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**How useful is consolidation
of public sector entities' financial
statements?**

Working paper / IDHEAP - 2013

Chaire de Finances publiques
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Abstract

Whether or not to consolidate financial statements is dealt with in IPSAS#6. This standard is by and large based on IAS#27. It deals with the criterion according to which an entity's financial statements should be considered and which consolidation technique should be used. However, it remains silent when it comes to exposing the reason why a public sector entity should consolidate its financial statements. The literature is almost as silent as IPSAS on this issue. Which means that there is a lack of both theoretical and empirical knowledge on this subject. This paper explores the usefulness of the consolidation of financial statements (CFS) for different categories of users. It aims at investigating for which purposes consolidation is most useful and whether enlarging the scope of the consolidate group serves these purposes. Five purposes are considered: information, decision-making, accountability, risk-assessment, statistics improvement. The paper also aims at investigating if some categories of users consider CFS more useful than others. The issue is essentially empirical. Therefore it is examined in light of the results of an in-person interviews. We surveyed 25 members of parliament, officials, creditors, and consultants of the Swiss central government. The results show that consolidating FS is considered especially important and useful for risk-assessment, information and accountability and to a somewhat lesser extent for decision-making and statistics improvement. Extending the scope of CFS may improve the situation when it comes to statistics but it would only marginally make CFS more relevant for decision making. Consultants and, to a lesser extent, members of the finance ministry are those respondents who deem the scope enlargement to be the most useful.

Key words: Accounting, Consolidation, IPSAS 6, Survey, Users' needs

JEL Classification: H83 (Public Administration; Public Sector Accounting and Audits)

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1. Introduction

The act of consolidating accounts involves combining the financial statements of several entities belonging to the same group in order to publish them as if they were, in fact, the accounts of a single undifferentiated economic entity. This type of act is regulated by the IPSAS 6 standard (International Public Sector Accounting Standard—Consolidated and Separate Financial Statements). This standard is largely inspired by the IAS 27 standard (International Accounting Standard). In essence, the IPSAS 6 reiterates several elements from the IAS 27, in particular with respect to the requirements of the preparation and presentation, the definition of the scope of consolidation and which consolidation procedures to use.

However, the IPSAS 6 does not address the fundamental rationale for consolidation nor what interest there may be for a public entity to engage in this exercise. This is a regrettable oversight. It is quite easy to understand why consolidating is useful in the private sector: in this sector, a company's financial responsibilities are defined according to essentially legal criteria. The definition of the scope of consolidation is thus simplified. This makes it possible, with relative ease, to define any risks that a company's creditors must undertake.

In the public sector, the usefulness of an essentially legal definition of the scope of consolidation must be relativized. Recent history and the saving of various financial institutions by public entities have shown that a legally defined scope should be relativized. Essentially, the consolidated statements that several governments could have offered before the 2008 financial crisis would not have educated the creditors of these governments regarding the risks they were taking. As a result, consolidating statements in accordance to IPSAS offers but an artificial vision, or, at the very most, a partial vision of reality.

Which is why this question of whether or not it is useful to consolidate public statements according to this standard needs to be addressed. This is the precise goal of this present study.

This paper explores the usefulness of the consolidation of financial statements (CFS) for different categories of users. It aims at investigating for which purposes consolidation is most useful and whether enlarging the scope of the consolidate group serves these purposes. Five purposes are considered: information, decision-making, accountability, risk-assessment, statistics improvement. The paper also aims at investigating if some categories of users consider CFS more useful than others. The issue is essentially empirical. Therefore it is examined in light of the results of an in-person interviews. We surveyed 25 members of parliament, officials, creditors, and consultants of the Swiss central government.

The survey developed out of the fact that, so far, the federal government has included in its consolidated financial statements only a portion of the entities it should have included in order to conform to the IPSAS 6 standard. The question then becomes—what is the usefulness of enlarging the scope of consolidation, aside from the fact that this expansion serves formally to respect the standard.

Following this brief introduction, we will discuss the literature that deals with the usefulness of financial statements (Section 2). Section 3 will provide an explanation on the methodology used and the context within which the methodology was applied. Section 4 presents the results of the study. Finally, the article concludes with a synthesis of the project and related discussion.

