IPSAS: Conceptual and Institutional Issues

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Major Issues to be Addressed

• In what general ways should IPSAS be similar to – and different from – International Financial Reporting Standards (IFRS)?
• How should the uniqueness of government be addressed in IPSAS?
• Who sets, finances and enforces IPSAS?
A Global Revolution in Government Accounting?

An Introduction
A Global Revolution in Government Accounting

• Recognition of importance of government accounting as an integral part of the financial management infrastructure of a government/nation.

• In response to demand for government financial accountability and transparency as an international norm demanded by donors and lenders.

• A consequence of spread of democratization and market economy since the late 1980s.
Main Features of the Global Revolution in GA

- Business-type *accrual accounting* is proposed to replace cash accounting commonly used by government
- Whole-of-government (consolidated) financial statements at year-end are proposed to replace detailed budget execution reports
- These features are evident in *International Public Sector Accounting Standards (IPSAS)*
International Public Sector Accounting Standards

General Introduction
International Public Finance Reporting Standards and Codes

- Financial reporting requirements in international treaties, agreements and contracts
- Government section of the UN and European System of National Accounts (SNA)
- International Monetary Fund (IMF) Government Finance Statistics (GFS)
- IMF Fiscal Transparency (FT)
- Organization for Economic Cooperation and Development (OECD) Budget Transparency
What Is New and Different About IPSAS

• Professional recommendations ("standards") for general-purpose external financial reporting by public sector entities world-wide
• IPSAS converge with IFRS unless public sector uniqueness requires a departure
• Set by a group of accounting experts under the auspices of IFAC – the global federation of national organizations of professional accountants and auditors
• IPSAS are endorsed by influential international donors and lenders
• Government are encouraged but not compelled by international treaty to adopt IPSAS
Translation

• IPSAS is not set by government officials in their official capacity. Current and former officials participate in their individual professional capacity

• IPSAS is “international” in the sense that persons from several nations participate in the process, but IPSAS is not the result of official (governmental) agreements

• IPSAS has become *de facto* global GA standards by virtue of endorsement of powerful institutions
Why the IPSAS Look the Way It Does

- So far, IPSAS is largely modest modification of business accounting and financial reporting standards set by the International [Business] Accounting Standards Board (IASB).
- **Business-like** standards are to be followed by standards dealing with unique public sector transactions and activities.
- The standards are written by accountants for accountants/auditors familiar with business accounting.
Justification for the Strategy

• It is desirable to have comparability and uniformity in accounting for similar transactions in similar ways.

• It was an economical and efficient way of producing a set of “core” GA standards.

• Accrual-based business accounting standards already deal with many similar GA issues.

• Why “reinvent the wheel”?

Source: Sutcliffe (2003, p. 31).
International Public Sector Accounting Standards

Concepts and Structure
The **Principles** Behind the **Standards**

- Government should issue financial reports to the public at the end of a fiscal year.
- At the core of a financial report are a set of financial statements, which are based mostly on actual transactions and activities, use the accrual basis and are presented in a consolidated format for the whole government.
- Accounting methods are chosen to achieve fair presentation in financial reports.
Key Concepts in IPSAS

• Reporting entity is the whole of government as an economic/financial entity

• Financial statements describe financial position and financial performance measured by accrual basis, and cash flows

• Financial statements report mostly the effects of past transactions and activities that are acknowledged (“recognized”) in the accounts.
Key Concepts in IPSAS

• General-purpose external financial statements should use accounting standards set by a body independent of the government, and should be examined by independent auditors.

