

# Summary

May 2006

## **Report on Central Government accounts**

### **Warning**

**T**his summary report has been drafted to make it easier to understand, and to comment on, the full Report, the only one that is binding on the *Cour des Comptes*.

The replies made by the government departments and public bodies concerned are included in the full version of this Report by the *Cour des Comptes*.

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<sup>1</sup> Organic Law on Public Accounts or Constitutional Bylaw on Budget Acts

# Introduction

*The August 1, 2001 Constitutional by-law on Budget Acts (LOLF), which came into force on January 1, 2006, provides for reform of the State budgeting system by changing the rules governing the presentation and execution of the State budget for the purpose of managing public expenditure on a performance-related rather than resource-related basis. Implementation of this side of the LOLF is analysed by the Cour des Comptes in its report on the government's fiscal management.*

*The LOLF also provides for an equally extensive reform of central government accounting. Henceforth, in line with accounting practice in the private sector, the State will have a balance sheet, an income statement and appendices to financial statements. In 2007, the Cour des Comptes will be charged with certifying the regularity of the central government's financial statements for 2006 based on a "true and fair view" audit opinion.*

*In order to lay the groundwork for the implementation of this reform and to prepare itself for this new mission, the Cour des Comptes, for the third consecutive year, has published a report on central government accounts, which foreshadows what will gradually become the audit certification report.*

*This year's report marks a new stage in this process of reform.*

*It not only reviews the implementation of the recommendations made in previous years, but also makes more general observations on the accounts for 2005, the last to have been drawn up in accordance with the former rules of government accounting. However, even in terms of the accounting standards in force at the time they were drawn up, these accounts contain some anomalies. In its report, the Cour des Comptes indicates what major changes need to be made to bring these accounts into line with the new accounting standards in force as from 2006. It highlights the areas in which there is a high risk of error or non-compliance with prevailing standards.*

*In its report, the Cour des Comptes acknowledges that the central government, and notably the Directorate General responsible for public accounting, has made a great effort to prepare for the implementation of State accounting reform. However, this has been delayed, particularly due to the concentration of central government staff and resources on the implementation of reform of the budgeting system under the LOLF.*

*From past experience in foreign countries of the introduction of public accounting systems comparable to the one France is adopting, it takes several years for a new audit certification process to be put in place. However, the drawing up of the central government's opening balance sheet as at January 1, 2006 and of public accounts for 2006 marks the completion of a key stage in the process of public accounting reform.*

*Thus, to help the government initiate reform of central government accounting, the report contains some important recommendations by the Cour des Comptes.*

## 1 Presentation of central government accounts

### Central government accounts prior to LOLF

Until now, central government finances have been managed and analysed almost exclusively through its budget, contrary to private sector financial statements. Although this budget has, for several fiscal years, formed part of a 3-year programme, it has continued to be voted and executed on a strictly annual basis. Such yearly budgeting meets the need for regular democratic scrutiny by Parliament, but prevents the State's financial commitments from being taken into account: even if these do not translate into expenses incurred during the fiscal year under review, they represent future expenditures. Moreover, Budget Acts are structured in such a way that they do not take the State's heritage into account: they do not account for its assets and liabilities.

In this framework, State accounting used to be focused almost exclusively on recording receipts and expenditures. The main role of public sector accountants was to check that the procedures for making expense payments and for recovering debt or receivables complied with the regulations in force.

True, in 1970, the State had adopted a chart of accounts that was similar to the National Accounting Code. This measure, which at that time was innovative, consisted of recording budget execution transactions as they occurred and of restating them at the end of the year in order to draw up the “general financial administration account”, made up of a balance sheet and an income statement, bringing public accounts more into line with private sector financial statements.

Although the State's chart of accounts was based on the National Accounting Code (NAC), in compliance with the general regulations governing public sector accounting, it actually remained quite different from it for a long time. Major innovations were introduced in 1987 and gradually from 1999 onwards, but the numerous changes made to the NAC were never automatically incorporated into the chart of accounts. The State general accounting system therefore continued largely to be based on cash accounting and not on accrual basis accounting, i.e. entries were not recorded when goods or services were received, but when funds were paid or received.

