The Chartered Institute of Public Finance & Accountancy

European Commission / EUROSTAT
Public consultation

Assessment of the suitability of the International Public Sector Accounting Standards (IPSASs) for the Member States

CIPFA's response

11 May 2012

the people in public finance

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. Our 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed.

As the world's only professional accountancy body to specialise in public services, CIPFA's portfolio of qualifications are the foundation for a career in public finance. They include the benchmark professional qualification for public sector accountants as well as a postgraduate diploma for people already working in leadership positions. They are taught by our in-house CIPFA Education and Training Centre as well as other places of learning around the world.

We also champion high performance in public services, translating our experience and insight into clear advice and practical services. They include information and guidance, courses and conferences, property and asset management solutions, consultancy and interim people for a range of public sector clients.

Globally, CIPFA shows the way in public finance by standing up for sound public financial management and good governance. We work with donors, partner governments, accountancy bodies and the public sector around the world to advance public finance and support better public services.

Note that the material below and on the following pages echoes the EUROSTAT form, but is not presented using the 'form' functionality in Microsoft Word.

Identification of the respondent:

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Type of respondent:

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Business/Company

Association/Organisation

Professional body

Public Accountant

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Public authority

Other (please indicate) ………………………………………….

Respondent active at:

Regional level

National level

European level

Questionnaire

1 Please state the main motivations for your interest in this public consultation.

Globally, CIPFA is the only professional accountancy body which specialises exclusively in the public services, and as such has a particular interest in promoting the improvement of public sector financial management and governance. In line with this we set out our thinking on the essential elements required for strong public financial management at all levels of the public sector in our publication *Public Financial Management: a Whole System Approach*.[1] CIPFA is also calling for action to make high quality public financial management the norm in governments and public sector organisations throughout the world. In our prospectus *Fixing The Foundations*[2] we have called for a step change in public financial management. We see adoption of International Public Sector Accounting Standards (IPSASs) as one of the key components of strong public financial management.

CIPFA is also engaged with all aspects of IFAC's standard setting which ranges across auditing and assurance, education, ethics and public sector financial reporting. For the reasons explained above we have a special interest in, and make substantial contributions to, the work of the International Public Sector Accounting Standards Board (IPSASB). CIPFA also contributes to the work of the Professional Accountancy Organisation Development Committee (PAODC) which seeks to improve the capacity of the accountancy profession in countries where the role of the accountant is less well developed.

2 Do you consider that International Public Sector Accounting Standards (IPSASs) are suitable for implementation in the EU Member States? (Yes/No/Partly)

Yes

Please explain the main reasons for your answer, and provide any available supporting information for your answer. If you answered 'partly' or 'no', do you consider that accruals accounting standards would nevertheless be suitable for implementation in the EU Member States?

Government revenues and expenditure represent very significant proportions of most economies, and the related assets and liabilities are very large indeed. It is vital that they are effectively managed. Governments need to be accountable to citizens, service recipients and private sector corporate taxpayers and investors from whom they receive revenue, for the benefit of whom they maintain public infrastructure and provide public goods and services.

At this time of economic uncertainty it is particularly vital that there is a consistent accounting framework that transparently links present decisions to current and future commitments. This will provide the transparency needed for the proper functioning of markets, without which there is a danger that investors in government bonds would be entering into transactions without a proper understanding of the level of associated risk. This in turn could create a contagion risk in some economies, which could be a significant impediment to financial stability.

[1] **www.cipfa.org.uk/international/whole_system_approach.cfm**

[2] **www.cipfa.org.uk/prospectus/**

In countries where no private sector company would dream of managing high value and complex affairs without using appropriate systems and reporting, managed by professional accountants, there is nevertheless a longstanding reluctance to manage government affairs using the same tools and adopting the same degree of professionalism. We have called for radical improvements in this area in *Fixing the Foundations*.

