Potential uses and usefulness of the Italian local government consolidated financial reporting. The case of town council of Brescia

Abstract

Debate on local government financial reporting has considerably increased over the years, also due to the various public sector accounting reforms. Among the reporting tools implemented to measure, plan, control and communicate performance, in recent years consolidated financial reporting has become increasingly important both for the practitioner and the academic debate. In this perspective, there have been several experiences at international level. As regards the Italian context, the debate on the consolidated report for local government is a fairly recent issue despite the importance of the phenomenon of corporatization. Legislative Decree no. 118/2011 will introduce consolidated financial reporting for local government with more than 5,000 inhabitants as from 2014, after an initial two-year "experimentation" period. The recent reform aims to represent the financial performance of the Italian local government group with particular reference to the need to manage and control public sector finance. Since implementation of the Italian regulation on the consolidated report is recent, and therefore not many town councils have already drawn up this document, the methodological approach implemented in the paper is based on a case study. The town council of Brescia is analyzed. This local government is one of the most important in Italy in terms of wealth, it participate in several entities and organizations (33) and finally, it is engaged in the "experimentation period" introduced to assess the adequacy of the new regulation for the purposes of the public sector accounting reform.

The aims of the paper are twofold. After a critical analysis of the Italian proposal in terms of local government consolidation area, performed also by means of a comparison with international experiences and in particular with IPSAS 6, an empirical analysis is proposed carried out via a case study. Assuming an internal perspective to the organization, the paper aims to contribute to the debate on consolidated financial reporting both from the theoretical and the empirical points of view. Looking at the decision making and stewardship/accountability theories, analysis of the regulation aims to investigate the most critical aspects of the proposal and identify its strengths.

Although this analysis is conducted mainly with reference to the public sector, discussion could also contribute to raising awareness concerning the objectives of the financial reporting with reference to the private sector. It is known, in fact, that the theme of the objectives to be assigned to the financial report is at the centre of the debate, also of the IASB, which has focused attention on the expediency of including also the objective of stewardship, in addition to that of decision usefulness, in the framework for preparation of the financial report.

Lastly, analysis of the concrete choices of one of the most important Italian town councils is useful for understanding the quality of the regulatory provisions and in particular for evaluating the coherence of the technical regulations for drawing up the consolidated report with the objectives of the public accounting reform.

This paper is the first part of a wide research project that aim to assess the potential uses of consolidated information. More specifically, the research project want to address to the following research questions:

1) What are the expectation's in order to the introduction of the new report that is finalized to represent the financial situation of the local government and its organizations as a whole?
2) Which are the expected benefits and the costs related to the consolidated report implementation?
3) What is the perceived utility of the consolidated information, considering the other periodical reports diffused by the Italian local government?

Due to the recent administrative elections and the turnover of the political parties with the consequent reorganisation of the Brescia town council, this paper focuses only on the first part of the research programme. We have conduct some interviews in order to collect data from managers on their perception of consolidated financial report. Due to the relative number of interviews, the results at this point, are not completely significant.

Key word: users, uses and objectives of financial report; consolidated report; local government

1. Introduction

Debate on local government financial reporting has considerably increased over the years, also due to the various public sector accounting reforms. From the point of view of many national governments, reforms (Ongaro, 2008; Hoque, 2008; Valotti, Ongaro, 2008) have been adopted on the assumption that improving the mechanisms of public governance will result in better public sector performance.

Among the reporting tools implemented to measure, plan, control and communicate performance, in recent years consolidated financial reporting has become increasingly important both for the practitioner and the academic debate (IFAC, 2000; IFAC, 2005; Walker, 2009; Karlsson et. al., 2010; Walker, 2011; IFAC 2013).

In this perspective, there have been several experiences at international level. We can cite the relevant cases of the Whole of Government Accounts, the consolidated financial statement of the UK public sector (Chow et. al. 2007), or the Government Finance Statistics promoted by the International Monetary Fund and implemented by the Australian Government (Barton, 2011). Looking at the European Union, the European Commission has launched a debate on the suitability of implementing the IPSAS as a common base to develop and harmonize public sector financial reporting (Grossi et. al. 2011; EC, 2013).

As regards the Italian context, the debate on the consolidated report for local government is a fairly recent issue despite the importance of the phenomenon of corporatization. Legislative Decree no. 118/2011 will introduce consolidated financial reporting for local government with more than 5,000 inhabitants as from 2014, after an initial two-year "experimentation" period.

The recent reform aims to represent the financial performance of the Italian local government group with particular reference to the need to manage and control public sector finance. The objective of Italian public sector consolidated financial reporting is to provide information about the financial position and financial performance of the local government and its controlled entities or, more in general, organizations. Consolidated financial reporting should show the results of the management's stewardship of the resources entrusted to it. This implies that consolidated financial reporting represents a suitable document to measure, plan and control the performance of the local government group as a whole. This is particularly relevant for the Italian context in which over the years, entities and organizations, controlled or participated by the local governments, have increased considerably (Grossi et. al. 2008; Teodori et. al. 2009; Teodori et. al. 2011).

Since implementation of the Italian regulation on the consolidated report is recent, and therefore not many town councils have already drawn up this document, the methodological approach implemented in the paper is based on a case study. The town council of Brescia is analyzed.

This local government is one of the most important in Italy in terms of wealth. In addition, the town council participates in several entities and organizations (33) which present widespread economic characteristics. Finally, the town council of Brescia is engaged in the "experimentation period" introduced by the decree of December 28th

2011 by the Italian Central Government to assess the adequacy of the new regulation for the purposes of the public sector accounting reform.

Specifically, the aims of the paper are twofold. After a critical analysis of the Italian proposal in terms of local government consolidation area, performed also by means of a comparison with international experiences and in particular with IPSAS 6, an empirical analysis is proposed carried out via a case study.

Assuming an internal perspective to the organization, the paper aims to contribute to the debate on consolidated financial reporting both from the theoretical and the empirical points of view.