• The **accrual basis** is preferable to the **cash basis** because accrual reflects the long-term financial consequences of past and current transactions and activities.
Classifications of IPSAS

• Cash-basis and accrual basis: 1 vs. many
• Convergent with IFRS and specific to the public sector: many vs. few
• Classified by generality of topics
  – General recognition and measurement: few
  – General financial reporting: some
  – Specific transactions and items: numerous
IPSAS: General Recognition and Measurement Standards

• Revenue from exchange transactions (No. 9)
• Revenue from non-exchange transactions (taxes and transfers) (23rd)
• The effects of changes in foreign current exchange rates (No. 4)
IPSAS: General Reporting Standards

• Presentation of financial statements (1\textsuperscript{st})
• Cash flow statements (2\textsuperscript{nd})
• ... \textbf{Budget information} ... (24\textsuperscript{th})
• Consolidated financial statements and accounting for controlled entities (6\textsuperscript{th})
• \textbf{Disclosure} ... about General Government Sector (22\textsuperscript{nd})
• Segment reporting (18\textsuperscript{th})
• ... Interest in joint ventures (8\textsuperscript{th})
• Related party disclosures (20\textsuperscript{th})
IPSAS: General Reporting Standards

• Financial reporting in hyperinflationary economies (10th)
• Events after the reporting date (14th)
• Fundamental errors and changes in accounting policies (3rd)
IPSAS: Specific Transactions and Financial Statement Elements

- Financial instruments … (15th)
- … Investments in associates (7th)
- Inventories (12th)
- Investment property (16th)
- Property, plant, and equipment (17th)
- Impairment of non-cash-gen. assets (21st)
- Impairment of cash-generating assets (26th)
IPSAS: Specific Transactions and Financial Statement Elements

- Lease (13\textsuperscript{th})
- Provisions, contingent liabilities and contingent assets (19\textsuperscript{th})
- Construction contracts (11\textsuperscript{th})
- Borrowing costs (5\textsuperscript{th})
- Net surplus or deficit for the period (3\textsuperscript{rd})
- Employee benefits (25\textsuperscript{th})
Exposure Drafts of Proposed Standards

- … Service concession arrangements (comments due August 1st, 2008)
- Social benefits: disclosure of cash transfers to individuals and households (comments due July 15th)
Current Projects (May 2008)

- Conceptual framework for general purpose financial reports of public sector entities
- Review of cash-basis IPSAS
- Financial instruments
- Fiscal sustainability of government programs and their financing
- Heritage assets
International Public Sector Accounting Standards

Standards on Issues Specific to Government
No. 23 **Revenues from Taxes and Transfers**

- Transfers refer to fines, donations and debt forgiveness, and resources from other non-exchange transactions.
- $\Delta \text{Assets} - \Delta \text{Liabilities} = \Delta \text{Net Assets}$ recognized as revenue under accrual basis and measured at fair value.
- Taxable event triggers potential resource flows.
- Definition of asset and liability is critical.
No. 21 Impairment of Non-cash Generating Assets

• These are fixed assets held not for producing commercial benefits.
• Depreciation is recognized on fixed assets.
• Impairment loss is the decline in fair value beyond depreciation expense.
• The standard requires the recognition of loss due to impairment.
No. 24 on **Budget Information in Financial Statements**

- Standard deals only with disclosure and assumes availability of budget information
- **Disclosure includes:**
  - Original & final budget (projected revenues and appropriations)
  - Actual amounts on the budgetary basis
  - Explanation of variances
  - Reconciliation of accrual and budgetary bases
No. 22 Disclosure of General Government Sector

• Consolidated financial statements includes entities controlled by the reporting entity
• Some of these entities are financial and non-financial public corporations in the General Government Sector (GGS)
• The standards permits additional disclosures about GGS to clarify relationships
Exposure Draft on Social Benefits

• **Social benefits** (such as public pensions) are not liabilities as currently defined, but are important enough to be disclosed outside of financial statements.