## Central government accounts since LOLF

Since January 1, 2006, the government accounting system has undergone a deep transformation.

Apart from the cost-based accounting method - which will play a decisive role in revealing the cost of public policies, but as yet only exists in embryonic form – the State now uses two main accounting methods. The LOLF clearly distinguishes one from the other.

First, as before, the State continues to use **budgetary accounting**, which is the best known and simplest method. It is a cash-based method that records the expenditures and receipts authorised by the Budget Act when they are respectively disbursed and collected. This method aims to ensure compliance with the resolutions voted by Parliament to authorise the collection of public funds and to set ceilings on commitments and expenditures. It enables the managers of public funds to monitor their credit consumption and expenditures on a day-to-day basis. Finally, it allows the budget deficit to be calculated at the end of the fiscal year.

The State will also use a more comprehensive **general accounting** system. This method not only records fiscal receipts and expenditures, but also accounts for other revenues and expenses, notably amounts allocated to depreciation, amortisation and provisions. These items are not recorded in budgetary accounting because they do not give rise to cash flows. The general accounting method also tracks transactions related to State assets, which are recorded in the balance sheet (fixed assets, receivables, financial and non-financial debt, etc.) and are not described in the Budget Acts.

At the heart of the accounting reform are changes to the State's general accounting.

The Constitutional Bylaw (LOLF) provides for general accounting transactions to be summarised in a balance sheet, an income statement and an appendix. In addition, it requires that these accounts should be drawn up in accordance with the same rules that apply to company financial statements, provided the sometimes marked specific features of public policies are taken into account.

The adoption of an accrual basis State general accounting system is part of an international trend towards the modernisation of accounting rules applicable to public sector entities.

France cannot stand aloof from this trend, all the more so as certain government entities in major industrialised countries will soon have their accounts certified as giving a “true and fair view”, a recognition from which these countries could benefit in terms of financial communication. Although our country is a few years behind the others, France has an advantage that may help it to make up for lost time: the Treasury (*Trésor Public*) has a network of local offices. This makes it possible to draw up a general balance of government accounts and financial statements, representing the first level of consolidation, which is not yet the case in other states, such as the United Kingdom.

# Presentation of Government Accounts

This reform of the State accounting system will provide two benefits inside France. First, it will add to the financial information already available some extra information about heritage assets. Second, it will help public sector decision-making in two ways: by systematically recording future expenditures (both certain and probable), non-financial debt vis-à-vis third parties, inventories, heritage real estate, off-balance sheet commitments; and by taking into account, through depreciation, amortisation and provisions, all events likely to affect the State's assets and liabilities. However, the success of this accounting reform depends on the extent to which managers understand the value of this general accounting to their decision-making. This calls for a sustained effort in favour of education and training, to which the *Cour des Comptes* is prepared to contribute.

The State will have to get used to using two accounting systems: budgetary accounting and general accounting. One will not be able to take precedence over the other. When Parliament votes on the Budget Review Act (*Loi de Règlement*), it will consider not only the balance of the Budget Act based on budgetary accounting, but also the cash-flow result and the accounting income based on general accounting. Each accounting system is now subject to distinctive rules, which means both systems may well process the same transaction in different ways. Therefore, every fiscal year will have a fiscal outcome and an accounting income that will be significantly different and will not have the same meaning.

Although these two accounting systems are distinct from each other, they are nonetheless linked. There is no direct and immediate link between general accounting data and budgetary transactions, but general accounting must fully play its role as a forewarning indicator (or “harbinger”) of future fiscal expenditures. For example, the setting aside of provisions for certain expenditures does not necessarily mean that credits will be appropriated in the following Budget Act to cover the possible expenditure incurred due to the risk for which the provision has been made, because this risk may materialise several years later. In other words, financial statements do not exist for the purpose of predetermining fiscal policy options. However, they will help to shed light on fiscal decisions and short-, medium- and long-term aims. As such, they will be a useful tool for fiscal policy and for keeping public expenditure under control.

## 2 Comments on 2005 Government Accounts

The accounts for 2005 are the last to have been prepared in accordance with the former State chart of accounts. Because of its defects, they do not give "a true and fair view" of the State's assets and financial position.