Looking at the decision making and stewardship/accountability theories, analysis of the regulation aims to investigate the most critical aspects of the proposal and identify its strengths. Although this analysis is conducted mainly with reference to the public sector, discussion could also contribute to raising awareness concerning the objectives of the financial reporting with reference to the private sector. It is known, in fact, that the theme of the objectives to be assigned to the financial report is at the centre of the debate, also of the IASB, which has focused attention on the expediency of including also the objective of stewardship, in addition to that of decision usefulness, in the framework for preparation of the financial report.

Lastly, analysis of the concrete choices of one of the most important Italian town councils is useful for understanding the quality of the regulatory provisions and in particular for evaluating the coherence of the technical regulations for drawing up the consolidated report with the objectives of the public accounting reform. The paper will be structured as follows. The second paragraph provides a theoretical review on the study of local government financial reporting. The third paragraph deals with the reporting entity concept and discusses the boundaries of the consolidated report, analysing in particular the test of control inherent in the IPSAS 6 and the accountability approach of the GASB. The fourth paragraph presents the Italian regulation on consolidated financial reporting, highlighting the main criticality. The fifth paragraph presents the case study, the results and the discussions. The final paragraphs summarise and conclude.

2. Literature review

From the point of view of the academic debate, important studies have been promoted on the topic of public sector financial reporting, in terms of central and local government and with reference both to the separate and consolidated report (Walker, 2003; Walker, 2011; Barton, 2011).

With reference to the consolidated public sector financial report, the most important aspect is connected with identification of the consolidation area and discussion of the effects deriving from the inclusion or exclusion of companies, organizations and entities (Hoque, 2001; Walker, 2011; Barton, 2011; IMF, 2009) from this area.

In the majority of the studies, the different solutions proposed in literature on the modes of definition of the consolidation area depend on (i) the user and the related (ii) usage of the report and finally (iii) the objective of the report, comparing the decision usefulness and the financial accountability approaches.

Although the majority of the studies refer to the separate financial report, the limited research carried out with specific reference to the consolidated report confirms the results of the studies on the separate financial report.

The users of the public sector financial report

As regards the first point, the search for users of the public sector financial report was carried out using the positive or normative approach (Rutherford, 1992). The former applies empirical methods to identify actors who use or could use public sector financial reports. The latter theorizes *a priori* the potential users. In this perspective, the authors (Rutherford, 1992; Walker, 2003) suggest that the majority of the conceptual framework developed by standard setters tends to be normative in approach, identifying the stakeholder information needs on a theoretical basis. In this sense a common feature of the conceptual framework is the assertion that the financial report should provide useful information for the external users who rely on the financial report as their major source of financial information. On the contrary, literature has collected data on the users of the public sector financial reports, using a positive methodology based on empirical investigation. The results (Brusca Alijarde, 1997; Coy et al, 1997; Jones et. al. 2004; Mack et. al, 2007) overwhelmingly support the evidence that the most relevant stakeholders interested in local government financial reports are members of the "internal community of the institutions" (Coy et. al 1997) and in particular: politicians, public managers, auditors and more in general categories of users that manage or control the public finance. These results also apply to the Italian context (Steccolini, 2004). External users, such as citizens, have limited interest in the financial report, they are not sophisticated users and are therefore not technically competent to understand the financial report, they have neither the time nor the resources to dedicate to analysis of the themes, and they prefer indirect forms of access to the information required, i.e. they obtain the information via tools other than the financial report.

The uses of the public sector financial report

The results that emerged from the empirical research require a more detailed analysis of the uses of the public sector financial report. Also with reference to this theme, the assertions of the normative approaches can be compared with the results that emerge from the empirical studies.

The normative approach, followed by the standard setters, pays little or no attention to the theme, simply recalling the role of the financial report in relation to the objectives assigned to it. In particular the conceptual framework is often confined to generically indicating that the financial report "is useful to a wide range of users in making and evaluating decisions about the allocation of resources" (IPSAS 1, 2013).

This approach has been widely criticised by the literature which, on the other hand, has tried to empirically identify the effective or potential uses of the financial report. Brusca Aliajrde found with reference to Spanish local government that financial reporting is used mainly for accountability to the audit offices. It is also used to draw up the budget for the next period, when loans are requested from a financial entity or bonds are issued, to make decisions on new indebtedness operations and to analyze the financial situation (Brusca Alijarde, 1997).

Steccolini, with reference to Italian local government, found that the annual reports are used to discharge accountability to 'internal' users. Moreover, they simply comply with legal requirements concerning preparation, producing poor quality reporting in which accrual-based results and service performance evaluation still have a marginal place. In addition it is not clear if the internal users actually read the annual report.

Walker (2009), referring to Australia, links the consolidated reports with the judgment of the users in relation to the information need considered routinely relevant (Table 1).

Table 1 – Uses of Consolidated statements by users

Judgment	Users
Results and sustainability of a government's financial management practices	Politicians; Public sector managers; Participants in capital markets; Private sector managers; Media analysts; Trade unionists; Community groups; Credit rating agencies; Public
Capacity to continue to deliver existing levels of services to the community at existing levels of taxes and charges *Corollary:* whether government needs to either increase taxes and charges, or reduce levels of service in some areas, because of financial pressure	Cabinet (and committees); Interest groups
Manner in which government is pricing services	Politicians; Departmental officers; Price regulatory agencies; Customers or consumers of services; Interest groups
Extent to which a government is subsidizing services that are sold to the community	Politicians; Taxpayers; Welfare agencies; Private sector service providers
How government has spent taxpayers' funds	Politicians; Public sector managers; Participants in capital markets; Private sector managers; Media analysts; Trade unionists; Interest groups
Whether a government is incurring obligations which will impose burdens on future generations	Politicians; Media analysts; Participants in capital markets; Politic committees; Public
Attractiveness of investing in issues of debt securities offered by a government	Prospective investors; Credit rating agencies Financial advisers; Media analysts
Attractiveness of maintaining investment in debt securities issued by governments	Existing investors; Credit rating agencies; Financial advisers; Media analysts
Risk of delays in payments to creditors	Private sector managers; Credit rating agencies Government lenders; Media analysts
Oversight of levels of borrowings by a government	Loan Council (or similar agencies)

The objective of the public sector financial report

The arguments that emerged from the empirical investigation on the users and uses of the public financial report are used to criticize the objective assigned to the public sector financial report. In this sense, although there is general agreement that the assertion on the decision usefulness purpose cannot describe the objective of the public sector financial report, some criticalities and open points remain, also concerning the stewardship/accountability purpose.

