

GOVERNMENT ADOPTION OF ACCOUNTING STANDARDS

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Issues to Consider

- What does “adoption” of IPSAS mean?
- How could IPSAS adoption be described, explained or predicted?
- Why would the U.S. and other developed nations not formally adopt IPSAS?
- Why would many developing countries adopt IPSAS? How?
- How could IPSAS and institutional structure be improved?

Background Readings

- ** J. Chan (1985), “The Birth of the GASB”
- ** J. Chan (1994), “... Federal Financial Management ... [the Birth of FASAB]”
- ** J. Chan (2003), “... Standards [the Birth of the PSC/IPSAS Board]”
- *** J. Chan (2006), “IPSAS and Developing Countries”

The Political and Economic Significance of IPSAS

To adopt or not to adopt?

Sources of Accounting Rules: Government vs. Profession

- Norms or *normes*
- Laws, rules and regulations
- Principles as in Generally Accepted Accounting Principles
- Practice as in Generally Accepted Accounting Practice
- Standards as in International Public Sector Accounting Standards

Basis of Authority

- **Legal basis:**
 - Accounting as an executive function
 - Accounting as a tool of legislative oversight
 - Standard-setting as self-determination of government
- **Professional expertise:** superior knowledge
- **Issues: which (should) carry more weight**
 - Legal authority
 - Technical competence
- **Basic issue: Should government be exempted from “players do not set the rules of the game”?**

Accounting Profession's Strategy of Avoiding Legal Conflicts

- Dilemma: the desire to be law-abiding and yet not willing to wait for or participate in the political process of improving laws.
- Ways out of this dilemma:
 - Inventing “general purpose financial reports” that co-exist with legal requirements
 - Obtaining endorsement of powerful partners who have economic leverage over government

Who Has Economic Leverage Over Government?

- When governments borrow
 - from capital markets: private-sector financial institutions, bond rating agencies
 - From official institutions: e.g. IMF, World Bank
- When governments seek grants
 - From multilateral official institutions: e.g. UNDP, World Bank
 - From bilateral official institutions: US AID
 - From private donors: foundations

Apparent IFAC Strategy Regarding Public Sector Acctg. Standards

- Appealing to ideals: public interest, accountability, transparency
- Claiming professional expertise as accountants and auditors
- Drawing analogy with International Accounting and Financial Reporting Standards
- Concession to having only advisory role
- However, making use of the financial leverage of international official institutions

Government Response

- Advanced British Commonwealth countries, and the U.S.: *de facto* adoption
- Developing countries: responsiveness due to endorsement of institutions with financial leverage
- Reformist developed countries: embracing the spirit of IPSAS but selective adoption
- Conservative developed countries: wait and see – little cost to waiting, little benefit in adopting

Interpretation of Statistics of Number of Adoption Countries

- Broadest possible definition of adoption and low threshold level are used.
- “Glass partly full”: IPSAS has received attention of developing countries and countries with transitional economies, often with encouragement of international institutions
- “Glass partly empty”: Inability so far to overcome inertia, neglect or opposition of countries that can afford not to adopt IPSAS

Points to Ponder about IPSAS

- What are the values that drive IPSAS?
- What are the stated and unstated assumptions of IPSAS?
- What ideas are common to business and government accounting?
- What business accounting practices are better, so that govt. accounting should converge to them?

Explaining Adoption or Non-adoption of IPSAS

A theoretical framework: Lueder's contingency model

Advanced British Commonwealth (ABC) Countries

- Adopters: Australia, Canada, New Zealand, United Kingdom
 - *de facto* adoption: having broadly consistent standards
 - *de jure* adoption: apparently unnecessary because their governments already embrace IPSAS-like standards
 - Question: Have these countries adopted IPSAS by law? Why or why not?

The United States of America

- Accountants and business accounting ideas have a long history of influencing government accounting.
- American governments and their officials are very sensitive about the “**jurisdictional issue**” – who can tell them how to account and report.
- **Guiding principle: “No compliance without representation.”**

Jurisdictional Concern in American Govt. Accounting

- Federal Accounting Standards Advisory Board (FASAB) for the Federal Govt. and Governmental Accounting Standards Board (GASB) for state and local governments
- Both FASAB and GASB were the outcomes of long negotiations among their “stakeholders”
- Even under the same sponsor, GASB and FASB argued about jurisdiction over quasi-public quasi-private entities.

Just “Politics” or Proper Institutional Governance?

- **Autonomy**: Accounting of government is necessarily done *by* government itself.
- **Credibility**: But government accounting and reporting is not credible if government itself decides the rules.
- **Political leverage**: Government can be ordered to provide information by a higher political or legal authority.
- **Economic leverage**: Even sovereign nations could **be** induced to provide information by the prospect of receiving commensurate benefits.

Explaining and Predicting IPSAS Adoption

- Governments susceptible to political and economic leverage are more likely to adopt IPSAS.
- Outright political leverage cannot be legitimately imposed on sovereign nations.
- Therefore, governments that borrow or rely on foreign aid are more likely to adopt IPSAS by the least costly means.