Thus, in order to provide guidance on the preparation of the opening balance sheet and accounts for 2006, in this year's report the *Cour des Comptes* has made some comments and recommendations on the differences of presentation between the accounts for 2005 and those that will have to be drawn up for fiscal year 2006. Deficiencies have been found in the 2005 accounts relating to several key balances.

Firstly, the financial statements for 2005 give only a **partial view of the State's non-financial fixed assets**:

- \* the value of the tangible fixed assets recorded on the assets side (€108.6bn) bears no relation to the value of the physical inventory of fixed assets, this inventory itself, moreover, being unreliable;

- \* the value of intangible fixed assets (€0.2bn) has been underestimated, as the State has only just begun to record and evaluate its

intangible fixed assets; the auctioning of UMTS licenses is a good example of revenue collected by the State, but which has not been offset in a capitalisation account;

- \* inventories have not been recorded in the accounts.

Secondly, there are anomalies in the presentation of **long-term investments**:

- \* the evaluation of the State's allocations to and interests in entities in both for-profit and non-profit sectors is inaccurate: the scope of such entities has not been defined yet; some entities, such as the *Fonds de financement des prestations sociales agricoles* (FFIPSA), are not accounted for; and in its books the State has not reflected the consequences (in the form of contingency and loss provisions) of its supplementary financing obligations when these entities report a negative net equity. Examples of such entities are *Réseau ferré de France* (RFF), the special fund for the amortisation of the debt of French Railways (SNCF), the corporation in charge of financing and restructuring the debt of *Crédit Lyonnais*, the *Fonds de solidarité vieillesse* (FSV) and the *Fonds de financement des prestations sociales agricoles* (FFIPSA);

# Comments on 2005 Government Accounts

\* loans and advances by the State to third parties are not properly tracked; some data are not consistent with those of financial intermediaries, notably the *Banque de France*; the €5.9bn advance to the *Agence centrale des organismes d'intervention dans le secteur agricole* (ACOFA) is reported as having been reimbursed on December 31, whereas it was actually collected in January, during the complementary period, whereupon another advance was promptly granted; loans whose reimbursement prospects were non-existent should have been recorded as losses and not as provisions for depreciation.

Thirdly, **the State does not record all its receivables and debts vis-à-vis third parties.** For example, the debt amounting to €1.2bn owed by UNEDIC to the State and the social security system's receivables from the State, worth nearly €6bn, are not offset in the State's accounts. The same criticism can be made of the State's financial relationships with certain bodies that it supervises. Thus, the State's debt to the *Fonds de financement des prestations sociales agricoles (FFIPSA)* amounting to €2.5bn has not been recorded on the liabilities side of its balance sheet.

Fourthly, **the State has recorded hardly any contingency or loss provisions.** The total amount of provisions on the liabilities side of its balance sheet amounted to only €74m in 2005. In its report, the *Cour des Comptes* gives examples of positions amounting, in some cases, to several billion euros for which provisions should be made in the 2006 accounts.

Generally speaking, according to the new accounting standards, a provision must be made whenever the three following conditions are met: the State has a financial obligation vis-à-vis a third party; this obligation will certainly or probably result in a cash outflow without any offsetting entry; the value of this outflow can be reliably assessed. The following loss provisions should also be made: coverage of the "losses" incurred by entities in which the State has a controlling interest; provisions for the "breakeven" subsidies the State will have to pay to the RATP and SNCF retirement pension funds; and provisions for removing asbestos from public buildings, etc. Contingency provisions will have to be made for litigation, notably involving taxpayers, in which the central government's liability will be recognised. It will also be necessary to record provisions for certain natural disasters whose costs could not be covered by current levels of government reserves, even though they do not exceed the central reinsurance fund's ceiling.

Fifthly, although financial debt poses no major problem from an accounting point of view, given that it has already been accounted for on an accrual basis since 1999, the same cannot be said of **non-financial debt**, which has not been taken into account until now through lack of monitoring of legal commitments and lack of specific dates on which to record the services rendered. Such debt includes losses or expenses that remain payable at the end of the fiscal year, and which the *Cour des Comptes* cannot approve.

