IFAC POLICY POSITION 4
March 2012

PUBLIC SECTOR FINANCIAL MANAGEMENT TRANSPARENCY AND ACCOUNTABILITY: THE USE OF INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS

Governments must implement the necessary institutional arrangements required to enhance public sector financial management transparency and accountability. An integral and essential part of these arrangements is the use of accrual-based accounting—through the adoption and implementation of International Public Sector Accounting Standards (IPSASs)—which promotes greater transparency and accountability in public sector finances and allows for enhanced monitoring of government debt and liabilities for their true economic implications.

Introduction

Over the years there have been many sovereign debt defaults and write-downs taken by investors in public debt. In the 21 years to 2011, there were 25 sovereign debt restructurings. The sovereign debt crisis engulfing the European Union in 2010-2012 and related government debt issues affecting the United States, and potentially other countries around the world, are cause for major concern. The problems highlighted by sovereign debt crises include the lack of transparency and accountability of governments, poor public finance management and public sector financial reporting, and the deficiency of institutions for fiscal management in many countries. These institutions create neither the constraints nor the incentives for governments to manage their finances in a manner that protects the public interest and also protects investors.

IFAC is of the view that governments around the world must implement the necessary institutional arrangements to protect the public as well as investors in government bonds. It is critical that governments work to establish greater trust between themselves and their constituents; this should be one of the highest priorities for national leaders and public officials. To establish such trust, it is important that governments provide accurate and complete information on expenditures and transactions, in order to demonstrate accountability and stewardship, and to reinforce their own credibility. This means providing clear and comprehensive information regarding the financial consequences of economic, political, and social decisions. This information must also focus on the longer term impact of decision making; something that cannot be achieved through the reporting and disclosure of only cash flows. Furthermore, given the prominence of banks and private sector investors that hold government debt, there is strong demand for the same level of financial transparency and accountability from the public sector as is expected from the private sector.

The type of information required can only be provided through a high-quality, robust, and effective accrual-based financial reporting system, which allows for government assets and liabilities (including debt) to be appropriately recorded, reported, and disclosed—and hence effectively monitored. The most globally accepted high-quality accrual-based financial reporting system is IPSASs. IPSASs provide for the full disclosure of all assets, liabilities, and contingent liabilities, which is vital for assessing the true economic implications of public sector financial management. The disclosure of all liabilities, including long-term obligations (e.g., pension obligations), also may encourage government leaders to make decisions that are driven by matters other than short-term political incentives.

Public Interest

Governments have a responsibility to enact legislation, formulate and implement policy, and deliver products and services to their citizens. The decisions made and actions taken in fulfilling these ambitions should be undertaken in the public interest.

Indeed, there is political accountability on the part of governments to ensure that they do act in the public interest. Governments have coercive powers to tax. Monies raised through taxation are allocated to spending, both recurrent (e.g., paying wages to public sector employees) and capital (e.g., spending on major infrastructure projects, such as roads and railways), for the benefit of the country and its citizens. This responsibility obliges governments to discharge their accountability by demonstrating the manner in which they have effectively and efficiently used the resources at their disposal. Additionally, where governments have shortfalls between amounts raised through taxation and amounts outlaid as government spending, they raise funds through debt markets. Where this is done, governments have a public interest obligation to market participants—investors and potential investors—to provide timely, reliable, and detailed information of their financial performance and positions—in the same way that listed companies have obligations to equity market participants.

However, without robust, transparent, and accountable arrangements for financial reporting and financial management, it is not possible to reliably assess whether decision making by governments has been in the public interest. Furthermore, it is unlikely that governments will be able to adequately discharge their accountability, and provide the standard of information required by investors, without being able to publicly report and disclose high-quality financial information. It is, itself, a major public interest concern that strong financial reporting and financial management arrangements are not in place in many countries around the world.

The implications of not having appropriate systems in place include:

- a potential failure by government to deliver services and products in the most effective and efficient manner, and in a way that maximizes sustainable social benefit;
- making decisions to invest, or not invest, today in projects and programs that result in foregone potential benefits, and which represent an opportunity cost where citizens in the future will pay for the mismanagement of today; and
- poor decision making that may be, at best, made with a short-term focus or, at worst, made in the self-interest of politicians and public servants who have incentives to operate in a particular fashion.