2. Literature

There is very little existing literature that deals with the usefulness of public financial statements. Existing references are limited to listing users of financial statements (for whom?) and identifying the ways in which users make use of them (for what?). Public financial statements must respond to the requirements of a greater number of involved parties compared to their equivalent in the private sector. For the latter, they are meant for, “existing and potential investors, lenders and other creditors” (IFRS, 2010). The Conceptual Framework of IPSAS holds that “the primary users of GPFRs are service recipients and their representatives and resource providers and their representatives” (IPSAS Board, 2013, p.11). This includes, “citizens [...], residents who pay taxes and/or receive benefits but are not citizens; multilateral or bilateral donor agencies and many lenders and corporations that provide resources to, and transact with, a government; and those that fund, and/or benefit from, the service provided by international governmental organizations” (p.11). Other users are then added to this first circle: “For example, government statisticians, analysts, the media, financial advisors, public interest and lobby groups and others” (p.11).

The Conceptual Framework brings to light a variety of needs to which financial statements must respond. Included are the needs generally cited in the literature—including those dedicated to the private sector—even if the literature doesn’t offer, to our knowledge, a generally accepted typology. Looking more specifically at the needs that consolidated statements must meet, the most general need is one of information (Gräfer 2012, Meyer 1993). Among the more specific needs are those linked to decision-making (Bergmann et al. 2006, Küting 2001, IPSAS Board 2013). Needs related to accountability are commonly mentioned (Grossi & Pepe 2009, Gleich 2006, IPSAS Board 2013). Needs related to risk detection and financial position evaluation are also highlighted (Gräfer 2012), as are the needs for statistical reports (Grossi & Pepe 2009).

Beyond these categories of users and needs, the degree with which financial statements actually satisfy these needs is hardly discussed and even less studied. Nevertheless, the Conceptual Framework of IPSAS anticipates that “The objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users of GPFRs [General Purpose Financial Reports] for accountability purposes and for decision making purposes” (IPSAS Board, 2013, p.11). It also states, however, that “Financial reporting is not an end in itself. Its purpose is to provide information useful to users of GPFRs” (p.11).

Nonetheless, as McDaniel et al. (2002) point out, the quality of financial reporting theoretically depends on the usefulness of the accounting information for the user. The value of the information thus depends on the user of the information. This is a fundamental postulate of welfare economics. Furthermore, to obtain the value of a good or a service one “must ultimately rely on the individual’s own evaluation” (Layard 1972, p.10).

The precise goal of this article is to contribute to the development of a mode of thinking about financial statements that will take into consideration their usefulness with respect to users. This is in line with the preoccupations of the Conceptual Framework and attempts to respond to the following: “The benefits of financial reporting should justify those costs. Assessing whether the benefits of

providing information justify the related costs is often a matter of judgment, because it is often not possible to identify and/or quantify all the costs and all the benefits of information included in GPFs (IPSAS Board, 2013, p.31). Cohen & Karatzimas's recent contribution (2013) is also interested in this question but considers it with respect to all financial statements while we are only interested here in consolidated statements.

3. Data and Method

The method we selected consisted of holding interviews with a sample of experts; interviews were conducted using an interview framework. The context of the survey takes advantage of the questioning on the scope of consolidation adequate for the Swiss Confederation. In essence, the Swiss Confederation has been publishing its consolidated financial statements since 2009. However, the scope of the performed consolidation does not completely correspond to that which is required by the IPSAS 6 standard. In particular, it does not include certain significant participations. Neither does it include social security funds. Our analysis is meant to discover whether it is worth it for the Confederation to enlarge its scope, independently of the fact that extending the scope would enable the Confederation to better conform to IPSAS standards.

Working via interview enabled us to collect responses to the closed-ended questions included in the interview framework. It was also a way to gather more detailed comments and interpretations. 25 experts were questioned. Table 1 provides details regarding expert backgrounds. Interviews were conducted face-to-face with three exceptions (one telephone interview, two written responses). In consideration of the fact that a single observation represents the group of entities to include in the scope of consolidation, we included this observation in the largest group of individuals in charge of consolidation with the members of financial administrations. In this way, we had six groups which could then be regrouped into two categories. On the one hand, statement users such as members of parliament, investors, and scholars. And on the other, and broadly speaking, statement producers: finance administration and entities to be consolidated (consolidators), State auditors, consultants.

Table 1 Background of surveyed experts

Category	Background	Num.
Users	National Parliament	4
	Investors	4
	Academia	2
Producers	Finance administration	3
	Confederation	5
	Cantons	5
	Consolidators	1
	Federal Railway	1
Auditors	2	
Confederation	2	
Consultants	4	
Total		25

The interview framework was transmitted several days before the interview and each interview lasted between 60 and 90 minutes. The largest part of the framework consisted of closed-ended questions relating to the needs to which a consolidation should respond. To do this, we used a typology we constructed upon completion of the literature review. Five types of needs were outlined (here in alphabetical order): accountability, decision-making, information, risk, statistics. Table 2 provides details on the content of these five types as they were presented to the experts questioned.

