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### Financial Reporting in The Public Sector in The Republic of Bulgaria under The Conditions of European Harmonization and Global Legitimacy of IPSAS

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#### Abstract

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The progress made in the development of accounting theory, as well as the accumulated experience of EU Member States, illustrate the growing advantages of public sector accounting systems based on the accrual principle over cash-based accounting. The adoption and application of accrual-based accounting standards and in accordance with the requirements of the IPSAS poses important questions for accounting harmonization within the Union. The various existing practices in the public sector are considered when choosing an accounting model. A challenge to the European harmonization of accounting systems in the public sector is also the differences between the national modified-cash based accounting systems and the adopted methodological principles of the European System of National and Regional Accounts 2010.

The purpose of this article is to enrich and further develop in a theoretical aspect the European debate on the key issues in the public sector, analyzing the modern trends and challenges facing financial reporting in Bulgaria - as a member state of the EU, in conditions of accounting harmonization and growing legitimacy of the IPSAS in a global aspect.

The major research method used in the study is the theoretical review of the European and national legislation and the practice in the field of public sector financial reporting.

The Conceptual Framework is the starting point of reference for creating a system of pan-European harmonized standards for the public sector in full compliance with accrual-based accounting principles.

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## **INTRODUCTION**

Public sector reform which originated towards the end of the 1980s and the beginning of the 1990s was primarily guided by the application of market-oriented management models intended to incite economic effectiveness of public management (Melo et al. 2022).

The introduction of management mechanisms and instruments from the private sector into the management of the public sector is at the root of the New Public Management concept. A basic feature of the concept is the enhancement of the quality of financial reporting in the public sector (Christiaens et al. 2015).

More specifically, an important stage of the extensive reform in the state administration is the implementation of an accrual-based accounting system and budgeting. Cash-based reporting, which is characterized by cash-based recognition of the effects of transactions and events, is regarded as an antipode to accrual-based accounting.

The concept of interrelation between the frameworks for statistical and financial reporting presumes the requirement for the application of accrual basis principle in accounting. The European regulatory framework adopted for business entities requires the application of IFRS (International Financial Reporting standards issued by International Accounting Standards Board-IASB) on a mandatory basis by the exchange-traded companies registered in the territory of the EU when preparing the consolidated financial statements. Financial statements based on IFRS appear to be the main source of information about the corporate activities in the national accounts. K. Zlatareva (2018) analyzed the development of accounting theory in the context of integrated reporting in organizations. Like business organizations, the information contained in the financial statements of public sector entities is used for the purposes of national accounts for the General Government. The latter presumes proper knowledge of the International Public Sector Accounting Standards (IPSAS) developed by the International Public Sector Accounting Standards Board (IPSASB) – a requirement adopted in Regulation (EU) No. 549/2013 of the European Parliament and of the Council on the European system of national and regional accounts in the European Union (ESA 2010). There is no European regulation for mandatory implementation of IPSAS by the Member States what implies the application of national legislation. According to M. Markova (2019) there is a lack of national accounting regulation for assets and services provided as a result of public-private partnership. In this connection, the differences between the national accounting legislations and the various existing accounting practices are the main challenge for the global transition to financial reporting harmonization in the public sector.

## **METHODS**

The major research method used in the study is the theoretical review of the European and national legislation in the field of public sector financial reporting. The method of summarization and analysis was applied in a number of aspects, for example, in the examination of the European public sector accounting practices, the outcomes of the public sector reform and its reflection on the level of European harmonization in reporting and the legitimacy of IPSAS. The observation of facts method and the method of comparison were employed in the examination of country's governmental policy conducted under the impact of the institutional environment at a macro level. The documents officially issued to international organizations and governmental institutions, as well as the research studies of the academic community published in the internationally reputed databases were used as sources of information.

The main limitation to this research affects its scope. The study is focused on the public sector reform of a single EU member state, namely the Republic of Bulgaria. The fact taken into consideration was that some considerable changes occurred in the national legislation over the years of transition from centralized planned economy to market economy, and the accession of the Republic of Bulgaria to the European Union in the year 2007. In addition to the above, the research is limited to public sector entities. Public enterprises (commercial public sector entities) and business organizations are excluded from its scope.

