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IPSASB Consultation Paper: Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities, Phase I – Comments

Dear Ms Fox,

The global organisation of Ernst & Young is pleased to respond to the above Consultation Paper.

We believe that the conceptual framework is critical to the future development and consistent application of IPSAS at an international level. We are convinced that the development of a public sector specific framework will further stimulate the use and the acceptance of the IPSASs worldwide. In spite of the standards being principally based on the IFRS standards (including modifications where necessary to address public sector specific issues) we see the need for a framework focusing on the specific information requirements of users of General Purpose Financial Reports (GPFRs) in the public sector. We are therefore pleased to see that the objective of the IPSASB's project is not simply to interpret the IASB framework for application to the public sector but rather to develop a conceptual framework for the public sector that makes explicit the concepts, definitions and principles underlying the developments of IPSASs. Whereas the IPSASs themselves (especially those standards which are part of the IFRS convergence project of the IPSASB) should be close to or in line with the IFRSs, the IPSASB Conceptual Framework offers the opportunity to specifically address, explain and highlight public sector issues and principles in order to point out differences in relation to private sector accounting and financial reporting.

Furthermore, we do not support the view expressed in the "Introduction" (page 4, 2nd paragraph), that Government Business Enterprises (GBEs) are profit-seeking entities. On the contrary, many GBEs strive only for cost recovery. In a European context, some GBEs do not even have a cost recovery approach as they are fully subsidized, e.g. theaters, fair exhibition companies, public swimming facilities, etc. We therefore suggest that the definition of GBEs

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should be refined in the context of the conceptual framework project and with respect to their dedication to public policies.

Another general remark which we would like to make refers to the concept of inter-generational or interperiod equity. This concept is inherent in (public sector) accrual accounting and should therefore be a central element of the conceptual framework project. In our view, reference to intergenerational/interperiod equity should be made in phase 1 of the conceptual framework project because it does not fit either into phase 2 or into phase 3. One of the major advantages of including this concept would be the interpretation of equity and changes of equity. Furthermore, the interpretation of a positive (or negative) result in the statement of financial performance would be much clearer, especially from a citizen's point of view.

Preliminary View 1 - The Authority of the IPSASB Framework (according to paragraph 1.7)

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.

In selecting accounting policies to deal with circumstances not dealt with in IPSASs or other guidance issued by the IPSASB, public sector entities will refer to, and consider the applicability of, the definitions, recognition criteria, measurement principles, and other concepts identified in the IPSASB Framework.

We support the view that the Framework will not override the provisions of existing standards.

However, the IPSASB Framework Project (especially phase 1 to 3) will have an impact on existing IPSASs, e.g. the definition of assets and liabilities. For example, the discussion on ED 34 "Social Benefits" showed that the current IPSASB working definition of a liability is significantly narrower than the existing definition in the IPSASB literature. We therefore see the need to be constantly aware of conflicts with existing standards during the work on the Framework project in order to ensure consistency by topical review and revision of those standards concerned (see CP 1.5).

In the light of these possible conflicts and for clarification we suggest to amend in the IPSASB Preliminary View 1 that "If an IPSAS currently on issue conflicts with the IPSASB Framework, the IPSASB may review that IPSAS and, through application of due process, revise it. However, until that occurs, the requirements of the existing IPSAS will apply." (after "nor will it override the requirements of existing IPSASs.").

In our opinion, the aim of a Conceptual Framework is to form the basis for all other IPSASs and to be consistent with the principles used in other IPSASs. Only in well-defined and well-

described cases should an exception to the principles set forth by the framework be possible in an IPSAS.

We support the view that when selecting accounting policies to account for circumstances not dealt with in IPSASs or any other guidance issued by the IPSASB, public sector entities will have to refer to, and consider the applicability of, the definitions, recognition criteria, measurement principles, and other concepts identified in the IPSASB Framework.

Preliminary View 2 - General Purpose Financial Reports (GPFRs) (according to paragraph 1.15)

GPFRs are financial reports intended to meet the common information needs of a potentially wide range of users who are unable to demand the preparation of financial reports tailored to meet their specific information needs.

We agree with the understanding of GPFRs expressed above. We furthermore support the view that GPFRs include, but are broader than, financial statements and their notes as currently dealt with in IPSASs (see CP 1.13). In our view the presentation of non-financial information about the achievement of the entity's service delivery objectives is extremely valuable in the public sector context. Therefore, we share the IPSASB's view that the financial reports are intended to meet the common information needs of a potentially wide range of users and that they may also comprise non-financial information. By their nature, GPFRs address users who are unable to demand the preparation of financial reports tailored to meet their specific information needs.