Table 2 Types of needs to which consolidation must respond.

Accountability	Consolidated statements contribute to better transparency and therefore to better accountability from the Confederation toward users
Decision-making	Consolidated statements can be used by both internal and external users as a help and foundation for guidance and mid-term and long-term planning
Information	Consolidated statements bring additional information that existing financial statements do not provide
Risk	Consolidated statements bring important information regarding the situation of the Confederation in terms of risk and finance, including consolidated entities
Statistics	Consolidated accounts offer financial data and additional statistics which can be used for research or by rating agencies. This would increase Switzerland's comparability with other countries.

For each type, three closed-ended questions were posed. A first question (Question 1) asked respondents whether they considered that consolidation—in its current scope—met the following needs: accountability, decision-making, information, risk, and statistics, with four possible levels of agreement : true statement (4), mostly true statement (3), mostly false statement (2), false statement (1)¹. This first question was thus about the **current response to expectations**. It enables us to judge whether the consolidation, as it is currently practiced, responds to expectations. The numbers mentioned in parentheses correspond to the way in which each response was coded with a view on results analysis.

A second question (Question 2) asked respondents whether they considered that consolidation—in an enlarged scope that conformed to the IPSAS standard—would meet the following needs: accountability, decision-making, information, risk, and statistics, with four possible levels of agreement: true statement (4), mostly true statement (3), mostly false statement (2), false statement (1)². This second question was thus about the **potential response to expectations** in the event the scope of consolidation was extended. It enabled us to know whether consolidation with an enlarged scope would respond to expectations and in particular respond better to expectations compared to consolidation as it is currently practiced.

A third question (Question 3) dealt with the importance of each need item, with four possible degrees of importance: important need (4), fairly important need (3), fairly unimportant need (2), unimportant need (1). This third question is thus about the **importance of expectations** with respect to consolidation: does consolidation have to satisfy a (fairly) important need, therefore does it faces (rather) high expectations (4 or 3); in contrast, does consolidation face low or no expectations (2 or 1).

¹ For example, “Can the consolidated statements in their current scope be used by internal and external users as a help and foundation for guidance and both mid-term and long-term planning? Do you consider this statement to be false, mostly false, mostly correct, correct?”

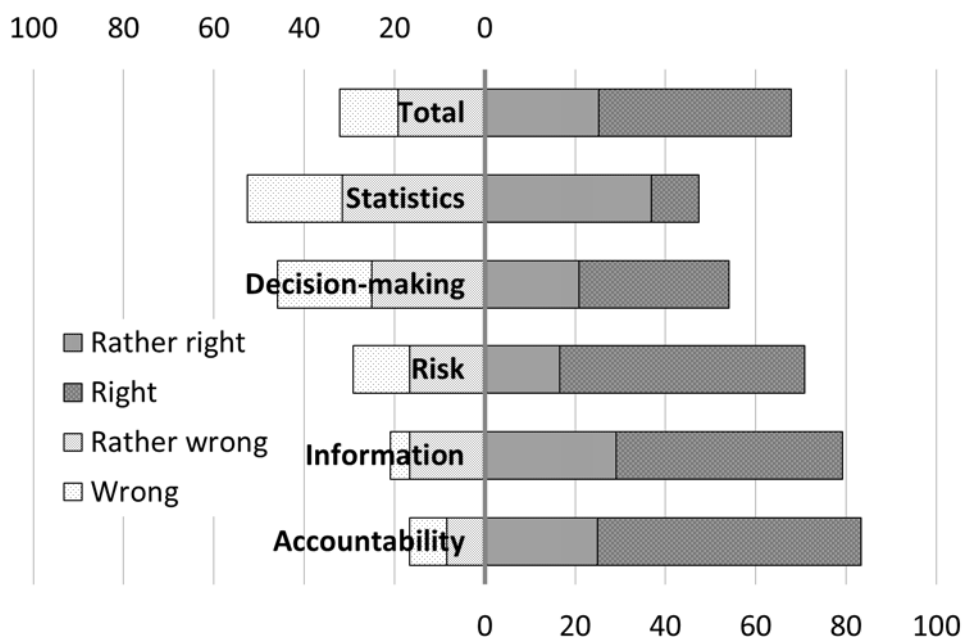
² For example, “Can the consolidated statements in an enlarged scope be used by internal and external users as a help and foundation for guidance and both mid-term and long-term planning? Do you consider this statement to be false, mostly false, mostly correct, correct?”

