



It's time...

for global, high quality
public sector financial
reporting

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Contents

4

FOREWORD

5

EXECUTIVE SUMMARY

6

INTRODUCTION

7

WHERE ARE WE NOW?

8

WHAT IS THE VISION?

10

HOW SHOULD THE VISION
BE ACHIEVED?

13

CHARTING A COURSE TO
ACHIEVE THE VISION

15

ARE WE UP TO THE CHALLENGE?

Foreword

The global financial crisis and ensuing uncertainty about the strength of global economic frameworks highlighted disparities between public and private sector reporting standards. Sovereign debt issues that continue to plague several countries bring to light the inherent need to improve government reporting, in particular.

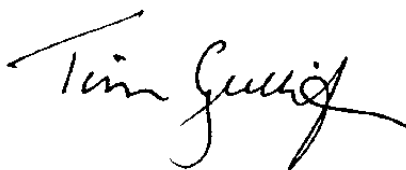
This publication seeks to influence the growing debate on developing greater consistency of transparency and accountability within financial reporting internationally. Irrespective of sector or operating environment, scrutiny of financial reporting needs to be consistent in delivering more efficient economic outcomes.

It's pleasing to see some jurisdictions around the world have taken steps towards reducing the disparity between the quality of reporting among the two sectors, however regulators and standard-setters need to continue to advocate for a more streamlined, uniform approach globally.

Governments raise debt in the same way organisations in the corporate sector do, and, as a result, need to be held to the same degree of accountability. Deficiencies within public sector reporting processes are fundamentally driving the push towards the development and adoption of high quality public sector accounting standards.

In releasing this publication to our international peers, the Institute would like to express gratitude and appreciation to Mr Warren McGregor, whose insights, knowledge and experience has shaped this publication.

I trust *It's time...for global, high quality public sector financial reporting* will encourage greater commitment towards improving financial reporting standards among the global public sector.



Tim Gullifer FCA

President 2013

Institute of Chartered Accountants Australia

There is an emerging consensus of the need for improvements in the quality of financial reporting by governments and their agencies around the world, and there is growing acknowledgement of the key role that the International Public Sector Accounting Standards Board (IPSASB) has to play in bringing this about. At their meeting in Moscow in February 2013, the G20 finance ministers and Central Bank governors observed that transparency and comparability of public sector financial reporting is one of the issues that need to be taken into account in pursuing their goal of strengthening the public sector balance sheet.

Executive *summary*



They charged the International Monetary Fund (IMF) and the World Bank with keeping them updated on the issues. This follows calls from the IMF and the World Bank for more widespread adoption of International Public Sector Standards (IPSAS), and a recent report by the European Commission to the Council of the European Union and the European Parliament on the suitability of IPSASs for adoption by EU Member States. These and other recent developments underpin the observation of the newly appointed chief executive of the International Federation of Accountants (IFAC), Faye Choudhury, in a recent interview that 'the day has come for global public sector financial reporting standards'.

Successfully pursuing financial reporting improvements at a national level by harnessing resources at a global level has been demonstrated by the IPSASB's private sector counterpart, the International Accounting Standards Board (IASB). Such improvements not only generate benefits to stakeholders and others by providing more transparent information about the financial performance and financial position of reporting entities, but also

enhance financial statement users' ability to compare the financial performance and financial position of those reporting entities across borders. With the emergence of the IPSASB as a serious international standard setter and the evident success of the IASB, there exists an opportunity both to accelerate the momentum of the IPSASB and to broaden the benefits of this global financial reporting revolution by positioning the boards within a common institutional architecture and having them develop standards by reference to a common financial reporting framework. This vision of a global standard setting architecture covering both the private and public sectors is presented in this paper. It is premised on the fact that reporting entities face common economic phenomena and the international accounting standard setters have a common mandate, i.e. to improve the quality of financial reporting with the objective of enhancing the decision making of the users of financial statements about the allocation of scarce resources and assessments of accountability.

Introduction

As we observe the rapid take-up of International Financial Reporting Standards (IFRSs) by countries around the world, the prospect of there being a single set of high-quality global accounting standards used by companies in all countries becomes ever more real. The benefits of this development have been extolled for some time now; enhanced cross border capital flows, improved capital market efficiency, lower costs of capital, etc., and there is mounting evidence that they are being achieved¹. The need for a set of global accounting standards has been reinforced by the global financial crisis, which both demonstrated the interconnectedness of the world's financial markets and highlighted the demand for transparent and comparable financial information within and between countries. As we shall discuss, this need extends beyond the private sector to the public sector.