## **THE MODERN TRENDS AND CHALLENGES FACING FINANCIAL REPORTING IN PUBLIC SECTOR**

A contemporary characteristic of the development of public sector financial reporting is the standardization of accounting. The global tendency towards standardization of public sector accounting is reflected in the establishment of a certain set of generally accepted rules and their implementation by the national governments at different levels of management and by international organizations including the European Commission (EC), North Atlantic Treaty Organization (NATO), United Nations Organization (UN) and others. The objective of the International Public Sector Accounting Standard Board (IPSASB) is

to “serve the public interest by contributing to the development, adoption and implementation of high-quality international standards and guidance; contributing to the development of strong professional accountancy organizations and accounting firms, and to high quality practices by professional accountants; promoting the value of professional accountants worldwide; and speaking out on public interest issues where the accountancy profession’s expertise is most relevant” (International Public Sector Accounting Board-IPSASB 2022).

Daniela Feschiyan (2018) maintains the statement that „Standardization of public sector accounting is an objectively determined dynamic process that provides for the establishment and application of generally accepted rules for the regulation of the accounting system and the creation of a uniform structure and content of the financial statements that meet all public interests with regard to obtaining reliable information about public finances.“ The result of author’s thesis being proven is a prerequisite for the realization of another scientific study dedicated to the applicability of standardized models for accounting of infrastructure assets based on the philosophy of IPSAS in the accounting systems of public sector entities in the Republic of Bulgaria. The empirical results confirm the benefits of the implementation of suggested new accounting models in the public sector practice in the Republic of Bulgaria (Feschiyan and Andasarova 2022).

Despite the initial proposal by the European Commission for adoption of IPSAS, after a series of professional debates and the continuing practices of some member states, including Bulgaria, in the application of budget-oriented and modified cash basis accounting systems, the European Parliament reached a compromise by providing an opportunity for conducting preliminary assessment of IPSAS “appropriateness” in separate jurisdictions within the EU. IPSASB at the International Federation of Accountants (IFAC) does not possess legal powers to demand from the EU member states to implement the requirements of IPSAS into their national accounting legislations. The Board relies on some convincing evidence and good practices for attaining legitimacy of public sector standards in a global aspect.

A number of scientific research studies have been dedicated in support of the reforms for improving accountability and transparency of public sector entities through the implementation of a set of generally accepted accounting standards (IPSAS) in separate jurisdictions (Chan 2006, 2008; Manes Rossi et al. 2014; Biondi and Soverchia 2014; Ismailia et al. 2021).

Over the past several decades, increased research interest has been observed within the academic community towards analysing the evolution of public sector accounting standardization based on accrual accounting principles (Brusca and Condor 2008; Martí 2006; Christiaens et al. 2015; Schmidhuber et al. 2022; Farshadfar et al. 2022).

According to Isabel Brusca et al. (2012), research studies addressing the development and propagation of IPSAS are principally focused on the countries applying the Anglo-Saxon model of accounting.

Countries like Australia, New Zealand, the USA and the United Kingdom have been pioneers in the realization of a far-reaching reform in state administration as early as in the 1980s which is known under the name of „New Public Management-NPM“. The public sector reform in these countries involves essential changes both to financial reporting and to the budgeting processes, which reform is accomplished through the transition to accrual based financial reporting and budgeting (Pallot 1994; Likierman 2003; Newberry and Pallot 2006).

On the other hand, the governments of some continental Europe countries such as Austria, France, Spain, Portugal, and Switzerland have also started a similar reform in the public sector by adapting their national accounting systems to the requirements of IPSAS retaining the traditional budgeting model based on the cash principle and on the modified cash basis of accounting (Brusca et al. 2015).

There is a group of authors who perform extensive scientific research dedicated to the challenges associated with the transition of the Organisation for Economic Cooperation and Development (OECD) member states to accrual based financial reporting and budgeting on the one hand, and on the other hand – regarding the applicability of IPSAS in individual jurisdictions of the member states. The research data definitively highlights the differences in the manner of perceiving the public sector reform by OECD member states, in the context of the transition to accrual-based financial reporting and budgeting. More specifically, the preferences of OECD member states to the accrual-based financial reporting (i.e., decisions at the organizational field) have been confirmed when compared to the adoption of accrual-based budgeting by individual agents in Organization’s member states among which are accountants, state officials, governmental bodies and politicians (i.e. decisions at an organizational level). A statement has been expressed that, in OECD member states, which have adopted a sector-neutral approach for the implementation of accounting standards, i.e., a uniform set of accounting standards (IFRS) in different sectors of economy, there are favorable conditions generated for the approximation of the national accounting systems to IPSAS. On the other hand, the authors substantiate the need of adopting IPSAS in the potential member states of the Organisation (such as Bulgaria, *author's note*) in terms of the lack of applicable public sector accounting standards within their jurisdictions (Adhikari and Gårseth-Nesbakk,

2016).