# Comments on 2005 Government Accounts

Following a special investigation, it has been estimated that such losses or expenses amount to just over €6bn. They were not paid during the fiscal year during which the services have been provided, for lack of funding or for reasons relating to accounting control or simply because the invoices were not received. The exhaustive recording and monitoring of such losses or expenses are major challenges in terms of the accuracy of State accounts and in terms of good management practice.

Finally, **off-balance sheet commitments** (retirement pensions, various financial commitments, litigation, etc.) have not all been exhaustively recorded. In spite of the progress made in recording guarantees given by the State and the retirement pensions of civil servants, the methods of assessment of such losses or expenses need to be refined. As in the case of contingency and loss provisions, the government is not used to drawing up a list of possible liabilities, the identification of which is a complex matter. Yet such possible liabilities may generate future expenditures, which the government absolutely must keep under control if it is successfully to manage future trends in public sector debt.

## 3 Implementation of Accounting Reform

The introduction of accrual accounting of government accounts since January 1, 2006 has required and continues to require a considerable effort on the part of government departments. Yet, under the provisions of the law, the structure of the State's general account should have been completely overhauled within a single fiscal year. In spite of all the preparatory work already done, this goal seems particularly over-ambitious.

Experience of State accounting reform in other countries has shown that the implementation of the type of reform laid down by the LOLF in France is a long process, which usually takes several years. A great variety of opinions has been expressed by government auditors on the success of such reforms. Their positions have ranged from unqualified opinion (in Canada and New Zealand) to disclaimer of opinion (on US Federal accounts for the ninth consecutive year and on the UK's Home Office account), while some auditors have expressed a qualified opinion (Australia, UK Ministry of Labour accounts).

The two most important components of the successful implementation of State accounting reform are: first, the formalisation of a new set of accounting standards, and second, restructuring of the network of accountants.

The purpose of the analysis and recommendations set out by the *Cour des Comptes* in this report is to allow great progress to be made in implementing the reform in the accounts for 2006.

### The future set of new accounting standards

#### Progress

The new accounting framework was established at the end of 2005. The new accounting standards were adopted in May 2004, and the instructions for their use have been drafted. These instructions present in detail the accounting rules and principles to be followed, specifying the linkages between budgetary and general accounting as well as the roles of the various players. They include an annotated chart of accounts and the usual schedules of the main types of accounting entries. Thanks to this important clarification work done in a very short time, State accountants and financial managers will be able, for the first time ever, to share a single set of common accounting instructions.

# Implementation of Accounting Reform

## Deficiencies

To ensure the perfect consistency of accounting standards, it is necessary to address a number of topics, many of which are of a technical nature.

For example, the processing, for general accounting purposes, of France's contribution to the financing of the European Union is a source of difficulties. According to the explanatory statement relating to standard no. 2, a part of this contribution should be accounted for as State expenditures, whereas the other part should be accounted for as income collected on behalf of the European Union (EU), without any impact on the income statement. In order to enhance the understanding of the financial mechanisms involved, all EU resources should be accounted for in a consistent way. Furthermore, the *Cour des Comptes* holds the view that all EU resources should be recorded as transferred income and not as expenditures, because the European treaties describe the EU's income as 'own resources', which cannot be put in the same category as national contributions to international bodies.

## Changes to accounting organisation and procedures

### Progress

Accounting departments have been set up in government departments (ministries) and placed under the authority of a ministerial budget and accounting controller, who acts as the

sole representative of the ministry of finance. This is an important reform of the accounting network, which will ultimately result in the production of ministerial accounts. The ministerial accounting departments have an important role to play in disseminating knowledge of the new accounting system across all management units, whose active participation in the keeping of the general accounts will be of crucial importance. Similarly, in order to ensure that accounting quality remains high, it may be necessary to continue the ongoing experiment in setting up billing/invoicing units charged with managing all the stages of financial relationships with suppliers, from the moment a bill/invoice is received to the moment it is paid, and including verification that a bill/invoice has been properly checked.

