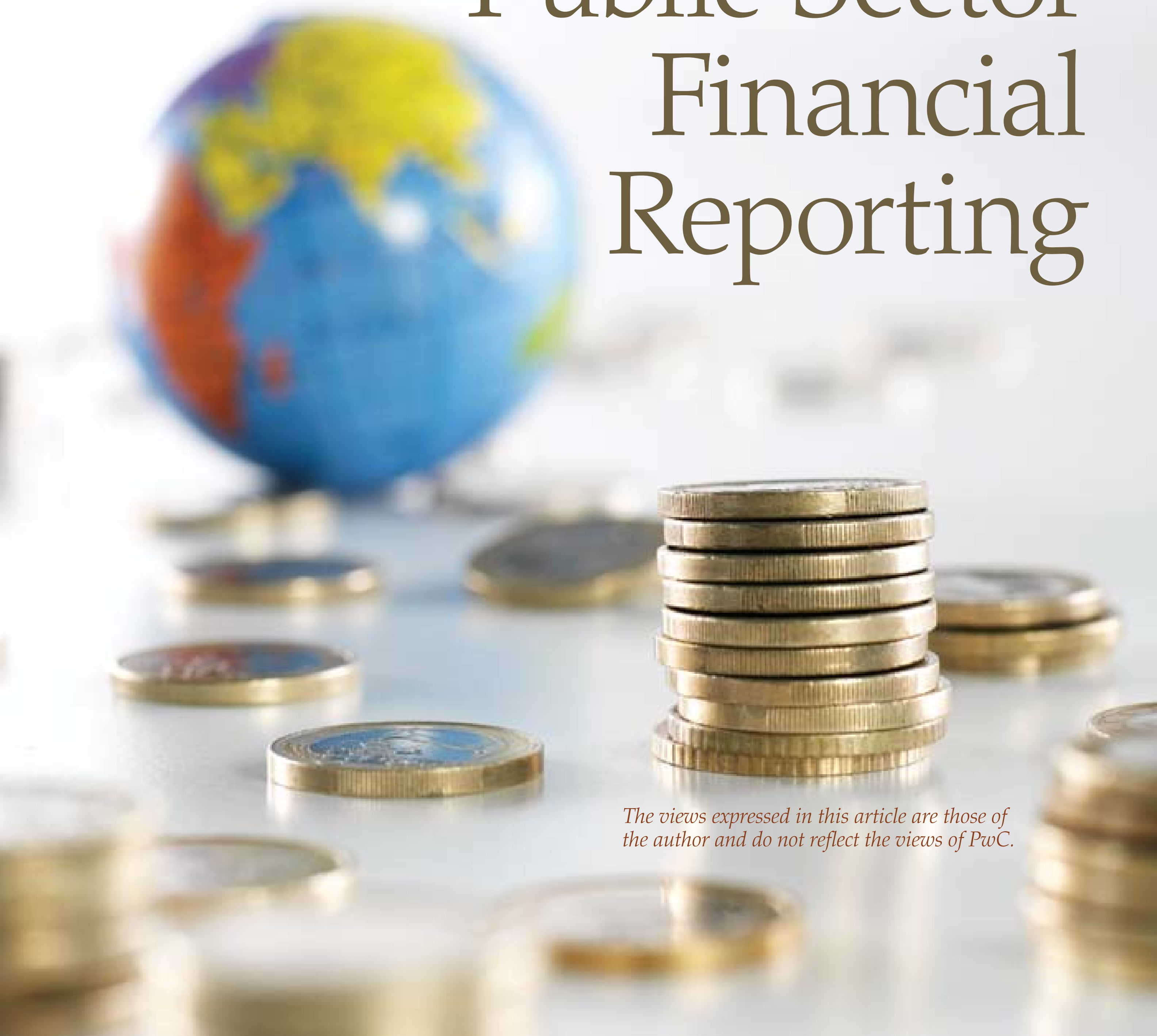
There's Nothing Foreign About International Public Sector Financial Reporting

By: Joseph L. Kull, CGFM, CPA



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"…Government accounts are usually pretty boring documents, mainly focused on compliance…presented in a form designed to discourage all but the most determined readers…"[1]

It is refreshing to read what is often thought. Change is in the wind, however. Whether driven by technology, fiscal uncertainties or financial mischief during recent years, demand is increasing for greater transparency and accountability in public sector reporting. This demand has drawn the attention of standards-setters at the Federal Accounting Standards Advisory Board (FASAB) and the Governmental Accounting Standards Board (GASB). Both boards have re-examined their conceptual frameworks to make sure that financial reports provide stakeholders with information that is clear, timely, relevant and usable.

