International
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Exposure Draft

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Comments requested by August 31, 2011

International Public Sector Accounting Standards Board

Key Characteristics of the Public Sector with Potential Implications for Financial Reporting

International Federation
of Accountants

REQUEST FOR COMMENTS

The International Public Sector Accounting Standards Board (IPSASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved for publication in March 2011 this Exposure Draft, *Key Characteristics of the Public Sector with Potential Implications for Financial Reporting.*

The text in this Exposure Draft may be modified in light of comments received before being issued in final form. **Comments are requested by August 31, 2011.**

Respondents are asked to submit their comments **electronically** through the IFAC website (www.ifac.org), using the "Submit a Comment" link on the Exposure Drafts and Consultation Papers page. Please note that first-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the IFAC website. Although IFAC prefers that comments be submitted electronically, e-mail may be sent to stepheniefox@ifac.org. Comments can also be faxed to the attention of the IPASB Technical Director at +1 (416) 204-3412, or mailed to:

The Technical Director
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Copies of this Exposure Draft may be downloaded free-of-charge from the IFAC website at www.ifac.org.

Objective of the Exposure Draft

This Exposure Draft (ED), *Key Characteristics of the Public Sector with Potential Implications for Financial Reporting,* has been developed by the IPSASB as part of its project on the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (the Conceptual Framework). The ED highlights certain characteristics of the public sector that may have implications for the development of a conceptual framework for the public sector and therefore on accounting standard setting in the public sector.

The Conceptual Framework project is being developed in phases. The components of the Conceptual Framework have been grouped as follows, and are being considered in the following sequence:

Phase 1—the scope of financial reporting, the objectives of financial reporting and users of general purpose financial reports (GPFRs), the qualitative characteristics of information included in GPFRs, and the reporting entity;

Phase 2—the definition and recognition of the "elements" of financial statements;

Phase 3—the measurement basis (or bases) that may validly be adopted for the elements that are recognized in the financial statements; and

Phase 4—the concepts that should be adopted in deciding how to present financial and non-financial information in GPFRs.

In December 2010 the IPSASB issued:

- An ED on Phase 1, *Role, Authority and Scope; Objectives and Users; Qualitative Characteristics; and Reporting Entity*;
- A Consultation Paper on Phase 2, *Elements and Recognition in Financial Statements*; and
- A Consultation Paper on Phase 3, *Measurement of Assets and Liabilities in Financial Statements.*

An earlier staff draft of this paper was made available at that time in order to provide some useful complementary information to constituents. The IPSASB considers that the discussion in this ED provides useful background on the characteristics of the public sector that may have implications for the development of a conceptual framework for public sector entities. However the IPSASB has not yet determined the most appropriate location for a finalized version of this material. It could be an integral part of the finalized Conceptual Framework or it could be located elsewhere in the *Handbook of International Public Sector Accounting Pronouncements*.

Guide for Respondents

The IPSASB would welcome comments on all of the matters discussed in the ED. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for proposed changes to the ED.

The IPSASB would particularly value comments on the Specific Matters for Comment below.

Specific Matter for Comment 1

Do you agree that this document provides useful background information on the key characteristics of the public sector and identifies some potential implications of those key characteristics for financial reporting? If not, please indicate how you would modify the document.

Specific Matter for Comment 2

Do you agree that this document should be included as part of the IPSASB's literature? If you agree, where do you think the material in this document should be located:

(a) As part of the Conceptual Framework;

(b) As a separate section of the *Handbook of International Public Sector Accounting Pronouncements*; or

(c) Elsewhere with some other status – please specify?