A system of internal accounting control has been designed to ensure that the new accounting rules are properly applied and to reduce the risk of anomalies in the accounts. This system will play a crucial role in the certification process. Among the first achievements of this new control system are the following: the beginnings of risk identification and mapping; the drawing up of action plans; and the setting up of accounting risk "governance" organisational structures.

## Deficiencies

The ministry of finance has steered the implementation of the accounting reform satisfactorily. However, the other government departments are behind schedule in adopting the new organisational structures and accounting procedures.

# Implementation of Accounting Reform

Since priority has been given to implementing the fiscal side of LOLF, and whatever the deficiencies observed by the *Cour des Comptes* in the implementation of the first stage of the reform, it is not surprising to note that government departments are behind schedule in implementing the new accounting system. Nevertheless, it is of crucial importance that managers should get even more involved in this reform, as from now on they share with the accountants the responsibility for keeping the general accounts. Unlike what existed before, accounting is no longer only the State accountants' business. Tangible and intangible fixed assets, inventories, financial commitments, expenditures and bases for provisions can only be valued with the help of all government departments.

One of the obstacles to the dissemination of the new accounting rules is government departments' lack of knowledge of general accounting. At both local and national level, government departments have become used to considering public sector accounting as a legal framework for budget execution and the monitoring of compliance with parliamentary fiscal authorisations. It is therefore necessary to continue to train and inform staff in management units, focusing on the purpose and usefulness of general accounting.

At the same time, it is of crucial importance to continue the deployment on an interdepartmental basis of the internal auditing and accounting control system. This consists of reorganising the numerous existing controls with a view to enhancing risk management. The new control mechanisms are gradually being adopted by the network of Treasury offices. However, they are still almost non-existent in other government departments. To reduce the risk of anomalies in the accounts, internal control must be deployed throughout the State's accounting and budgeting information system and, consequently, in both management and accounting units.

## The modernisation of information systems

The initial deployment of the State's accounting and budgeting information system under the "palier 2006" name has been adapted to meet the minimum requirements of the LOLF, pending the deployment of the CHORUS and COPERNIC systems, which will enable all of the LOLF objectives to be met.

# Implementation of Accounting Reform

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The reporting system has been renovated. Since the beginning of 2006, the monthly reports allow the State's expenditures to be monitored on a mission-by-mission basis and contain more detailed information on receipts. And since the start of 2006, the INDIA LOLF system has gradually been providing both managers and accountants with all the data from the "palier 2006" system.

However, not all the applications that feed data into this information system allow accounting entries to be traced back to their origins. Yet such traceability is a key criterion for assessing the "auditability" of accounts. In the absence of traceability, the auditors cannot do their job as they cannot form an opinion on the existence or absence of material misstatements. If the *Cour des Comptes* expressed a disclaimer of opinion (one of the five possible options laid down by international auditing standards), it would simply state that it had not been able to complete its assignment. Every effort must be made in 2006 to create the right conditions for the *Cour des Comptes* not to take this option.

## 4 Results of the *Cour's* work on the 2005 accounts and the prospects for certification

### Results of the *Cour's* work on the 2005 accounts

The checking of the 2005 accounts by the *Cour des Comptes* was more extensive than that of the 2004 accounts. However, the 2005 controls did not meet the requirements laid down by international auditing standards or their scope was limited by IT constraints or the unavailability of relevant data. Checking process will have to be fully completed in 2006.

These limitations related firstly to the unaccountability of numerous accounts, notably the following:

- \* tangible and intangible fixed assets, which were not linked with a physical inventory;

- \* inventories, which were not accounted for;

- \* sovereign receipts/revenue, notably taxes;

- \* accrued expenses payable and prepaid expenses, which are not recorded by general management of State accounting in regular accounts, but by a survey of government departments;

- \* commitments vis-à-vis the staff (except for pension commitments)

- \* specific budget accounts and trading accounts, which are reflected in the accounts only by their cash balances;

- \* the accounts of the public authorities, which fall within the scope of the certification of State accounts, but whose auditing criteria have not been brought into line with international standards yet.

Checks and controls by the *Cour des Comptes* were also limited as far as the internal audit and control systems are concerned. These were not audited because they were still at an experimental stage in the Treasury network and at the design stage in management units.