The accrual IPSASs comprise the most globally accepted financial reporting standards developed specifically to address the needs of public sector entities. Many of the transactions entered into by governments are the same as those entered into by private sector entities. To the extent appropriate for the public sector, IPSASs therefore draw on the International Financial Reporting Standards (IFRSs) set for the private sector. Both IFRS and IPSAS are high quality sets of standards, and the IPSASB standard setting process maintains comparable treatments for transactions which have the same economic substance in both private and public sectors, while providing additional interpretation and guidance where necessary.

While IFRS are the most globally accepted standards framework for private sector 'public interest entities', they are explicitly framed in terms of relevance to investors who are expecting to receive a return on their investment at some stage. They require interpretation in order to apply them to public sector financial reporting, and there are several important issues for public sector financial reporting on which they are silent. While many of the early IPSASs were developed precisely as an interpretation of key IASs/IFRSs, in its subsequent work, IPSASB has increasingly addressed public sector specific issues, such as accounting for taxation and other non-exchange revenue, where it developed an entire new standard (IPSAS 23).

While the EU has specific data collection requirements (beyond those already covered by the European System of Accounts) and could consider developing its own stand-alone accrual accounting standards for individual entities, we do not believe that this is the most appropriate course of action. Establishing a process to develop independent standards from scratch, would be time consuming and extremely resource intensive. Instead CIPFA believes that dedicating time and resources to support the further development and implementation of IPSASs is a more efficient and cost-effective approach that would achieve the EU's goals and objectives.

In its individual entity and consolidated 'Whole of Government' accounts, the UK government has adopted IFRS, as interpreted and adapted for the public sector. Where IFRS is not compatible with the economic characteristics of the public sector or otherwise does not fit public sector requirements, the IPSAS framework is the next source of guidance considered. In practice, about 60% of the IFRS standards have required some form of interpretation or adaptation, ranging from the withdrawal of options within a standard to introducing requirements not found in IFRS, In general, as a result of an adaptation process which uses IPSASs as one of its reference points, this has had the effect of bringing the UK public sector requirements closer to the IPSASs. The remaining IFRSs are mostly ones where the IPSAS and IFRS are essentially equivalent, or ones which have little relevance to public sector preparers. Effectively the UK already therefore substantially complies with IPSASs, even though it has not formally adopted them as the primary basis for public sector financial reporting.

There is a significant degree of overlap and potential for synergy between government statistical reporting and IPSASs. A comprehensive accruals accounting system, such as that designed to produce IPSAS-based financial statements, will facilitate preparation of government financial statistics, and greatly improve the source data for government finance statistics (GFS). We discuss this further in our responses to subsequent questions.

3 What do you consider would be the main advantages, opportunities and benefits from any future implementation of IPSAS in EU Member States?

Accrual based reporting facilitates assessment of the impact of fiscal policy decisions, and helps governments to be accountable to electorates, taxpayers, and investors by reporting the economic substance of transactions. It also, when taken together with the systems which are necessary to produce reliable financial reporting information, greatly enhances resource allocation decisions, expenditure monitoring, and internal accountability. CIPFA's believes that:

- The benefits of accrual accounting (using credible standards that work for the public sector) are very substantial, and in our view outweigh the costs;

- IPSAS are the most appropriate choice of standards framework (notwithstanding the further development required in some areas, which we refer to later); and

- IPSASs also have other benefits, including better supporting Government Financial Statistics and information required for the purposes of the Excess Deficit Procedure.

Data generated by government accrual accounting systems can also be used as a basis for the preparation of the GFS which are crucial to fiscal and spending decisions in most jurisdictions. The European System of Accounts (ESA95), as a statistical framework using the accrual basis, requires the systematic gathering and processing of accrual basis data. The availability of audited financial reporting data on an accrual basis reduces the risk of systematic errors in the data used for the preparation of GFS substantially and therefore in data used for policy making.

Notwithstanding the benefits which may be obtained from supporting GFS preparation with IPSAS information, our principal view of the benefits of IPSAS is that as high quality accrual standards, they can provide far better information on the performance and financial position of governments and government bodies than cash based accounting.