The need for globalisation of financial reporting has to date been focused principally on the for-profit private sector and has been driven in recent years by the IFRS Foundation, through the International Accounting Standards Board (IASB). However, the benefits of globalisation of financial reporting by public sector entities are increasingly being recognised and efforts to establish a set of global accounting standards for the public sector are being pursued by the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC). A recent paper by the International Monetary Fund highlights the present inadequate reporting and accountability by many governments around the world and, inter alia, recommends greater use of International Public Sector Accounting Standards (IPSAS) to help remedy the situation². However, like the IASB's predecessor body, the International Accounting Standards Committee (IASC), the IPSASB faces significant constraints in pursuing its mission.

In November 2011, the IASB and the IFAC entered into a Memorandum of Understanding (MOU) to strengthen their co-operation in developing private and public sector accounting standards³.

While the MOU focuses on co-operation as the IASB and the IPSASB pursue their separate mandates, the rationale underpinning the MOU, a common belief in high-quality, transparent financial reporting, provides a foundation for greater integration of their activities. The following comments by the IASB chairman, Hans Hoogervorst, at a recent conference in the Netherlands highlight this commonality of purpose:

'One has only to look at the insurance industry to see how essential proper accounting standards are. Currently IFRS does not have a full-blown standard for insurance. As a result, financial reporting by the industry is riddled with non-GAAP measures and there is a serious lack of comparability. Because the industry's reporting lacks the underlying rigour of uniform accounting, investors demand a higher price for capital to make up for the lack of transparency.'

'Public sector accounting also demonstrates the primitive anarchy that results without the discipline and transparency that good financial reporting provides. While the IPSASB has created good standards for the public sector, based on IFRS, they are used only haphazardly. Around the world, governments give very incomplete information about the huge, unfunded social security liabilities they have incurred. Many executives in the private sector would end up in jail if they reported like Ministers of Finance, and rightly so.'⁴

This paper endeavours to make the case for coordinated action to achieve globalisation of financial reporting across both sectors, and to achieve it in a way that results in comparable reporting between the sectors. It presents a vision of an institutional framework and a financial reporting framework that could achieve that outcome, and discusses how this vision could become a reality.

FOOTNOTES

1. See Brown, P and Tarca, A. 2012, 'Ten Years of IFRS: Practitioners' comments and suggestions for research', *Australian Accounting Review*, December, pp319-330 and IFRS Foundation 2012 Report to the Trustees of the IFRS Foundation: *IFRS Foundation staff analysis of the SEC Final Staff Report – Work Plan for the consideration of incorporating IFRS into the financial reporting system for US issuers*, Appendix The Case for Global Accounting Standards: Arguments and Evidence, pp 68-84, accessible at www.ifrs.org/Use-around-the-world/Global-convergence/Convergence-with-US-GAAP/Documents/Analysis-of-SEC-Final-Staff-Report.pdf.
2. International Monetary Fund 2012, *Fiscal Transparency, Accountability and Risk*.
AUTHOR'S COMMENT: Concerns about the current lack of transparency and comparability of public sector financial reporting were undoubtedly behind the observation of the G20 Finance Ministers and Central Bank Governors at their meeting in Moscow in February 2013, that transparency and comparability of public sector financial reporting needs to be taken into account in pursuing their goal of strengthening the public sector balance sheet. See *Communiqué*, Meeting of Finance Ministers and Central Bank Governors, Moscow, 15-16 February 2013, paragraph10. Accessible at www.g20.org/load/781209773.
3. International Accounting Standards Board and International Federation of Accountants, *IASB and IFAC to enhance co-operation in developing private and public sector accounting standards*, 22 November 2011. Accessible at <http://go.ifrs.org/IFACMOU>.
4. Hans Hoogervorst, *The imprecise world of accounting*, presentation to the International Association for Accounting Education & Research conference, Amsterdam, 20 June 2012.

Where are we now?

The development of financial reporting standards for the public sector has lagged its private sector cousin and has been the focus of attention in few national jurisdictions. As for the private sector, the development of public sector standards emanated primarily from Anglo-American countries. Australia, Canada, New Zealand and the United States were the early pioneers, establishing separate standard-setting bodies through the 1980's and early 1990's charged with the task of developing standards for public sector entities. In the case of Australia and New Zealand, the standard setting boards took a transaction-neutral approach to developing accounting standards in different sectors, i.e. a given transaction or other event is accounted for the same way, regardless of the nature of the entity (whether for-profit or not-for-profit) and the sector in which it operates, on the basis that the underlying economics are the same⁵. In addition, both countries developed transaction-neutral conceptual frameworks.