• Further research is conducted on their recognition and measurement, and on the disclosure of the **sustainability** of government programs and their financing.
Research Project on Heritage Assets

• Heritage assets as a special kind of fixed assets, such as Su Nuraxi

• Heritage assets are owned and controlled by the reporting government

• Problems relate mostly to the availability and meaningfulness of financial measures of cost and economic value

• Non-financial disclosure is a likely option
Consultation Paper on Service Concession Arrangements

- Service concession arrangements (SCA) enable a private-sector entity (operator) to deliver an asset, normally infrastructure, to government (grantor).
- A IPSAS would address the government’s recognition of underlying assets and revenues, and the disclosure of risks and benefits.
Conceptual Issues
A List of **Conceptual Issues**

- The wisdom of setting standards before agreement on a conceptual framework.
- The wisdom of starting IPSAS by modifying existing international business accounting and financial reporting standards (IFRS)
- Accrual basis vs. cash basis
- Aggregated vs. disaggregated reporting
- Budgetary reporting and comparison in financial reports: yes or no; if yes, where and how
Conceptual Framework

Conceptual Issue 1
A Conceptual Framework Project
After Setting Many Standards

• Objectives of financial reporting
• Scope of financial reporting
• Qualitative characteristics of financial info.
• Characteristics of the reporting entity
• Definition and recognition of elements of financial statements
• Measurement
• Presentation and disclosure
Problems With Accounting Conceptual Frameworks

- Research on conceptual framework is open-ended and time-consuming, and not of practical value.
- Conceptual frameworks are found not useful in making accounting policy choices.
- Conceptual frameworks are still needed to delineate the scope of standards and give general direction to standard setting.
- The way forward: commitment to an explicit theory, such as one based on accountability to specific stakeholders, so that accounting measures are derived from accountability requirements.
No Coherent Standards Without Principles

• “User decision usefulness” a problematic conceptual framework.
• Disillusionment with conceptual frameworks in standard-setting: oversold and under-performed.
• Current fashion: principles-based standard setting.
• Question: What are the principles of government accounting?
• Answer: To be found case by case.
• Likely consequence: incoherent/inconsistent standards.
Simple Government Accounting Principles: A Sample

• Prepare and publish budgets, maintain complete financial records, provide full disclosures, and submit to independent audits.
• Accurately measure the government’s financial condition & performance.
• Measure cash and other financial consequences of transactions and events.
• Keep track of assets, liabilities, revenues, expenditures/expenses.
• Issue user-friendly financial reports.
No Principles Without Theory

• Standards and principles are normative.
• Theory can be
  – Normative: how the world ought to work.
  – Positive: how the word works.
• Normative theory: accountability.
• Positive theory: organizational equilibrium.
Demand for Accountability Leads to More/Better Accounting

• Global expansion of democracy and market economy fosters the norm of reciprocity.

• Government incurs political and economic accountability.

• Accounting information is used to monitor and enforce terms of political and economic exchanges.
Political Exchanges in Constitutional Government

• Democratic governance requires
  – Separations of powers: legislature, executive and judiciary;
  – Checks and balances.
• Conflicts exist between the power to withhold information and the right to know.
• Openness is determined by distribution of power.
• Transparency reduces information asymmetry and redistributes power.
Who is Accountable to Whom?

**Principal**
- Political executives
- Legislature
- The people

**Agent**
- Civil servants
- Executive departments
- Government
# Models of Accounting and Accountability

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Theory of Government

• Business accounting is based on an owner-centered theory of the firm (Coase, 1937).
• Public sector counterpart: voter-centered theory of government.
• From stockholders to stakeholders.
• From voters also to stakeholders: an organization theory of government based on equilibrium of interests of stakeholders.
Government and Stakeholders

- Grant givers (higher-level governments)
- Donors (bilateral, international organizations)
- Taxpayers
- Fee payers
- Investors in government securities
- Creditors
- Borrower, insured,
- Contractors: vendors of goods and services
- Employees
All Stakeholders Want to Know …

• Government’s benefits to them: amounts, timing, and degree of uncertainty.

• Government officials balance between
  – Contributions of stakeholders
  – Inducements (benefits) from government.

• Inspiration from Simon (1945) and Barnard (1938) and need for further research and development.
Emulating Business Accounting

Conceptual Issue 2
A Critique of the Strategy of Emulating Business Accounting

• A set of IPSAS without dealing with issues unique to government cannot be called “core” standards.

