for the retirement benefit programmes and the labour market have coincided with a stagnation of tax revenues. The proportion of capital expenditure in the budget total has declined continuously. The arising funding gaps were closed by transactions generating non-recurring proceeds (sale of shareholdings and receivables) and increased net borrowing. Additional adverse factors to be considered are the burdens and risks for future budgets that have been described under item 2 above.

Given these developments, we advocated that the upward trend in the business cycle and the resulting increases in tax revenue should consequently be used to limit net borrowing. This step could contribute to sustainable budget consolidation.

Furthermore, the consolidation process should be encouraged by an effective legal or even constitutional provision imposing a borrowing limit. The German Constitution currently demands that the proceeds from borrowing must not increase total budgeted capital expenditure ('golden rule'). Exceptions are admissible only to avert a disturbance of the overall economic equilibrium. In our view this constitutional provision on the borrowing limit has turned out to be inadequate for restricting the growth of indebtedness. Therefore, we suggested that a legal provision should be developed under which borrowing to finance the budget expenditure will be ruled out altogether in times of normal economic development. As an interim step, at least the way of calculating capital expenditure, which is decisive for determining the borrowing limit, should be redefined. Above all, proceeds from the sale of assets should be deducted from capital expenditure because they reduce total assets. The same applies to the proceeds from granting loans and from claiming compensation under

warranties. In addition, the depreciation affecting all tangible fixed assets should be taken into account to prevent re-investment, i.e. capital expenditure incurred only to preserve asset value.