In particular 'pure' cash based accounting is inherently incomplete, providing no information on most assets or liabilities, and the information it does provide relates to the timing of cash flows, rather than underlying economic substance of transactions. This lack of information is particularly significant given the long term nature of much government activity, whether embodied in specialised military equipment, government debt, or commitments to pay pensions or provide benefits. In practice, almost all users of cash accounting realise that it provides insufficient information to allow them to effectively manage their operations, and they very often develop additional systems and procedures in order to manage their underlying assets, liabilities, programmes and commitments.

In seeking to fill information gaps left by cash accounting, governments and public sector bodies use a wide variety of approaches. These are often unique, and not an adequate substitute for proper systems for asset management and other financial management. These inadequate systems are also often difficult to understand, and may be especially vulnerable to institutional loss of knowledge when key staff leave. In addition, because of the frequently unique nature of the approaches used, most users will not know on what basis the information before them has been prepared. They are therefore unable to form an informed view about risk in dealing with the body.

Also, while any system which informs performance measurement is likely to be susceptible to 'gaming', this is particularly true when it is difficult to make a clear link between the thing measured and the underlying activity.

4 What do you consider would be the main obstacles and disadvantages concerning any future implementation of IPSAS in EU Member States?

Implementation costs

The obstacle normally attributed to implementing accrual accounting is the cost of implementation. However the extent and nature of the obstacles and disadvantages to IPSAS implementation will depend on the circumstances in the individual Member State and the approach taken to implementation. We would note that while there would still be costs in moving from one accrual basis to another, as would be the case in a number of Member States, the work involved would be much smaller and therefore less costly than the shift from cash to accrual.

Member States may incur very substantial costs if the implementation process exposes a significant lack of capacity in public financial management systems generally. Introducing accrual accounting requires cultural change in the government and commitment from politicians and senior government officials. It requires careful project management, and the support of the whole government, not just the finance community. It also requires investment in accounting and internal control systems, but the direct cost of accrual implementation can be reduced if it is phased to fit better with the normal systems replacement cycle.

The cost of implementing accrual accounting or IPSAS is a visible cost, whereas the continuing costs of poor or less well-informed decision making resulting from incomplete, less coherent and less comparable accounting information are extremely difficult to quantify. While the visible costs may appear large in absolute terms, they are generally relatively small compared to the level of financial transactions of governments.

Risks relating to the IPSASB standards

The IPSASB reviews its existing standards as part of its ongoing work programme, which includes maintaining 'convergence' between those of its standards which are on topics covered by IFRS. 'Convergence' in this context does not mean that the standards are identical, but instead means that differences other than those relating to terminology should be justified by a clear and coherent rationale reflecting the specific circumstances of public sector bodies.

As with other accounting frameworks, there are currently gaps in the coverage of the IPSAS framework. In these cases, public sector preparers currently need to develop their own accounting policies. The IPSAS framework suggests that public sector preparers look to other standards, and often the most natural framework to use is IFRS. Where IFRS is relied on to fill gaps in the IPSAS framework, these will often need to be interpreted to reflect the fact that assets may be held for their 'service potential' or capacity to provide services, rather than their capacity to generate income.

Development of a Conceptual Framework for public sector financial reporting is the IPSASB's most important project currently. This is due for completion in 2014. Although there is a risk that following completion, changes may need to be made to existing standards, with the issue of Exposure Drafts on Elements and Measurement this Autumn it should be possible to assess the extent of likely changes with reasonable certainty.

Social Benefits are perhaps the most significant category of transactions not currently covered by an IPSAS. The IPSASB started work on this key public sector project in 2002. To date it has issued an Invitation to Comment, a Consultation Paper and an Exposure Draft. However it has proven impossible so far to achieve consensus on an appropriate accounting treatment. During the development of the project the IPSASB determined that in order to focus on the fundamental issues involved, work on the Elements phase of the Public Sector Conceptual Framework project was an essential prerequisite for the success of further work on social benefits. In addition work was initiated on the project in respect of reporting on the long-term sustainability of public entity finances as an interim step in ultimately developing standards on social benefits. The Board has recently resumed discussions on this project and is considering an appropriate timeline for re-initiating this project.