At an international level, the IFAC established a Public Sector Committee (PSC) in 1986 to inter alia develop programs to improve financial reporting in the public sector. However, it was not until 1996 that actual standards development work began. The scope of that initial work was focussed primarily on developing public sector standards based on private sector standards issued by the private sector IASC, to the extent that those standards were applicable to the public sector. This initial development work, in a sense, mirrored the initial development work of the IASC which had been established in 1973 and spent its early years 'harmonising' standards issued by Anglo-American national standard setters.

In 2003, IFAC commissioned a review of the PSC by an externally chaired review panel⁶. The review, which became known as the Likierman Review after the external chairman Sir Andrew Likierman, led to the establishment of the IPSASB as an independent board with a clear mandate to develop and issue IPSASs.

With a new name and a renewed mandate the IPSASB set about bringing its body of standards up to date with those of the IASB as well as continuing to develop standards of particular significance to the public sector. With the benefit of increased funding the IPSASB has been able to improve the currency and comprehensiveness of its body of standards, but has struggled to keep pace with the IASB which has been undertaking an extensive work program of issuing new IFRSs and revising and updating existing IFRSs. Moreover, notwithstanding the elevated status of the IPSASB, its improved productivity and the significant progress that has been made in a relatively short period, the take-up of IPSASs around the world while now taking place at an increasing rate has to date been limited⁷.

There are many parallels between the evolution of the IPSASB and the evolution of the IASC. Both bodies were children of the worldwide accounting profession, both had modest objectives in the early years of their existence, both relied on voluntary contributions from accounting professionals who were typically employed on a full-time basis by other organisations, both operated on very limited budgets, and both struggled to obtain support from their constituents for the use of international accounting standards in place of countries' national accounting standards. In short, both bodies suffered from being part-time, resource constrained and structured in a way that made it difficult to achieve political legitimacy⁸.

The IASC's reincarnation as the IASB was designed to overcome these constraints. We believe it provides a blueprint for its public sector counterpart.

FOOTNOTES

5. In June 2012 the New Zealand External Reporting Board and the New Zealand Accounting Standards Board issued proposals for a new accounting standards framework that would require certain categories of public sector public benefit entities to apply IPSASB standards. See External Reporting Board, *Proposals for the New Zealand Accounting Standards Framework*, March 2012. Accessible at www.xrb.govt.nz. Australia continues to develop transaction-neutral standards based on IFRSs.
6. International Federation of Accountants, *Report of the Externally Chaired Review Panel on Governance, Role and Organisation of the International Federation of Accountants Public Sector Committee*, June 2004. Accessible at www.ifac.org/sites/default/files/downloads/PSCExternalReviewReport.doc.
7. **AUTHOR'S COMMENT:** While a number of intergovernmental organisations have adopted IPSASs, for example, the Organisation for Economic Cooperation and Development (OECD) and the North Atlantic Treaty Organisation (NATO), very few countries have adopted them. However, a number of countries are in the process of adoption (of either cash-based or accrual-based IPSASs) or have undertaken to adopt them by a specified date. For example, Brazil plans to fully implement them in 2013, and, as noted previously, New Zealand is proposing to adopt them for certain public benefit entities. In addition, the Council of the European Union asked the European Commission (EC) to assess the suitability of IPSASs for EU Member States by 2012. The EC's Report was issued in March 2013. While the EC did not recommend adoption of IPSASs in member states at this point in time, it did note that the IPSAS standards represent an indisputable reference for potential development of European Public Sector Accounting Standards (EPSAS). See Report from the Commission to the Council and the European Parliament, *Towards implementing harmonised public sector accounting standards in Member States*, The suitability of IPSAS for the Member States, March 2013. Accessible at http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/documents/1_EN_ACT_part1_v5.pdf.
8. **AUTHOR'S COMMENT:** Political legitimacy is a difficult issue for global organisations seeking to impact practices in national jurisdictions. For countries to be willing to embrace the output of global organisations by effectively delegating rule making authority to them, they need to have confidence in the efficacy of an organisations' institutional framework, in particular its governance arrangements. This was an issue the IASB and its oversight body, the IFRS Foundation Trustees, had to address during the early years of the organisation's existence.

What is the vision?

High-quality, transaction-neutral, global financial reporting standards that are applied by reporting entities in the private and public sectors around the world.

We noted earlier in this paper that the IFRS Foundation is well advanced in having a set of high-quality global accounting standards adopted around the world for publicly accountable for-profit entities in the private sector. We also noted that the benefits of this financial reporting revolution are beginning to be achieved. The benefits of a similar financial reporting revolution in the public sector are potentially significant as demonstrated at a national level in those countries that have already embraced high-quality financial reporting frameworks for public sector entities. Moreover, as the recent IMF paper makes clear, failure to bring about global improvements to the quality of reporting by governments and their agencies represents a significant threat to financial stability and economic growth⁹. Indeed, as the sovereign debt crisis has spread across the globe and the parlous financial state of a number of countries has become evident, many are asking why the financial statements of governments failed to reveal the existence and extent of the problem.