KEY CHARACTERISTICS OF THE PUBLIC SECTOR WITH POTENTIAL IMPLICATIONS FOR FINANCIAL REPORTING

1. Introduction

1.1 The nature of governments and other public sector entities and the environment in which they operate has implications for the concepts that underpin accounting requirements and guidance. This short paper identifies, and provides a general overview of, some of the main characteristics of the public sector that distinguish it from the for-profit private sector (hereafter referred to as the private sector, unless stated otherwise) and therefore have potential implications on the development of a conceptual framework that reflects public sector circumstances, and accounting standard setting for the public sector. It is not intended that this paper provide an exhaustive listing of all the areas in which the public sector can be distinguished from the private sector.

1.2 Governments are characterized by the breadth of their powers in comparison with the private sector. Such powers involve the ability to establish and enforce legal requirements. Globally the public sector varies considerably in both its constitutional arrangements and its methods of operation. The governance of governments and other public sector entities generally involves the holding to account of the executive by a legislative body (or equivalent).

1.3 The term "the public sector" includes national governments, sub-national governments, local government units and regulatory bodies. In the context of this paper the term also extends to international organizations that are public sector entities, such as the United Nations system. It also includes a number of other entities with varying structures and governance arrangements. Such entities include Government Business Enterprises (GBEs), which are known as public corporations in statistical accounting guidelines. GBEs have similar characteristics to private sector entities, but are governed by a public sector entity, which benefits from the GBE's activities. They may be profit seeking or have a financial objective to break even. The public sector does not include the private not-for-profit sector, although this sector shares many of the characteristics of the public sector.

1.4 Public sector entities may contribute to wealth generation through the application of economic stimulus measures and fiscal interventions. Governments also make decisions on the distribution of resources between different sectors of the economy. Unlike most private sector entities, the future existence of public sector entities is not dependent upon the generation of profits. The size of the public sector and the goods and services that it provides are dependent upon factors such as political ideology and the size of the economy.

1.5 There are numerous areas where the transactions, events and other economic phenomena that occur in the public sector are the same as those in the private sector. In such cases the concepts that should be applied to determine appropriate financial reporting will probably be the same. However, the characteristics of the public sector identified in this paper may give rise to conceptual perspectives that differ from those in the private sector.

1.6 This paper discusses:

- The volume and financial significance of non-exchange transactions (paragraphs 2.1–2.9);
    - Taxation and other non-exchange transfers (paragraphs 2.4–2.7);
    - Provision of goods and services in a non-market or limited-market environment (paragraphs 2.8–2.9);
- The importance of the budget (paragraphs 3.1–3.3);
- The nature of property, plant, and equipment (paragraphs 4.1–4.2);
- Responsibility for national and local heritage (paragraphs 5.1–5.2);
- The longevity of the public sector (paragraphs 6.1–6.6);
- The regulatory role of government (paragraphs 7.1–7.2);
- Ownership or control of rights to natural resources and phenomena (paragraph 8.1); and
- Statistical bases of accounting (paragraphs 9.1–9.3).

2. The Volume and Financial Significance of Non-Exchange Transactions

2.1 One of the main objectives of public sector entities is to deliver goods and services and not to generate profits. This characteristic means that there is a high incidence of non-exchange transactions of great financial significance in the public sector. In the private sector the large majority of transactions are of a voluntary exchange nature. Exchange transactions are transactions where one entity receives assets or services or has liabilities extinguished and directly gives approximately equally value in exchange. Conversely, under a non-exchange transaction, an entity receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving equal value in exchange.

2.2 While there are non-exchange transactions in the private sector they occur under more limited circumstances. Public sector entities engage in many commercial transactions of an exchange nature that are the same or similar to those in the private sector. These include contracts for the delivery of goods and services from private sector suppliers, such as construction contracts, remuneration for employees under the terms of employment contracts, and borrowing and lending on money markets. Non-exchange transactions involve the provision of goods and services, largely financed by involuntary transfers, principally taxation, or transfers from other tiers of government, which are initially financed through taxation. A public sector entity must constantly assess the need to undertake activities to provide goods and services in a non-exchange environment and its capacity to do so. Such an assessment includes consideration of factors such as the governing legal framework, the cost, quantity and quality of the goods and services provided and the outcomes of key programs. It also involves the management of the assets used to provide those goods and services, the servicing of debt and the ability to raise revenue and/or borrow funds in an environment where revenue is primarily from taxation and transfers rather than voluntary exchange transactions. An assessment of all these aspects of performance is important for accountability as well as decision-making purposes.