• The PSC incurred not only actual expenditures, but also opportunity cost for six years.

• The PSC overlooked the valuable experiences of developing GA standards in the United States since the 1970s at least.

• The PSC ignored the critical differences between the firm and government that affect their accounting and reporting.
Premises of Business Accounting

• Primacy of owners and creditors
• Valuation of the firm = value to owners
• Recognition of private property rights
• Voluntary market exchanges to determine prices
• Legal system for enforcing contracts
• Sufficiency of monetary measurement
In Contrast to Business, the State ...

• Is sovereign and has power to tax and make laws
• More symmetrical status of various stakeholders
• Pursues macro-economic goals sometimes to the detriment of its own short-term financial standing
• Promotes equity by redistributing income/wealth
• Unique role in producing public goods
• Generates hard-to-measure non-financial outputs and outcomes
Governmental Accounting

Uniqueness of Govt.
• Public goods
• Redistributive function
• Power to tax
• Regulatory power

Acctg. Consequences
• Cannot individualize prices and match expenses
• Equity as performance criteria
• Non-reciprocal transactions
• Not obligated to accept private-sector rules
Some \textbf{Characteristics of Government}

- Divided power in constitutional government
- Nature of public property in terms of origin, value other than economic value, longevity
- Broad interpretation of government responsibility for general welfare
- Tax and “transfer” revenues cannot be recognized on the basis of services rendered
Not All’s Well With Business Accounting

• “Rational expectations”: transactions structured to avoid or take advantage of accounting rules.
• Accounting rules – accruals and reporting entity – susceptible to manipulation to boost earnings.
• Inconclusive debates on values vs. costs.
• Multiple acceptable methods for depreciation and inventory, with huge impacts on numbers.
• Ad hoc and strategic earnings forecasts.
Accrual Basis

Conceptual Issue 3
IPSAS Board’s Stance and Dilemma

• Accrual of revenue and expense is tied to recognition and measurement of assets and liabilities
• Fundamental commitment to accrual basis is contradicted by cash-basis IPSAS for countries which are the target adopters of IPSAS.
• No clear alternative to full accrual of revenue based on service effort and accomplishment
• Cash and accrual are viewed as polar opposites, while accrual is really a matter of degree.
Back to the Basic Financial Accounting Framework

• **Accounting equation (identity):**
  assets - liabilities = net assets

• **Revenues and expenses/expenditures as increases and decreases in NA, respectively**

• **Basic requirements for accrual accounting:**
  – A beginning balance sheet with a chart of asset and liability accounts
  – A double-entry recording system
  – The ability to interpret financial consequences of transactions and events in terms of effects on financial position
Other Than Full Accrual: Degrees of Accrual

- **Mild accruals**: short-term financial assets and short-term liabilities.
- **Moderate accruals**: add long-term financial assets and long-term liabilities.
- **Strong accruals**: add capital assets and contingent liabilities.
- “Radical” accruals: add legislated benefits.
Transition to Accrual

- Disallow the cash-basis; distinguish between “cash flow accounting” and “cash basis accounting”
- Agree to the balance sheet perspective
- Adopt the gradual, symmetrical approach
  - Gradual: from mild to moderate to strong
  - Symmetrical: at each degree, recognize assets and liabilities to avoid distortion and manipulation
Level of Aggregation in Reporting

Conceptual Issue 4
Premise of Consolidated Financial Statements in Corporate Reporting

- Management control over all resources
- Majority ownership interest in subsidiary as quantitative criterion of consolidation
- Users of financial statements prefer economic substance over legal form
- Investors and creditors need to know about the whole reporting entity
- Additional disclosures can be made for dissimilar lines of business
Nature of Public Sector Entities

• The range of government functions depends on political and economic system
• Government functions can include: state or governmental activities, business-type activities, and fiduciary activities (e.g. pensions)
• Besides ownership, there are other complex and indirect methods of control and influence
• Political power is often diffused among levels of government, and among branches of government at the same level
Variations of Consolidated Financial Reporting