A common feature of the conceptual framework is the proposition that the general financial report should provide useful information to its users. In the normative approach of conceptual framework these users are taken to be external parties to the organization, who do not have access to the underlying data, who cannot call for specific information in order to satisfy their information needs and take their economic decisions. The decision-making approach implicitly assumes an agency theory problem deriving from the division between ownership and management of the entity and in which the figure of the owner-principal is opposed to that of the manager-agent.

Simplifying the financial statement may be of value to the investor (in a broad sense) for taking economic decisions.

Against this approach the available theory suggests (Jones, 1992) that the economic incentives that might explain an interest in business accounts cannot be applied to the audited financial statements of local authorities. This is because theory and empirical research suggest there are no external users of a local authority's published accounts and because the characteristics of the public sector differ significantly from those of private companies. There is no reference shareholder, it is not possible to transpose the principal-agent relationship, there are no incentive schemes designed to limit the misalignment of interests, the politicians can be considered subjects external to the organisation if they are unable to directly access the information and have to base themselves essentially on the information provided by the annual reports.

Jones (Jones 2004), in order to propose a theory for the published public sector financial report, used Ijiri's (1975) theory of accounting measurement which is attractive in emphasising the need for accounting 'to facilitate the smooth functioning of accountability relationships among interested parties' (1975, p. ix). This theory allows preparers and auditors to express their accountability in a technical language that does not need to be understood by those to whom accountability is owed.

In this perspective the literature on the financial report has therefore become progressively more sensitive to the forms of reporting based on the accountability theory which are often assimilated to evolution of the concept of stewardship theory (Davis et. al 1997). Among the different notions proposed, accountability or better financial accountability for the financial report context could be defined as "being obliged to explain one's actions, to justify what one does. Accountability requires governments to answer to the citizenry—to justify the raising of public resources and the purposes for which they are used. Governmental accountability is based on the belief that the citizenry has a —right to know, a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives. Financial reporting plays a major role in fulfilling government's duty to be publicly accountable in a democratic society" (GASB , 1987).

However, in the light of the results obtained in the studies on the users and uses, the literature has maintained a critical attitude also towards the accountability approach. In addition to the consideration that accountability is a multifaceted and evolutionary concept (Patton, 1992; Steccolini 2004), Walker (Walker, 2009), in his paper referring to the consolidated financial report, argues that the conceptual framework and in general normative studies looking at the decision usefulness or accountability purpose: (i) have not presented detailed explanations or illustrations of the precise type of judgments which might be made by these (assumed) users of financial data and what data may be relevant to those judgments; (ii) have not articulated propositions about the circumstances in which postulated users may seek to use different forms of report, the extent to which reliance is placed on intermediaries; and (iii) have not sought to support speculations about the uses which might be made of financial information with research evidence, so that contributors have done little more than share their speculations about how information might be used.

Jones argues that the published audited accounts of local authorities are simply the means by which the preparers provide implicit assurance of the underlying accounting: they legitimate the internal accounting. If this is the extent of any public interest in the published accounts, then a compelling rationale for the increased convergence with business GAAP might be that this increases the legitimacy of the internal accounting and therefore enhances the value of the implicit assurance. The mainly particular corollaries of this conclusion are that publication is not addressed to external users so it is acceptable for preparers and auditors to use a technical accounting language that is not necessarily understood by those to whom accountability is owed (Jones et al. 2004).

3. The reporting entities concept and the boundaries of the consolidated report

Users, potential uses and the objectives of the public sector financial report are central to understanding in a critical perspective the operational aspects connected with drawing up of the public sector financial report. On this theme there is substantial agreement in literature which considers that the most important and most critical aspect is definition of the consolidation area.

Concerning the boundaries of the public sector consolidated financial report, the many solutions proposed are embodied in two reference approaches. These differ in relation to the reporting entity concepts adopted and therefore, in the last analysis, in relation to the objective assigned to the consolidated report and to the notion of users and uses adopted.

These approaches are the test of control approach and the financial accountability approach. They have been sustained to a considerable extent by the standard setters. In this perspective some accounting standard setters identify the area of consolidation on the basis of the test of control. The most interesting situation for the European context, also in the light of their growing importance, is represented by the IPSAS (IPSAS 6). On the other hand the USA GASB has emphasized that the appropriate tests for determining the boundaries of the reporting entity concept should be based on the notion of financial accountability (GASB 14).

Test of control

The test of control approach is proposed in its best-known version by IPSAS 6 – *Consolidated and Separate Financial Statements* (2013), which is drawn primarily on IAS 27, *Consolidated and Separate Financial Statements* (2003).

In the perspective of IPSAS control is "the power to govern the financial and operating policies of another entity so as to benefit from its activities" (Grossi, Steccolini, 2008). As in the IAS 27, IPSAS 6 establishes that control is basically presumed when an entity holds a majority shareholding interest in an entity and this power to control is exercisable. In IPSAS 6 control is also presumed to exist when at least one of the power conditions and one of the benefit conditions, jointly, exists (par. 39). While the power conditions identify the possibility to govern the financial and operating policies of another entity, the benefit conditions represent the ability to benefit from the activities of the other entity.