Regarding Differential Reporting, we agree with the approach of the IPSASB not to establish different concepts for application by different types or classes of entities. Requirements for differential reporting should not be a subject matter for the Conceptual Framework. We would support dealing with these issues in a separate Differential Reporting Project rather than considering differential reporting requirements in the development of individual IPSASs (as outlined as alternative approach in CP 1.17) to ensure a consistent development and application of these differential requirements for all standards.

Preliminary View 3 - The Users of GPFRs (according to paragraph 2.7)

As a mechanism for focusing on their common information needs, the potential users of GPFRs of public sector entities are identified as:

- recipients of services or their representatives;
- providers of resources or their representatives; and
- other parties, including special interest groups and their representatives.

The legislature is a major user of GPFRs. It acts in the interest of members of the community, whether as recipients of services, providers of resources, or citizens with an interest in, or need for, particular services or activities.

We support the view of the IPSASB that the legislature as a democratically elected body is a major user of GPFRs, as it acts in the interest of the members of the community in general.

However, from our perspective, the IPSASB has chosen a rather unspecified approach in identifying and clustering potential user groups of GPFRs. Regarding, for example, resource providers (or their representatives), one could argue that there are different views and informational needs of private sector and public sector service providers. Defining these two groups as one class of "resource providers" would imply that they have the same information needs.

However, this does not hold true: Public sector representatives as well as the legislature are mainly interested in service delivery objectives (effectiveness and efficiency), whereas private sector resource providers, such as banks or private investors (PPP), tend rather to focus on the financial figures (economy). Moreover, these institutions are interested in future-oriented information whereas for the legislature and public sector representatives alike past performance is more important (accountability). The taxpayer as "involuntary resource provider" is different again from both groups - the taxpayer is mainly interested in expenditure aspects of the collected resources.

Furthermore, we assume that control bodies such as the court of auditors are included in "Other Parties" without being mentioned explicitly. These institutions are significant users of GPFRs on behalf of the citizens and their information needs differ from other parties, e.g. analysts.

Therefore, in our view, the "resource providers or their representatives" and the "other parties" might need to be specified in more detail in order to define relevant, clearly identifiable potential users of GPFRs for public sector entities that share common information needs. Being aware of the different users of financial reporting is crucial for the discussion of the qualitative characteristics of information included in GPFRs. In light of the various users, financial reporting information needs to be rendered objective and neutral.

Moreover, we would suggest considering a kind of hierarchy among the various users of GPFRs: for example, where public policies are set by a democratically elected body, this body has to be seen as the primary addressee.

Preliminary View 4 - The Objectives of Financial Reporting (according to paragraph 2.22)

The objectives of financial reporting by public sector entities are to provide information about the reporting entity useful to users of GPFRs for:

- accountability purposes; and
- making resource allocation, political and social decisions.

We strongly support the IPSASB's view that accountability purposes and making resource allocation, political and social decisions should be the central objectives of financial reporting by public sector entities.

From the perspective of the information users it would be helpful to define the term "social decisions" more specifically. In our understanding, the notion "social" might be interpreted as addressing the whole society. Alternatively, it might be understood to refer to "social policy", including social benefits for special needy groups of the society. We tend towards the latter interpretation and would therefore suggest adjusting the expression to "making resource allocation and political decisions, including social policy decisions".

In addition, we would like to see an (adapted) reference to the key features of the objectives of GPFs proposed by the IASB (as outlined in CP 2.8). Bearing in mind that private sector resource providers (such as lenders and creditors) are included in the group of users of public sector GPFs, the provision of information that is useful to lenders and other creditors in making (**economic**) decisions in their capacity as capital providers should not be excluded from the public sector objectives. This objective should be mentioned separately because in our understanding it is not covered by "accountability purposes" in general.

Preliminary View 5 - The Scope of Financial Reporting (according to paragraph 3.18)

The scope of financial reporting encompasses the provision of financial and non-financial information about:

- economic resources of the reporting entity at the reporting date and claims to those resources;
- the effect of transactions, other events, and activities that change the economic resources of the reporting entity and claims to those resources during the reporting period, including cash inflows and outflows and financial performance;
- the reporting entity's compliance with relevant legislation or regulation and legally adopted or approved budgets used to justify the raising of monies from taxpayers and ratepayers;
- the reporting entity's achievement of its service delivery objectives; and
- prospective financial and other information about the reporting entity's future service delivery activities and objectives, and the resources necessary to support those activities.

It also encompasses explanatory material about: (a) the major factors underlying the financial performance of the entity, the achievement of its service delivery and other objectives and the factors which are likely to influence its performance in the future; and (b) the assumptions underlying and major uncertainties affecting the information included in GPFs.