Modes of Adoption

- Symbolic adoption: by making general declaration of intent to adopt IPSAS
- Operational adoption is far more costly
 - Making legal or contractual commitments
 - Securing financial and human resources
 - Purchasing hardware and software
 - Installing systems and training personnel
 - Putting accounting system into operation
 - Producing financial reports

Personal Observations on IPSAS

This I Believe... Values

- Herbert Simon: Decisions are based on values and facts.
- I believe in
 - Accountability
 - Transparency
 - Accrual basis of accounting
 - Aggregated reporting
 - International benchmarks

Accountability

- In private sector, it is acceptable to regard management as accountable solely to owners, according to agency theory.
- Both in theory and in practice, public managers are accountable to multiple stakeholders, although more directly to elected officials and ultimately to the people.

Transparency

- Need for clear definition:
 - Accessibility to information – mostly yes
 - Full disclosure – qualified yes
- Governments have the right to keep secrets about/for national defense
- Full disclosure is impossible because govt. has unlimited amount of data, and is unnecessary because users would be overwhelmed by too much information
- In practice, extent of transparency is the outcome of balancing outsider's right to know and government's authority to withhold info.

Accrual Basis of Accounting

- Accrual basis is preferable to cash basis because it consider (a) a broader range of resources and (b) long-term consequences.
- Accrual basis in business (full accrual) recognizes revenues and income based on goods and services sold to specific customers.
- Except for business activities, government cannot use full accrual because of indivisibility of public goods and tax financing.

Accrual (continued)

- Accrual basis in the core public sector (governmental activities) is based on claims:
 - government's claim on others' resources
 - Government's obligation to meet others' claims
- Accounting recognition becomes a determination of the legitimacy of claims, which are ultimately a matter of law

Aggregated Reporting

- Extent of aggregation (types and number of entities put together) depends on user needs, span of control, and homogeneity
- Consolidation is one but not the only level of aggregation
- Alternative aggregated reporting:
 - Separate columns for governmental and business activities
 - Additional column for legally separate but financially interdependent entities

International Benchmarks

- International benchmarks are
 - Desirable because some practices are better than others
 - Necessary because of need for information and comparability
- International benchmarks
 - Obligatory if binding/official agreement (Maastricht Treaty, conditionality)
 - Advisory if compliance is voluntary (IPSAS)

Conceptual Reservations about IPSAS

- IPSAS has not defined accrual applicable to governmental activities
- IPSAS sees cash and accrual bases as “black or white”
- IPSAS regards cash basis as acceptable for some countries in the short term
- IPSAS overlooks dispersed power that makes consolidated reporting inappropriate for many governments

Implementation Issues

- IPSAS cannot be effectively implemented on a large scale without
 - Double-entry accounting system capacity
 - A large number of accounting personnel familiar with business financial accounting
 - Sophisticated software and consultants
- Willingness/unwillingness of IPSAS sponsors to
 - Require IPSAS for grants and loans
 - Invest heavily in developing info. systems

In Praise of Financial Accounting

- Financial accounting: recognizing, measuring and reporting the consequences of *past* transactions and events
- Financial accounting as writing financial history of an entity
- Financial accounting provides a “**reality check**” to speculations and promises

A Rationale for “ipsas”

- “ipsas” refers to the concept of international public sector accounting standards, not necessarily IPSAS
- “ipsas” as a way for international lenders and grantors to reduce the cost of enforcing overlapping accountability requirements
- “ipsas” as a global public good, and the need for financing its production

Accountant's Contribution to Developing Countries

- Assurance of financial integrity of government and its officials
 - Preventing corruption
 - Detecting corruption
 - Enforcing financial integrity
- Accurate accruals and competent financial management so that government can at least
 - Collect receivables on time
 - Liquidate payables on time

Limitations of IPSAS

- IPSAS, as currently conceived, can make only limited contribution to improving financial management in developing countries.
- Reasons:
 - No clear road map for “reverse engineering” from financial statements to accounting systems
 - Capacity to decide the future (budgeting) is a higher priority than to look back at the past (financial acctg)
 - Capacity to manage parts of a government throughout the year (special purpose reports) is more urgent than to monitor the whole government at year-end (annual consolidated financial statements)

Unrealistic Assumptions of IPSAS

- A robust system of internal control exists to assure reliability of financial data
- A double-entry bookkeeping system is in place to accumulate numbers for interim and year-end reporting
- Book-keepers and accountants in government can analyze transactions and events to make recordings in the accounts

Re-directing Accounting Resources

Poverty Reduction Strategy and Millennium Development Goals

1. A differential diagnosis that identifies needed policies and investments
2. An investment plans that indicates required amounts and timing
3. A financial plan that estimates financing gap
4. A donor plan that details donor commitments
5. A management plan that specifies governance and administrative mechanisms for implementation