Based on the work done and with a view to preparing the opening balance sheet for 2006, the *Cour des Comptes* uncovered some deficiencies in the 2005 accounts, which need to be put right so that the financial statements for the next fiscal year comply with the new accounting standards.

# Results of the *Cour*'s work on the 2005 accounts and prospects for certification

Within the scope of its remit, the *Cour* drafted 48 comments, eight of which were taken into account before the closing of the 2005 accounts. Adjustments to the results amounted to €3bn. The 40 other comments, the most important of which have been mentioned in this summary, related to the following: entry reclassifications, which will also be used for the opening balance sheet; adjustments affecting the net financial position as at January 1, 2006; and modifications to the appendix, which describes, in particular, the off-balance sheet commitments.

The size of the amounts concerned must not be misinterpreted. It simply shows that the new State accounting system will by nature generate amounts in the opening balance sheet and 2006 accounts that are very different from those produced in previous years.

Any change of accounting standards inevitably leads to entry reclassifications and very significant adjustments. This explains why the National Accounting Code classifies them in the 'change in net equity' category. In the case of the State, these reclassifications and adjustments are all the larger and more numerous as the State has not used accrual basis accounting until now and has executed a limited number of closing entries. It therefore has to review all its accounts and reconcile them with the third parties who have already switched to accrual accounting, particularly the social security authorities.

## Prospects for certification

The government departments, and notably the directorate general in charge of public sector accounting, have worked very hard, it must be recognised. However, there is much more to the accounting reform than just a change of accounting standards. It has forced the State to do a number of things it has never done before, such as: reconcile the goods tracked in its accounts with physical inventories; ensure that account audits retrace all entries, i.e. that they enhance traceability; and finally, take into account a great variety of transactions and commitments, by making up for the deficiencies of an accounting and budgeting information system whose modernisation will not be completed before 2009-2010. The accounting reform requires all players to be very rigorous. It also requires active cooperation between managers and accountants, and between government departments and auditors.

The first challenge facing the State's new general accounting system will be the production of the opening balance sheet for 2006, which may well be a milestone in its development. In fact, this document will be the first one to have been drawn up in accordance with the new accounting standards.

# Results of the *Cour's* work on 2005 accounts and prospects for certification

It is crucial to draw up an opening balance sheet that is as exhaustive and reliable as possible, because in principle the subsequent changes made to it will have to go through the income statement. For example, if a provision has been omitted, its recording in the following year or the disbursement of the amount not covered by a provision will adversely affect the result for the year in which it is recorded. Scrutiny of the opening balance sheet will enable the *Cour des Comptes* to check if the recommendations it has made in this report have been complied with or not. However, the *Cour's* opinion on the State's accounts will be based on all the financial statements closed at the end of fiscal year 2006.

In accordance with international auditing standards, the opinion of the *Cour des Comptes* expressed for the first time on the 2006 accounts may be one of the following:

- \* an unqualified opinion, which means the *Cour* did not find any material misstatement likely to call into question the "true and fair view" given by the accounts;

- \* a qualified opinion, which means there is disagreement over the choice or application of the accounting rules and methods or that the scope of the audit has been limited ;

- \* an adverse opinion, in case of disagreement over accounting rules and methods, leading the *Cour des Comptes* to hold the view that this adversely affects the truth, fairness and compliance of the accounts as a whole;

- \* a disclaimer of opinion, which means that it is impossible for the *Cour des Comptes* to certify the accounts due to limitations on the scope of the audit,

thereby forcing it to state that it cannot form an opinion on the existence or absence of material misstatements ;

- \* a refusal to certify the accounts, due to a large number of serious uncertainties likely to have a very significant impact on the accounts submitted to the scrutiny of the *Cour des Comptes*.

The opinion of the *Cour des Comptes* will directly depend on the view its controls will allow it to form on the compliance of the financial statements with the new accounting standards. The quality of the accounts will result, on the one hand, from the effective implementation of the new accounting procedures and of the internal audit and control systems, as well as, on the other hand, from the government's ability to overcome the shortcomings reported by the *Cour des Comptes* and to implement its recommendations.