The traditional approach applicable by the researchers when conducting similar research studies aims at tracing the entire process of public sector reforms. In 2015, Isabel Brusca and her team published a collective scientific paper addressing the results of public sector reforms in 14 countries, the greater part of which are EU member states, taking into account that Bulgaria is not part of the extensive study. The empirical results outline the contemporary challenges facing the international harmonization in the field of financial reporting, budgeting, and public sector auditing (Brusca et al. 2015).

The national specifics of the European countries concern a number of limitations which impede the process of harmonization and the achievement of comparability among the financial statements of public sector entities. Summarisations in the research study come out to be a serious theoretical basis for evaluating the effects of IPSAS adoption by the European countries over the implementation of national accounting standards.

An analogous study has been conducted by M. Kowalczy and J. Caruana (2022) among other two EU member states – Malta and Poland. The authors arrive at the conclusions that, in response to the reform intended to enhance the reporting and budgeting in public sector, the two countries demonstrate dissimilar accounting and budgetary practices at central government level regardless of the institutional environment influence at a macro level on the part of EU and IMF.

As at present, Bulgaria has been strictly adhering to the improvement of the budgeting process with focus of the implementation of the European framework for statistical reporting and fiscal data presentation based on the methodology of the European System of Accounts (ESA 2010) and the Government Finance Statistics Manual of the International Monetary Fund. This change is realized on the account of postponement of governmental decisions for an accounting reform in public sector entities within the context of accounting standardization and full-fledged implementation of the accrual principle.

To analyze the specifics of the reform in public sector accounting of the Republic of Bulgaria is the main task of this research the conducting of which aims at identifying the important perspectives facing the national government on its way to the European accounting harmonization and growing legitimacy of IPSAS on a global scale. The more noteworthy of them are as follows:

- *Regulation of public sector reporting by national laws, subordinate legislation, as well as mandatory orders and instructions.* The country-specific national financial reporting regulation in the public sector involves the application of rules contained in the Law on Accounting, Public Finance Law and the multitude of instructions drawn by the Ministry of Finance. The existing tradition in the country for not applying public sector accountings.
- *Implementation of a budget-oriented accounting system based on the modified cash principle.* Under the impact of national legislation, the accounting practice is “sealed” as a dominating and acceptable model excluding any possibility for implementation of alternative accounting models. The absence of broader consideration of infrastructure assets in accounting standards hampers judgements and decisions that are to be made with a view to ensuring high-quality accounting information that should presumably be helpful for the users of financial statements and a clearer idea about this large group of public sector assets (Daskalov 2020). In response to the regulatory function of the state is the accounting practice existing for decades in Bulgaria on the implementation of the accounting principle of cash-based recognition of some kinds of revenue and expenditure (for example, tax revenue, social security contributions, budgetary credits). The accrual basis principle founded on the European System of Accounts (ESA-2010) standard and adopted by the European practice differs from the national requirements for modified cash-basis reporting.
- *Lack of accounting practice for the preparation of accrual-based consolidated financial statements.* As far back as in the year 2016, Daniela Feschiyan, in a paper titled „On the need of adjusting public sector financial statements to the requirements of IPSAS”, brought forth the problems associated with not preparing consolidated financial statements in the public sector and provided some projections for their improvement. In addition, it could be indicated that „consolidation of financial statements is a process of combining and subsequent synchronisation of data from the statements of a certain group of entities for the purpose of presenting summarised information on a consolidated basis about the assets and financial position, about the financial performance, the cash flows, and about the changes that have occurred in group’s equity, in a single pack of reports“ (Nachkova, 2020).“It is necessary to develop some additional internal bylaws for clearer decisive regulatory requirements

to the organization and methodology of accounting, the applicable chart of accounts, as well as specific procedures and techniques for preparing financial statements“ (Nikolova, 2020).