In a recent letter to the G20 Deputies and Finance Ministers, IFAC identified the benefits of improved public sector financial reporting and also put them in a global context:

'The use 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, accountability, and long-term sustainability. As a universal set of public sector accounting standards, IPSASs would also provide better information regarding systemic

risks associated with government liabilities, and would represent a significant step forward in achieving the financial transparency of national governments worldwide.'¹⁰

IFAC's views about the benefits of improved public sector financial reporting were recently mirrored by the EU in its report to the Council of the European Union and the European Parliament:

'Harmonised accruals-based government accounting improves transparency, accountability and the comparability of financial reporting in the public sector, and may serve to improve the efficiency and effectiveness of public audit ...

... Harmonised standards for public sector accounting would enhance transparency, comparability and cost efficiency, and provide the basis for improved governance in the public sector...

... Governments have a public interest obligation to market participants – owners of government debt securities and potential investors – to provide timely, reliable and comparable information on their financial performance and position, in the same way that listed companies have obligations to equity market participants. Also, there is a need to ensure a minimum level of international comparability, especially as government securities compete against each other in a global financial market, which calls for a system based on general public-sector standards accepted worldwide.'¹¹

The benefits identified by IFAC and the EU apply across all levels of government; from national or federal; to state or provincial; and, to local government, and to all spheres of government activity, including government business enterprises. Accounting standards that are focussed on meeting the needs

FOOTNOTES

9. International Monetary Fund, *ibid*.
10. International Federation of Accountants, *Letter from Ian Ball Chief Executive Officer to The Group of Twenty Deputies and Finance Ministers*, April 6, 2012.
11. See Report from the Commission to the Council and the European Parliament, *Op. Cit*, paragraph 3.

of the users of the financial statements of public sector entities (i.e. taxpayers, elected representatives, investors and the general public) will enhance the quality of information provided to those users and thereby facilitate both improved decision making about the allocation of scarce public sector resources and assessments of the accountability. The existing constraints on the IPSASB's ability to achieve these outcomes need to be removed.

In addition to the benefits that will flow from having a more empowered IPSASB that is able to bring about needed improvements in the quality of public sector financial reporting across the globe, there are likely to be synergistic benefits in having this dual-sector financial reporting globalisation occur on a comparable basis. In other words, significant benefits are likely to be gained from having reporting entities in the public and private sectors prepare high-quality, transparent financial statements that are comparable both within their respective sectors and across the sectors. This should facilitate cross-sector capital flows nationally and both cross-sector and cross-border capital flows internationally.

The global financial crisis, the sovereign debt crisis and the growing importance of sovereign wealth and similar funds have underscored the need for financial reporting comparability across sectors.

At the margin, the division between the public and private sectors has always been difficult to discern. This has been acknowledged by national and international standard setters who have in the past required or encouraged for-profit public sector entities to apply private sector accounting standards¹². This division has been blurred even more by the global financial crisis which resulted in many governments and their agencies being forced to acquire direct ownership stakes in private sector entities, many of them major international commercial enterprises. Some major private sector companies are now controlled by governments, in some cases with ongoing private sector investors. Users of the financial statements of these entities (including governments) expect to be provided with high-quality, transparent financial information. They would find it anomalous if they were deprived of this

because a change in ownership dictated a financial reporting regime that was unable to deliver the information that they required.

It is often overlooked that governments and their agencies are major participants in the world's capital markets through their debt raisings. The sovereign debt crisis has brought this to the world's attention and has highlighted the need for governments to provide high-quality, transparent financial information to government bond holders. With the credit ratings of sovereign states coming under increasing scrutiny, investors are demanding more transparent information about countries' financial health. In a recent interview, the CEO of IFAC stated:

'It is in investors' own interest to push for more transparent public accounts, common and more thorough accounting standards, and audits as strict as those corporates face ...'

'As we discovered in the case of Greece, the question of how reliable the accounting is, was called into question. If governments were accounting as companies do, we would be in a somewhat better position to assess whether the numbers were reliable.'¹³

Investors value comparable information highly. High-quality, comparable financial information will facilitate governments' capital raisings by enabling investors to better price their debt issues.

With the growth in the use of sovereign wealth and similar funds, governments are increasingly becoming stakeholders in vehicles similar in nature to private sector managed investment funds, and through these funds they are becoming major investors in private sector entities. Just as governments would expect their funds to be provided with high-quality, transparent financial information about the funds' private sector direct investments and potential investments, so too would government stakeholders (taxpayers, investors and the general public) expect to be provided with high-quality, transparent financial information about the performance and financial position of the funds.