Not to be outdone, the International Public Sector Accounting Standards Board (IPSASB) is conducting a similar review, aptly named, "Conceptual Framework for General Purpose Financial Statements by Public Sector Entities."

This article summarizes the IPSAB's releases to date on its review of the Conceptual Framework, and originally was intended to compare the IPSASB efforts with those of FASAB and GASB efforts. Finding more similarity than difference, however, shifts the conclusion to examine the new interest in reporting. We'll also learn that our profession may need to shift its thinking on reporting if we are to remain relevant to the users of financial information.

IPSASB in the Standards-Setting Food Chain

IPSASB is part of the International Federation of Accountants (IFAC), and was set up to improve the quality of General Purpose Financial Reports (GPFR) by public sector entities. It evolved out of IFAC's Public Sector Committee, to establish accounting standards in the public sector.

IPSASB standards apply to all national governments, regional governments, including state, provincial and territorial governments, local governments and related entities, such as commissions, agencies and boards. Currently, 31 standards are based on accrual accounting and one on cash basis. Where appropriate, IPSASB will adopt International Financial Reporting Standards, issued by the International Accounting Standards Board, but will make departures it believes warranted.

The Conceptual Framework

December 2010 was a busy month for the IPSASB. It released an Exposure Draft, two Consultation Papers and a paper on "Key Characteristics of the Public Sector," all related to its project to develop a Conceptual Framework for General Purpose Financial Reporting by public sector entities. The Conceptual Framework will be a key project for the next couple of years, as it will form the basis for setting global public sector standards for next 10 to 15 years.

Comments on the Exposure Drafts and Consultation Papers were due to IPSASB by June 15, 2011. Comments on the "Key Characteristics…" paper were due August 31, 2011. The Conceptual Framework is being developed in phases through the following four interconnected components.

The first component is an Exposure Draft titled, "Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Role, Authority, and Scope; Objectives and Users; Qualitative Characteristics; and Reporting Entity." It is the result of a Consultation Paper issued in 2008, dealing with concepts that apply to GPFR under the accrual basis of accounting. It makes clear that the Conceptual Framework's role is to help develop IPSASs, and not establish authoritative requirements.

While financial statements remain at the core of GPFR, the Exposure Draft suggests that GPFRs are more comprehensive than financial statements since they can report past and present financial and non-financial, that is, quantitative, information regarding the achievement of financial and service objectives, as well as projected future service delivery and resource needs, performance and cash flows; compliance with the budget; service delivery achievements; and prospective financial and non-financial information.

The Exposure Draft notes that GPFRs provide information for accountability and decision-making purposes to users who are unable to require financial reports tailored to meet their specific information needs. The ED defines the primary users of GPFRs to be service recipients and their representatives, and service providers and their representatives. Recipients need information to assess whether:

- The entity has used resources economically, efficiently, effectively and as intended, and whether such use is in their (the recipients') interests;
- Its cost of services are appropriate, and;
- Current tax levels and other resource flows are sufficient to maintain current volume/quality of service.

While providers need information to assess whether:

- The entity is achieving objectives desired;
- Operations were funded with monies raised in the current period-taxes or borrowings etc.; and
- Additional or fewer resources will be needed in the future, and how those resources will be obtained.

The qualitative characteristics of information as defined in the Exposure Draft include the usual suspects—relevance, faithful representation, understandability, timeliness, comparability and verifiability—constrained by materiality and cost-benefit considerations. The final section deals with the reporting entity and the group reporting entity.

Each of the four sections includes an appendix that summarizes the same information for the System of National Accounts, which are internationally agreed-upon standards on how to compile and present measures of economic activity so as to facilitate institutional, sector and cross-country comparability, perform macroeconomic analysis and monitor the behavior of an economy.

The second component is described in a Consultation Paper titled, "Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements," which identifies alternate asset and liability-led and revenue and expense-led approaches to financial statements, and considers the key characteristics of assets, liabilities, revenue and expenses.

This paper explores assets and liabilities in GPFS, by asking questions related to the substance of an asset/liability, the criteria for determining whether it is the entity's asset/liability, and whether it is an asset/liability at the reporting date. One of the more interesting questions is, "Are taxes an inherent right of governments at every reporting date, (perpetual asset), or must taxpayers meet certain conditions required by legislation before assets…exist."

