

*International Public Sector Accounting Standards
Board*

Key Characteristics of the Public Sector

Staff Draft—Not Approved by the
International Public Sector
Accounting Standards Board



International Federation
of Accountants

Preface

This draft document has been prepared by the staff of the IPSASB as part of the IPSASB's project on the Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities. The staff draft highlights certain characteristics of the public sector that may have an impact on development of a conceptual framework for the public sector and therefore on accounting standard-setting in the public sector. It is informed by the IPSASB's deliberations on the Conceptual Framework project. The document has not been approved by the IPSASB and therefore does not represent the views of the IPSASB.

The IPSASB approved for issue an Exposure Draft 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* in December 2010. The IPSASB agreed that this staff draft should be made available at the same time as the Exposure Draft and Consultation Papers in order to provide some useful complementary information to constituents.

The staff draft is for information purposes only. The IPSASB is not seeking comments on it at this stage. This document will be considered by the IPSASB at its meeting in March 2011, with a view to approval for issuance for public comment.

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KEY CHARACTERISTICS OF PUBLIC SECTOR

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 private sector and therefore have a potential impact on the development of a conceptual framework that reflects public sector circumstances, and accounting standard-setting for the public sector. It is not intended to be 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. The main objective of governments and other public sector entities is to deliver goods and services rather than to generate profits. Globally the public sector varies considerably in both 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). This needs to be borne in mind when considering the users of financial reports and the objectives of financial reporting. 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.
- 1.3 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, such as the United Nations system. It also embraces Government Business Enterprises (GBEs). GBEs are cash-generating, profit-seeking entities whose financial and operating policies are governed by a public sector entity, which benefits from the GBE’s activities. GBEs generally operate in market-based environments and satisfy certain conditions relating to their governance and operating environment. Historically GBEs have tended to adopt the same or similar financial reporting approaches as private sector entities. The public sector does not include the private not-for-profit sector, although this sector shares many characteristics of the public sector.
- 1.4 This document discusses:
 - The volume and financial significance of non-exchange transactions;
 - Provision of goods and services;
 - Taxation and other involuntary transfers;
 - The importance of the budget;
 - Property, plant, and equipment deployed in the public sector;
 - Responsibility for heritage items;
 - The longevity of public sector entities and programs;
 - The regulatory role of government;

- Ownership or control of rights to natural resources and intangible items; and
- Statistical bases of accounting.

2 The Volume and Financial Significance of Non-Exchange Transactions

- 2.1 An important characteristic that distinguishes the public sector from the private sector is that the main objective of public sector entities is to deliver goods and services rather than to generate profits. This 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, such as where a controlling entity provides a controlled entity with a loan at off-market interest rates. Public sector entities engage in many commercial transactions of an exchange nature which 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, construction contracts, and remuneration for employees under the terms of employment contracts, and borrowing and lending on money markets. However, in the public sector a high proportion of both inflows and outflows of economic resources are in non-exchange transactions. Such transactions involve the provision of goods and services financed by involuntary transfers, principally taxation, or transfers from other tiers of government, which will be initially financed through taxation. Public sector entities are therefore primarily wealth accumulators and distributors rather than wealth creators. Public sector entities may contribute to wealth generation through application of economic generation powers. 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.
- 2.3 A public sector entity must constantly assess the need and capacity to undertake activities to provide goods and services. Such an assessment includes 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. Such an assessment of performance is also important for accountability as well as decision-making purposes.
- 2.4 Because the primary objective of public sector entities is to deliver goods and services rather than to generate profits their success can be only partially evaluated by examination of their financial position and financial performance at the reporting date. This means that users of financial reports of public sector entities have diverse information needs in relation to profit-oriented 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 the following:

- (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? Were the current-year taxes and its other resources sufficient to cover the cost of current-year services?
- (c) Did the entity's ability to provide services improve or deteriorate compared with the previous year? Was part of the burden of paying for current services shifted to future-year taxpayers?
- (d) What resources are currently available for future expenditures and to what extent are resources reserved or restricted for specified users?

Provision of Goods and Services

- 2.5 Economic theory suggests that governments have a role in providing social goods (also called public 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. 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 still 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. 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 elements; and (c) the measurement of those elements.