Source: Jeffrey Sachs (2005)

Fiscal Trap and Governance Failure

- Fiscal trap: lack of resources to pay for infrastructure and public goods critical to economic development
- Governance failure: evidence by corruption, weak judiciary, unclear property right, inability to enforce law, inability to perform basic government function

Fiscal Trap and Governance Failure

- Under-development of government accounting as a cause of: fiscal trap? Governance failure?
- Under-development of government accounting as an effect of: fiscal trap? Governance failure?
- Answer: Both a cause and an effect, but mostly an effect

Government Accounting as Institutional Infrastructure

- Common perception: government accounting as a bureaucratic function
- My view: government accounting as an important part of a country's institutional infrastructure
- Analogies: the foundation of a house, or the sewer lines of a city
- Characteristics: invisible until it fails

Functions of Accounting According to H. Simon (1954)

- Good government accounting system: keeps accurate financial scores
- Better government accounting system: directs the attention of policy makers and managers to problem areas
- Better government accounting system: provides information for decision making.

Accounting as a Support Function

- Accounting does not have values of its own.
- Accounting does not allocate resources to achieve goals.
- Accounting follows public money!
- Allied functions: information system design, internal control, pre-audit, post-audit, revenue administration, expenditure management

For Whom Are IPSAS Made?

- IPSAS are intended primarily for developing countries that want or need international financial assistance.
- Most English-speaking developed countries already have IPSAS-like government accounting standards
- Developed nations that have government accounting standards different from IPSAS can choose to ignore IPSAS without costs

Responsive to the Needs of Developing Countries?

- PSC focused attention and resources on modifying international accounting standards to suit the public sector, and largely neglected the needs of developing countries during Phase I (1996 to 2002) of IPSAS development
- Issuance of comprehensive cash-based IPSAS in 2003 (updated in 2006 and 2007)

What's Wrong with Issuing Cash-based IPSAS?

- A “stepping stone” could become a permanent settlement: de facto long-term de facto standards for developing countries
- The cash-based IPSAS undermines the argument for the universality of accrual-basis, and the credibility of the IPSAS Board – the inability of harmonize its own standards

As Unnecessary as Undesirable

- Why unnecessary? The IPSAS Board could require accrual-basis *in principle* but let developing countries take as long as necessary to implement it.
- Why undesirable? Poor countries are debt-ridden and need cash.
- Accrual accounting sheds light on payables as liabilities and receivables as assets

Cash-Basis Standard Is an Over-reaction to Extreme Accrual

- Extreme accrual refers to requiring governments to recognize heritage assets and depreciation expense.
- Why extreme?
 - Financial measurement is impossible or not meaningful
 - Resulting information is unreliable and not useful

My Proposal

- Gradual, symmetrical approach
- Mild accrual: current financial resources offset by current liabilities = net current financial resources
- Moderate accrual: net current financial resources + (long-term financial resources + long-term liabilities) = net financial resources
- Further accrual: proceed with caution

Goals of IPSAS (IFAC, 1996)

- Greater government accountability
- Improved quality and reliability of financial information
- Better financial and economic performance
- Better financial management and discipline
- International harmonization of reporting requirements

Goals of IPSAS: Rearranged

- International harmonization of reporting requirements
- Improved quality and reliability of financial information
- Better financial management and discipline
- Greater government accountability
- Better financial and economic performance

Better Government Accounting as an Investment

- Investing in better government accounting requires:
 - Foresight: anticipate consequences of bad or no accounting
 - Insight: better accounting leads ... eventually to a better political system, a better economy and a better society

Social Cost and Benefit of Government Accounting Reform

- Government accounting reform directly and readily improve financial management
- Government accounting reform has only indirect and long-term social benefits.
 - Better government accounting → Government financial management → government performance → less poor people
 - Better government accounting → more credible government → more taxes and donations → more services to the people

Political Will and Financial Ability

- Least difficult situation: a government has the political will and the financial ability
- Difficult situations:
 - A government has weak political will but strong financial ability
 - A government has strong political will but weak financial ability
- Most difficult situation: a government has weak political will and weak financial ability

Political Support and Resource Support

- Political support means approval of powerful people
- Who decides whether to change government accounting system?
- In the executive branch: senior managers and ministers
- In the legislature: legislators

Recommendation on Standards

- The IPSAS Board should
 - Rescind the cash-based IPSAS
 - Formulate a claim-based accrual concept for government
 - Explore multiple formats for consolidated financial reporting
 - Then articulate a number of principles that give purpose and coherence to the standards

Recommendations on Institutional Issues

- Creating a pluralistic oversight mechanism for IPSAS, including but not limited to IFAC
- Restructuring the IPSAS Board by giving greater representation to
 - Developing countries
 - Budget Officers
 - Government auditors

Conclusion

- Having good international public sector accounting standards is a necessary, but not sufficient, condition for improving public financial management and governance.
- More attention and resources should be devoted to the creating conditions for effective implementation of accounting standards and related measures.