4. Findings

Satisfaction of needs under the current scope of consolidated statements

The small sample size forces us to treat our results rather summarily, especially when focusing on the average of the obtained values³. Therefore, Figure 1 shows how the opinions given are divided up with respect to consolidation in its current scope (Question 1). Participants judged that it was a correct statement (58% of participants), or a fairly correct statement (25%) to say that consolidated statements in the current scope satisfy the need for accountability (83% in all). Responses were similar for the need for information (50% and 29%, for 79% in all) and for risk-assessment (54% and 17%, for 71% in all). Responses with respect to meeting the needs for decision-making were barely positive (33% and 21%, for 54% in all). In contrast, respondents indicated that the current scope of consolidation does not really meet statistical needs (11% and 37%, for 48% in all). Overall, 68% of all respondents responded positively or mostly positively (43% and 25%).

Figure 1 Respondent opinion on the statement that the CURRENT scope of consolidation satisfies different user needs^a



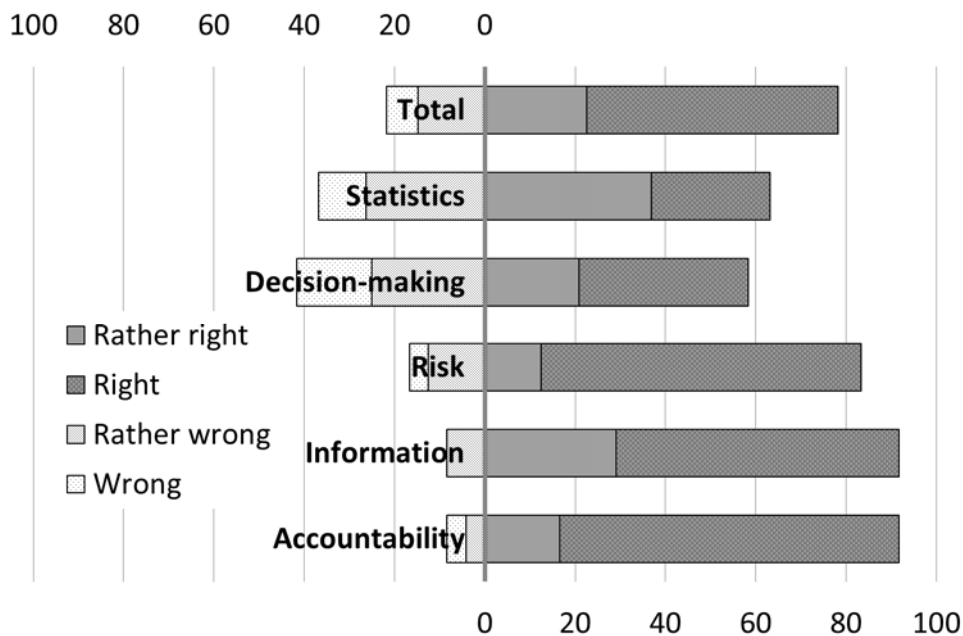
^a This figure presents the types of needs, going up, by decreasing order of satisfaction, beginning with Accountability. At its top it presents the Total for all needs combined. N=25.

³ Averages are calculated directly according to the values obtained from each respondent. On occasion, certain individuals preferred not to reply to certain questions. Which means that there are values missing in a few places in our matrices. In this situation, the average of the averages (average of the averages of the lines or average of the averages of the columns) may slightly differ from the average of the values of the matrix.

Satisfaction of needs under an enlarged scope of consolidated statements

Figure 2 shows how the opinions given are divided up with respect to the usefulness of consolidation in a scope enlarged to satisfy the IPSAS standard. Respondents indicated that it is correct or mostly correct to say that consolidated statements in an enlarged scope would satisfy the different needs considered: opinions were (mostly) positive with 92% with respect to accountability and information, 83% for risk-assessment, 58% for decision-making and 63% for statistics. Looking at the percentage of positive opinions here, it is clear that enlarging the scope of the consolidation improves the satisfaction of needs. The total of (mostly) positive opinions increases from 68% (Figure 1) to 78% (56% and 22%). This improvement is further highlighted in Figure 3.