2.3 Because the primary objective of public sector entities is to deliver goods and services and not to generate profits their success can be only partially evaluated by examination of their financial position at the reporting date and financial performance during the reporting period. This means that users of financial reports of public sector entities have broader information needs than users of financial reports of private sector entities, where key issues are the return to investors and the ability to meet obligations to creditors. Users of public sector financial reports may need information in order to answer questions such as:

(a) Has the entity provided its services in an efficient and effective manner?

(b) How did the entity finance its activities and meet its cash requirements?

(c) Were revenues from current-year taxation and the entity's other resources sufficient to cover the cost of current-year services?

(d) Was part of the burden of paying for current services shifted to future-year taxpayers?

(e) Did the entity's ability to provide services improve or deteriorate compared with the previous year?

(f) What resources are currently available for future expenditures and to what extent are resources reserved or restricted for specified uses?

Taxation and Other Non-Exchange Transfers

2.4 The principal source of revenue for governments and many other public sector entities is taxation, which is a legally mandated involuntary transaction between individuals or business entities and the government. Conversely, as noted, private sector entities rely for the large majority of their revenue on exchange transactions that are entered into voluntarily.

2.5 Tax raising powers can vary considerably. In centralized jurisdictions it is likely that most tax raising powers will lie with central government, with sub-national entities having circumscribed rights to inflows from specified taxes and a highly limited ability to create new tax sources. In decentralized jurisdictions sub-national public sector entities may have more extensive rights to the inflows from broader sources of taxation and much more discretion over the creation of new sources of taxation and the levels at which taxes are levied.

2.6 Where entities have limited access to direct tax inflows they are likely to be dependent upon transfers from entities at other levels of government. While some of these transfers may have conditions attached to them, and, arguably, are quasi-contractual in nature, they are non-exchange in essential character.

2.7 International organizations are largely funded by inflows of a non-exchange nature. These may be governed by treaties and conventions or be made on a purely voluntary basis. Similarly to the provision of goods and services in non-exchange transactions, the reliance on taxation and other involuntary transfers has implications for a number of aspects of a public sector conceptual framework, such as the definition of assets and liabilities.

Provision of Goods and Services in a Non-Market or Limited-Market Environment

2.8 Economic theory suggests that governments have a major role in providing public goods (also called social goods). Public goods have the characteristics that (a) consumption of the goods by one individual does not reduce their availability for consumption by others and (b) individuals cannot be effectively excluded from consuming the goods. One of the best examples is public parks. In accordance with this theory the main objective of government is to provide goods and services that enhance or maintain the well-being of citizens and other eligible residents. Many government services are provided in a non-competitive environment, because they are unlikely to be provided by other entities, e.g., welfare programs, or because it is not considered appropriate for them to be provided through competitive market mechanisms on public policy grounds, e.g., policing and defense.

2.9 The level and quality of publicly provided goods and services received by an individual is not normally related to the amount that an individual contributes through taxation or contributions. Dependent upon the provisions of the program, an individual may have to pay a charge or fee and/or have had to make specified contributions to access certain services. Notwithstanding this point, such transactions are, for the most part, of a non-exchange nature because the amount that an individual or group of individuals obtains in benefits will not be approximately equal to the amount of any fees or contributions made by the individual or group. The provision of goods and services through non-exchange transactions has implications for a number of aspects of a public sector conceptual framework. These include, but are not limited to: (a) the scope of financial reporting; (b) the definition of the building blocks such as assets; and (c) the measurement of those building blocks.

