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BUDGETING AND ACCOUNTING REFORMS WITHIN PUBLIC FINANCIAL MANAGEMENT FRAMEWORK: THE PORTUGUESE CASE

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1. INTRODUCTION

This chapter discusses the role of budgetary and accounting systems within the Public Financial Management (PFM) framework. Additionally, it describes the reforms nowadays taking place in Portugal, namely taking into consideration new budgetary and accounting systems starting implementation, explaining how they are included in a broader reform of the PFM structure.

PFM implies governments to use integrated systems to allocate funds and control spending execution, involving a wide approach, including policies design and internal and external auditing assessment systems. Also accounting reforms are essential to achieve PFM purposes, namely applying accrual basis to prepare and report financial statements under the international accounting standards approach (Lawson, 2015).

In Portugal, in the latter years, within the public sector, there has been a great fragmentation of accounting and reporting systems applied to different entities, raising inconsistencies and creating difficulties when trying to assess the Whole of Government financial condition. In this context, the Portuguese government, under strong recommendations of the loaners (because of the financial assistance through *Troika*), started a set of PFM reforms, including changing the existing public sector accounting system by adopting the International Public Sector Accounting Standards (IPSAS) as the benchmark (Nogueira *et al.*, 2017).

Accordingly, in 2015 relevant legislation was issued: the new Budgetary Framework Law (LEO – Law 151/2015) and the new System of Accounting Standards for Public Administrations (SNC-AP – Law-decree 192/2015). In 2016 a unit to assure the implementation of these new budgetary and accounting systems was created, designated as UniLEO. According to Viana (2017), the mission of this unit configures a true PFM reform.

Hereafter, the chapter is organised in four sections. Section 2 addresses the harmonization problems related to accounting reforms in financial accounting and their inclusion in a broader reform process under PFM objectives. Section 3 explains the benefits of integrating budgetary and financial accounting innovations in a broader PFM reform, also highlighting how PFM systems outputs could be used to change the EU convergence criteria framework. The Portuguese PFM reforms, including budgeting and accounting changes, presently being implemented, are described in Section 4. In Section 5 some final marks and conclusions are synthesised, highlighting the Portuguese PFM reforms as a reference at an international level.

2. WHY FINANCIAL ACCOUNTING REFORMS HAVE BEEN NOT SO SUCCESSFUL

2.1. Harmonization issues in accounting systems

Under the New Public Management (NPM) framework, countries all around the world, including the EU Member-States, started reforms in their budgetary and accounting systems, to implement accrual-based financial accounting, in complement to the traditional cash-based budgetary accounting. Groot & Budding (2008) highlight that one of the most relevant characteristic of the NPM was replacing traditional cash-based by accrual-based accounting, for purposes of financial reporting, in order to achieve better transparency and accountability. Accrual-based accounting systems, as an alternative to cash-based, provide the necessary information to better support decision-making processes regarding planning and managing resources (Christiaens & Rommel, 2010).

However, authors as Groot & Budding (2008) and Paulsson (2006) underline that, within Governmental Accounting (GA) systems, accrual accounting is mostly used for assessing performance and control of governmental entities and less adopted for budgetary decisions and policymaking. Cash-based budgetary accounting remains the

most relevant to assess the budgetary control and to support policy decisions.

Therefore, one important discussion that emerges from the GA reforms is the introduction of accrual basis in the budgetary accounting systems, since most countries have adopted accrual basis in their financial accounting systems, but not in the budgetary systems, namely in the budget preparation as well as in the budget execution reporting (Montesinos & Brusca, 2009).

Additionally, a problem of nonexistence of harmonization is identified, since there is a great diversity of GA systems across countries worldwide, and among EU Member-States, where accrual basis has been implemented in different ways (European Commission, 2013a):

- Some countries have already budgetary accrual-based accounting (e.g. Austria, France, United Kingdom), while others still keep their budgetary systems cash-based;
- Within each country, accruals in financial accounting are not been adopted at all levels of government (e.g. Germany).

