***Michael E. Bradbury*** *PhD, FCA, CMA*
*Professor*
*Department of Accountancy*
*Massey University*
*Private Bag 102 904 NSMC*
*Albany Campus*
*Auckland, New Zealand*

*Tel: +64 9 4140800 X9415*
*Fax: +64 9 4418133*
*Email: m.e.bradbury@massey.ac.nz*

The Technical Director
*International Public Sector Accounting Standards Board*
International Federation of Accountants
227 Wellington Street West, 6th Floor
Toronto, Ontario M5V 3H2
CANADA

E-mail: stephaniefox@ifac.org.
**Exposure Draft: Key Characteristics of the Public Sector with Potential Implications for Financial Reporting**

Thank you for the opportunity to comment on this Exposure Draft. I am a New Zealand academic and in Appendix A I provide a short 'bio' of my standard setting experience.

In the following pages I answer the specific questions raised for comment in the Exposure Draft.

Yours sincerely

Michael Bradbury
August 22, 2011

## Appendix A

**Michael Bradbury** is a professor in accounting at Massey University, New Zealand. He served on the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand from 2000 to 2009 and on the International Financial Reporting Interpretations Committee of the International Accounting Standards Board from 2004 to 2008. He was on the International Joint Working Group for Financial Instruments from 1998 to 2000. His research interests are in financial reporting and financial analysis.

## Specific Matters for Comment

1. **Does this document identify key characteristics and potential implications of those key characteristics for financial reporting?**

I comment under each heading in the document.

**GBEs**
A problem with the document is that it separates ‘public sector’ and ‘private sector entities’ on the basis of ‘governance’. For example, in para 1.3 a GBE is different from a private sector entity by virtue of being ‘governed by a public sector entity’. I suspect this is really ‘ownership’ rather than governance. So a <u>necessary</u> criterion for differentiating public sector and private sector is ownership (or governance).

I am not convinced that other characteristics in the ED are <u>necessary</u> to define public sector.

Furthermore, with regard to ‘ownership’ in the wider sense, the document does not appear to consider the information needs of stakeholders. Clearly this ought to have implications for financial reporting.

I think the solution is to drop GBEs out of this document. The remaining public sector entities can be described as public benefit entities. The IPSASB should put its main focus on accounting for public benefit entities. While the IPSASB has an obligation to improve for-profit accounting for GBEs, this is a second order issue. The primary producer of for-profit accounting standards is the IASB.

**Volume and financial significance of non-exchange transactions**
I do not find this criterion very satisfactory.

There are many non-exchange transactions in the private sector:

- Taxes. The ED mentions that taxation is a major public sector non-exchange transaction. However, most private sector entities pay tax – this is also a non-exchange transaction. In aggregate the sum of tax revenue equals the sum of tax paid – so it is not clear to me that the volume or significance of tax is greater for public sector. It might be argued for small private sector entities tax is more material.
- In a group situation, intra-group transactions have the potential to be non-exchange transactions because the parent has control.
- The description in 2.2: “A public sector entity must constantly assess the need to undertake activities to provide goods and services in a non-exchange environment… Such an assessment includes consideration of factors such as the governing legal framework, the cost, quantity and quality of goods and services provided and the outcomes of key programs”. This description would also be true for private sector entities that make donations, undertake sponsorships and for some exchange transactions (e.g., advertising).

Paragraph 2.3 states “the primary objective of public sector entities is to deliver goods and services and not to generate profits..”. But private sector entities also have to consider the quality, quantity, price and timeliness of goods and services AND make a profit.

Private sector entities also need information to answer the questions in 2.3 (a) to (f). This list equally applies to private sector entities.

If the difference between private and public sector entities is based on volume or financial significance, then the issue is one of materiality. While there are transactions that might be more material for public sector than private sector, I do not see these as being solely the domain of public sector. I acknowledge that current IFRS might not provide high quality solutions for these transactions. However, the IPSASB should treat these transactions as lower order issues and try to influence IFRS. That is, the primary focus of the IPSASB should be on issues that are fundamental to the public sector (and public benefit entities in particular).

**Taxation and other non-exchange transfers**
The power to tax is a distinguishing characteristic of a public entity. However, unless the IPSASB is seriously considering reporting this as an 'asset', then it is not clear why this is important for public sector financial reporting.

**Provisions of goods and services in a non-market or limited-market environment**
I think this heading is misleading. Private sector firms deal in non-market and limited market transactions all the time. Most manufacturing firms or long-term construction projects have transfers between departments or subsidiaries, which are non-market transactions.

I suspect the limited-market issues is really a subset of the non-cash generating nature of public sector assets. For example, determining fair value for non-cash generating assets when there are no market transactions.

