October 2011

Exposure Draft of a Recommended Practice Guideline: Summary

ED 46—Reporting on the Long-Term Sustainability of a Public Sector Entity's Finances

This summary provides an overview of Exposure Draft 46, *Reporting on the Long-Term Sustainability of a Public Sector Entity's Finances*

Project objectives: This objective of this project is to provide guidance on how to present information on a public sector entity's long-term fiscal sustainability to supplement information in the general purpose financial statements and meet the objectives of financial reporting—accountability and decision-making.

The project and stage: In November 2009, the IPSASB published a Consultation Paper, *Reporting on the Long-Term Sustainability of Public Finances*. The IPSASB has considered comments on this paper and, those comments have informed the development of this ED of a Recommended Practice Guideline (RPG).

Next steps: The IPSASB seeks feedback to guide it in finalizing a RPG for the presentation of information on a public sector entity's long-term fiscal sustainability.

Comment deadline: The ED is open for public comment until February 29, 2012.

Background and Objective

In October 2011, the International Public Sector Accounting Standards Board (IPSASB) issued ED 46, *Reporting on the Long-Term Sustainability of a Public Sector Entity's Finances*.

The IPSASB initially commenced a project on accounting for social policy obligations in 2002. This led to the issue of an Invitation to Comment (ITC), *Accounting for Social Policies of Government* in January 2004. The IPSASB considered comments on this ITC and initiated a project to develop accounting requirements for social policy obligations (subsequently re-termed social benefits).

Due to difficulties in identifying the point at which liabilities arise for many social benefits and the extent of those liabilities, the IPSASB decided not to develop proposals further relating to recognition and measurement. Their deliberations had also led the IPSASB to the view that the financial statements cannot provide all the information that users need on social benefits.

As an interim step, the IPSASB developed proposals for the disclosure of amounts to be transferred to those eligible at the reporting date for cash transfers (benefits settled in cash). ED 34, *Social Benefits: Disclosure of Cash Transfers to Individuals or Households* was issued in March 2008.

The IPSASB sought feedback on issues relating to recognition and measurement in a Consultation Paper, *Social Benefits: Issues in Recognition and Measurement* and issued a Project Brief, *Long-Term Fiscal Sustainability Reporting.* Both these documents were issued at the same time as ED 34.

In October 2008, the IPSASB reviewed responses to all of the above documents. In the light of these responses, it was decided not to develop ED 34 into an IPSAS. The IPSASB also noted that a large majority of respondents agreed that the financial statements cannot convey to users sufficient information about the long-term financial implications of governmental programs providing social benefits.

In light of this view, the IPSASB decided to initiate a project on long-term fiscal sustainability. This led to the issue of a Consultation Paper, *Reporting on the Long-Term Sustainability of Public Finances,* in November 2009.

Relationship between Financial Statements and Reports on Long-Term Fiscal Sustainability

Information on the long-term sustainability of a public sector entity's finances supplements the financial statements.

The financial statements are at the core of financial reporting. However, they do not provide information on (a) inflows for expected resources that will be realized in the future but are not recognized as assets at the reporting date or (b) future obligations that are not recognized as liabilities at the reporting date. Information on the long-term sustainability of an entity's finances can therefore complement information in the financial statements and help meet the objectives of financial reporting. The exhibit below shows in the shaded boxes the information that the statement of financial position provides. The additional information that long-term fiscal sustainability reporting can provide is shown in the white boxes.

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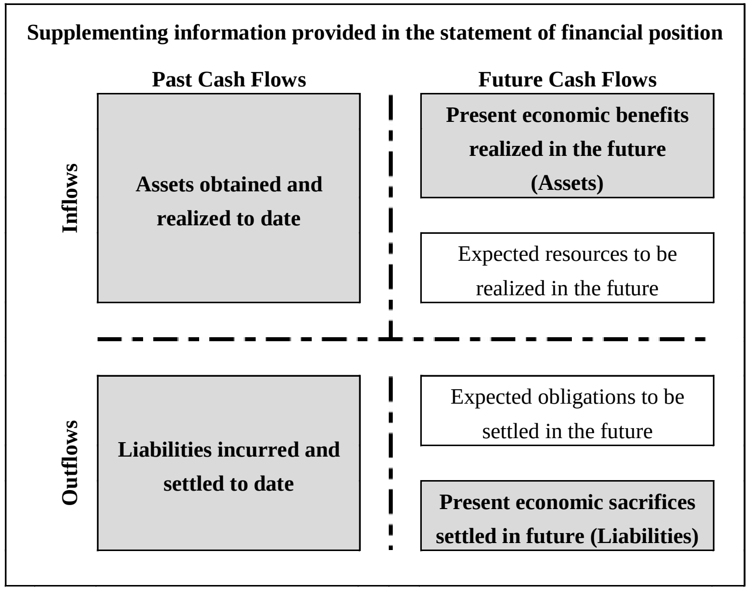

Status, Scope and Determining Whether to Report on Long-Term Fiscal Sustainability

The reporting of information in accordance with this ED represents good practice.

This draft RPG is not an International Public Sector Accounting Standard (IPSAS) and therefore an entity is not required to comply with it in order to comply with IPSASs. However, it does represent good practice. An entity reporting on the long-term sustainability of its finances is encouraged to follow this RPG and disclose the extent to which it has been followed.

The flows relating to programs providing social benefits, including entitlement programs, can be a highly significant component of reporting on long-term fiscal sustainability. However, the scope of the RPG includes all an entity's projected outflows and is not limited to those related to programs providing social benefits.