The power conditions are represented by the right: to appoint or remove a majority of the members of the board of directors or equivalent governing body; to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting; to cast the majority of votes at meetings of the board of directors or equivalent governing body.

The benefit conditions consist in the right: to dissolve the other entity and obtain a significant level of the residual economic benefits (i.e. dividends) or bear significant obligations; to extract distributions of assets and/or be liable for certain obligations of the other entity.

In order to explain the notion of control, IPSAS 6 contains specific guidance on whether control exists in a public sector context (par. 40). These indicators are indicative of the existence of control. Among the power indicators IPSAS 6 lists the following: (a) the ability to veto operating and capital budgets; (b) the ability to veto, overrule or modify governing body decisions; (c) the ability to approve the hiring, reassignment and removal of key personnel; (d) the mandate of the other entity is established and limited by legislation; (e) the holding of a golden share that confers rights to govern the financial and operating policies. Among the benefit indicators: (a) the entity holds direct or indirect title to the net assets/equity of the other entity, with an on-going right to access these; (b) the right to have a significant level of the net assets/equity of the other entity in the event of a liquidation, or in a distribution other than a liquidation; (c) the possibility of directing the other entity to cooperate with it in achieving its objectives; (d) exposure to the residual liabilities of the other entity.

Financial accountability

This approach is consistent with the underlying notion that all functions of (central or local) government are responsible to elected officials and consequently they should be reported as part of one of those levels of government.

In analysing the concept of reporting entity[1], the explanatory material in GASB 14 considers that an entity is financially accountable, and not simply accountable, if first of all the government appoints a voting majority of the entity's governing body. The reporting entity is subsequently broadened to include other criteria. In particular an entity is financially accountable if: (1) the government "is able to impose its will" on that entity; (2) there is a potential for that entity to provide specific financial benefits to the government; (3) there is a potential for that entity to impose specific financial burdens on the government; (4) that entity is physically dependent on the government regardless of whether it has or has not a separately elected governing board.

In particular a government has the ability "to impose its will" on an entity if it can significantly influence the programs, projects, activities or level of services performed or provided. Examples could be the possibility to modify or approve the budget of the entity, to modify or approve rate or fee changes affecting revenues, to overrule, or modify the decisions of the entity's governing body; to appoint, hire, reassign or dismiss those persons responsible for the day-to-day operations (management) of the organization.

In addition, entities that provide specific financial benefits to government, or impose specific financial burdens on government actions, are also included in the reporting entity concept.

An entity has a financial benefit or burden relationship with the government if the government is legally entitled to or can otherwise access the entity's resources, not

[1] GASB Statement 14 (1991) emphasizes tests of accountability, rather than control. It states that 'the financial reporting entity' consists of '(a) the primary government, (b) organizations for which the primary government is *financially accountable*, and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete' . Walker, 2009.

necessarily whether there was an actual transaction during the period, but also when the entity contributes in a substantial way to providing assets of financial benefit to the government. Examples are public utilities for the purpose of providing basic public services and charge rates sufficiently high to also provide a financial benefit to the government. Again, in the accountability approach the reporting entity is extended including also entities in which the government is legally or substantially obliged to finance the deficits of the entity or has to provide financial support to the entity. In these cases, public policy may dictate that a local government provides financial support to the entity to increase the availability and affordability of the service to a broader segment of the citizenry. The reporting entity concept also comprises cases in which the government is obliged in some manner for the debt of the organization.

While IPSAS and consequently the "test of control" is more related to a consolidated report drawn up on the basis of notions of power, benefit and control, similar to that of business accounting, GASB and the "accountability" approach, on the other hand, stress more the attention on the responsibility to govern the public resources, either separately or by means of a group. So in the case of entities in which government does not have a shareholding interest, or this interest is not sufficient to assure the control of the governing body, but these entities depend financially on the government, they are not consolidated according to IPSAS whereas they come under the reporting entities concept in GASB.

The test of control and accountability approaches, sustained to a considerable extent by the standard setters, have contributed to fuelling the academic debate. In this regard there is no lack of strong criticism of these positions in literature. One of the main criticisms is the one formulated by Walker (Walker 2009) who, although maintaining the utility and expediency of structuring a consolidated report on the basis of the accountability approach, underlines its epistemological limits. He clarifies that the definition of the area of consolidation, the most relevant aspect for this document, should be defined in relation to the information routinely relevant to the users or potential users. In a subsequent work, he (Walker 2011) concludes that the analysis of users and potential uses shows that the optimal form for the consolidated report is "whole public sector" reporting .

He proposes that the area of consolidation encompasses, as a minimum:

- ✓ departments and agencies that are primarily dependent on funding from taxes and related charges, via budgetary allocations;
- ✓ owned and controlled public trading enterprises operating in both financial and non-financial sectors, that generate the majority of their own revenues via user charges;
- ✓ controlled entities that generate revenues from fees, levies or compulsory charges;
- ✓ entities that hold assets that have been contributed to assist government agencies to provide services to the community (directly or indirectly);
- ✓ entities that have incurred obligations that will be satisfied from the resources of government.

Finally he concludes on the possibility of producing different forms of consolidated report in relation to different objectives assumed in the preparation of public sector consolidated statements and in relation to the relevance of data to judgments routinely made by stakeholders.

4. The consolidated financial report in Italy: a critical analysis of the new Italian regulation

The aim of the paragraph is to carry out a critical analysis of the accounting standard concerning drawing up of the consolidated report of the "Public Administration Group"[2].

The first observation, which immediately highlights an evident difference with regard to the general national and international accounting standards, concerns the composition of the consolidated report, which is very restrictive as it is limited to the income statement and the balance sheet. The report is completed by two annexes (actually three): the management report, which comprises the explanatory notes, and the report of the audit committee.