FOOTNOTES

12. **AUTHOR'S COMMENT:** Indeed, the IPSASB currently requires government business enterprises to apply IFRSs in the preparation of their financial reports.
13. Ian Ball, *Uniformity needed for country balance sheet reporting, says global accountancy body*, interview for Investment Europe, 19 March 2012.

How should the vision be achieved?

For the vision to be achieved, we believe two separate yet related developments need to occur: the IPSASB needs to be transformed and the private and public sector financial reporting models need to be integrated.

TRANSFORMING THE IPSASB

Like the IASC before it, the IPSASB needs to be restructured and adequately resourced in order to successfully pursue its mission of establishing a set of high quality global accounting standards that can be applied by public sector reporting entities around the world. This transformation will enhance confidence in the IPSASB's governance processes and the quality of its standards. In so doing it will present a more compelling case for national jurisdictions considering embracing IPSASs as part of their legislative frameworks¹⁴.

One of the aims of the restructuring should be to create an environment in which the IPSASB can act, and can be perceived to be acting, independently of its constituents.

The importance of independence in standard setting was recently succinctly articulated by the accounting and reporting subcommittee of the International Organisation of Supreme Audit Institutions (INTOSAI):

'A successful standard-setting process produces high-quality standards that yield relevant, reliable, neutral, consistent, and comparable financial statements that meet the needs of users. To achieve this goal, the standard-setting process must be rigorous, transparent, objective, and participatory, but most importantly, it must be carried out by an independent standard-setting body. If those who set the standards are not independent from those who prepare the financial statements, the standards could be arbitrarily changed to suit the preferences of the current management and could result in inconsistent or misleading financial statements.'¹⁵

The concern is not so much whether members of the IPSASB act independently in their decision making; it is with the perception of independence. Stated differently, while there is no evidence of actual conflict or bias, the existing structure may create the perception that they do exist.

While the changes recommended in 2004, in particular placing the Board within the scope of the Public Interest Oversight Board of IFAC and appointing public members to the IPSASB, would go some of the way to addressing the perception issue, further changes are needed. The IPSASB remains a standing committee of IFAC and may be seen as being under the direct influence of the IFAC Council in the first instance and more broadly the worldwide accounting profession. Like the IASB, it needs to be positioned in a way that clearly separates it from its constituents. Similarly, the appointment of public members to the IPSASB would not remove the concern that Board members who are not full-time standard setters may be constrained in their actions by loyalty to their employers. This was a concern expressed about the IASC and led to the appointment of 12 of the 14 members of the inaugural IASB on a full-time basis. The IPSASB needs to follow a similar course.

Another aim of the restructuring should be to establish appropriate governance arrangements relating to the creation of a formal relationship with national public sector financial reporting regulators, the appointment of IPSASB members and members of related committees, and oversight of the Board's due process. These are matters that have recently been the focus of attention of the IFRS Foundation Trustees in the context of the operations of the IASB and the IFRS Foundation Trustees. A number of amendments to the original governance arrangements have been introduced in response to concerns expressed by the IASB's constituents. We believe the enhanced arrangements are equally relevant for the IPSASB.

As noted earlier, the IPSASB has a small professional staff and relies heavily on contributions from its Board members and their supporting staff, as did the IASC.

FOOTNOTES

14. **AUTHOR'S COMMENT:** The IPSASB's current structure and level of resourcing were identified by the EU as reasons why IPSASs are not at the present time suitable for adoption by EU Member States. The EU Report stated: 'At present, the governance of IPSAS suffers from insufficient participation from EU public-sector accounting authorities. During 2012, the governance framework of IPSAS was being reviewed to address issues of concern to stakeholders. Any reform should ensure that the independence of the standard-setting process is strengthened, while public-sector-specific needs are effectively addressed. In addition, the IPSAS Board currently seems to have insufficient resources to ensure that it can meet with the necessary speed and flexibility the demand for new standards and guidance on emerging issues in the evolving fiscal climate, particularly in the wake of the crisis.' See EU Report to the Council and European Parliament, Op. cit, paragraph 4. The need for the IPSASB to be restructured in order to sustain its momentum and ensure its long-term viability was also recently proposed by a senior member of the Organisation for Economic Cooperation and Development. See presentation by Jon Ragner Blöndal, Head, Budgetary and Public Expenditures, Organisation for Economic Cooperation and Development, 12th Annual OECD Accruals Symposium, Paris, 9 March 2012, accessible at www.oecd.org/gov/budgeting/49849808.pdf.
15. International Organisation of Supreme Audit Institutions, *The importance of an independent standard-setting process*, INTOSAI Subcommittee on Accounting and Reporting, 2010. The paper was endorsed by the XX International Congress of Supreme Audit Institutions (INCOSAI) in November 2010.