Figure 2 Respondent opinions on the statement that the ENLARGED scope of consolidation satisfies different user needs^a

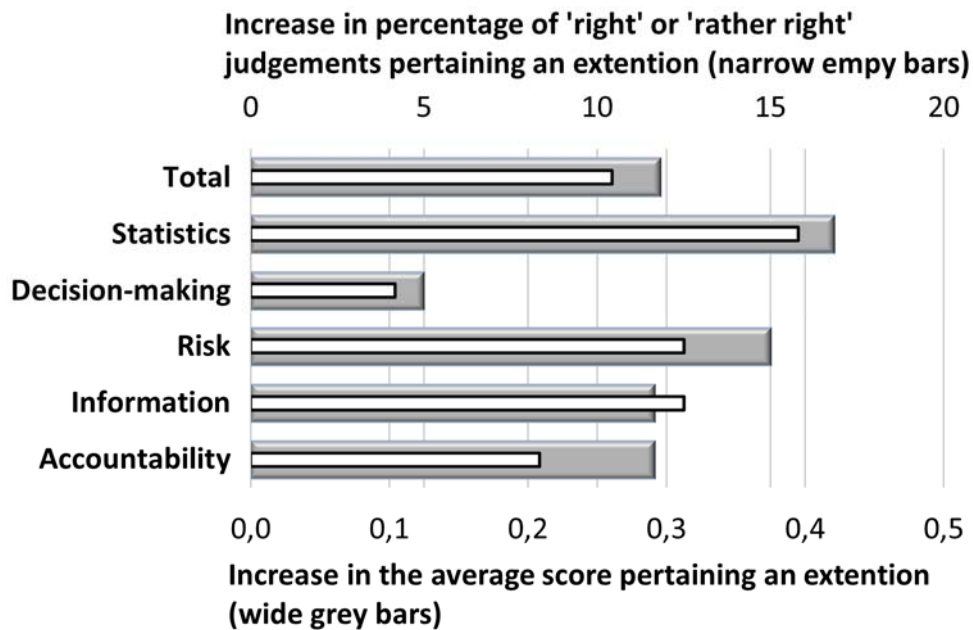


^a This figure presents the types of needs in the same order as Figure 1. This is why the types of needs are not always classified, going up, in decreasing order of satisfaction. The Total of all combined needs is also included. N=25.

In Figure 3, the narrow empty bars show the increase of positive responses between the needs satisfied by the current scope and the needs satisfied by an enlarged scope. The bars show that the largest increase in satisfaction concerns statistical needs (from 47% to 63%, an increase of 16 percentage points). Risk-assessment needs were also reported with a higher level of satisfaction (from 71% to 83%, an increase of 13 percentage points). Decision-making needs were also increasingly satisfied. But the increase was smaller (from 54% to 58%, an increase of 4 percentage points). This indicates that decision-making needs were only marginally more satisfied (Figure 2), yet these are needs that, in comparison, the consolidation satisfies the least (Figures 1 and 2).

In Figure 3, the large gray bars provide the same result but were determined using a different calculation. They were calculated using the average of the respondents' replies (1: false ; 2: mostly false ; 3: mostly correct; 4: correct) The average response for statistical needs moved from 2.37 to 2.79 (+0.42) and from 3.13 to 3.50 (+0.37) for risk-assessment. For decision-making needs, the average moved from 2.67 to 2.79 (+0.12). Overall, the average score increased 0.30, moving from 2.97 to 3.27.

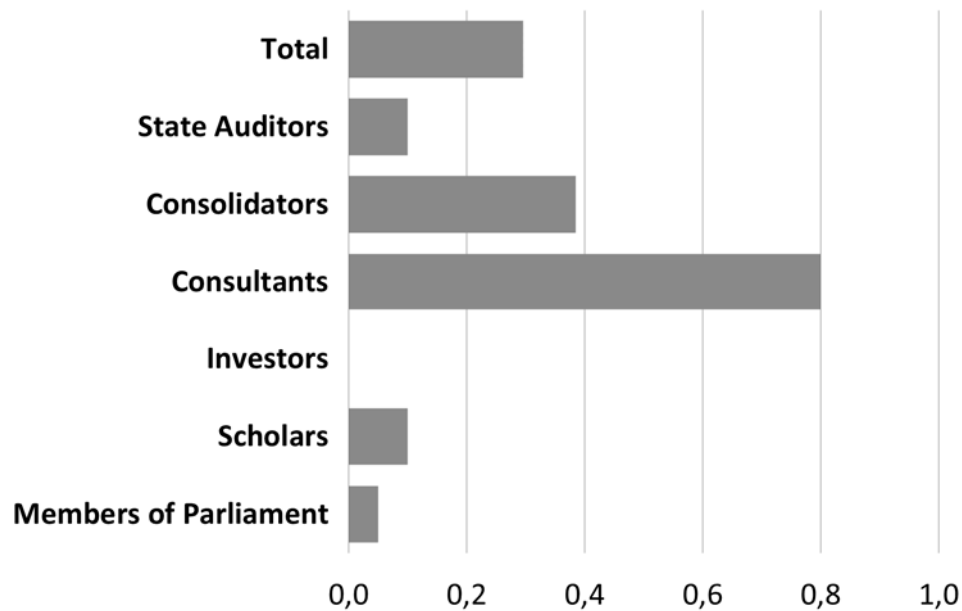
Figure 3 Improvement of need satisfaction linked to enlarging the scope of consolidation^a