Given the profound difference in content, it is difficult to understand the significance of a management report which contains the explanatory notes. For many accounting and communication reasons, it is preferable to totally differentiate the two documents, in order to strengthen their specific nature and information characteristics, since the two documents presuppose different competences, languages, subjects involved and recipients. The explanatory notes are of a technical nature while the management report is of a political nature; the explanatory notes are intended for a public with specialist knowledge of financial reporting whereas the management report should be addressed to all the stakeholders, first and foremost the citizens; the explanatory notes complete the statements via definition of the criteria for and methods with which the values have been determined and the causes underlying their variation, while the management report illustrates the economic-social context in which the overall results have been achieved. For these reasons it makes more sense for the explanatory notes to be one of the components of the consolidated report, together with the income statement and the balance sheet, while the management report can remain an accompanying document to the report.

Having defined the composition of the consolidated report, we now focus attention on the main stage in its preparation: the definition of the boundaries.

The consolidation area – Definition

The definition of the consolidation area, a fundamental stage in general, is even more relevant in this specific case since, as will be seen below, there are many different operating solutions that can affect the information capacity of the consolidated financial report.

The law indirectly defines the concept of "Public administration group", identifying, in addition to the controlling local government (Region, Province, Municipality), the

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[2] The normative references are in the Legislative Decree no. 118 of 23rd June 2011 and Prime Minister's Decree of 28th December 2011. The former defines the criteria for harmonisation of the accounting systems and account formats of the local governments; the latter establishes the terms and procedures for a relatively long experimentation period (two years), in addition to defining the accounting standard commented on in the paragraph and the statements to be used. A sample of controlling local governments was also identified, with different dimensions and characteristics.

entities that should be considered in the consolidated report. These individual entities, although referred to differently within the standard, can be summarised as follows:

- ✓ agencies (“enti strumentali”) and departments (“organismi strumentali”);
- ✓ firms;
- ✓ controlled companies;
- ✓ participated companies.

The whole set, consisting of the controlling local government and the four groups listed above, represents the potential consolidation area, which is now discussed in detail.

The term “department” is of no relevance in operational terms since, as it is only an organisational branch of the “parent”, it is an entity without an independent financial report. The only relevance of the department is of the qualitative type, as it will be commented on during illustration of the composition and organisation of the group and the activities carried out.

The first important entity therefore consists of the agencies, which in practice comprise the firms: for this reason they are dealt with together. No specific definition is provided but only the conditions, described below, for them to come under the consolidation area. The concept of “agencies” (and “firm”) should be differentiated: it comprises everything which, in juridical terms, is different from a company (for example, a foundation), independently of the nature of the shareholders (private or public).

a) Possession, direct or indirect, of the majority of votes that can be exercised in the agency or firm. It is a classic control by law and identifies all the agencies (firms) in which the shareholding is higher than 50%, assuming that shareholding and voting rights coincide.
b) Power assigned by law, statute or agreement to appoint and revoke the majority of the members of the decision-making bodies, competent to define the strategic choices and sector policies, and to decide on the orientation, planning and programming of the activity of an agency or firm.
c) Exercise, direct or indirect, of the majority of the voting rights at the sessions of the decision-making bodies, competent to define the strategic choices and sector policies, and to decide on the orientation, planning and programming of the activity of the agency or firm.
   The previous two points are dealt with together, as they are connected. In these cases the shareholding is not important, as the governing power is assured via other instruments or conditions. In the latter case, observance of the requirement of continuity is fundamental, in the sense that exercise of the controlling influence must not depend on exceptional, extraordinary or fortuitous situations but must represent the normal operating condition.
d) Obligation to balance the finance deficits, in the cases permitted by the law, for percentages higher than the shareholding. This situation can occur for agencies or firms that carry out particular institutional or social activities.
e) Exercise of a controlling influence pursuant to statutory agreements or clauses, in the cases in which the law allows said agreements or clauses. The public service agreements and concessions stipulated with departments or firms which carry out mainly the activity subject of these contracts entail the exercise of

controlling influence. The concept of controlling influence is explicitly introduced even though it was already present in the preceding conditions. In short, it is an example of control in substance, where the shareholdings are below 50%. The law also identifies two specific cases, public service agreements and concessions, specifying that the entity must carry out the business regulated by the above agreements and concessions as its primary activity; however, it is not specified how the concept of "primary activity" should be measured.

A further three entities are also considered agencies:

- ✓ companies operating under special agreements (art. 30, Legislative Decree 267 of 18 August 2000);
- ✓ consortiums of companies (art. 31, Legislative Decree 267 of 18 August 2000);
- ✓ special companies (art. 114, Legislative Decree 267 of 18 August 2000).

In the case of the companies operating under special agreements, it is not clear what the potential consolidation would comprise, as the transactions of the associations are already contained in the local government financial report. The consortiums are only those formed between local authorities, in which other public authorities can take part. The special companies are agencies of the local authority, having legal personality, independent management and their own statute. For the purposes of statistical classification, the individual agencies must be assimilated to the cases regulated by the law governing local government financial reports, in order to identify their mission. It would be very interesting, albeit not explicitly required, to provide some segment indications, i.e. on the individual areas of activity where the group carries out its activity and exercises its influence.

The <u>second</u> entity identifies the controlled companies. The distinguishing element is the concept of company, as defined by Italian commercial law and with evident reference to companies with share capital. Here again, reference is made to control by law and control in substance, both direct and indirect.

In the cases in which the autonomous participation is below 50%, it is necessary to identify the existence of some elements, such as the shareholders' agreements, exercise of controlling influence, public service agreements or concessions. In short, entities in which the following elements exist are considered controlled companies:

- ✓ possession, direct or indirect, also via shareholders' agreements, of the majority of exercisable votes at the ordinary general meeting;
- ✓ sufficient votes to exercise a controlling influence at the ordinary general meeting;
- ✓ the right, pursuant to statutory agreements or clauses, to exercise a controlling influence, in the cases in which the law allows said agreements or clauses. Public service agreements and concessions stipulated with companies that carry out the activity regulated by these agreements as their primary business entail the exercise of controlling influence.

