General comments on the "Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities"

by

Eugenio Anessi-Pessina
Università Cattolica, Rome, Italy
Largo F. Vito 1
00168 Rome (RM)
Italy
eugenio.anessi@unicatt.it
ph +39 06 3015 6115

Ileana Steccolini
Università Bocconi, Milan, Italy
Via Bocconi, 8
20136 Milano (MI)
Italy
ileana.steccolini@sdabocconi.it
ph +39 02 5836 2087

Mariafrancesca Sicilia
Università Bocconi, Milan, Italy
Via Roentgen, 1
20136 Milano (MI)
Italy
francesca.sicilia@unibocconi.it
ph +39 02 5836 5475

Silvia Rota
Università Bocconi, Milan, Italy
Via Roentgen, 1
20136 Milano (MI)
Italy
silvia.rota@unibocconi.it
ph +39 333 8301870

The development of the draft *Conceptual framework for general purpose financial reporting by public sector entities* (henceforth referred to as the *Proposed Framework*) is an important endeavor and a key step towards meeting the need for common financial reporting guidelines in the public sector. Moreover, the effort to capture the peculiarities of public sector entities is a major improvement to the current configuration of IPSASs, which are highly influenced by IAS/IFRS. The following comments are provided in the hope that they will assist in further improving the draft.

The process for the development of the conceptual framework

Over the years, IFAC-PSC and IPSASB have carried out several studies concerning the actual practices of accounting, budgeting, and reporting in the public sector. These studies have great value, since they show the variety of approaches emerging in different countries and levels of governments. Looking at current practices and actual user and preparer needs is crucial to ensuring both the effectiveness and the acceptance of guidelines and standards.

In mid-2006, the IPSASB agreed to lead a collaborative project with national standards setters and similar bodies (NSS) to establish a public-sector conceptual framework. The IPSASB Conceptual Framework Project was developed on the basis of papers prepared by authors from NSS and IPSASB staff. We wonder whether this process can adequately capture the views of the actual preparers and users of public-sector reports worldwide. In Italy, for instance, the accounting professions for the public and private sectors are separate. Certified public accountants ("dottori commercialisti") may serve as auditors for public sector entities, but often they are not fully aware of public-sector specificities, both in general and with specific regard to budgeting, accounting, and reporting issues. A more direct involvement of public-sector accountants would have consequently been advisable.

Finally, participation would have probably been encouraged by the inclusion, in the consultation paper, of an appendix explaining the bases for the Board's proposals.

The relationship with existing IPSASs

The relationship between the conceptual framework and the IPSASs is critical. The framework is being developed after the preparation of more than 20 IPSASs which, in turn, are profoundly inspired by IAS/IFRS. This may produce two opposite but equally undesirable consequences: (i) a conceptual framework that ends up being excessively anchored to private-sector concepts, or (ii) a conceptual framework that takes into due account public-sector specificities, but is largely inconsistent with existing IPSASs.

In our view, the conceptual framework should include a discussion of these risks and the steps taken to avoid them. As to the provision whereby "the IPSASB Framework will not establish new authoritative requirements for financial reporting by public sector entities that adopt IPSASs [...], nor will it override the requirements of existing IPSASs" (§ 1.5), we find it inescapable. However, we feel that it should be accompanied by a strong and explicit commitment to revise the existing IPSASs within a stated deadline. At present, the Proposed Framework only states that "If an IPSAS currently on issue conflicts with the IPSASB Framework, the IPSASB *may* [italics added] review that IPSAS and, through application of due process, revise it" (§ 1.5).

The focus of the conceptual framework

The Proposed Framework, like the IPSASs, focuses on general purpose financial reporting by public sector entities that adopt the accrual basis of accounting. We feel that more attention should be devoted to budgeting and nonfinancial information and wonder whether the IPSASB views these topics as exceeding its mandate or simply as issues to be tackled at a later stage.

Budgeting has traditionally been – and still is – the fundamental phase of the accounting cycle in the public sector. In our view, the reliance on cash or commitment-based budgets to place *ex-ante* caps on spending has been the most important factor hindering the introduction of accruals accounting in the public sector: governments fear that, should they abandon such budgets, they will lose control over spending; the coexistence of cash or commitment-based budgets with accruals-based reporting, on the other hand, has often been disappointing. In our view, moreover, budgeting and reporting in the public sector are profoundly connected and the principles governing them cannot be considered separately. The Proposed Framework does recognize the budget's importance (see for instance §§ 2.11 ff.) and IPSAS1 already mentions the adoption of the same basis of accounting for budgets and financial reports. However, the Proposed Framework seemingly assumes a strong separation between budgeting and reporting and clearly focuses on the latter, while the former is usually mentioned only in its role as a term of comparison to show whether resources were obtained and used in accordance (a) with the legally adopted budget, and (b) with legal and contractual requirements, including financial limits. In our view, the Framework should also provide some guidance on the purposes and features of budgets. In addition, it should clarify the relationship between the budget and the "prospective financial and other information" discussed in §§ 3.13-3.16 (eg is the "prospective" information related to a longer time-horizon than the budget? Is it a projection based on current laws and policies, whereas the budget may incorporate the effects of policy changes?).