This limited resource base has severely hampered the IPSASB in keeping its standards up to date with IFRSs and in pursuing relevant public sector specific projects. Although a recent modest increase in funding has improved the situation, the current level of funding is clearly inadequate. Not only do significantly more resources need to be devoted to standards development, significantly more resources are also needed for engaging with constituents throughout the standards development process and for facilitating the use of IPSASs around the world. The IASB has a large, full-time professional staff and devotes considerable resources to its due process and to liaison with its constituents.

INTEGRATING THE REPORTING MODELS

Integrating the private and public sector financial reporting models to enable the preparation of high-quality, comparable financial statements by reporting entities irrespective of whether they operate in the private or public sector requires the establishment of transaction-neutral accounting standards. As noted earlier, transaction-neutral accounting standards are formulated with the objective of accounting for like transactions in like ways and unlike transactions in different ways. Thus, whether an entity that holds a debt instrument as an investment is a bank in the private sector or a sovereign wealth fund in the public sector, they would account for the investment in the same way. Similarly, whether an entity that has incurred a defined benefit pension obligation is a private sector mining company or a state or federal government, they would account for the liability in the same way¹⁶.

Some have interpreted transaction-neutral accounting standards as meaning that identical standards would apply to entities in both sectors or that private sector standards should apply to public sector entities. This is a misunderstanding of the notion of transaction-neutral standards.

Transaction-neutral standards should reflect the nature of the transactions and other events affecting the entity in question. For example, a for-profit entity (whether in the private or public sector) acquires and uses assets to generate profits for stakeholders.

Accounting standards addressing the potential impairment of these assets should focus on the recoverability of the assets' carrying amounts by reference to future cash flows expected to be generated by them. A not-for-profit entity (whether in the private or public sector) acquires and uses assets to provide needed goods and services in accordance with its service delivery objective, not to directly generate future cash flows. Accounting standards addressing the potential impairment of these assets should focus on whether the assets will continue to provide the service potential required to deliver the needed goods or services, not on whether the carrying amounts are recoverable from future cash flows. The impairment standards should be the same for for-profit entities in either sector but different from the impairment standards for not-for-profit entities in either sector¹⁷.

Similarly, accounting standards dealing with reporting performance should focus on the different nature of for-profit and not-for-profit entities. For example, an accounting standard dealing with reporting performance by for-profit entities arguably should focus on profit-generating activities with particular emphasis on profit and comprehensive income. An accounting standard dealing with reporting performance by not-for-profit entities arguably should focus on service delivery activities with particular emphasis on the cost of service delivery, and perhaps should place greater emphasis on non-financial performance indicators than a similar standard dealing with for-profit entities.

TRANSACTION-NEUTRAL CONCEPTUAL FRAMEWORK

The key to developing transaction-neutral accounting standards is to base those standards on a transaction-neutral conceptual framework. Such a framework would identify the basic concepts for the preparation of general purpose financial statements applicable to reporting entities irrespective of the nature of the entity or the sector in which it operates. The framework would be written in language that would reflect both private and public sector perspectives. For example, the objective of general purpose financial reporting could be expressed in terms broad enough to

FOOTNOTES

16. **AUTHOR'S COMMENT:** In the same sense, if a reporting entity, whether it be a government agency, a private sector charity or a publicly listed company, receives resources from external parties that are different in nature, then those transactions should be accounted for differently. For example, if the resource transfer is a loan to the entity it should be accounted for differently from a resource transfer that is a contribution by an owner or a charitable donation.
17. **AUTHOR'S COMMENT:** Of course, the impairment standards for for-profit and not-for-profit entities may be different for different types of assets held by those entities.

encompass all reporting entities, such as to provide information to users to assist them in making economic decisions and in assessing accountability. The narrative would then provide more detail about the types of information that users of the financial statements of the different entities would require for meeting the broad objective.

As a further example, while the basic characteristics of the elements of the financial statements, e.g. assets, liabilities, income, expenses, equity, contributions by owners, distributions to owners, etc., should be the same for all entities since these elements are descriptions of real world economic phenomena, the explanations of those characteristics would as appropriate highlight the different entity perspectives. The element 'assets' would, for example, be described as having a number of characteristics including that it is a 'resource'. The narrative accompanying the discussion of asset characteristics would then explain that in the case of for-profit entities, 'resource' refers to the capacity to generate future cash inflows, and, in the case of not-for-profit entities, 'resource' refers to service potential, i.e. the capacity to provide goods and services in the future.