We generally support the description of the scope made by the IPSASB. Nevertheless, we have some additional comments concerning particular scope issues.

a) Economic resources, claims to those resources and changes in them

We share the view that information about the financial performance of the entity will include assessments of matters such as whether the entity has acquired resources economically and used them efficiently and effectively to achieve its service delivery objectives. However, the ability of the statement of financial performance to provide profound information on the costs of service delivery and the amount and sources of cost recovery (taxes, rates, user charges, donor contributions, transfers etc.) should not be overestimated (see CP 3.7). First of all, the information delivery regarding this point depends on the budget structure (see below "Compliance"), which has then to be prepared output- or product-oriented (in contrast to organization-oriented). Furthermore, in our experience the assignment of costs to single issues of service delivery is feasible, but the correct assignment or allocation of cash inflows to obtain information on cost recovery is difficult to achieve. Accordingly, information on cost recovery could only be generated on a very high level of classes of service delivery.

b) Compliance

We totally agree with the view that reporting in relation to the budget is a key tool for discharging accountability by a government to its constituents. We therefore share the opinion that the inclusion in GPFRs of information to assist users in assessing the entity's compliance with legally adopted or approved budgets will enhance the usefulness of GPFRs for accountability purposes. Furthermore, such compliance enables achieving the objective of sustainability of public expenditure. One precondition for that is, however, that the basis is the same for the approved budget and the statement of financial performance (accruals based) – in other words: that the figures are comparable (see CP 4.25). Even if they report on the accruals basis, many governments still prepare their budget on the cash basis. In these cases the GPFRs should include a reconciliation of budget and actual figures.

c) Service delivery achievements

We strongly support the view of the IPSASB that the scope of financial reporting should encompass the provision of financial and non-financial information (see CP 3.11). Users of GPFRs will benefit from the inclusion of non-financial information as well as of the explanatory material. We share the opinion that decisions about the allocation of resources are also made in response to non-financial information about service delivery outputs and outcomes. Because of this we wish to add that the aspect of "relevance" (see CP 4.7 to 4.10) is of considerable importance in order to prevent the preparers of GPFRs from creating an

information overflow, which would be in contradiction to the objectives of GPFs. We feel that this aspect should be borne in mind when the scope is put into concrete terms during the project.

d) Prospective financial and other information

Although we share the view of the IPSASB outlined in CP 3.2 that financial reporting does not encompass involvement in matters of policy formulation, we feel that it should be mentioned that the requirement to prepare prospective financial information on, for example, the financial impacts of certain political programs can have an impact on the process of shaping the public or political opinion. We therefore recommend including as an obligatory element of prospective financial information in the scope information on the fiscal sustainability such political programs that are to be operated in the long term (see CP 3.16).

Preliminary View 6 - Evolution of the Scope of Financial Reporting (according to paragraph 3.22)

The scope of financial reporting should evolve in response to users' information needs, consistent with the objectives of financial reporting.

We agree with the IPSASB's viewpoint.

Preliminary View 7 - The Qualitative Characteristics of Information Included in GPFs (according to paragraph 4.40)

The qualitative characteristics of information included in GPFs of public sector entities are:

- *relevance, which encompasses confirmatory value, predictive value, or both;*
- *faithful representation, which is attained when depiction of economic or other phenomena is complete, neutral, and free from material error;*
- *understandability;*
- *timeliness;*
- *comparability; and*
- *verifiability (including supportability).*

Constraints on financial reporting are materiality, cost, and achieving an appropriate balance between the qualitative characteristics.

In general, we support the set of qualitative characteristics of information presented by the IPSASB. Furthermore, we are convinced that extending the use of these qualitative characteristics to non-financial information, prospective financial information, and

explanatory material or other narrative reporting will be an important issue for the public sector (see View 5 c)). The qualitative characteristics have been developed after considering the qualitative characteristics proposed in the IASB Framework ED "Objective and Qualitative Characteristics". As expressed in CP 4.3, they differ in some respects from those proposed by the IASB. We generally support this approach, which responds to the different objectives of public sector GPFRs and reflects a potentially broader scope of public sector financial reporting. However, we would recommend explaining more specifically in which topics an adjustment has seen to be necessary and why. For example, the question remains open why the IPSASB decided not to distinguish between "fundamental" and "enhancing" qualitative characteristics like the IASB. We do not see where the public sector differs from the private sector in that respect and what justifies the deviation.

a) Qualitative characteristics

- Faithful Representation

We noticed that the substance over form principle is part of faithful representation. The IASB and FASB concluded that faithful representation means that financial reporting information represents the substance of an economic phenomenon rather than solely its legal form. Accordingly, the proposed IPSASB framework does not identify substance over form as a separate qualitative characteristic or component thereof (see CP 4.12), as doing so would be redundant. Given the importance of the substance over form principle for the public sector we strongly recommend that the relationship between faithful representation and substance over form be explained more explicitly (as is done by IASB/FASB).

