EURO PEAN

PUBLIC SECTOR ACCOUNTING

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CHAPTER 6
DIFFERENT PERSPECTIVES IN PUBLIC SECTOR ACCOUNTING HARMONISATION: IFRS, GFS AND IPSAS

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Summary

In order to compare financial information across companies, organisations, and public entities, accounting standards and accounting practices have to be harmonised. For this purpose, first, the International Financial Reporting Standards (IFRS) have been developed for the preparation of general purpose financial statements of profit-oriented entities. However, some governments also have based their national public accounting standards on IFRS. Second, the Government Finance Statistics (GFS) provide statistics on financial operations, financial position and liquidity situation, especially of the general government sector, and enable analysis of fiscal statistics. Third, public sector accounting should be harmonised at the global level by adopting the International Public Sector Accounting Standards (IPSAS). This chapter describes these three different perspectives in public sector harmonisation and refers to challenges associated with accounting harmonisation.

Keywords

Public sector accounting, accounting harmonisation, IFRS, IPSAS, GFS

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1. Introduction

In general, accounting harmonisation is associated with greater international comparability of financial information. When accounting practices are harmonised, multinational companies are able to prepare and consolidate financial statements without considering different national accounting practices. Furthermore, operations from multinationals can be easier understood, for example, by the administrations of developing countries. Relatedly, international accountancy firms and tax authorities benefit from a harmonised measurement of foreign incomes. Next to transparency and usability, accounting harmonisation is advantageous for the use of decision-making instruments such as investment appraisal or performance management, due to its ease of use and comparability. Having these benefits of accounting harmonisation in mind, this chapter aims to describe different perspectives of accounting harmonisation and related challenges. International accounting harmonisation is realised by applying international accounting standards and regulations on statistical reporting, such as the **International Financial Reporting Standards** (IFRS), the **Government Finance Statistics** (GFS) Manual 2014 and the **International Public Sector Accounting Standards** (IPSAS). Referring to high levels of government debt and fiscal pressure, transparent and comparable financial information is especially important for public sector entities.

This chapter has the following **aims**:

- Giving reasons why accounting harmonisation is important.
- Describing different perspectives of public sector accounting (PSA) harmonisation (i.e. IFRS, GFS, IPSAS) and linking them to their significance in PSA.
- Outlining challenges associated with PSA harmonisation.

The chapter is structured as follows: **Section 2** illustrates harmonisation efforts of the private sector accounting system and describes the IFRS in more detail. **Section 3** concentrates on GFS, explains the purposes of GFS and the differences between GFS and IPSAS. **Section 4** gives an overview on harmonisation in PSA, refers to the IPSAS standards and introduces the EPSAS standards project. **Section 5** concludes by summarising the different perspectives in PSA harmonisation.

2. Harmonisation of the private sector accounting system

The emergence of IFRS has begun with the establishment of the International Accounting Standards Committee (IASC) in 1973. At that time, there have been major differences in national accounting laws and standards between the founding member states of the IASC (Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States of America), so that financial information was not fully comparable for international investors and other user groups. Therefore, the IASC Agreement and Constitution aimed to develop and publish basic accounting standards and to promote their worldwide acceptance.[1] Even though the IASC (which later became the International Accounting Standards Board; IASB) was restructured several times and confronted with conflicting national interests throughout its history, its original mission of advancing private sector accounting harmonisation still remains unchanged. The current IFRS Foundation Constitution specifies the objectives of developing a single set of principle-based, high-quality, understandable, enforceable and globally accepted financial reporting standards and to promote the worldwide use and rigorous application of those standards.[2]

Since the formation of the IASC, different jurisdictions reacted in different ways and speeds to the prospect of a single set of globally accepted financial reporting standards. The 2002 decision of the EU to require IFRS for the preparation of consolidated financial statements of

[1] Camfferman and Zeff (2015), pp. 8-9.

[2] IFRS Foundation (2018a), para 2.

listed companies within all member states starting from 2005 can be seen as a milestone and important stimulus for other nations outside the EU to make similar commitments to international financial reporting.[3] As of April 2018, already 144 out of 166 profiled jurisdictions require the use of IFRS for at least a subset of their domestic public companies.[4]

International Financial Reporting Standards (IFRS) are standards and interpretations published by the International Accounting Standards Board (IASB). IFRS are designed for the preparation of general purpose financial statements of profit-oriented entities (e.g. entities engaged in commercial, industrial, financial and similar activities). The overall objective of IFRS is to provide financial information about the reporting entity that is useful for the economic decision making of a wide range of different user groups, including investors, creditors, employees or the interested public at large. To achieve this objective, the fair presentation principle (or true and fair view) demands that the financial statements shall present fairly the financial position, financial performance and cash flows of the reporting entity. The Board presumes that full compliance with IFRS will usually result in a fair presentation. The term IFRS has to be interpreted broadly and is used to indicate the whole body of literature published by the IASB, including:

- the **Conceptual Framework** (CF) for Financial Reporting which describes the objectives and general principles for the preparation of general purpose financial statements. The main purpose of the CF is to assist the IASB in developing new standards by providing a consistent foundation of clearly articulated principles and concepts. Furthermore, the CF is designed to assist financial statement preparers in developing consistent accounting policies in case no specific standards apply for certain transactions or other events. Finally the CF also assists all parties (e.g. users, preparers and auditors) to understand and correctly interpret the standards.