3. The Importance of the Budget

3.1 Most governments and other public sector entities prepare annual financial budgets covering areas such as revenue and capital spending. Entities may also develop budgets covering longer time scales. These budget documents are often widely distributed and published. In the private sector commercial confidentiality means that budgets will very rarely be made publicly available.

3.2 In many jurisdictions the budget has a special legal significance and, historically, has been more important than the financial statements for communicating with citizens. A government's overall budget is usually the basis for setting taxation levels, is part of the process for obtaining legislative approval for spending and the mechanism for demonstrating compliance with legal requirements. Globally, the approved budget is the primary method by which the legislature exercises oversight and citizens and their elected representatives hold the government's management financially accountable.

3.3 Because of the budget's significance, information that helps users assess actual spending against budget estimates and the resulting budgetary surplus or deficit for the reporting period, compared with that budgeted, is important in determining how well a public sector entity has met its financial objectives. Comparison of actual results to the budget therefore provides information about one aspect of financial performance and is important accountability information for users of public sector financial reports. Therefore, the importance of the budget needs to be borne in mind in assessing the needs of the users of financial reports and in determining the scope of financial reporting.

4. The Nature of Property, Plant, and Equipment

4.1 In the private sector the primary reason for holding property, plant, and equipment and other assets is to generate cash flows that contribute to the profits of the entity, either directly or in combination with other assets. In the public sector, the primary reason for holding property, plant, and equipment and other assets is to provide goods and services to citizens and other eligible individuals and groups, rather than to generate positive cash flows. Certain assets will generate cash flows, but in most cases cash inflow generation will not be the primary objective of holding them. For example, most tenants of social housing units will pay rents. While rental income may be an important inflow on which future maintenance and refurbishment of the housing stock wholly or partially depends, the primary purpose of social housing is to provide accommodation for individuals and households which are not home owners and may not be able to participate in the private rental sector.

4.2 Because of the nature of the services they provide, a significant proportion of assets deployed by public sector entities are specialized in nature, for example roads and military assets. There may be a very limited market for such assets and, even then, they may need considerable adaptation in order to be used by other operators. This characteristic, while not unique to the public sector, is more pervasive in the public sector and has potential implications for measurement.

5. Responsibility for National and Local Heritage

5.1 Governments and other public sector entities may have extensive responsibilities for the national and local heritage. Such responsibilities include the protection or preservation of national art treasures, historical buildings, and other artefacts that contribute to the historical and cultural character of the nation or region. Governments generally also have responsibilities for the preservation of national parks and other areas of natural significance and native flora and fauna.

5.2 There is a strong intergenerational aspect to these responsibilities. Such buildings, art works and natural areas are part of a nation's endowment and, therefore, many consider that they need to be maintained for future generations. There are issues concerning whether such items meet the definition of an asset, the recognition criteria for assets and, if so, the appropriate measurement basis.

6. The Longevity of the Public Sector

6.1 The nature and extent of activities undertaken by a public sector entity and the legal formation of such entities generally means that these entities continue to exist for a very long time. There are certainly recent examples of the division or fragmentation of nation-states into a number of smaller nation-states, particularly in the former Soviet Union and Eastern Europe in the 1990s. However, generally, although political power may change regularly, national governments usually remain in existence. While recent global experience has demonstrated that governments may encounter severe financial difficulties they will cease to exist only very rarely.

6.2 At sub-national levels public sector entities may be merged or amalgamated. However, it is likely that basic public services will continue to be provided by successor or merged entities.

6.3 Governments may operate a number of programs with very long-term horizons where the effects of past decisions may only become clear many years, even decades, into the future. It can be unclear whether obligations related to such programs meet the definition of a liability in the financial statements. The ability to meet such obligations depends upon future tax flows. This gives rise to the issue of whether the power to tax is an asset.

6.4 The going concern principle is fundamental in compiling the financial statements. It assumes that the reporting entity will continue for the foreseeable future, unless there is an intention to liquidate that entity, or for it to cease operating, or if there is no realistic alternative but to do so. Where there are material uncertainties that cast significant doubt upon the entity’s ability to continue as a going concern, those uncertainties must be disclosed and particular accounting treatments may be required.