- *The decisions of the national government on the implementation of accrual-based accounting system pursuant to the principles of IPSAS and the lack of real reforms for translating them into action are intended for the purposes of institutional legitimacy.* On a nationwide scale, the practice for preparing specific cash-based statements is maintained by public sector entities for the purposes of financial reporting and the Consolidated Fiscal Program. The existing regulatory texts in the Public Finance Law on the preparation and presentation of annual financial statements based on accounting standards developed in consistence with IPSAS and the lack of recognised and published public sector accounting standards in the Republic of Bulgaria are quite contradictory as at present.
- *The link between public sector financial reporting and government's political incentives.* Public sector financial reporting in Bulgaria has a relatively lengthy history associated with undertaking a political commitment rather than as an effective contemporary accounting system based on global accounting standards.
- The reform in the public sector of the Republic of Bulgaria evolved in 2013 with the publication of a monography concerned with accounting standardization and the models of reporting fixed assets in the public sector. The author, D. Feschiyan (2020), maintains the thesis about „the need of accounting standardization in public sector entities with full application of the accrual principle and of the rules and provisions of IPSAS.“ Subsequently, the government of the country undertook significant changes to the accounting legislation for public sector entities among which accrual of depreciation, recognition of a strategic group of resources within the public assets such as public infrastructure, military equipment, heritage assets, etc. and inclusion of income statement as a mandatory component of the general purpose annual financial statements. The undertaking of this first step of the government towards reforms in the public sector is acceptable and refers to the usefulness of the information in financial statements for the purposes of taking managerial decisions in the process of implementing governmental policies and achieving transparency of public finance.

## DISCUSSION

For all the EU member states, particularly those that are currently using only cash-based reporting or reporting based on the modified cash principles, the implementation of the Conceptual Framework and IPSAS will mean a substantial reform. Some of the problems that might spring up and which, in our point of view, will affect Bulgaria are:

- conceptual and technical accounting problems.
- expert knowledge of employees and consultants, training skills.
- communication with managers and decision makers, as well as their training.
- connection with auditors, as well as their training.
- correction and modernization of IT systems.
- adaptation of the existing national legal frameworks.

If the adoption of IPSAS based on the accrual accounting principle and the philosophy of the Conceptual Framework in the EU member state is initiated, Bulgaria will find itself in a stressful and unequal situation (Feschiyan 2010).

Due to the non-application and lack of IPSAS knowledge and understanding, as well as owing to the overall lack of standardization in the public sector accounting system (Feschiyan 2012), trainings will need to be organized, as well as exchange of expert knowledge, support to the government on conceptual and technical issues, coordination, and exchange of plans of reforms for the public sector accounting with member states having greater depth of experience. Our reservations are that due to the lack of adaptation of public sector accounting to the Conceptual Framework and IPSAS, Bulgaria will be treated as a state with substantial and obvious drawbacks, failings, and inconsistencies in the financial management information systems across the public sector. Therefore, it is expedient to carry out urgent reforms and innovation in the accounting system (Feschiyan and Raleva 2013).

Extensive research, approval and implementation of the Conceptual Framework and IPSAS need to begin immediately and turn into an incessant process which should be realized within a certain period of time. This has to be accomplished gradually by laying the initial focus on the accounting issues where the

harmonization is of utmost importance, for instance:

- full observance of the accrual accounting principle.
- internationally harmonized financial statements.
- compatibility with the philosophy of the Conceptual Framework and the provisions of IPSAS.

In view of the fact that IPSAS are the conceptual basis for the development of national accounting standards in distinct jurisdictions, our country will have much higher methodological preparedness and significant degree of readiness for the transition. Review and categorisation of the adopted accrual based IPSAS should be performed and they can be classified in three categories:

- standards which can be applied directly or with minimum adaptation.
- standards that need adaptation or a selective approach.
- standards that need substantial amendment in order to be implemented.

The transition to IPSAS, the philosophy of which incorporates the complete implementation of accrual accounting principle, will provide for the adequacy of the national accounting framework in the process of harmonization and integration of Bulgaria into the European Union. This is some sort of innovation in the public sector accounting system. Such innovation will reduce the possibilities for financial data manipulation what makes the cash basis possible (for example, a payment can be carried forward in time or deferred in order to be presented in a period selected by the entity of the public sector). The accrual accounting principle, however, is not intended to remove or replace cash-based reporting for the purposes of budgeting and budget control. At a macroeconomic level, accounting standardization will ensure timely and reliable financial and fiscal data and an opportunity for greater comparability of financial statements. Thus, good conditions can be created for the implementation of most of the principles laid down in the Directive on budgetary frameworks (EC 2011/85/EU).

## CONCLUSION

The existing scientific debates most assertively illustrate the usefulness of the implementation of accounting standards in the public sector based on the accrual accounting principle. The existence of various accounting practices in separate countries raises important questions related to the expected level of European harmonization of the public sector accounting systems.

Extensive study and application of the Conceptual Framework of IPSAS which regulates the specifics in the public sector accounting systems is required. That way, a variety of differences in the accounting treatment and in the financial statements of public sector entities in different jurisdictions will be eliminated. The Conceptual Framework of IPSAS is the starting point of reference for creating a system of pan-European harmonised standards for the public sector in full compliance with accrual-based accounting principles.

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