The <u>third</u> and last category identifies the participated companies. In this phase it is a well-defined type of entity, which presupposes total public participation and the direct outsourcing of local public services. In the presence of the two requisites, which must be considered binding, the shareholding of the individual entity is not relevant. The participated company must therefore not be confused with the associate company, which is not autonomously referred to in the specific accounting standard. It is present only in the form of a brief reference for the future as it is established that "on the basis of the results of the experimentation, the definition of participated company can be extended to companies in which [the "parent"], directly or indirectly, holds a significant share of votes that can be exercised at the meeting, equivalent to or greater than 20 percent, or 10 percent if it is a listed company".

From the analysis performed, it emerges that the concept of control underlying the membership of the public administration group is very broad, as it comprises control by law, control in substance and "contractual" control, also in the cases in which, theoretically, there is no participatory link, either direct or indirect. In addition to the cases of control, the introduction of participated companies takes us in the direction of joint control, but without existence of the conditions for identifying the category of Joint venture. In fact, the IFRS 11 defines a *joint arrangement* (of which Joint ventures form a part) as a contractual agreement which involves two or more parties, subject to joint control, understood as sharing of the control in a business activity. Joint control is the contractually agreed sharing of control over an economic activity, and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control (the venturers).

There is no trace of any of this in the law: proportionate consolidation is applied only in the case of "participated companies" and not for the "joint control".

The consolidation area – Causes of exclusion

After identifying the potential consolidation area, i.e. all the entities that possess the characteristics to be consolidated and which we could define, albeit inaccurately, the "group area", the possibilities of exclusion must be evaluated, leading to the actual area of consolidation, i.e. to the entities that will be unitarily represented in the consolidated report. It is worth pointing out that this is a discretional choice, i.e. an option, the exercise of which will decisively influence the information capacity and usefulness of the consolidated report. The law identifies three precise causes of exclusion.

The <u>first</u> refers to irrelevance, also establishing precise quantitative parameters:

- ✓ total assets;
- ✓ equity;
- ✓ total characteristic revenues.

For the purposes of exclusion of the entity from the consolidation area, all the parameters must be below the established threshold, i.e. 5% (Regions) and 10% (Provinces and Municipalities) of the corresponding values of the report of the controlling local government.

Two problems have to be solved: the first concerns how to verify that the threshold has not been exceeded. It needs to be clarified whether this should be done for each entity individually, or considering globally the entities that could come under the exemption. From reading of the text of the law it would appear that the first hypothesis applies, as possible exclusion is established "when the report of a member of the group is irrelevant …".

This solution would, in our opinion, significantly reduce the usefulness of the consolidated report, since it would deprive it of its role as a tool for complete reporting of the management activity by the controlling local government. This cause of exclusion could be implemented in the case of entities under common control when shareholding is limited. In the case of exclusion the most appropriate criterion for evaluation of the participation should be identified and applied, according to the shareholding.

The second aspect concerns identification of the characteristic revenues. The problem arises above all for the controlling local government because the income statement of the local government is not immediately comparable with that of the private companies.

The second cause is connected with the impossibility of obtaining the information necessary for consolidation in a reasonable timescale and without disproportionate costs. This cause is substantially non-usable or applicable in extremely limited cases, in order to avoid instrumental behaviour.

The third and last cause is connected with entities with cash-based financial report not participating in the experiment. This is an understandable cause but should be limited to the experimental period.

A particularly critical aspect concerns the listed controlled companies: in fact, in the ambit of the accounting standard, there are no references to their treatment. In general terms, in fact, for the purpose of construction of the consolidated report, the legal status and type of entity appears irrelevant, while the type of link existing is decisive. For this reason, when the participation is in a listed company and the necessary pre-conditions obtain, it should be consolidated. However, another normative reference, the Law of 7 December 2012, no. 213, art. 147 quater c. 4, reads that the "*overall results of the management of the local authority and non-listed firms participated, are identified by means of the consolidated report, according to accrual*". Only the non-listed entities are referred to, thus implicitly excluding the others. Although from a theoretical point of view this exclusion appears debatable, especially in the cases in which the participated company distributes large dividends to the local government, in operating terms it decisively simplifies the consolidation, at least in the experimental phase. As known, listed companies use the international accounting standards to draw up their reports.

To summarise:

	Agencies and firms	*Controlled companies*	*Participated companies*
Direct or indirect possession of the majority of votes	X		
Direct or indirect possession of the majority of votes also via shareholders' agreements		X	
Appointment or revocation of majority of members of decision-making bodies	X		
Direct or indirect exercise of the majority of voting rights at the meetings of the decision-making bodies	X		
Obligation to balance the finance deficits in excess of the shareholding	X		
Exercise of controlling influence by means of statutory agreements or clauses	X	X	
Controlling influence as a result of public service agreements and concessions	X	X	
Controlling influence at ordinary meeting		X	
Total public participation and direct outsourcing of local public services			X

5. The consolidation area for the town council of Brescia

Italy's administrative organisation is on three levels: the Regions (20, 5 of which have Special Statutes); the Provinces (110); the Municipalities (8,092). All these entities, if the pre-conditions exist, can draw up the consolidated report. Under Italian law this document is optional only for Municipalities with fewer than 5,000 inhabitants, of which there are 5,826. It is therefore an obligation that can potentially involve almost 2,400 controlling local governments, a very important figure, even though in Italy a process tending towards rationalisation of the phenomenon of corporatization is currently in progress.