^a This figure presents the types of needs in the same order as Figure 1. This is why the types of needs are not listed in increasing order or decreasing order of improved need satisfaction. The Total of all combined needs is also included. N=25.

It is interesting to see from whose perspective the potential for improved satisfaction is either strong or weak. In other words, amongst the individuals questioned, who sees a strong or weak potential for improved need satisfaction in the event the scope of consolidation is extended. Figure 4 answers this question. It shows that the potential for increased satisfaction is highest in the group of consultants: the score increased from 3.05 to 3.85 (+0.80). Another group sees a significant potential: individuals in charge of consolidation (+0.38). In contrast, the other groups—whom we can call external users—do not estimate that extending the scope of consolidation is capable of satisfying needs better. Investors who responded felt that enlarging the scope would bring no increase in usefulness (0.00), while members of parliament were not far from the same opinion (+0.05).

Figure 4 Evaluation of the improvement in need satisfaction linked to enlarging the scope of consolidation, as a function of respondent group^a

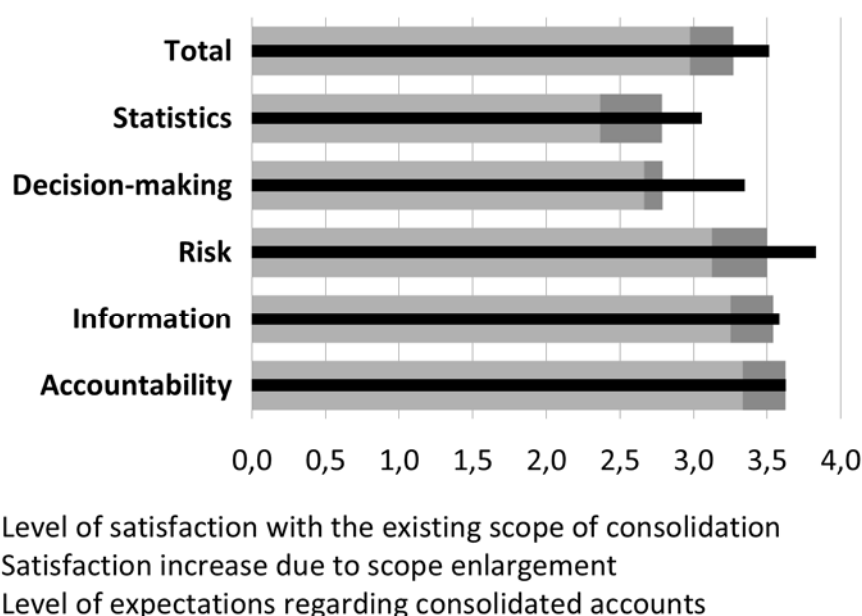


^a This figure presents the results for each user group (members of parliament, scholars, investors) in the lower half and for each producer group (consolidators, State auditors, consultants) in the upper half. The Total of all combined groups is also included. N=25.

Comparison of need satisfaction by consolidated statements with expectations

Figure 5 and Figure 6 facilitate a comparison between the questions on the importance of expectations and the information presented in the previous section. In these two figures, the importance—in order words, the level—of expectations is indicated by narrow black horizontal bars. The manner in which the current consolidated statements satisfy needs is indicated by the larger, slightly gray bars. The increase in satisfaction brought by enlarging the scope of consolidation lengthens the slightly gray bars by a darker gray segment. When the narrow black bar passes the larger gray bar, this indicates that the expectations regarding consolidated statements are not wholly met, even by an enlarged scope compared to the current scope. Figure 5 gives this information with respect to the listed types of needs; Figure 6 with respect to the groups of respondents.