Nonfinancial performance in the public sector is key to the entire accounting and managerial cycles, from planning and budgeting to control and reporting. Like budgeting and reporting, financial and nonfinancial information are profoundly intertwined; accountability on financial issues will also be dependent on accountability on the nonfinancial dimensions of performance. Once again, the Proposed Framework does recognize the importance of non-financial performance information (see for instance §§ 1.13.c, 2.11 ff, 3.9-3.11), in fact more so than it does with budgets. However, we feel that a wider effort is required in this direction. On a more practical note, we would like to point out a possible inconsistency in Figure 1, where "General Purpose *Financial* Reports" are shown to include "*nonfinancial*" information [*emphases* added].

Accountability and decision usefulness

We share the IPSASB's views that (i) the objectives of financial reporting by public sector entities should include accountability, and that (ii) decision usefulness should be referred to such a wider and public-sector specific range of issues as "resource allocation, political and social decisions".

At the same time, we feel that the Board should better clarify what specific features of financial reporting should stem from the accountability objective. In other words, what features will be required that wouldn't be if the sole objective were decision usefulness? A greater detail in the information provided (in general and / or with respect to specific topics) is a potential candidate. Another is less measurement discretion, including a greater reliance on historical costs vis à vis fair value accounting.

User and user needs

We have three comments on this topic.

In general, we wonder whether the integral approach chosen by the IPSASB is consistent with an accountability perspective. The accountability perspective implies a wide definition of information users and thus a wide and heterogeneous range of user needs. The integral approach, on the other hand, focuses on common information needs and is thus usually viewed as more coherent with decision usefulness.

At a more specific level, we are not entirely convinced by the classification of users put forward in the Proposed Framework (Preliminary view 3). While certainly effective in grouping users into few manageable categories, it may not be equally effective in classifying user needs. For instance, recipients of services are acknowledged to also need information about "resources raised" (§ 2.11). Conversely, resource providers are acknowledged to also need information about "the amount and type of resources used in the provision of services" (§ 2.13). In our view, the IPSASB should investigate other potential classification criteria, which indeed are already mentioned in the Proposed Framework, such as the distinction between voluntary and involuntary resource providers (§ 2.6) or the distinction between users whose needs are similar to private-sector settings (lenders, suppliers and purchasers of government services: § 2.9) and users whose needs are specific to the public sector.

At an even more specific level, finally, we believe that the list of information users should include other governments (eg neighbouring governments, higher-tier governments).

Going Concern

The Proposed Framework does not discuss the going concern assumption. We believe it should. Not only is going concern a major foundation of general purpose financial reporting; in the public sector, it takes on peculiar features that warrant specific consideration. Just to mention the most common examples:

- Governments are usually shielded from the threat of insolvency and their life expectancy is longer than private firms'.
- At the same time, their operations are strongly affected by political cycles. As a consequence, many will not adopt budgets that incorporate decisions to be taken after the next election and some will publish reports covering the entire (eg 4- or 5-year) term of the outgoing administration.
- Nevertheless, as acknowledged by IPSASB itself, governments frequently make public announcements regarding the nature or amount of social benefits that may be provided in the future and/or commit themselves to future actions; in addition, a government may be seen as having an obligation to provide particular goods and services in the future simply as a result of previous and current public undertakings or commitments.

Prudence

Prudence, or conservatism, is not identified as an essential component of faithful representation, but rather viewed as encompassed by the quality of neutrality (§ 4.19). Once again, we believe that prudence deserves a closer examination in light of public-sector specificities. At the same time, we recognise that the overall impact of these specificities cannot be easily identified. On the one hand, prudence seems consistent with the need to both protect future generations and offset political short-sightedness. On the other hand, however, prudent *management* may require prudent *budgeting*, but not necessarily prudent *reporting*. In addition, whenever sub-national governments have little tax raising powers and are mainly funded by transfers from higher-tier governments, prudence may help overstate expenses and deficits in order to claim larger transfers.

Criteria for inclusion within the whole of government group reporting entity

The "power" and "benefit or financial burden/loss" criteria do not seem to work as well for the public sector as they do in the private sector, so much so that the Proposed Framework itself already includes a list of exceptions or special cases (§§ 5.28-5.31).

While the limits of the power criterion are clearly exemplified by such exceptions, we would also like to draw the IPSASB's attention to the limits of the benefit criterion. When motivating the exclusion of regulated firms from the perimeter of consolidation, for instance, the Proposed Framework (§ 5.21) claims that "in these cases, the government is unable to exercise that power for its own benefit". However, regulation is a means to implementing government policy. Therefore, it may in fact be viewed as beneficial to the regulating government, since "the benefit may also be in the form of an ability to direct the other entity to work with the government to achieve the service delivery objectives of the government" (§ 5.25). In other words, while we agree that regulated private firms should be excluded from the perimeter of consolidation, we believe that the benefit criterion in its current form does not clearly motivate such choice.