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## **The Importance of Accrual-based Financial Reporting In the Public Sector**

### **Introduction**

IFAC has consistently promoted the need for enhanced transparency and accountability in the public sector, noting in particular the risk that a lack of transparency and accountability presents to the efficiency of capital markets, global financial stability, and long term sustainability.

The ongoing impact of the sovereign debt crisis emphasizes the seriousness of the results of poor financial management and financial reporting in the public sector. This increased focus on public sector financial management has created increasing demands for high-quality standards and for guidance on how to adopt and implement such standards. The International Public Sector Accounting Standards Board (IPSASB) is the international body dedicated to developing accounting standards for public sector entities (IPSASs).

High-quality, robust and effective accrual-based financial reporting systems, such as those based on IPSASs, are integral to enhancing accountability and transparency in government financial reporting.

Citizens are affected by a government's financial management decisions. Strong and transparent financial reporting has the potential to improve public sector decision making and make governments more accountable to their constituents. The failure of governments to manage their finances has in the past, and could again in the future, have dramatic consequences such as loss of democratic control, social unrest, and the failure of governments to meet their commitments today and in the future.

The failure of fiscal management in the public sector is widespread and has an economic impact that far exceeds the impact of losses incurred by corporate failures in the first decade of this century. The sovereign debt crisis demonstrates that the policies chosen to address the global financial crisis may inadvertently have changed the nature of the problem, moving it from the corporate to the government sector. In a recent Insight Report on Global Risks, the World Economic Forum reported the results of a survey of 469 experts from industry, government, academia, and civil society, examining 50 global risks across five categories. It noted that the current most significant global economic risk is "chronic fiscal imbalances"<sup>1</sup>.

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<sup>1</sup> Refer: World Economic Forum, *Insight Report: Global Risks 2012, Seventh Edition*, An initiative of the Risk Response Network, 2012

## **The Need for High-Quality and Timely Accrual-Based Financial Reporting in the Public Sector**

A key issue for public sector financial reporting is that many 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. Given the prominence of banks and private sector investors in holding government debt, it is of no surprise that there is a growing demand for the same level of financial transparency and accountability from the public sector as is expected from 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.

Accrual-based accounting standards ensure greater transparency and accountability in public sector finances as well as better monitoring of government debt and liabilities.

### *i) Greater transparency and accountability in public sector finances*

In a time when sovereign debt issues are prominent, and the veracity of government reporting and transparency are being questioned, it is critical that governments work to establish—as a priority—greater trust between themselves and their constituents. 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; reinforce their own credibility; and provide clear and comprehensive information regarding the financial consequences of economic, political, and social decisions.

This information must focus on both the short-term and longer-term impacts of decision making; the latter of which cannot be achieved through the reporting and disclosure of only cash flows. That is, the type of information required can only be provided through a high-quality, robust, and effective accrual-based financial reporting system.

### *ii) Monitoring of government debt and liabilities for their true economic implications*

The sovereign debt crisis, and the consequences that are being felt around the globe, illustrate the public sector balance sheet management failures by many governments, and highlight the inability of organizations such as global financial institutions, investors in government debt, and credit rating agencies to adequately monitor the financial positions of governments.

A major priority for all governments should be reducing economic uncertainties and the significant threats posed by inappropriately managed debt. However, it is important to recognize that government debt alone does not provide a comprehensive picture of fiscal soundness. The full disclosure of all assets, liabilities, and contingent liabilities is vital for assessing the true economic implications of public sector financial management. Furthermore, the disclosure of all liabilities, including the long-term obligations of government (e.g., pension obligations), may encourage government leaders to make decisions that focus on long-term sustainability, and which are not driven by short-term political incentives.

Only through a high-quality, robust, and effective accrual-based financial reporting system can all government assets and liabilities (including debt) be appropriately recorded, reported, and disclosed, and hence effectively monitored.

It is imperative for governments to address long-term sustainability and the welfare of future generations should compel governments to recognize and act, now and into the future, to enhance the reporting, transparency, accountability, and decision-making of the public sector.

### **Adoption and Implementation of IPSASs**

High-quality and timely accrual-based financial reporting in the public sector can be achieved through the adoption of globally-accepted, high-quality reporting standards developed specifically for the public sector, i.e., IPSASs.

The adoption of IPSASs by governments 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. Additionally, financial reporting using IPSASs supports the ability to conduct high-quality audits of governments' financial statements, as they provide a solid foundation and suitable criteria upon which auditors (in most cases, public sector auditors and supreme audit institutions) can undertake their work.

The adoption of IPSASs would represent a significant step forward in achieving the financial transparency of national governments worldwide.

While the application of IPSASs alone would not solve the problems highlighted by the sovereign debt crisis, the appropriate use of 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. Indeed, it can be argued that without better reporting and enhanced transparency and accountability, the problems highlighted by the current sovereign debt crisis will never be truly and adequately resolved.

## 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.

## The Context of Public Finance Management

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 governance<sup>2</sup>—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.

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.

## **Momentum in adoption globally**

The increased focus on public sector financial management has created increasing demands for high-quality standards and for guidance on how to adopt and implement such standards. Over the past 5 years there has been an increasing interest in the IPSASs and a strong trend towards their adoption; this trend is anticipated to continue.

Currently over 80 jurisdictions have either adopted or have processes in place to adopt IPSASs, directly or indirectly, including the government of New Zealand, South Asian countries like Thailand, Indonesia and Malaysia, African countries such as Nigeria, and South Africa, Latin and South American countries such as Peru and Brazil and some European countries, Switzerland, Austria, Lithuania and Estonia among them. A number of international organizations have also adopted IPSASs, for example, the United Nations Systems, the Organisation for Economic Co-operation and Development (OECD) and Interpol.

The European Commission (EC) report issued during 2013 considered the suitability of IPSASs for the member states of the European Union and described the standards as an “indisputable reference” in the development of European Public Sector Accounting Standards (EPSASs). A recent paper issued by the Federation of European Accountants (FEE) highlighted the importance of a single set of high quality principle-based standards, noting that this could greatly contribute to stability and sustainability of public finance – accruals-based accounting standards ensure completeness and reliability of information; harmonised public sector accounting standards enhance comparability.

FEE noted that Europe needs foreign investors and since sovereign debt is traded on global markets, these standards should ideally be international - the only international public sector standards are IPSAS's. Making European public sector information more accessible and understandable should facilitate investment and benefit Europe. Sound public sector financial information will also better contribute to effective and robust public sector financial management.