Figure 5 Comparison of degree of need satisfaction with the importance (the level) of expectations ^a



^a This figure presents the types of needs in the same order as Figure 1. The Total of all combined needs is also included. N=25.

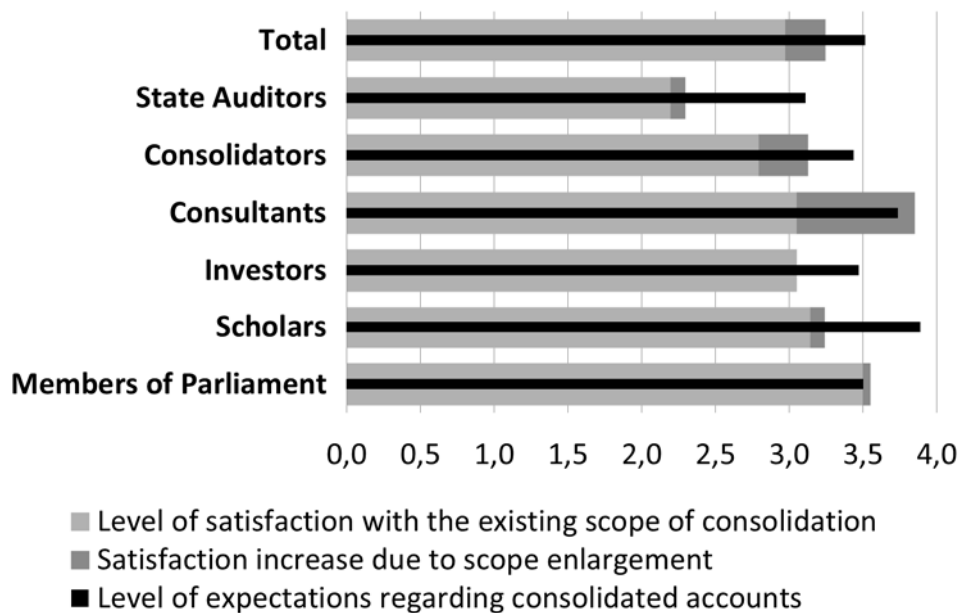
Figure 5 shows that, according to respondent opinions, the expectations with respect to consolidated statements are the highest in terms of risk-assessment: the black bar indicates a value of 3.83. Expectations related to two needs come next: accountability (3.63) and overall information (3.58). The level corresponds to the overall level (total) of expectations (3.51). Expectations are weaker with respect to decision-making (3.35) and statistics (3.06).

Despite this relative weakness, these expectations are not satisfied by the Confederation's consolidated statements, neither by the current scope (slightly gray bars), neither by an enlarged scope that would conform to IPSAS norms (darker gray). There is a lack of satisfaction with respect to risk, exactly where expectations are particularly high. The lack here is -0.33 compared to -0.56 for decision-making. In contrast, responses given indicated that enlarging the scope would satisfy expectations with respect to accountability and overall information.

Having said that, in all, this kind of enlargement would still leave some expectations unsatisfied (deficit of -0.24 as for Total).

In turn, Figure 6 shows that expectation level varies between respondent groups. Scholars (3.89) and consultants (3.74) had the highest expectations. Members of parliament (3.50) had similar expectations to investors (3.47) and individuals in charge of consolidation (3.44). State auditors had slightly lower expectations (3.11). Even if their expectations were held at different levels, investors, scholars and auditors saw their expectations fairly unsatisfied, either by the current scope of consolidation or by an enlarged scope: the deficit, respectively was -0.42, -0.60 and -0.81. The great increase in satisfaction for consultants through an enlarged scope means that their expectations were satisfied, even slightly exceeded. The expectations of members of parliament was largely met. In their case, the fact that needs were satisfied beyond expectations (+0.05) comes out of the enlarged scope. Members of parliament and consultants were the only two groups whose expectations were satisfied by consolidation, either by the current scope (Members of Parliament) or with an enlarged scope (consultants).

Figure 6 Comparison of the degree of satisfaction of the different respondent groups with the importance (the level) of expectations
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^a This figure presents the results for each user group (members of parliament, scholars, investors) in the lower half and for each producer group (consolidators, State auditors, consultants) in the upper half. The Total of all combined groups is also included. N=25.