In the context of the financial crisis, the EU Parliament recognised this problem of lack of accounting systems harmonization; consequently, the EU Commission issued important documents strongly recommending the adoption by the EU Member-States of accrual accounting, supported by the IPSAS (European Commission, 2013a, 2013b).

This approach is a consequence of the lack of transparency and accountability detected in the public sector accounts of EU Member-States, increasing the risk for capital markets and consequently contributing for the financial instability in the EU context (Jesus & Jorge, 2015, 2016).

In a primary approach, the EU Commission Report exposes the IPSAS as the most suitable reference for public sector accrual accounting in Member-States, allowing to overcome the present problem of comparability rising from the lack of harmonisation (European Commission, 2013a). The Report underlines that most countries already apply public sector accounting practices near accruals or modified accruals, although using in parallel cash accounting systems in different levels of government. Moreover, budgetary systems are mostly cash-based in the majority of Member-States (European Commission, 2013a, 2013b).

In addition, several academic studies (e.g., Christiaens *et al.*, 2010; PwC, 2015 and Bellanca & Vandernoot, 2014) evidence this diversity of accounting practices at

GA accounting systems. Moreover, they also underline that EU Member-States still use cash-based mainly in their budgeting processes, although using accrual accounting in their financial systems, more or less close to IPSAS.

Manes Rossi *et al.* (2016) highlight that, in spite of the reforms introduced in public sector financial accounting systems, budgeting systems and budgetary reporting are still mostly cash-based in the majority of European countries (as shown in Brusca *et al.*, 2015), and budgetary information continues having the most important role for decision-making. Financial reporting comes in a secondary place (Heiling *et al.*, 2013).

In summary, the literature shows many differences in how European countries apply accrual accounting and reveals different stages in the process of applying IPSAS (Nogueira *et al.*, 2017).

To tackle the problem of the lack of harmonization, the EU started to develop European Public Sector Accounting Standards (EPSAS), having the IPSAS as benchmark (Pontoppidan & Brusca, 2016). Nevertheless, some still point out that, in spite of EPSAS, harmonization difficulties will remain (Sforza & Cimini, 2016; Eulner & Waldbauer, 2018).

2.2. The accounting perspective of PFM systems

From the above, one may say that the reform efforts towards enhancing the role of accrual-based financial accounting in the public sector, particularly in the context of EU countries, have not been so successful.

To succeed in achieving their purposes, accounting reforms in the public sector seem to need to be integrated in a major challenge – the implementation of broader reforms, in a suitable Public Financial Management framework (Kazarian, 2017).

The domain of public sector finance and financial management is concerned with decision making at mainly three different levels (Lawson, 2015; PEFA, 2016):

- (i) The broader macroeconomic goals and targets and, within this domain, mainly debt control and debt management;
- (ii) The more political sphere of budget accounting, delivering information regarding resource allocation and budget execution; and
- (iii) Microeconomic (financial) accounting, delivering information needed for management decision.

The accountant's perspective on financial reporting under accrual-based systems must be considered as a tool for larger purposes, explicitly improving decision-making

and allowing decision-makers to have a comprehensive picture of the economic reality of financial transactions with a higher level of complexity they must decide about. Financial reports must be used at a micro level for entities' management purposes and also to assist macro level decisions, considering the financial impact of the policy decisions.

In the end, countries need an integrated reform plan to improve knowledge of their financial performance and risks, using accrual-based financial accounting tools, as government consolidated financial statements. Only assessing these tools, decision-makers have the necessary capability to manage financial and budgetary risks and to evaluate financial performance of the public entities, at a micro level, and of the governments as a whole, at a macro level.

Governments cannot seek to move to accrual-based accounting systems as a standalone measure. The successes of these depends on make them part of wider PFM, reforms under a framework that will be describe in the next section.