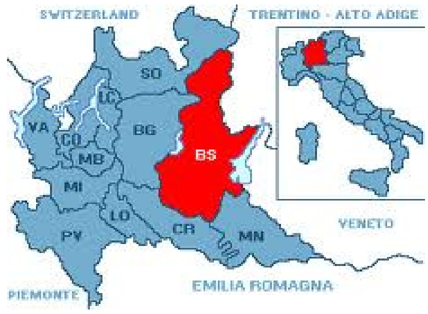
In Italy, the existence of entities in which local government has shareholdings is particularly widespread. The Italian phenomenon of corporatization is due both to external influence and to particular national characteristics. Of the external conditions, the one that has contributed most significantly to outsourcing of the services commonly offered by local government can be attributed to the influence of the new public management paradigm which, from the 80s, has provided the basis for reform of the public sector of many EU countries. New Public Management theories (Hood, 1995, Hoque, 2001), based on economic rationalism, have reflected the high level of trust in market and private business methods. The resulting reforms have led in most EU countries to a diversified and plural institutional landscape in which a public service can often be produced looking at several alternatives. Direct production by the local government department is nowadays in competition with autonomous entities, belonging to the same government or to several other jurisdictions, or with consortiums of local governments or with public-private partnership (PPP). Often public services can be provided with the contracting-out formula or by devolution to a private non-profit organization.

Of the various modes of offering public services, in Italy the phenomenon of corporatization, via which the public service is provided by an external entity in which the local government has a shareholding, is very common. In addition to EU pressure towards increased competitiveness of the public sector by deregulation and by the dissolution of local monopolies, already described, the phenomenon has been stimulated by three major drivers (Grossi et al. 2008). Local government has aimed to improve its local public sector conditions to ensure regularity, continuity and efficiency. It has also tried to attract private entrepreneurship in the offering of services and, finally, by corporatizing, it has aimed to achieve economies of scale.

To understand the importance of corporatization in Italy, it is useful to refer to the recent data provided by ANCI (Anci 2012). It has been highlighted that overall the Italian town councils have shareholdings in 7,723 entities, 3,662 of which are represented by companies. The analysis of the distribution per geographical area highlights that the phenomenon of municipal capitalism is particularly widespread in northern Italy, with the region of Lombardy in top position at national level. In this region, which comprises the town council of Brescia, 1,547 town councils have shareholdings in 1,502 firms, 597 of which are companies.

For the purposes of the analysis, therefore, the town council of Brescia is particularly important, first and foremost because, as has been seen, it is located (Figure 1) in Lombardy, a geographical area of northern Italy in which the phenomenon of corporatization is the most widespread in Italy.

Figure 1 – The province of Brescia



Taking a detailed look, the town council of Brescia participates in several entities and organizations (total 33) which present widespread characteristics. In term of status, these companies are both listed and unlisted; in terms of economic scope, the town council participates in profit and non-profit entities; in terms of dimension, the participated companies are large, medium and also small companies and operate in different sectors, also in the manufacturing sector; in some cases the entities controlled are holdings of subgroups. Finally, the town council of Brescia is engaged in the "experimentation period" introduced by the decree of December 28th 2011 by the Italian Central Government to assess the adequacy of the new regulation for the purposes of the public sector accounting reform.

During the period 2012-2013 the town council of Brescia will be engaged in a twofold commitment. On the one hand, it is required to contribute to improvement at national level of the regulation on the consolidated report. On the other, it has to develop all the internal operations for preparing the consolidated financial report. Of these operations, the most important one is identification of the companies to be included in the consolidated report.

As mentioned, the group area of the town council of Brescia is represented by 33 entities comprising companies (21), consortiums (2), foundations (6) and associations (4). In addition to providing public services such as transport, mobility, health care, electricity production and distribution, waste collection and disposal, and culture, these entities are also active in trade and the production of goods. The economic dimension, expressed by the turnover, indicates a varied scenario. The majority of the entities (16) are micro-firms with turnover not exceeding 2 million euros. Alongside these 6 entities are small firms with turnover below 10 million euros. The remainder are medium-sized or large firms, at the head of corporate subgroups. In one case the company is listed in the main index of the Italian stock market (FTSE/Mib) with a turnover of around 6 billion euros.

Looking at the case study in detail, three important aspects emerge if we analyse Brescia town council's approach to definition of the consolidation area. It should be preliminary underlined, in agreement with the literature, that also in the case of Brescia town council, definition of the boundaries of the consolidated financial report responds more to needs of compliance with the law rather than to considerations concerning the information capacity of the document. In particular, as will be argued below, the town council has moved in the direction of a broadly-based consolidated report, not availing itself of the option to exclude smaller and therefore irrelevant entities. However, this desire to ensure adequate representation of the local public group is limited by the regulatory provisions themselves, which exclude listed companies from the consolidation area.

Firstly it should be highlighted that the participation relationship substantially represents the main criterion that guides identification of the consolidation area. If we exclude the three cases in which this relationship cannot exist due to the particular legal status of some associative forms, the other criteria established by the Italian law (appointment of the governing body, power to influence strategic, management and financial decisions, and existence of public service contracts) are not relevant if considered separately from the criterion of intensity of the participation relationship.

This circumstance, fairly usual in the Italian context, can be examined in greater detail by relating the intensity of the participation relationship with the further criteria established by the consolidation standard.

As shown in table 2, in the case of 8 entities, participation takes the form of control by law. These entities are those that constitute the area of consolidation. In a further 5 cases the participation relationship does not guarantee control by law but the extent of the participation is such as to permit the appointment of some members of the governing board. Lastly, in the majority of cases (17), the participation relationship is limited or even residual. For some of these entities, however, the town council has the right, accorded by statute, to appoint members of the governing board, without ever exercising control. Lastly, in the case of the town council of Brescia, there are no so-called "participated companies" as defined by the accounting standard.

Table 2 – Intensity of the participation relationship

Participation intensity	**no.**
> 50.01%	8
20.01% < x < 50.00%	5
10.01% < x < 20.00%	4
< 10%	13
Total	**30**

Looking in detail at the other criteria established by the standard to identify the consolidation area, it can be observed that the guarantee of appointment of the members of the governing board is present where the participation is of a controlling nature or the right to do so is established by the statute (Table 3).