The Consultation Paper also considers two approaches for reporting public sector financial performance. The first measures performance as the net result of all changes in the entity's economic resources and obligations during the period. This is the asset-liability led approach. The other approach measures financial performance as the result of revenue inflows and expense outflows more closely associated with operations of the period. This is the revenue-and-expense led approach. These different approaches result in different definitions and yield different reporting results.

One of the most critical issues is how revenue and expenses should be associated with the reporting period. Under the asset-liability led approach, the focus is on items that represent changes in net resources between the reporting dates. The paper notes that this approach avoids artificial smoothing of results since "judgment is not required to determine which transactions…are included or excluded from the specific period's measure of financial performance."

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The revenue-and-expense led approach focuses on the costs of services attributed to the period, thus requiring that taxes and other revenues be attributed to finance the related costs. This holds the entity accountable for the raising of revenue and its use of that revenue. The ultimate objective is to charge taxpayers today for the services they receive today and not pass those costs on to future generations.

The CP also looks beyond the four basic elements by soliciting comments related to deferred in/outflows, the existence of a residual interest in net assets/liabilities, and the nature of contributions and distributions with respect to residual/equity interests. Finally the CP asks questions related to recognition—incorporating an item that meets the definition of an element [existence] and can be reliably measured.

The third component is laid out in a Consultation Paper called, "Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements" and considers measurement bases appropriate for particular elements recognized in financial statements. It discusses historical cost, market value and replacement cost, and then examines deprival value (discussed in detail later) as an approach to select the most relevant measurement base.

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Entry values represent the consideration paid for an asset or assumed for a liability, while exit value looks to the amount that will be derived from an asset, either through its sale or its service potential. Entity-specific values are based on economic constraints and opportunities rather than intentions and expectations, and can be seen as more relevant than market values, which tend to depend on a deep and liquid market to satisfy the qualitative characteristics of financial information. This may pose a problem for valuing specialized assets, which are commonly used in the public sector.

This Consultation Paper regards replacement costs as highly relevant as they reflect the economic position of the entity and permits cost of services to be reported in current-cost terms. The downside is that replacement costs can be complex and costly, diminishing timeliness, comparability and verifiability.

The paper introduces the deprival value (asset) or relief value (liability) model as one that selects a measurement basis that is relevant in specific circumstances. For an asset, it identifies the amount that would be compensated for the loss of an asset in the form of a replacement cost or recoverable value. The same logic applies for liability valuation. The paper poses that this model produces bases that are current, entity-specific and close to market where appropriate. It concludes that the model would be highly relevant but may not incorporate the other qualitative characteristics of financial reporting.

The fourth component deals with presentation. At its March 2011 meeting, IPSASB considered, but did not release, a draft consultation paper on presentation. However, the board did release an Exposure Draft, "Key Characteristics of the Public Sector with Potential Implications for Financial Reporting." The document had been released in December 2010, as a staff draft titled, "Key Characteristics of the Public Sector" to provide some complementary information to those commenting on the Exposure Draft and two Consultation Papers. The draft specifically asked for comments on two questions, on the usefulness of the background information presented, and on whether the instant document should be included as part of the IPSASB's literature.

The "Key Characteristics" Exposure Draft starts with objectives, the private sector being profit-driven while the public sector delivers goods and services. It characterizes government by its breadth of powers (compared to private sector) including the ability to establish and enforce legal requirements; a high volume of non-exchange transactions; and little relation between the goods and services received by a recipient and the tax or contribution made by that individual. This has implications for the scope for financial reporting, as well as the definition and measurement of elements.

Most entities are evaluated by their financial position and performance. Since public sector entities are primarily wealth accumulators and distributors, their financial position and performance measurement is defined by a different set of questions than one might ask to the private sector:

- Has the entity provided its services in an efficient and effective manner?
- How did the entity finance its activities and meet its cash requirements?
- Were the current-year taxes and other resources sufficient to cover the cost of current-year services?
- Did the entity's ability to provide for services improve or deteriorate compared to last year?
- Was part of the burden for current services shifted to future-year taxpayers?
- What resources are currently available for future expenditures, and to what extent are resources reserved or restricted for specified users?

Another distinction is that budgets loom large in public sector reporting as they are often widely distributed and discussed. Private sector budgets are rarely publicized since they hold the key to the entity's strategy and direction. Public sector budgets are critical since they are the key by which legislatures exercise oversight of the executive, and the electorate holds elected representatives accountable. Comparison of actuals to budget is a key measure of accountability, and of interest to users, impacting the scope of financial reporting. By nature, budgets are also prospective documents and thus equally important within the GPFR.