3. PUBLIC FINANCIAL MANAGEMENT AND ACCOUNTING REFORMS

3.1 The PFM framework

According to Lawson (2015), PFM concerns to systems used by governments to collect revenue, allocate public funds and assume public spending, account for funds, and audit results. It involves a broader set of functions and it is conceived as a cycle of six phases, beginning with policy design and ending with external audit and evaluation (Figure 1).

Figure 1: The PFM cycle and the key actors involved



Source: Lawson (2015: pg.1)

PFM reforms are based on the above definition and they must be understood, used and communicated as an overall change in the whole system to improve governments' performance.

The key word at the centre of PFM is 'performance' and it needs the engagement of a large number of actors in the whole cycle to ensure the entire system operates effectively and in a transparent way, aiming to reach accountability purposes.

Performance is assessed through the following PFM outcomes (Lawson, 2015): (1) Monitoring of aggregate fiscal discipline; (2) Achieving allocative efficiency; and (3) Achieving operational efficiency.

However, the core objective of PFM is promoting accountability and transparency. This objective implies that PFM systems must follow a proper way to be implemented, and must be understood within this essential purpose, by being transparent, providing information accessible to the citizens and applying democratic procedures to ensure accountability.

The success of a PFM system depends on its flexibility, allowing targeted sectors to adjust easily, and in the desired manner, within the public sector changes embracing the whole of the PFM cycle, as presented in Figure 1. Accordingly, Lawson (2015) and PEFA (2016) underline the main key lines that shall be considered in a PFM reform process:

1. Aggregate financial management – fiscal sustainability, resource mobilisation and allocation;
2. Operational management – performance, value for money and strategic financial planning and management;
3. Governance – transparency and accountability; and
4. Fiduciary risk management – controls, compliance and oversight.

The expected improvements in public sector financial management cannot occur unless all components in the PFM system use common measures of what constitutes financial performance and financial position, as defined in international public sector accounting standards (PEFA, 2016).

Therefore, PFM systems must allow decision-makers to have a comprehensive picture of the economic reality of complex financial transactions happening in the public sector; they will provide indications about prospective liabilities, and financial reports must assist in ranking financial impact of alternatives.

3.2 Budgeting and accounting systems and PFM reforms

All the above being said, one may ask what is the role of budgeting and accounting systems reforms in PFM systems?

Regarding budgeting for PFM systems, Ronnie *et al.* (2017) underline the need of implementing performance accrual-based budgeting (performance information is provided with financial information, with consequences for the budgets allocations) and managerial performance accrual-based budgeting (performance information on a results approach used for managerial purposes and not focused on budget allocations).

The implementation of a PFM system implies to have a financial accounting approach too (also named ‘balance sheet’ approach) when preparing information to evaluate governments’ performance, managing government financial resources and risks. This approach is especially relevant to prepare consolidated financial statements, which provide the necessary outputs to assess governments’ performance as a whole (Kazarian, 2017).

The ‘balance sheet’ approach involves the adoption of accrual-based accounting in financial systems (Lawson, 2015; Kazarian, 2017). In order PFM systems to work properly, accurate budgetary and financial accounting is fundamental. Therefore, it is necessary to go back to the key principles of accounting by using accrual-based rather than cash-based accounting. It becomes also essential countries adopt an internationally harmonized public sector accounting system, such as IPSAS, so that Whole of Government Accounts (WGA) can be produced and reflect appropriately the countries’ economic situation.

To close the PFM cycle, there is also a need for independent financial audit to the countries’ consolidated financial statements prepared according to IPSAS (or to some IPSAS-based approach) and not only auditing budgetary expenditure (regularity and legal conformity audit), as it is usually done. Moreover, it is important that financial accounting statements are used not only for reporting purposes but they should be required during the whole of the decision-making process.