• One column for the reporting entity
• Reporting entity = Primary government (PG) + legally independent organizations for which the PG is accountable
• Primary government only in one column
• PG total = Governmental activities + Business activities
Sources of the Problem

• One set of general-purpose financial statements for diverse user groups
• Lack of consensus on external user groups
• Lack of information about intermediary and end users, and their needs and capabilities.
• Appropriate level of appropriation cannot be determined without adequate info. about users.
Budget Reporting and Comparison

Conceptual Issue 5
Sources of Problem

• The budget is inherently speculative and financial statements are necessarily tardy
• Separate institutional structures for setting budgeting and accounting rules
• Different theoretical foundation, professions and training
• Different concepts, standards and methods due to differences in purpose
Including Budgets and Financial Statements of Different Years

• To overcome the inherent limitations of a budget and financial statements:

• Budget document for year (t+1) could show financial statements for year (t-1) and budget for year t.

• Financial statements for year (t) could show budget for year (t+1) and possibly (t+2).
# Accounting in Relation to Budgeting

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Reconciliation as a First Step Toward Integration

• Use of budgetary basis for “actual to budget” comparisons
• Reconciliation is the most that can be expected due to differences in
  – Purpose: control vs. fair presentation
  – Emphasis: flows vs. stocks and flows
  – Time horizon: annual vs. long-term
  – Measurement: cash and obligational vs. accrual
Indications of Accounting Influences on Budgeting

• Legally and formally accounting is not permitted to regulate budgeting

• Budgeting cannot avoid dealing current and future financial consequences of past decisions

• Budgeting can/should use accrual accounting information

• Perhaps this is “accrual budgeting”
Contemporary Government Accounting in Perspective
Priority of Accounting Services for Government?

- **Basic purpose**: To safeguard public money by preventing and detecting corruption and graft.
- **Intermediate purpose**: To facilitate sound financial management.
- **Advanced purpose**: To demonstrate and discharge financial accountability to the public.
Developing **Accounting Capacity in Support of Management**

- IPSAS represent the most advanced development
- First **stage**: cash management
- Second stage: managing short-term financial resources and liabilities
- Third stage: managing long-term financial resources and liabilities
- Fourth stage: managing operating fixed assets
- Fifth stage: protection of all fixed assets
Institutional Issues

Who sets standards for whom?
IPSAS: “Authoritative and Independent”

• “… for the first time there is an authoritative set of independent financial reporting standards for government” – International Federal of Accountants, Public Sector Committee (1987-2004) succeeded by the IPSAS Board since 2004.
Goals of IPSAS

- Greater government accountability in all countries.
- Improved quality and reliability in accounting and financial reporting.
- Better financial & economic performance.
- Better financial management and discipline.
- Harmonization of reporting requirements.
- International harmonization.

Guiding Philosophy and Strategy

- Commitment to *convergence with IFRS* unless there is a public sector specific reason for a departure
- **High quality standards** for global use in preparing general purpose financial statements
- **Add value** to quality and transparency of public sector financial reporting
The Standard Setters

- IPSAS Board is a part of the International Federation of Accountants (IFAC), composed of 157 national associations of professional accountants in 123 nations
- IPSAS Board has 15 members nominated by national bodies, and 3 public members
- IPSAS Board is assisted by a Consultative Group
Funders and Observers

• Observers who provide(d) financial support:
  • International Monetary Fund
  • World Bank
  • United Nations Development Program
  • Asian Development Bank

• Observers who do not provide financial support:
  • International Organization of Supreme Audit Institutions
  • Organization for Economic Cooperation and Development
  • International Accounting Standards Board
  • European Commission
Due Process

• Wide dissemination of research studies and exposure drafts of proposed standards
• Consideration of comments
• Open meetings around the world
• Adoption of standards by at least $\frac{3}{4}$ of members present (9 members constitute a quorum).
Institutional Issues
The Success and Leadership Role of Business Accountants and Auditors

- By virtue of expertise, IFAC is understandably closely allied with IASC
- In most countries and globally, accounting and auditing profession is dominated by members working in the private [not public] sector
- Business accounting has the longest and most successful professional standard setting globally and in some countries
- Harmonization of specialties enhances the unity of the accounting profession and discipline
Reverse Regulation?