Context: Public Sector Financial Management

Public financial management is defined by The Chartered Institute of Public Finance and Accountancy (CIPFA) as "*the system by which financial management resources are planned, directed and controlled to enable and influence the efficient and effective delivery of public service goals*."[1] CIPFA describes public financial management in terms of a "whole system approach." IFAC supports a whole system approach to public sector financial management, and recognizes the critical importance of the foundations of the system—stakeholder consultation, the demand for services and projects, and

1 CIPFA, *Public Financial Management: A Whole System Approach*, Volume 1, 2010, page 5

governance[2]—which, along with the key process elements, aims to deliver public, community, and individual value as part of the overall objective to deliver sustainable social benefit.

For the purposes of this position paper, IFAC is focused on aspects of two of the key process elements: namely, standards and assurance. IFAC supports the use of high-quality financial reporting standards for the public sector that allows for independent assurance. Also, the use of high-quality financial reporting standards requires the implementation of primary institutional arrangements to support their effectiveness, as a tool for enhanced public sector financial management.

Use of International Public Sector Accounting Standards (IPSASs)

IFAC supports the global adoption and implementation of IPSASs for public sector financial reporting.

A key issue for public sector financial reporting is that most governments still adhere to the cash basis of accounting, and therefore provide minimal disclosures relative to what the public, banks, investors, and credit providers generally expect of the private sector. Current cash-based accounting systems, which operate in many countries, may provide inappropriate incentives for decision makers. For example, cash-based reporting systems would promote an obvious decision about whether to offer wage increases to government workers today, or whether to offer them increased pension benefits that they can access at a future date. A cash-based system, which does not require pension liabilities to be recorded and reported, will provide incentives for politicians to opt for the latter. No cash is exchanged today—that is, there is no increase in reported spending, and hence no pressure to raise debt—when the decision is made to offer increased pension benefits. However, an accrual-based accounting system that requires pension liabilities to be reported will promote more careful analysis, and could result in an alternative decision to be made when factors such as the government's financial position, net worth, and long-term sustainability are able to be considered.

The need for accrual-based public sector accounting is recognized by many governments around the world that already prepare financial statements on an accrual basis.[3] The need is also explicitly recognized by the European Parliament, which in its Report on the *proposal for a Council directive on requirements for budgetary frameworks of the Member States,* in May 2011, included in its draft legislative resolution that "*Member States shall have in place public accounting systems, applying the accrual basis of accounting and comprehensively and consistently covering all sub-sectors of general government as defined by Regulation (EC) No 2223/96 (ESA 95). Those systems shall be subject to independent control and audit.*"[4]

Financial Reporting Standards - IPSASs

IPSASs are issued by the International Public Sector Accounting Standards Board (IPSASB), an independent standard-setting board supported by IFAC. The adoption of IPSASs by governments

---

2 The Professional Accountants in Business (PAIB) Committee of IFAC and CIPFA are cooperating to develop an international governance framework for the public sector.

3 As at December 31, 2011, there are 39 countries which prepare government financial statements on an accrual basis, including the US, the UK, Japan, France, Canada, Brazil, Switzerland, Australia, and New Zealand. Of these countries, 11 use, or are committed to use, IPSASs. The European Commission, North Atlantic Treaty Organization, the United Nations system, and the Organisation for Economic Cooperation and Development are several examples of organizations that also have adopted IPSASs for their reporting.

4 Refer www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2011-0184&language=EN

worldwide will improve the quality of financial information reported by public entities, which is critical for investors, taxpayers, and the general public to understand the full impact of decisions made by governments with respect to their financial performance, financial position, and cash flows. Global adoption of these standards will facilitate the comparability of such information on a global basis and assist in internal management decisions in resource allocation (planning and budgeting), monitoring, and accountability. Furthermore, as a universal set of public sector accounting standards, IPSASs would also provide better information regarding systemic risks associated with government liabilities. The adoption of IPSASs would represent a significant step forward in achieving the financial transparency of national governments worldwide.

IPSASs are designed to apply to the general purpose financial statements of all public sector entities, and are developed primarily for an accruals-based accounting context. While application of IPSASs would not solve the problems associated with government debt, the appropriate use of the financial information rendered from such standards would assist public officials and other groups in assessing the implications of fiscal decisions proposed or made by government.