3.3 PFM systems and EU Member-States assessment

One can argue that it is perhaps time for the EU Commission to change their assessments criteria of Member-States convergence and economic stability and growth,

moving from the Maastricht Treaty criteria (General Government Sector deficit and debt) and beginning to evaluate Member-States according to criteria based on PFM systems, paying attention to changes in the Net Worth as a fiscal objective to be accomplished.

The Net Worth is the difference between Total Assets and Total Liabilities, and its changes over time represent a much more accurate and robust quantitative information than debt (only a single line in the balance sheet) or deficit/surplus (calculated under government statistical methods). This alternative to evaluate EU Member-States must be presented with enough reliability, so it implies using a credible Balance Sheet supported by countries' Consolidated Financial Statements (WGA), based on an effective management and communication of Governments' Balance Sheets prepared according to internationally harmonized accounting standards to the public sector as a whole, namely the IPSAS.

Thus, the Government Net Worth means the amount taxpayers must provide to finance public assets used to deliver public services, and might be designated as 'Taxpayers' Equity' (Kazarian, 2017). It becomes a relevant indicator easily understood by the citizens to evaluate countries' or governments' financial performance. Its changes overtime will assess the outcome of the whole of a government's activities and not only part of them, as it is done using expenditures, revenues, deficit or debt ratios.

The focus on this Net Worth method for countries' assessment in the EU avoids the short-term view of the current focus evaluation based on nominal debt¹ and on cash balances. It will give a long-term overview of the countries' financial performance and risk (Kazarian, 2017).

These main traits of a PFM approach are especially relevant to the market forces that profit from volatility and risk assessments, namely the rating agencies, the hedge funds and the investment banks. It is urgent that countries give to these actors accurate and rigours assessment indicators, not susceptible to be manipulated. Consequently, market forces might trust the governments' outputs information and so evaluated them in a proper way under the Financial Statements prepared accordingly the IPSAS guidance.

¹ According to the OECD Glossary of Statistical Terms (<https://stats.oecd.org/glossary/index.htm>), the nominal value of a debt instrument is the amount that, at any moment in time, the debtor owes to the creditor at that moment; this value is typically established by reference to the terms of a contract between the debtor and creditor. It refers to the current value of the debt, as debts have not been adjusted for factors like inflation.

4. PUBLIC FINANCIAL MANAGEMENT IN PORTUGAL: RECENT BUDGETING AND ACCOUNTING REFORMS

4.1 Recent accounting reforms: main objectives and characteristics

In the early 1990s, Portugal started introducing reforms in public sector financial management and accounting, through the Public Accounting Basis Law (Law 8/1990). This required applying accrual-based financial accounting for entities with financial autonomy, using a system very similar to business accounting, along with a budgetary accounting system remaining cash-based (Jorge, 2015). In 1997 the first Public Sector Accounting Plan (POCP, Law-decree 232/97) was legally passed, embracing cash-based budgetary accounting together with accrual-based financial and cost accounting, including budgetary and financial statements in the annual accounts and using a chart of accounts. POCP became the reference for other various accounting plans particularly oriented to different sectors within the Public Administration, namely local government, health, education and social security.

In the last years, within the Portuguese public sector there have been entities adopting the IFRS directly, others adopting the business accounting system IFRS-based or non-for-profit accounting standards, and others still using the five different public sector accounting plans attending the respective subsector entities belong to (Jorge, 2015). This fragmentation has raised inconsistencies and created difficulties when it comes to consolidated accounts within the organizations individually considered or to the government as a whole. Consequently, bodies as the Budget General Department and the National Institute of Statistics, have great difficulties in analysing the whole of the Public Administrations because accounting information is prepared using different accounting and reporting systems.