5. Conclusion and Discussion

The goal of this study was to examine the usefulness of consolidating public financial statements for different categories of users. A parallel goal was to determine for which needs consolidation is most useful and if enlarging the scope of the consolidated group serves these purposes. To do this, we surveyed 25 experts from a variety of backgrounds. The context was an eventual enlargement of the scope of the Swiss Confederations consolidated accounts to conform to the requirements of IPSAS standards. On the one hand were statement users such as members of parliament, investors, and scholars. And on the other, and broadly speaking, were statement producers: finance administration and entities to be consolidated (consolidators), State auditors, consultants. Their opinions were gathered using a questionnaire that was given within the framework of an interview. It is important to keep in mind the small sample size and thus consider these results with caution. Despite this, our results provide a glimpse into a problem that has, until now, been unexplored—the usefulness of consolidated financial statements as well as the marginal usefulness of enlarging the scope of consolidation.

According to the study respondents, consolidated statements respond with varying degrees of success to diverse needs. They are most useful to the needs of accountability, information and risk. They are slightly less useful for needs linked to decision-making and statistics.

Enlarging the scope of consolidation would essentially serve needs related to risk awareness and statistics. However, they would least help the needs linked to decision-making. Among those interviewed, statement producers—in particular, consultants—saw the greatest gain from enlarging the scope. On the other hand, users of consolidated statements—and in particular investors—do not foresee that an enlarged scope would better meet their needs. This statement is rousing and should get us thinking.

Beyond knowing which are the needs to which consolidation responds, the respondents' answers also provide information about whether consolidation responds to the expectations that surround it. It is in terms of risk-assessment that respondents generally have the highest expectations for consolidation. But this expectation remains partially unsatisfied, even with an enlarged scope. In contrast, enlarging the scope helps satisfy expectations related to information and accountability needs. Expectations linked to statistics and decision-making are certainly lower than the others. But, despite this, they remain partially unsatisfied, even after enlarging the scope of consolidation.

Among the groups we formed, two felt their needs were satisfied. The first was the consultant group, who felt their expectations were satisfied through the enlarged scope. And the second was Members of Parliament whose expectations were satisfied by the current scope of consolidation. As a result, for this last group, enlarging the scope of consolidation went beyond their expectations and their requests. Among the users of consolidated statements, both the scholars (whose expectations were high) and the investors saw their expectations remain unsatisfied, even with the enlarged scope of consolidation.

According to the qualitative data gathered during the interviews, most respondents indicated—to varying degrees—that enlarging the scope would offer benefits.

These individuals highlighted that in their current state, the Confederation's consolidated statements offered a high level of quality, both in substance and in form. This may explain why, to some respondents, the marginal benefit expected from enlarging the scope remained modest. Nevertheless, the advantage often mentioned from an enlarged scope was often more linked to a better conformity with recommended international standards than with benefits in terms of satisfying needs. Certain respondents, however, reproach the consolidated statements for presenting a level of aggregation so that the statements become abstract and disincarnate. With respect to the usefulness for decision-making, many of the respondents foresaw a real usefulness in terms of planning (evolution of debt and contingent liabilities). They saw less usefulness in terms of guidance. Within this perspective, several times throughout the interviews, it was suggested that the Confederation should not only present consolidated statements but also a consolidated budget.

With respect to accountability, it was also mentioned that it is necessary to present consolidated figures, independent of the fact that there may or may not be a demand for this: this is more about the need for State transparency. A better transparency would give citizens more confidence in the State. This could lead to a joint-effect through the fact that this would increase discipline within the State. In essence, the fact of having to deliver accounting information for the consolidation increases the quality of financial statements of the entities being consolidated.

Within the statistical field, consolidation and enlarging the scope brings something. But respondents believed that more is necessary to truly improve international comparisons. Which is why it is in this field that consolidation responds not only the least to a need, but also that here expectations were the lowest.

Respondent opinions underscored the quantitative results regarding risk-assessment. Respondents felt strongly about this topic. Nonetheless, several respondents signaled doubts regarding the fact that enlarging the scope to respect international standards would provide this kind of knowledge. In other words, even by enlarging the scope, we would not be able to meet the high expectations in terms of risk assessment. A nuance can be added here by the fact that, in the past, the State engaged itself well beyond the scope of consolidation defined through a legal framework or an accounting framework. Just think about the banks and other airline companies rescued from bankruptcy or taken over by the State on the basis of a purely political decision.

Finally, it is important to look again at the fact that the users of consolidated statements are those for whom the marginal usefulness of enlarging the scope is the most limited. This is data that would warrant and will warrant being validated by future studies, notably in countries other than Switzerland, but also through larger survey samples.

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