We would also note that there is currently no IPSAS relating to public sector entity combinations, and the direct application of IFRS 3 *Business Combinations* to many (or perhaps most) public sector combination or reorganisation would be problematic. The IASB specifically scope out from IFRS 3 those circumstances where entities under common control are combining, such as in group reconstruction. This is an important gap, both in IFRS and IPSAS. The IPSASB is currently undertaking a project with a view to producing an IPSAS on public sector combinations, and it should be possible to complete this by December 2014, in line with the likely timescale for adoption in all but the most advanced Member States.

At present, the IPSASB has relatively limited resources which may limit its capacity for dealing with multiple developments simultaneously. This could be a risk to the implementation of IPSAS should further gaps in the IPSAS framework or conflicts with current Eurostat approaches be identified (over and above those already included in the IPSASB work programme). As EU adoption of IPSAS would represent a step change for the adoption of IPSAS worldwide, CIPFA recommends that the European Commission considers contributing to the funding of the IPSASB to enable the Board to address the public sector issues of potential concern to Eurostat.

5 If you have any observations concerning the connections or links between possible future IPSAS implementation and financial reporting for the Excessive Deficit Procedure, please provide them here.

As noted in our answers to earlier questions, we consider that the benefits of IPSAS adoption would be wider than those which purely relate to the Excessive Deficit Procedure (EDP). However, as regards specific issues relating to EDP:

- In order for EDP to be a credible part of a fiscal surveillance process and for it to be considered to be applied in a fair and equitable manner, it is essential that EDP information from Member States is of high quality and prepared on a consistent basis, preferably at entity level.

- The accrual IPSASs are principle based standards that provide for the full disclosure of assets and liabilities including financial instruments, and the disclosure of financial flows which range more widely than cash transfers and include movements in financial and non-financial assets and liabilities. Applying IPSASs would provide a more coherent and comparable framework for the public sector than any other available financial reporting framework.

- IPSASs are already substantially converged with Government Finance Statistics (GFS) and the IPSASB has an on-going project to further enhance and promote the reconciliation and harmonization of IPSASs and statistical reporting guidance for the public sector, as far as this is possible. It is likely to conclude that production of GFS and EDP information can be further facilitated through:
  (a) removing IPSAS option choices (for example between current value and historical cost) where for Eurostat purposes a specific treatment is required; and
  (b) chart of accounts design.

- The use of a common set of financial reporting standards by all Member States might reinforce some of the guidance in the Manual on Government Deficit and Debt by applying requirements at the entity level where the accounting transactions actually take place, rather than at the national statistical level. Such transactions may potentially be subject to audit as part of an entity's normal financial statements audit, thereby providing additional assurance on reliability of the data used by statistics and reducing the need for estimation and adjustments. If an entity's financial statements were not audited, this could reduce the usefulness of the information, both for the EDP and a wider audience, as there would be no external assurance regarding the completeness and consistency of the information.

6 Please give any views or comments concerning the process and timetable for any future implementation of IPSAS in EU Member States.

In terms of the process for implementation in each country it is important that a plan is developed based on full IPSAS implementation covering:

- Overall project management
- Developing a process to determine how IPSAS applies to the specific forms of government and public sector organisation in that country, for example whether IPSAS should be applied at entity level, whole of government level or both;
- Training of accounting staff, and education of other staff whose role impacts on financial management;
- Development of systems to support IPSAS accrual accounting, which may need to run in parallel with legacy systems for cash based information; and
- Liaison between public sector bodies and their auditors, to manage the transition to the preparation of fully compliant accounts which can receive a clear audit report. In some cases, this may require interim stages where there is partial compliance with IPSAS, and in determining the approach to adoption Eurostat would need to balance priorities of cost and capacity with data collection priorities.