Assurance

Financial reporting using IPSASs—a globally recognized and accepted, high-quality financial reporting framework and set of standards—supports the ability to conduct high-quality audits of governments' financial statements. This is particularly important for public sector auditors, supreme audit institutions and the International Organization of Supreme Audit Institutions (INTOSAI), which have responsibility for, and interest in, the auditing of government information and reporting. The use of IPSASs provides a solid foundation and suitable criteria upon which auditors can undertake their work.

In relation to auditing standards, INTOSAI cooperates with the International Auditing and Assurance Standards Board (IAASB) to enable it to draw upon International Standards of Auditing (ISAs) and the International Standard on Quality Control (ISQC) 1 in the development of the International Standards for Supreme Audit Institutions (ISSAIs).

Institutional Arrangements

The adoption of IPSASs and the preparation of full accrual-based financial statements alone will not enhance the transparency and accountability of governments. IFAC recognizes that to enhance public sector financial management, governments must implement the necessary institutional arrangements to support transparency and accountability, including measures such as:

- The preparation and delivery of high-quality and timely accrual-based financial reporting for the public sector. As systems develop, governments should aim to have information publicly available on at least a monthly basis;
- The publication, in a timely manner—no longer than within six months from the end of the reporting period—of independently audited financial statements for the public sector;
- The preparation and publication of public sector budgets and appropriations on the same basis; that is, on an accrual basis and in a timely manner;
- Full transparency—preparation and publication—of all financial reporting (position and performance), budgets, and appropriations in a sufficiently appropriate amount of time ahead of elections;

- Established, well-defined, and publicly available principles for fiscal management and control, with full transparency (publication in a timely manner) to demonstrate that principles are being followed.

Implications for IFAC Members and Associates

IFAC members and associates are required, among other things, to support IFAC's mission and programs and to demonstrate compliance with the seven Statements of Membership Obligations (SMOs).[5] SMO 5, titled *International Public Sector Accounting Standards and Other IPSASB Guidance*,[6] sets out the obligations of IFAC members and associates in relation to IPSASs and other guidance issued by the IPSASB. These obligations are that member bodies should:

- notify their members of all IPSASs, guidelines, studies, and occasional papers developed by the IPSASB; and
- use their best endeavors:
  - to incorporate the requirements of IPSASs into their national public sector accounting requirements, or where responsibility for the development of national public sector accounting standards for financial reporting by governments and others in public sector organizations lies with third parties, to persuade those responsible for developing those requirements that general purpose financial statements of public sector entities other than government business enterprises (GBEs) should comply with IPSASs, and disclose the fact of such compliance; and
  - to assist with the implementation of IPSASs, or national public sector accounting standards that incorporate IPSASs.

As well as meeting these obligations, member bodies and associates are encouraged to participate in supporting the adoption and implementation of IPSASs in other ways, including, where appropriate:

- the inclusion of IPSASs and public sector financial reporting and auditing in professional programs and continuing development courses;
- promoting the role of professional accountants in the public sector, potentially working with governments to identify opportunities for such promotion;
- providing input into public sector financial reporting standard setting, both locally and internationally; and
- commenting on relevant exposure drafts and other consultations related to public sector financial reporting and financial management, both locally and internationally.

This Policy Position has been prepared by IFAC. The approved text of this Policy Position is published in the English language. For further information, please email: publicpolicy@ifac.org.

[5] The objective of the SMOs is to provide clear benchmarks to current and potential IFAC members to assist them in ensuring high-quality performance by professional accountants. The SMOs cover an IFAC member body's obligations to support the work of the independent standard-setting boards supported by IFAC and the International Accounting Standards Board, and obligations regarding quality assurance and investigation and discipline.

[6] All seven SMOs are currently under revision. Proposed changes to SMO 5 include: clarifying the best endeavors concept and the applicability framework; clearly defining requirements relating to adoption and implementation of international standards issued by the IPSASB; and adding the translation requirement.

ISBN: 978-1-60815-117-2

IFAC's Mission

IFAC's mission is to serve the public interest by:

- Contributing to the development, adoption and implementation of high-quality international standards and guidance
- Contributing to the development of strong professional accountancy organizations and accounting firms, and to high-quality practices by professional accountants
- Promoting the value of professional accountants worldwide
- Speaking out on public interest issues where the accountancy profession's expertise is most relevant

International Federation of Accountants

529 Fifth Avenue, 6th Floor, New York, NY 10017
T +1 (212) 286-9344 F +1(212) 286-9570
www.ifac.org