The Exposure Draft makes interesting comparisons regarding property, plant and equipment (PP&E), noting that the private sector holds PP&E to generate cash flow that contribute to profits, while the public sector holds such assets to deliver services. Moreover, a high proportion of public sector PP&E is specialized in nature and not readily sellable, which has implications for measurement.

The draft also discusses the longevity of public sector entities and programs and draws a conclusion sure to generate comments. It posits that since the effects of past decisions may transpire only after many years or even decades, it is unclear whether obligations related to such programs meet the definition of a liability for financial statement purposes. The paper states that "…[meeting] such obligations depends on future tax flows…(which)…gives rise to the issue of whether the power to tax is an asset."

Ironically, this leads to a discussion regarding the going-concern concept, which heretofore has not been widely discussed with respect to the public sector. Without arguing its merits, the paper goes on to note that what is becoming increasingly important is the long-term sustainability of key programs. Because the effects of past financial decisions only become clear over many years, prospective financial information becomes necessary for accountability and decision-making. This, too, will impact the scope of reporting.

The paper concludes with a discussion regarding the importance of the statistical basis of accounting to the public sector. It also concludes that full convergence is neither likely nor desirable due to the different objectives of the two systems and the focus on different reporting entities.

Standardize data. Make it a commodity, so it can be repackaged, reused and available to the public as the public wants it. There will be a market for such data, so let the market provide it and absorb the risk.

There's Nothing Foreign…

No, there really isn't anything foreign about the IPSASB Conceptual Framework project. As noted earlier, comparisons with other efforts to improve reporting may be interesting, although one suspects the differences are at the margin.

Why so much attention to reporting now? Arguably, reporting is the ultimate goal of why we do accounting—to accumulate financial transactions in a comparable and consistent manner so as to make it useful to someone. But why the attention?

Perhaps it is the mistrust of reported information, from the financial mischief of corporations such as Enron and the like, to the financial, housing and credit crises wreaking havoc on industries and governments. Better controls and better audits might help, but regardless, reporting credibility took a hit.

Perhaps the reason for the attention is the Internet, which enables people to get and want information—any information—faster. Unfortunately, financial data is not yet "Net-friendly." Standardizing data and making it interactive are inevitable steps to realizing the productivity promised in our digital world.

Perhaps the public expects more from government financial reports. Recent studies[2] suggest the public wants entities to report on social, environmental and governance activities; include more performance-related information; and place a greater emphasis on prospective information, especially sustainability. Such a better citizen-type report could help restore reporting credibility, and suggests "the bottom line" may have a whole new meaning.

And where did this interest in sustainability—arguably the public sector equivalent to going concern—come from? Perhaps it started when the public sector started reporting on the accrual basis of accounting and it brought to light real and contingent liabilities, especially related to pensions and other social insurance-type programs. Or the real cost of war. Or the fact that assets and infrastructure wear out and need to be replaced. Or that taxes may not be as elastic as once thought. Shedding light on such costs continues to be important to better inform the budget debate, and help shape or reform programs and policies.

So it is a good thing that our profession is on a path to continuously improve reporting. Unfortunately, we take too long to make those changes. We spend years, if not decades, quibbling and nibbling at the edges of change, while the rhetoric stays the same, as if we are trying to prove Einstein's theory of insanity.

Maybe we need to shift our thinking on reporting, and not just a little. We know there are multiple users with multiple needs; we know that accounting data can be biased by the scope, basis, measurement, etc.[3] chosen; we know that people want reliable data quickly, data that either they can access themselves, or be custom-fed; and we must restore the public's faith in the information we generate.

So put as much information out there as fast as possible, and make it easily accessible, searchable and interchangeable. Let's not talk about transparency—let's be transparent. Shed as much light on as much data as fast as possible—let people see, as Tapscott and Ticoll suggest in the Naked Corporation.[4]

Is this risky? Perhaps, but without risk there is no gain, and we can take steps to mitigate risk. Shifting away from auditing line items in statements to validating processes that generate real-time information would mitigate some risk. Standardize data. Make it a commodity, so it can be repackaged, reused and available to the public as the public wants it. There will be a market for such data, so let the market provide it and absorb the risk. As Tapscott and Ticoll point out, there may be a greater risk for not being transparent.

What is far riskier to the credibility of our profession is to continue to talk and not act.

End Notes

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Joseph L. Kull, CGFM, CPA, a member of AGA's Washington, D.C. Chapter, is AGA's Immediate Past National Treasurer and a director in the Washington Federal Practice, PwC.