The RPG applies to all public sector entities, except Government Business Enterprises. In assessing whether it is appropriate for an entity to report on the long-term sustainability of its finances an entity needs to assess whether users exist for prospective financial information.

There are likely to be users for long-term fiscal sustainability information for entities with one or more of the following characteristics:

- Significant tax and other revenue raising powers,
- Powers to incur debt, or
- Wide decision-making powers over service delivery levels.

Presenting Projections of Prospective Inflows and Outflows

The core information presented will be projections of inflows and outflows commencing in the current reporting period for a period selected and disclosed by the entity.

Projections may be presented in a statement or through graphs supported by narrative reporting.

In determining the format of tabular statements entities need to balance considerations of understandability and relevance. Multi-columnar presentation of a large number of time periods between the reporting date and the end of the time horizon provides a more complete information set, but risks information overload and the impairment of understandability.

Conversely, a focus on a very small number of time periods may neglect trends arising from key events between time periods.

In selecting an appropriate time horizon the qualitative characteristics of verifiability and faithful representation need to be balanced. Long-time horizons capture more events. However, the assumptions underpinning the projections become less robust and potentially less verifiable. Conversely, excessively short time horizons may increase the risk that the impact of events outside the time horizon may be ignored, thereby reducing the relevance of projections.

The level of fiscal dependency is an important factor in determining time horizons.

A single presentation approach is unlikely to satisfy the objectives of financial reporting—accountability and decision-making. Statements need to be complemented by additional presentational methods involving a combination of narrative reporting, graphical presentation and the use of indicators. Projections of net debt are likely to be central for many reporting entities.

Other examples of indicators include:

- Total gross debt,
- Net worth,
- Net financial worth,
- Fiscal gap,
- Inter-temporal budget gap,
- Net debt/total revenues, and
- Fiscal dependency.

Addressing the Dimensions of Fiscal Sustainability

The three inter-related dimensions of fiscal sustainability are:

The presentation of information on the long-term sustainability of an entity's finances needs to be faithfully representative. This can be done by presenting information on both a historical and prospective basis to address these dimensions.

Fiscal capacity

Fiscal capacity is the ability of an entity to meet financial commitments, such as the servicing and repayment of debt and liabilities to creditors, on a continuing basis over the period of the projections without increasing levels of taxation.

Service capacity

Service capacity is the extent to which (a) the entity can maintain services at the volume and quality provided to current recipients at the reporting date and (b) meet obligations related to entitlement programs for current and future beneficiaries.

Vulnerability

Vulnerability is (a) the extent to which an entity is fiscally dependent upon funding sources outside its control, principally inter-governmental transfers and (b) the extent to which an entity has powers to vary existing taxation levels or other revenue sources and to create new sources of taxation and revenue.

Disclosure of Principles and Methodologies

It is important that the basis of preparation of projections is clear. This means that the principles, assumptions and approaches to methodology that underpin the projections are transparent. ED 46 includes discussion of:

- Updating of projections and frequency of reporting,
- Current and future policy,
- Approach to revenue flows,
- Demographic and economic assumptions,
- Approach to age-related and non-age-related programs,
- Impact of legal requirements and policy frameworks,
- Inflation and discount rates,
- Sensitivity analysis, and
- Reliability of projections.

- **Updating of projections and frequency of reporting** – The date on which a full set of projections was made and of the basis and timing of subsequent updating should be disclosed.
- **Current and future policy** – Where flows for particular programs and activities are individually modelled, information is most useful if it is assumed that current policy is held constant through the entire projection period.
- **Approach to revenue flows** – The main sources of taxation and other revenue flows, such as inter-governmental transfers, should be identified, together with their significance to an entity's revenue sources.
- **Demographic and economic assumptions** – An entity should disclose the key assumptions that underpin projections. These are likely to include economic growth rates, inflation, and demographic assumptions such as fertility, mortality and migration rates, and workforce participation rates. Such disclosures may extend to assumptions about the fiscal impact of environmental factors.
- **Approach to age-related and non-age-related programs** – Age-related programs may be individually modelled while non-age-related programs may be projected to increase in line with other variables, such as GDP, or to be constant in real terms.
- **Impact of legal requirements and policy frameworks** – ED 46 encourages disclosure of key aspects of governing legislation, underlying macro-economic policy and fiscal frameworks.
- **Inflation and discount rates** – Entities should indicate how they deal with inflation, in particular whether inflation has been taken into account in making projections or whether projections are made at current prices.
- **Sensitivity Analysis** – ED 46 encourages disclosure of the sensitivity of demographic and economic assumptions and, at a high level, the results of any key sensitivity analyses. Entities also need to indicate how they deal with inflation.
- **Reliability of projections** – Steps taken to ensure that key assumptions underpinning projections are realistic should be disclosed.

Next steps:

The deadline for comments is February 29, 2012.

During the comment period, IPSASB members are available to discuss the proposals with a wide range of parties.

How can I comment on the proposals?

The IPSASB welcomes comments on all the proposals in the ED and particularly values comments on the Specific Matters for Comment.

Comment letters will be posted on the IPSASB website.

The IPSASB will carefully consider all feedback and, as usual, discuss responses to the proposals in public meetings.

The IPSASB plans to issue a finalized RPG in 2012.

Stay informed

The IPSASB will announce on its website the dates and location of meetings to discuss feedback on ED 46.

To stay up to date about the project please visit: http://www.ifac.org/public-sector