Portugal was seriously affected by the economic and financial international crisis from 2009, which led to requiring financial assistance by the *Troika* (International Monetary Fund, European Central Bank and the European Commission) in 2011. Consequently, Portugal was under a Programme of Financial and Economic Assistance, having signed with those international bodies a ‘Memorandum of Understanding’², obliging the country to accomplish to very restrict economic and fiscal targets. One of the conditions imposed by the loaners was on the implementation of an improved public

² http://ec.europa.eu/economy_finance/eu_borrower/mou/2011-05-18-mou-portugal_en.pdf

sector accounting system, demanding for better accountability and transparency. They strongly recommended changing the existing public sector accounting system through adopting IPSAS as the reference for that changing (Law 64-C/2011). In 2012 a new governance regime for the accounting standard-setter was passed (Law-decree 134/2012), clearly including a committee for public sector accounting standards (CNCP), whose main task would be to create the new IPSAS-based public sector accounting system, issued in 2015 (Law-decree 192/2015 – System of Accounting Standards for Public Administrations (SNC-AP).

The main characteristics of SNC-AP might be summarised as follows (Nogueira *et al.*, 2017):

- It is an IPSAS-based system and thus it carries important changes, namely by the application of general accepted accounting principles (e.g., introducing substance over legal form as a general principle to be applied, and the concept of assets control);
- This new system is also rather based on principles than in rules, demanding for much more judgement by professionals; this requires a training challenge to all accounting experts in the Public Administrations setting;
- Accrual basis is applied only in financial accounting and reporting, remaining the budgetary accounting system (budget preparation, execution and reporting) cash-based, under a specific standard (NCP 26); and
- It includes a specific standard concerning Management Accounting practices and reporting, in order to supply guidance on this domain to assess public sector entities performance (NCP 27).

The initial target date for starting implementation was January 2017. However, the Ministry of Finance, body ultimately in charge of the public sector accounting reforms, decided to postpone the implementation of SNC-AP to January 2018, considering the entities were not yet properly prepared. It was defined a dissemination strategy defined (Order 128/2017), covering staff training, adaptation of ICT systems and the establishment of a technical group to monitor the SNC-AP implementation (UniLEO). In spite of this strategy, technical, legal and institutional conditions to implement this new system are still undergoing.

This reform does not merely address the accounting and reporting system, but it is considered a part of a broader reform of the PFM system in Portugal, reflected in the new Budgetary Framework Law (LEO – Law 151/2015). Therefore, the implementation

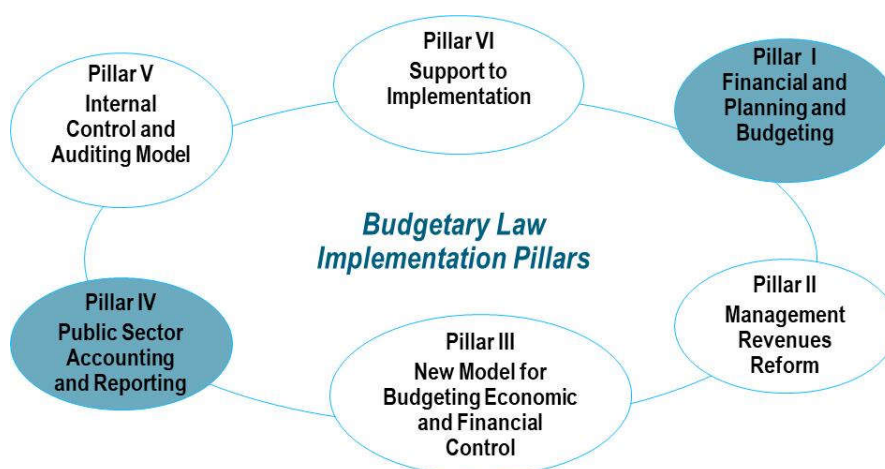
of LEO is a cornerstone to this reform overall, justifying the importance of UniLEO³ to assure the implementation of this framework, as well as to monitoring the implementation of SNC-AP.