However, the public or social good nature of public sector activities is a characteristic that potentially gives rise to different accounting issues.

**Importance of the budget**
The fact that the budget is used for setting taxation levels indicates that the *objective of financial reporting* might be different for public sector entities. For a private sector entity the setting of service and product prices is not (typically) based on the reported financial statements, but on supply and demand. This suggests the main function of reporting actual results in the public sector is the comparison with budget. Hence, the main qualitative characteristic of public sector financial statements is that they are prepared on the same basis as the budget. However, in setting the budget it is not clear that private sector qualitative characteristics or accounting standards will be the most suitable for public sector entities. This is because the main objectives of budget reporting in the public sector (stewardship) and reporting of actual results in the private sector (resource allocation) might be different.

**Nature of property, plant and equipment**
I think the heading of this section is misleading. It does not matter if it is property plant and equipment or inventories; the issue is whether the asset generates cash

flows. I note a private sector firm may have stocks of stationary or promotional material, which do not generate cash. This is not too different from items discussed under the *'volume and financial significance'* heading.

**Responsibility for national and local heritage**
I am not convinced this is an appropriate characteristic to make it a key issue, as it is based on 'intent'. I do not believe the reasons for holding an asset are important. The important factor is that these assets are public or social assets.

The intergenerational issue (noted in para 5.2) is a key characteristic for public sector firms. A public sector entity will (in the long-run) try and achieve break-even. At break-even the tax collected is fully distributed to the current tax payers. [There may well be issues relating to whether the costs of services will equal the value of the benefits provided. For the purposes of discussion I will ignore issues of effectiveness]. That is, at breakeven there is no intergenerational anomaly. When a loss arises it is funded from accumulated reserves or debt; which has implications for past and future taxpayers respectively. This does not happen in the private sector because the owner settles up and is compensated based on the negotiated future prospects.

**Longevity of the public sector**
I do not think that 'longevity' is a suitable characteristic. First, a fundamental basis for financial reports is 'going concern' – hence private sector reports are based on an assumption of longevity. This is also reflected in the way assets and liabilities are classified into current and non-current. Furthermore, it is not the case that if a private sector entity goes into liquidation, the assets suddenly disappear.

**Regulatory role of government**
Why is this characteristic any different form the ability to tax (i.e., para 2.4 to 2.7)? I acknowledge that this might be an issue in determining 'control', but the level of benefits related to this characteristic is infinite, so it would be physically impossible to draw up financial statements using this as a characteristic.

**Ownership or control of rights**
I am not sure why this is different from regulatory role of government. The 'potential' is unlimited and therefore infinite and therefore unaccountable.

Once created then presumably there is a market and a fair value can be estimated; or there is no market and it is a likely to be a non-exchange transaction.

**Statistical basis of accounting**
In financial reporting for the private sector the rates of depreciation for taxation purposes are ignored because they are more likely to reflect government policy than a proper basis for asset measurement under GAAP. A similar parallel here would be GFS accounting.

**Non-financial reporting**
Given the need for non-financial measures in a not-for-profit environment, I am surprised that this was not considered a key characteristic. While private sector also has non-financial reporting issues (e.g., management commentary) I think the

development of non-financial measures is critical to the measurement and assessment of levels and maintenance of service.

The fact that non-financial measures was not highlighted in the document perhaps indicates that the ED has focused on characteristics of public sector, rather than the characteristics of users' needs in financial reporting. Clearly, both are important.

**Summary:**
I think the weakness of this document is that it has identified examples of transactions rather than fundamental properties. Hence, items like taxes appear under several headings (e.g., non-exchange transactions and regulatory role).

I summarise what I think are the main fundamental properties underlying the document:

*Primary*
**Reporting objective**: as a basis for determining revenue (*ex ante*) versus stewardship reporting (*ex post*).

**Intergenerational reporting:**

**Non-financial reporting:**

**Public good (or social) assets:**

*Secondary*
**Non-exchange transactions:**

**Non-cash generating assets:**

Secondary issues are those that also have implications for private sector entities (although the materiality may be lower). I suggest the IPSASB try to work with the IASB on these issues.

**2. Do you think this document should be part of the IPSASB's literature?**

This has been a useful document in developing thinking about financial reporting issues in the public sector. This document (if revised) would be useful in determining the work priorities of the IPSASB. That is, the IPSASB should work on those issues that are more fundamental to public sector financial reporting.

Should it be part of the conceptual framework? I do not believe the whole document should be in the *Framework*. It may be that some parts of it are suitable for framework (e.g., the objective of reporting); parts might be suitable for other frameworks (e.g., non-financial reporting); and parts might be suitable for individual accounting standards (e.g., non-cash generating assets).