6.5 Going concern has generally been less relevant in the public sector than in the private sector because of the general longevity of governments, the long-term character of many public sector programs and the very broad tax-raising powers of national governments. If sub-national entities get into financial difficulties their main service delivery commitments may continue to be funded or transferred to restructured successor entities, rather than lapsing completely.

6.6 While the going concern principle may be of less significance in the public sector, the long-term sustainability of key programs is of increasing relevance. Because the financial consequences of many decisions will only become clear years or even decades into the future, prospective financial information covering lengthy time horizons may be necessary for accountability and decision-making purposes. This has implications for the scope of financial reporting.

7. The Regulatory Role of Government

7.1 Many governments have powers to regulate entities operating in certain sectors of the economy, either directly or through specifically created agencies. The composition of such agencies and their modes of operation are likely to be governed by legislative requirements. The main public policy rationale for regulation is to safeguard the interests of citizens and residents, acting as consumers, or to protect the population from certain risks that would not be conveyed through pricing mechanisms. Regulatory intervention also occurs where there are market imperfections or market failure for particular goods or services, and where the cost of particular transactions and activities are not transmitted through pricing and may therefore be borne by those other than producers or consumers (that is, externalities occur).

7.2 Private sector entities do not generally have such regulatory responsibilities. Regulatory intervention can involve governments and regulatory agencies making determinations affecting the pricing structures and operating approaches of private sector entities. The existence of such regulatory responsibilities will need to be considered in the determination of the reporting entity and the scope of financial reporting in the public sector.

8. Ownership or Control of Rights to Natural Resources and Phenomena

8.1 Governments often have the rights to natural resources such as mineral reserves, water, fishing grounds and forests, which allow them to grant licences or obtain royalties and taxes. They also have rights over phenomena such as the electromagnetic spectrum. It may not be clear whether such rights give rise to assets, and, if so, whether such assets meet the criteria for recognition in financial statements.

9. Statistical Bases of Accounting

9.1 The purpose of reporting under statistical bases of accounting is to provide aggregated information for macro-economic analysis and modeling purposes. Such information is primarily for decision-making purposes, including economic analysis and comparability between jurisdictions. In the public sector the Government Finance Statistics Manual (GFSM), issued by the International Monetary Fund, provides the specialized macroeconomic statistical system designed to support fiscal analysis. This system is consistent with the System of National Accounts, which was last updated in 2008. The GFSM provides the economic and statistical guidelines to be used in compiling statistics on the fiscal position of nations. The European System of Accounts (ESA) provides the guidelines for Member States of the European Union.

9.2 Reporting on the statistical bases of accounting is therefore highly important in the public sector. For statistical reporting purposes, the public sector is divided into the general government sector (GGS) and public corporations. The GGS includes all institutional units whose output is intended for individual and collective consumption and that are mainly financed by compulsory payments made by units belonging to other sectors, and all institutional units principally engaged in the redistribution of national income and wealth. The GGS is typically sub-divided into four subsectors: central government, state government, local government and social security funds. Unlike whole of government IPSAS-compliant financial statements, where entities at sub-national levels of government are consolidated when central government has the ability to direct their financial and operating policies, the boundary of the GGS is not dependent upon the relationship between central and sub-national government units.

9.3 IPSAS and statistical bases for reporting financial information have different objectives, focus on different reporting entities and treat some transactions and events differently. However, they also have many similarities in treatment, deal with similar transactions and events and, in some cases, have a similar type of report structure. There has been considerable convergence between statistical and IPSAS-compliant reporting bases in recent years, although the different objectives of the two systems and the focus on different reporting entities means that full convergence may not be feasible. In developing concepts for the public sector the requirements of statistical accounting need to be considered, for example, in developing definitions of elements.

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