4.2 Linking LEO's purposes and PFM systems

As Viana (2017) pointed out, UniLEO's mission is to assure the implementation of the Budgetary Framework Law in all its dimensions, in order to provide the State with the necessary tools to assess public policies in an outcomes approach. Consequently, this unit's mission configures a true PFM reform, inasmuch as it considers the new LEO as a jurisdictional tool to a broader reform in the public sector accountability and transparency processes, including financial accounting and reporting systems (Law 151/2015, articles 62 and 63).

The implementation plan of UniLEO comprises several projects and activities, related to six pillars aligned with the PFM system, as in Figure 2.

Figure 2: Main pillars in the LEO implementation, as a PFM system



Source: Source: Adapted from Viana (2017)

These pillars are connected to the PFM cycles presented in section 3 (Lawson, 2015), beginning with policy design and ending with external audit and evaluation, highlighting performance and accountability as the key words of PFM systems. They also present the same basics principles of a PFM framework (PEFA, 2016): (i)

³ UniLEO was created within the Ministry of Finance, in November 2016 (Decree-Law 77/2016).

budgetary reliability; (ii) public finances transparency; (iii) assets and liabilities management; (iv) political decisions supporting financial strategies and budgets; (v) predictability and control of budgetary execution; (vi) accounting and reporting; and (vii) external scrutiny and auditing.

The Court of Auditors' Report (Tribunal de Contas, 2017) emphasized that LEO, linked to SNC-AP rules and procedures, introduces relevant changes in both budgetary and accounting systems and in the programming model of budgetary preparation and execution, assuring fiscal disciplinary and improving transparency and quality in the results-oriented reporting information.

4.3 Main characteristics of budgeting and accounting pillars of the Portuguese PFM reform

This section summarises the pillars guiding UniLEO's action, focusing those related to budgeting and accounting (Pillars I and IV in Figure 2).

Pillar I – Financial and Budgetary Planning Model, comprises:

- The prediction of a Budget Programming Multiannual Framework – *Quadro Plurianual de Programação Orçamental* (QPPO), involving a set of procedures to present and manage expenditures and revenues in a plurennial view; it configures an approach to a Planning Programming Budgeting System (PPBS);
- The definition of a programming budgetary model obeying to a set of rules aligned with the political priorities and with the institutional assemblies;
- The need to define a budgetary classification to support the political priorities, based on a costing system to properly assess the costs and the benefits of each programme, hence endorsing accrual-based and performance budgeting;
- The preparation and disclosure of estimated financial statements to be included in the Budget framework, to evaluate the programmes effects in economic and financial terms, and not only for controlling payments and receipts; and
- The estimated financial statements as a relevant contribute to transparency and analysis capability, improving the quality of public discussion and, consequently, accountability.

Pillar IV – Public Sector Accounting and Reporting, is the reform pillar already moving on by the implementation of SNC-AP, ongoing since January 2018. UniLEO engaged in the responsibility of SNC-AP implementation, already creating the S3CP (*Sistema Central de Contabilidade e Contas Públicas*) – Central System of Public

Sector Accounting and Reporting, as the main IT support for public sector entities to report budgetary and financial information to the Budget General Department.

This pillar has five main purposes: (i) to make possible the use of new assessment indicators; (ii) to contribute to the transparency in public sector as a whole; (iii) to make financial accounting and reporting to become a tool for Public Financial Management; (iv) to make financial accounting and reporting to be an instrument of accountability; and (v) to provide accrual-based outputs to facilitate the data transposition between GA and NA.