We would also note that some public sector auditors may already have expertise in accrual accounting, especially in countries where some public bodies already prepare accounts on an accrual basis. Other public sector auditors may need additional training in order to effectively carry out their audit responsibilities.

UK experience in central government would suggest that converting from mature cash based accounting to an accrual basis required an implementation phase of five years for individual entities and perhaps longer for consolidated ‘Whole of Government’ Accounts. We would however note that the process was facilitated by the fact that:

- Some UK central government bodies with significant asset bases (generally trading activities) were already required to prepare accounts on an accrual basis; and
- Some UK central government bodies had produced memorandum figures on the full costs of certain services, for which accruals type information needed to be provided or estimated.

Set against these advantages, some UK central government bodies were in a position where they managed large volumes of assets, without any systems or procedures to track the location, condition, value or other indicator of the remaining useful life of assets, or the likely replacement profile of its asset base, For these bodies, the lack of financial information relating to the management of assets needed to be addressed before they were able to produce balance sheet figures.

We expect that many countries will have bodies which face similar issues to the above, and in these cases it may be more important to address the gaps in public financial management information systems before using this information for financial reporting purposes. The UK experience is moving from cash to accrual is set out in HM Treasury’s Delivering the benefits of accruals accounting for the whole public sector[3].

[3] www.hm-treasury.gov.uk/media/F59/87/pbr05_accounting_281.pdf

7 Please provide any other observations or information you would like to make available which are not covered by your earlier answers.

- The IPSASB has an active work plan for the development of future accounting standards and the maintenance of existing standards. Development of new public sector specific standards is being carried out in line with the development of a robust conceptual accounting framework for public sector financial reporting. Maintenance of existing standards includes consideration of the extent to which links with related IFRS standards need to be maintained – in general IPSAS treatments are equivalent to those in IFRS where they relate to matters with comparable economic substance. Active maintenance of accounting frameworks is essential in order that benefits (whether relating to improved public financial management or fiscal surveillance) will continue to be obtained in the face of changing circumstances.

- The IPSASB project to minimise inessential differences between IPSASs and National Accounts (SNA / ESA) should over time provide greater consistency between each Member States government financial reporting under IPSAS and the public sector elements of National Accounts. Where the requirements cannot be harmonized, the differences will be known and can be addressed by additional data collection.

- Consideration will need to be given to both the European and national legal frameworks that are required for the implementation of IPSASs. One question that will need to be addressed is whether a European endorsement process for IPSASs is required or not. Whilst such a process has been followed for IFRS, it is not clear that it would be directly appropriate for IPSASs. The process for endorsing IFRS has lead to one standard (IAS 39) not being adopted in full, and there have been occasions when EU adoption of a standard has been extended beyond the IASB's effective date. If similar issues arose with IPSAS endorsement, this could hinder comparisons with countries outside Europe, and direct implementation of IPSAS may be preferable. Ideally, a decision about endorsement would be taken at the same time as a decision to implement IPSAS; if this is not possible, the decision should be taken as soon as possible thereafter to minimise any period of uncertainty for Member States. A requirement to endorse all current IPSASs prior to implementation may result in a longer implementation period than would be the case if IPSASs were implemented without an endorsement process.

- We have set out in our response the benefits of accrual accounting. CIPFA considers that further benefits can be achieved through the subsequent adoption of accrual budgeting. The experience in the UK is that this will better align the budgeting and decision making processes with high quality financial information, and will therefore assist better decision making, The adoption of a high quality financial reporting framework such as IPSAS is a prerequisite for accrual budgeting.

- It is our understanding that the IPSASB is keen to further enhance its processes by placing its work under formal public oversight arrangements similar to those operated in relation to other international standard setting boards. This is an enhancement which CIPFA strongly supports. It is currently the subject of a formal consultation which is being undertaken by the Monitoring Group. We would recommend that the European Commission engages with this discussion.