As noted previously, Australia and New Zealand have developed transaction-neutral conceptual frameworks with respect to private and public sector entities. The US Financial Accounting Standards Board has developed a transaction neutral-conceptual framework for private sector for-profit and not-for-profit entities. Accordingly, a good deal of the intellectual development has already been undertaken. However, neither the IASB nor the IPSASB has developed a transaction-neutral conceptual framework.

The IASB inherited the IASC's for-profit private sector conceptual framework and has recently been revising the framework. However, to date the for-profit perspective has been retained¹⁸. The IPSASB is in the process of developing a conceptual framework for public sector reporting entities. The time is right to coordinate these efforts with the objective of producing a transaction-neutral conceptual framework. Failure to do so would create a risk that either or both Boards could entrench fundamental concepts that are incompatible with that objective and lead to the development of accounting standards that are not transaction neutral¹⁹. This risk was recently acknowledged by the New Zealand Accounting Standards Board, which noted '... because the IPSASB and the IASB prepare financial statements (sic) for specific sectors, there is a risk that the two boards will develop separate standards that treat like transactions in similar circumstances in quite different ways'²⁰.

FOOTNOTES

18. **AUTHOR'S COMMENT:** Although the IASB originally planned to encompass private sector not-for-profit entities in its conceptual framework project, it recently announced its intention to limit the scope of the project to for-profit entities. This tentative decision has been met with criticism from some of its constituents, including the Australian Accounting Standards Board.

19. **AUTHOR'S COMMENT:** The possibility of this happening is illustrated by a proposal of the IPSASB to identify two additional elements of the financial statements, 'deferred inflows' and 'deferred outflows', in its recent conceptual framework exposure draft. If this decision was to be confirmed by the IPSASB after public exposure of the proposals, the IPSASB's conceptual framework would be fundamentally different from those that have been developed by private sector standard setters over a considerable period of time, including the IASC and the FASB. See IPSASB. November 2012. *Conceptual Framework Exposure Draft 2 – Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements*, Section 5.

20. External Reporting Board – NZ Accounting Standards Board. September 2012. *Exposure Draft 2012-4 Framework: PBE Standards – Mixed Groups, Explanatory Guide AX: NZASB Strategy to Respond to Emerging Differences Between PBE Standards and NZ IFRSs (EG AX)*, paragraph 5.

Charting a course to achieve the vision

The vision of high quality, transaction neutral, global financial reporting standards that are applied by reporting entities in the private and public sectors around the world could potentially be achieved in a number of different ways. For example, a new international public sector standard setting body could be established with the features and operating mandate identified above. Alternatively, an existing global standard setting structure could be modified to encompass the changes we believe are necessary²¹.

The establishment of a new international public sector standard setter might logically be pursued by national jurisdictions entering into a multi-lateral arrangement, perhaps through the auspices of an existing intergovernmental body such as the United Nations, the World Bank or the International Monetary Fund. This would have the advantage of achieving 'buy-in' from countries at the outset, which should facilitate adoption of the standards. It should also ensure that the body is adequately resourced; something standard setting bodies have historically struggled to achieve. However, the difficulties and disadvantages of pursuing this approach are many.

For example, it would be very difficult to achieve agreement amongst diverse countries to the establishment, structure and operating mandate of such a body²². It would also be very difficult to achieve 'buy-in' up front from countries because this would effectively require them to commit to adopting the body's standards²³.

There are two principal disadvantages of pursuing this course of action: the time it would take to establish a new body and the perceived independence of the body.

Earlier in this paper we observed that events have conspired to create the ideal environment for convincing countries to support the development of global public sector accounting standards. The world cannot afford to let this opportunity slip by trying to 'reinvent the wheel'; now is the time for action.

We also observed earlier in the paper that independence is the cornerstone of an accounting standard setting structure. A standard setting body charged with developing public sector accounting standards that was established by governments, is funded by governments and, presumably, is overseen by governments would not engender the very necessary perception that the body is independent²⁴.

We believe the most efficient and effective course of action to pursue is to build on an existing global standard setting structure, i.e. the IPSASB of the IFAC or the IFRS Foundation. Changes that would need to be made to either of these standard setting arrangements could be made much more quickly than establishing a completely new arrangement. In addition, the independence concerns with an inter-governmental body would be avoided because both the IPSASB and the IFRS Foundation reside within the private sector. Although funding would be more challenging than under an inter-governmental arrangement, the IFRS Foundation has demonstrated that a viable funding model can be established. Convincing countries to adopt the standards will prove to be challenging irrespective of the model. As has been the case with the IASB, the global public sector standard setter will have to rely on the quality of its standards and the influence of external forces to induce countries to adopt its standards.