The power of appointment of all or the majority of the governing board is strictly connected to the intensity of the participation relationship. In fact, control by law also ensures responsibility for the management of the participated entity. The sole exception is represented by a foundation in which the town council has a participation of 92% of the capital but appointment of the governing board is shared, by statute, proportionally among the three shareholders.

Where the town council holds a non-controlling participation (11) it often has the right to appoint part of the governing board. It is significant that in these cases appointment of the directors is not correlated with the participation share.

Table 3 – Appointment of the governing board

Appointment of the governing board	no.
Majority or totality	7
Some members (statutory power)	11
Not defined (left to the meeting of shareholders)	15
Total	**33**

In only two circumstances, and in any case when the participation relationship is total or particularly intense (99.75%), the town council can influence, by statutory provision, the management strategies and decisions of the participated entities.

In no case is the town council obliged to balance finance deficits in excess of the participation shares.

Lastly, the criterion for the outsourcing of public services deserves examination. For the town council of Brescia this parameter is found in 6 cases. Also in this case the criterion of the intensity of the participation share represents the significant indicator for outsourcing of the public service. In only one case is a public service outsourced to an entity in which the town council does not have exclusive control by law, the multiutility listed company controlled jointly with the town council of Milan.

A second consideration can be formulated concerning the overall representation of the consolidation area identified by Brescia town council and, in particular, cases of optional exclusion due to irrelevance. Although in the case in question entities are present which can be identified as irrelevant, with reference to the quantitative parameters established by the accounting standard, Brescia town council has chosen not to avail itself of this option. This should be assessed positively both in the light of accountability and the need for effective control, programming and monitoring of the use of public resources.

Lastly, the criticality that appears to be most relevant is represented not by a decision taken by the town council but is inherent in a derogation to the accounting standard introduced by an *ad hoc* law (Law 213/2012). This exclusion is questionable in the light of the purposes of the consolidated financial report, as assigned by the legislator, thus limiting its usefulness for the management and control of public finance and compromising its communication role vis-à-vis the external stakeholders.

In the contest of the town council of Brescia, this limitation is particularly evident for three reasons. Firstly because the participation held in the listed company represents the main investment of the local government. Secondly, the participated entity offers a wide range of public services which require an appropriate form of reporting and disclosure. Lastly, the transfers of economic and financial resources between the listed company, the town council and the other companies in the group area are very intense. One figure alone illustrates the criticality of the participation: in 2011 the dividends distributed by the listed company were equivalent to 25% of the ordinary revenues of the town council and only thanks to these dividends was the town council able to safeguard its solvency.

6. Conclusions, main limitations and future research

The paper has a twofold objective. After a critical analysis of the Italian proposal concerning the local government consolidation area, carried out also via a comparison with international experience and in particular with IPSAS 6, an empirical analysis is proposed performed by means of a case study.

With reference to the first point, the novelty of the consolidated financial report in the context of local government appears evident. The national legislator has given this instrument three main functions: a) compensate for the lack of information of the individual financial reports of local governments who pursue their functions also via departments and hold important participations in companies, providing an overall representation of their orientation, planning and control strategies; b) give the controlling local government a new tool for programming, managing and controlling its group more effectively; c) obtain a complete vision of the financial position of the local government group. In the intentions of the legislator, the objective of the consolidated financial report is therefore mainly internal, as a tool for the control of public finance, and its stakeholder information role is of secondary importance: discussion on the users and the uses of consolidated report is totally absent.

Looking in detail at the criteria for identifying the consolidation area, some critical points emerge. On the one hand the broad formulation of the conditions that dictate definition of the consolidation area is positive, but on the other exclusion of the listed companies raises many questions concerning the capacity of the consolidated financial report to fully meet the needs of accountability, control and management of public finance.

In comparative terms with the international accounting standards (IPSAS 6), the approach followed by the law has many traits in common with the test of control due to the emphasis given to the criteria of control and benefit. The Italian law, however, also recalls some criteria of the accountability approach where it provides for financing of the deficits or financial support to the entity.

The aspects of criticality highlighted inevitably also condition the behaviour of the town councils. The study of the approach of Brescia town council is of particular importance due to the complexity and particular characteristics of the group area. The most evident limitation derives from the impossibility of including in the consolidation area the main participated entity. On the other hand, the policy adopted in the direction of accountability is positive and has resulted in non-exclusion of the smaller participated entities. Analysis of the criteria followed to identify the consolidation area has highlighted the pre-eminence of the participation relationship. The further criteria established by the accounting standard for the consolidation, i.e. control of the governing board and the possibility, under the statute, of defining the strategic approaches and management choices of the participated entity, are found in the presence of a participation relationship of control.

The methodological approach followed in the paper has focused on the analysis of a case study. The conclusions that emerged therefore need to be adapted in order to be generalised.

Further research will be carried out maintaining the internal approach to the organisation. Analysis of the potential uses of consolidated financial reporting by politicians and public managers will be particularly important, in order to assess the expectations of this group of stakeholders on the consolidated financial report, the expected benefits and the costs related to the consolidated report implementation and the perceived utility of the consolidated information, considering the other periodical reports diffused by Italian local government.

The interviews are structured in three sections: potential users; (ii) potential uses; (iii) utility, benefits and costs.

The preliminary results of the interviews suggests that: (i) the potential utility of consolidated financial report is limited to the managers and the politicians with the responsibility to administrate the town council; (ii) the mandatory provision of the consolidated report imply a strategic management of the local group, both for the town council and the single company. Benefits deriving from consolidated report is linked to the ability to purse this goal; (iii) the high technicality of the report, is a limit in the comprehension of consolidated information for not sophisticated users, first of all politicians and citizens. The effective utility of the consolidated information imply a different communicative approach, that permit to synthetize the financial information and joint this with the most relevant initiative followed in the period by the town council and controlled entities.

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