Taxation and Other Involuntary Transfers

- 2.6 The principal source of revenue for governments and other public sector entities is taxation, which is a legally mandated involuntary transaction between individuals or business entities and the government. Conversely, for-profit entities rely for the large majority of their revenue on exchange transactions that are entered into voluntarily.
- 2.7 Tax raising powers can vary considerably. In centralized nations 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 countries sub-national 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.

- 2.8 Where entities have limited access to direct tax inflows they are likely to be dependent upon transfers from entities at higher 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 character. 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.

3 The Importance of the Budget

- 3.1 Most governments and other public sector entities prepare annual financial budgets covering 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, been more important than the financial statements for communicating with citizens. A government's overall budget is usually the basis for setting taxation levels and is part of the process for obtaining legislative approval for spending. It is still the case that 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 a budget and the resulting 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 therefore the scope of financial reporting.

4 Property, Plant, and Equipment in the Public Sector

- 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, because the main objective of public sector entities is the provision of goods and services to citizens and other eligible individuals and groups, most assets are not held primarily for cash-generating purposes, but in order to deliver services. Certain assets will generate cash flows, but in most cases this will be incidental to the provision of services, rather than 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 families who are not home owners and may not be able to participate in the private rental sector.

- 4.2 Because they exist primarily to deliver services a high proportion of assets deployed by public sector entities are specialized in nature. 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 Heritage Items

- 5.1 Governments and other public sector entities may have extensive responsibilities for heritage items. Such items include 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 national 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 and, if so, the appropriate measurement basis for their recognition.
- 5.3 Private sector for-profit entities may control historical buildings, e.g., factory buildings which may be considered of historical significance, and regulations may restrict the way that such buildings are used or modified. Private sector for-profit entities may also own and display works of art. However, this is likely to be for investment purposes or to provide attractive and imposing surroundings in corporate buildings.

6 The Longevity of Public Sector Entities and Programs

- 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 unless a cataclysmic event, such as invasion or a revolution occurs.
- 6.2 At sub-national levels public sector entities may be merged or amalgamated, but it is likely that basic public services will continue to be provided by successor or merged entities. While recent global experience has demonstrated that governments may encounter financial difficulties they will cease to exist only very rarely.
- 6.3 Governments may operate a number of programs with very long-term horizons where the effects of past decisions may only transpire many years, even decades, in 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 the entity or to cease operating, or 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 are generally 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 time horizons many years into the future 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 the market for particular goods or services has significant imperfections or 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 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 regulatory responsibilities may need to be considered in the determination of the reporting entity and the scope of information about performance to be included in general purpose financial reports.

8 Ownership or Control of Rights to Natural Resources and Intangible Items

- 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 immediately clear whether such rights give rise to assets.

9 Statistical Bases of Accounting

- 9.1 The purpose of reporting under statistical bases of accounting is to provide aggregated information for macro-economic and statistical modeling purposes. Such information is primarily for decision-making purposes. In the public sector the Government Finance Statistics Manual, issued by the International Monetary Fund, provides the specialized macroeconomic statistical system (the GFS system) designed to support fiscal analysis. This system is consistent with the system of national accounts which was last updated in 2008. The Manual provides the economic and accounting principles to be used in compiling statistics on the fiscal position of nations.
- 9.2 Reporting on the statistical bases of accounting is therefore highly important in the public sector. The focus of this reporting is on the general government sector (GGS). 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/or all institutional units principally engaged in the redistribution of national income and wealth. The GGS is typically subdivided 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 only consolidated where central government has the ability to direct their financial and operating policies, the boundary of the GGS is not dependent upon the existence of such relationships.
- 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 also 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 would be neither feasible nor desirable. The importance of statistical accounting can lead to users being confronted by the presentation of financial information according to two different bases and for different reporting entities. In developing concepts for the public sector the requirements of statistical accounting need to be considered, for example, in developing definitions of elements.

10 Conclusion

- 10.1 There are numerous areas where the transactions of government and other public sector entities and other economic phenomena are the same as those in the private sector. In such cases the conceptual underpinning will probably not differ from the private sector. However, the areas identified in this paper may give rise to conceptual perspectives that differ from those in the private sector.



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