We also support the view of the IPSASB that the prudence principle is not identified as an essential component of faithful representation in the public sector (see 4.19). In light of the demand for intergenerational equity, the exercise of prudence which leads to creation of hidden reserves is not adequate for public sector accounting, as it is misleading and does not give a fair presentation. In that context we acknowledge the conflict between neutrality and prudence.

- Understandability

With respect to "understandability" we would like to stress the citizen perspective. We believe that the application of this characteristic to the process of preparing public sector GPFRs is of greater importance than in the private sector. Public sector GPFRs therefore should be written in a language that a citizen can understand (see 4.20). Furthermore, the IPSASB should strive to reduce complexity in financial reporting whenever possible. On the other hand we support the opinion of the IPSASB that relevant information should not be excluded from

GPFs solely because it may be too complex or difficult for some users to understand (see CP 4.21) - as, for example, might be the case in reporting on financial instruments.

- Comparability

In par. 4.25 the IPSASB points out that "consistent application of accounting policies to budget or other prospective information about a future period, and actual outcomes for that period, will enhance the usefulness of any comparison of projected and actual results." This implies that the same basis of accounting has to be chosen for budgeting and for financial reporting. As outlined above (View 5) many public sector entities have a different basis of accounting for budgeting and reporting.

b) Constraints on information included in GPFs

- Materiality

We would like to stress that the concept of materiality (known from private sector accounting/auditing) might be more or less unknown to some public sector entities, especially those converting from the cash basis to the accrual basis of accounting. When used, the level of materiality typically is significantly lower than in the private sector. The public sector specifics of this criterion should be elaborated further in the Framework.

- Cost

We agree with the view that the benefits for financial reporting should justify those costs. As in the private sector, cost cannot be the sole argument to prevent the preparer from generating relevant information. Therefore, we would recommend explicitly emphasizing the conflict with "relevance", and explaining the public sector answer to that conflict.

Finally we would like to add that we support the view of the IPSASB that information provided by GPFs is necessary for the discharge of accountability (see. CP 4.37). Nevertheless, we wish to point out that elected politicians being in charge might tend to overemphasize this aspect of discharging in order to reduce responsibility. The constraint of "cost" might take a back seat in the public sector context, compared to the private sector where the person in charge might themselves have an interest in reducing the cost of preparing GPFs (e.g. because of income-based salary).

Preliminary View 8 - Characteristics of a Reporting Entity (according to paragraph 5.10)

The key characteristic of a reporting entity is the existence of users who are dependant on GPFs of the entity for information for accountability purposes, and for making resource allocation, political, and social decisions.

A public sector reporting entity may be an entity with a separate legal identity or other organisational structure or arrangement.

We support the view of the IPSASB on the key characteristics of a reporting entity. In our opinion, the IPSASB's reflection is in line with the approach taken by the IASB. We share the IPSASB's views on defining a "public sector entity" (see CP 5.2).

We agree that not-for-profit entities are not envisioned as reporting entities in the Conceptual Framework. Furthermore, we think that extending the reporting entity definitions to include organizational structures, administrative arrangements, or activity without a legal identity would better reflect the requirements of the public sector (CP 5.1. and 5.9). In CP 5.10 the IPSASB describes exceptions to the key characteristics of reporting. We feel it would be helpful to state one or more specific practical examples to illustrate what is meant by these exceptions.

Preliminary View 9 - The Composition of a Group Reporting Entity (according to paragraph 5.35)

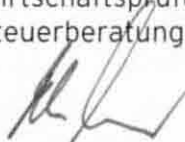
A group reporting entity will comprise the government (or other public sector entity) and other entities when the government (or other public sector entity):

- *has the power to govern the strategic financing and operating policies of the other entities (a "power criterion"); and*
- *can benefit from the activities of the other entities, or is exposed to a financial burden that can arise as a result of the operations or actions of those entities; and can use its power to increase, maintain, or protect the amount of those benefits, or maintain, reduce, or otherwise influence the financial burden that may arise as a result of the operations or actions of those entities (a "benefit or financial burden/loss" criterion)*

We agree with the view of the IPSASB in defining a group reporting entity. We also agree with the new terminology chosen by the IPSASB.

Sincerely yours,

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Dr. Peter Oser



Thomas Müller-Marqués Berger