• The accounting and auditing profession argues for greater independence, i.e. free from government and political interference
• Professional licensing and standards rest on a legal foundation
• Can / Cannot governments regulate its own accounting?
The Roles of Official Representatives of Governments

- **Legislators**, who have the authority to write laws on a jurisdiction’s government accounting and can provide/withhold legal basis and appropriations for IPSAS
- **Finance ministers**, who oversee a government’s accounting
  - Budget directors, who provide/withhold resources
  - Chief Accounting Office, who implement any changes
- **Government auditors**, who use financial data in investigations and attest to financial statements
Distribution of Board Seats

• Nomination by IFAC institutional members vs. public members
• Possible bases of distribution of membership
  – Geographical, nationality
  – Stages of national economic development
  – Types of government accounting system
  – Professional experience and expertise
• Issue: relationship between adoption of standards and representation on IPSAS board
What Does “Adoption” Mean?

- “Adoption” and “process of adoption” are too vague for the list of adopter nations to be complete and reliable.
- At issue is the varying interpretation of “accrual”
- Is adoption of cash-basis IPSAS equivalent to accrual-basis IPSAS? Not in my view
- De facto adoption by nations whose GA standards are “broadly consistent” with IPSAS
- Adoption should be a formal decision accompanied by an implementation plan with adequate resource commitments
IPSAS and Developing Countries

• The cash-basis IPSAS, in effect, is an escape clause for many developing countries

• Personal view: Accrual in principle for all nations, but implementation in stages

• Step 1: The willing to leave an audit trail

• Step 2: The ability to analyze transactions and record effects in a double-entry system

• Gradual advance from mild to moderate degree
Conclusion
A Premature Revolution

- Intellectually:
  - Transferability of business GAAP to govt.
  - Competing models: good, better, and best?
  - Uniform rules for a diverse world.

- Institutionally:
  - Professional authority over govt. authority.
  - Accounting profession over other professions.
  - IFAC over other international organizations.
Business Accounting Rules for Government

• The business of government is more than government businesses.
• Inheriting problems along with solutions.
• Business – lead; government - lag.
• “Drips” (standards) vs. “package” (system change-over).
• Global markets vs. nation-states.
Superiority of Model A?

• A model resting on soft foundations:
  – Info. costs and user’s rational ignorance.
  – The sum and the parts: the fallacy of consolidated financial statements.
  – Effect of advance budget disclosure on the info. value of year-end financial reports.

• Good, better, and best models: the lack of a consensus standard for judging standards.

• Existence and legitimacy of Model B.
Globalization of Model A

• Minimum requirements or unreachable stars?
• Issues: comparability vs. uniformity; principles vs. standards.
• How much accounting uniformity, given national diversity in:
  – Political and government systems.
  – Economic systems.
  – Culture.
  – Stages of development.
  – Public sector involvement of accounting profession.
Professional and Governmental Authority

• The virtues of the professional.

• Should accounting rules of government be set by government or for government?

• Rules of professional engagement: government’s delegation or invitation? Over-reaching initiative?

• The primacy of GAAP in relation to laws and regulations: audit opinions in capital markets and political markets.
Accounting Standards by Accountants (Alone)?

• The accountant’s professional relatives: budgeters, auditors, managers,...

• Constituencies of accounting standards boards: the incidence of costs and benefits.

• Participation and due process: a seat at the table – who? how many?
IPSAS raises at least as many questions as answers!
References and Further Readings

• *Public Money and Management* (Jan. 2003)
  – “Measuring and Reporting the Nation’s Finances: Statistics and Accounting” by R. Jones.
  – “The Standards Programme of the IFAC’s Public Sector Committee” by P. Sutcliffe.
Thank you!

Please address comments and suggestions to
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