The following characteristics should be highlighted:

- The two main innovations of this pillar are the establishment and implementation of the State as an Accounting Entity (*Entidade Contabilisitca Estado – ECE*) and the use of consolidated financial and budgetary statements (WGA) to manage and assess the Portuguese government at a macro level, embracing financial and budgetary information;
- The implementation of the ECE is a unique project with great relevance within the SNC-AP implementation process. This new entity is supposed to aggregate all data concerning to all financial assets and liabilities, as well as all the revenues (e.g. taxes) and commitments (e.g. PPP obligations) related to the State itself, and not recorded in any separate entity. This ECE project is an integrated part of the S3CP system and the target is to have the opening balance of the ECE ready, within three years from 2017;
- The development of the ECE is essential to the other key issue of this pillar, to get information outputs from the consolidated financial statements (WGA), that should embrace this entity's net worth;
- The WGA, as defined before, must consider accrual-based financial information as well as cash-basis budgetary outputs, because they are very important tools to: (i) a better macro management of the public finances; (ii) an overview of all assets and liabilities, including the contingent ones and other sources of budgetary risks; and (iii) consider other indicators, besides public deficit and debt, to monitor the Portuguese performance in terms of public finances sustainability;
- WGA must assure decisions makers accountability, not only about their cash-based decisions, but essentially regarding the economic and financial impact of their decisions – assessing decisions impact on the government net worth;

- WGA will allow preparing the National Accounts (NA) making adjustments from accrual-based accounts and not from the Governmental Accounting cash-based balance how it is currently made; this will change significantly the reliability of the NA outputs.

As the UniLEO Coordinator recognizes, in the end, this reform requires public sector managers with different skills and responsibilities, joining professionals of different areas (accountants, managers, economists and law experts) and puts them dialoguing. PFM demands for different players' contribution and the key word for its implementation is communication between all the institutions involved as well as political decisions makers, information users and information producers (Marçalo, 2017).

5. FINAL REMARKS

Portugal is undergoing a fundamental reform of the public sector budgeting and accounting systems, inserted in a broader perspective of a PFM framework, to be implemented according to a new Budgetary Framework Law (LEO). As explained in this chapter, LEO' objectives are the basis for a true PFM reform towards performance assessment and accountability in the public sector.

The main characteristics of the Portuguese PFM reforms may be synthetized as follows:

- The PFM system must allow to gather information for financial performance evaluation at several levels (entities, government departments, and government as a whole), both in the budgeting and in the accounting perspectives, thus using accrual-based performance budgeting and year-end financial IPSAS-based information.
- IPSAS-based financial reporting at year-end is a crucial pillar of the underway reform, although not including accrual-based budgetary reporting for political decisions;
- The reform embraces auditing IPSAS-based financial statements, but there is still a long way to run to improve citizens' trust and confidence in government.

Therefore, the most significant reforms are linked to new budgeting and accounting systems (reflected in LEO and SNC-AP, respectively), whose most relevant contribution is a new model of what could be called an «integrated financial reporting», It is expected that, when fully implemented, these reforms provide full accrual-based budgetary and financial statements, prepared and reported monthly, comparing actual

with estimated numbers, in both budgeting and accounting perspectives. The goal is to offer a higher degree of transparency – the impact on net worth of the activities and decisions taken in the reporting period must be very clear, improving accountability of public sector entities, governments bodies and departments, and ultimately in the government as a whole.

The impact of this PFM system on decision-making (including political decision-making) should not be underestimated. It means that the financial consequences of decisions will be published and in the public arena within some weeks after the decisions have been made. This, in turn, means that decision-makers will support the costs (or see the benefits) of their decisions in a very short period, improving accountability and assigning responsibilities, consequently implying the implementation of new approaches for planning, programming and budgeting and a new look to the financial statements reporting. These reforms are also expected to have consequences on the assurance of a consistently strong financial discipline.

The Portuguese experience has been followed by other EU countries, because accounting reforms are integrated in a broader PFM system. It is expected that the Portuguese reforms in both the budgeting and the accounting systems will be successful, because they are integrated in a new PFM framework, following a true reform consistent with the international PFM systems purposes. As stated, accounting reforms can only be successful, achieving their purposes, if they are considered within a major challenge – the implementation of broader reforms, in a suitable Public Financial Management framework, so as its impacts and usefulness can clearly be perceived.

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