Building on either the IFAC's or IFRS Foundation's standard setting arrangements could achieve the vision of high quality, transaction neutral, global financial reporting standards. However, we believe the IFRS Foundation course of action, which would involve bringing the IPSASB into the IFRS Foundation, would be a more efficient strategy and would be more likely to be successful in achieving the vision.

FOOTNOTES

21. **AUTHOR'S COMMENT:** Some might consider that another viable alternative is to use the standards of a national or regional standard setting body. That standard setting body would be a de facto global standard setter in much the same way that the United States' Financial Accounting Standard Board (FASB) was a de facto global standard setter for the private sector before the establishment of the IASB. We do not agree with this view. We do not believe countries will be prepared to embrace public sector standards developed by a national or regional standard setter. The experience of the private sector supports this view. Although a few countries based their local standards on FASB standards and some allowed their multi-national companies to use FASB standards, the vast majority of countries continued to develop and use their own standards. The advent of the IASB saw a major change in countries' preparedness to forgo their own standard setting activities and effectively adopt those of another (international) body. The private sector experience is not surprising. Countries understandably displayed an unwillingness to use the standards of a body that is populated by members from a single country, develops standards in consultation only with people from that country, addresses issues that are of concern to that country and resolves those issues in the context of that country's particular circumstances. We have no reason to expect countries to have a different response to the use of the public sector standards issued by a national or regional public sector standard setter.
22. **AUTHOR'S COMMENT:** Indeed, some have suggested that were such a body to be established it would likely resemble a 'united nations of standard setters' with the capacity for lively debate but a propensity to achieve very little.
23. While many countries have either adopted IFRSs or permitted their use, they have done so almost without exception by subjecting the standards to a local 'endorsement' mechanism.
24. **AUTHOR'S COMMENT:** The following observation by the accounting and reporting subcommittee of INTOSAI, noted earlier in the paper, is apposite: 'if those who set the standards are not independent from those who prepare the financial statements, the standards could be arbitrarily changed to suit the preferences of the current management and could result in inconsistent or misleading financial statements.' International Organisation of Supreme Audit Institutions, Ibid.

In the first place, the basic architecture is already in place. The critical design features discussed earlier in this paper that are missing from the existing IPSASB structure were carefully crafted in creating the IFRS Foundation, and have been further refined during the 12 years since the organisation was established. In particular, requirements and processes designed to safeguard the independence of IASB members are in place and, we believe, have proven to be effective in creating the perception of independent decision making by IASB members. In addition, well developed oversight processes and procedures exist and the overall governance arrangements have been developed to the point where the organisation has, arguably, obtained political legitimacy. Also, the IFRS Foundation has been putting in place a sustainable funding model that could be readily adapted to include public sector constituents.

Secondly, achieving an essential element of the vision; transaction-neutral standards, is much more likely if the two boards are working together in the same organisation.

The architecture of the standard setting organisation provides the framework within which high quality accounting standards can be developed. However, developing transaction-neutral standards will require a commitment by the IPSASB and the IASB to that goal, and ongoing co-operation between them to bring it about. Even with the best of intentions and goodwill between the boards and their governing bodies, having them operate in separate organisations will inevitably see them drift apart. Even now we see that notwithstanding the Memorandum of Understanding that was recently entered into by the IPSASB and the IASB there is clear evidence (noted earlier in this paper) that the boards are increasingly going their own separate ways.

To implement our preferred course of action, we believe the following changes to the IFRS Foundation and the IPSASB would be necessary:

- The IFRS Foundation's Constitution would need to be amended to include the development of accounting standards for public sector entities, and the missions of the IASB and IPSASB would need to include the development of transaction-neutral standards
- The IFRS Foundation Monitoring Board would need to include members from the public sector with responsibility at a national level for the regulation of public sector financial reporting. Ideally, members from the public and private sectors should be equal
- The IFRS Foundation Trustees would need to include members from the public sector. Ideally, members from the public and private sectors should be equal in number
- The IPSASB would need to be repopulated with a smaller number of full-time members²⁵
- The IFRS Foundation's funding model would need to be enlarged to include contributions from public sector constituents.

FOOTNOTES

25. **AUTHOR'S COMMENT:** After the transition to the modified IFRS Foundation has occurred and the two boards have been successfully pursuing their mandates, consideration could be given to merging the boards.

Are we up to the challenge?

The calls for fundamental reforms to public sector financial reporting are growing louder and becoming more widespread as the level of awareness of the potential benefits of such reforms nationally and globally increases. But will the G20, the EU, the World Bank, the IMF, IFAC, the IFRS Foundation and others rise to the challenge?

We sincerely hope the answer is yes because now is the time to seize the moment and pursue a change in the world's financial reporting landscape that will have lasting benefits. This opportunity may not re-emerge for some time, if ever!

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