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[3] Camfferman and Zeff (2015), p. 56.

[4] IFRS Foundation (2018b). For a comprehensive overview about which companies have to follow IFRS in different jurisdictions see Pacter (2017), pp. 29-177.

- the **International Financial Reporting Standards** (IFRS) as issued by the IASB and International Accounting Standards (IAS) as issued by the IASC which set out the main requirements in regard to recognition, measurement, presentation and related disclosures dealing with certain transactions and events that are important in preparing general purpose financial statements. Usually, the standards are supplemented by various annexes, like Illustrative Examples, Implementation Guidance and the Basis for Conclusions, which give further insights into the reasoning of the IASB and the interpretation of specific accounting guidelines.
- the **interpretations** by the IFRS Interpretations Committee and its predecessor the Standing Interpretations Committee (SIC) which give authoritative guidance on reporting issues that would otherwise likely lead to divergent practices or unacceptable treatments. Although interpretations are drafted by the IFRS IC, they must be approved by the IASB in order to be adopted.

In fulfilling its objective of creating a single set of globally accepted financial reporting standards, the IFRS Foundation identified the need to develop an **organisational framework** that ensures transparency in developing and maintaining accounting regulations as well as establishing structures for effective communication and involvement of its constituency. Therefore, the IFRS Foundation Constitution[5] sets out an organisational framework of different institutions involved in developing and maintaining IFRS (see Figure 6.1):

[5] IFRS Foundation (2018a).

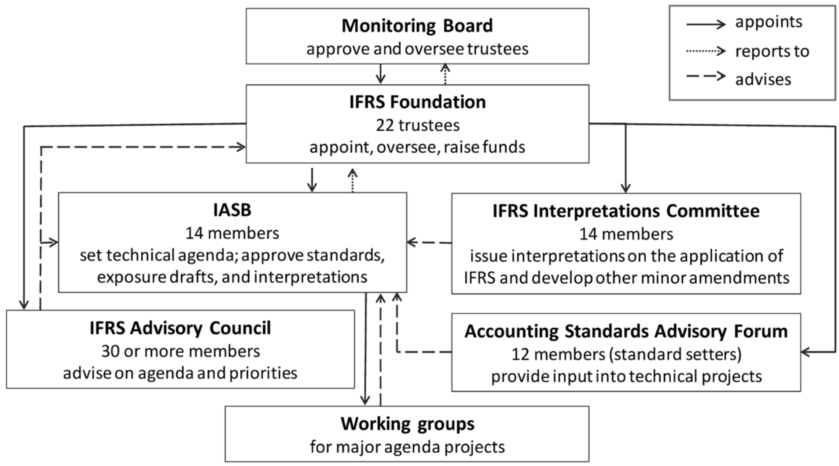

Figure 6.1: Organizational framework of the IFRS Foundation and related institutions (Source: IFRS Foundation, 2018a)

The **IFRS Foundation** is comprised of 22 trustees, which are tasked primarily with the governance of the IASB and its related institutions. The trustees are required to be financially knowledgeable individuals from a variety of different professional backgrounds and have to reflect an overall geographical balance. The main duties of the trustees are to appoint members of the IASB, the International Financial Reporting Interpretations Committee (IFRIC), the IFRS Advisory Council and the Accounting Standards Advisory Forum (ASAF) and to establish and amend their operating procedures. Furthermore, the IFRS Foundation shall establish and maintain appropriate financing relations and review broad strategic issues affecting financial reporting standards.

The **Monitoring Board** provides a formal link between the trustees and public authorities. The main responsibilities of the Monitoring Board are to approve the appointment of trustees and to review and advice the trustees on the fulfilment of their responsibilities.

The **IASB** is comprised of 14 members, which, as a group, shall represent the best available combination of technical expertise and relevant professional experience, including preparers, users, auditors, academics and market or financial regulators. The Board has full responsibility for all technical matters, including developing and pursuing its technical agenda, preparation and issuing of IFRS, Exposure Drafts (ED) and Discussion Papers (DP). In fulfilling these tasks, the Board has full discretion over project assignments and can form working/advisory groups to support their work on major projects.

The objectives of the **IFRS IC** are to interpret the application of IFRS and to provide timely guidance on any financial reporting issues which are not specifically addressed by the standards. Users of IFRS can refer financial reporting issues to the Interpretations Committee, which can then either decide that the issue will be addressed by issuing an interpretation or by proposing an amendment to an existing IFRS or that the issue can be solved by the correct reading of the existing standard (therefore an interpretation or amendment is not needed).

The **IFRS Advisory Council** provides a forum for the participation of 30 (or more) individuals and organisations interested in international financial reporting. The main objectives of the Council include giving advice to the Board on agenda decisions and priorities and informing the Board about the views of Council members on major standard-setting projects.

The **Accounting Standards Advisory Forum** (ASAF) was established with the objective to increase the involvement of national standard setters in the development of IFRS. The main purpose of ASAF is to support the standard-setting process by providing the IASB with technical advice and feedback on major standard-setting projects.

As the IASB is a private sector standard-setter it has no legal authority to prescribe the mandatory use of IFRS in any jurisdiction. Therefore, countries that want to adopt IFRS have to implement an **endorsement mechanism** that mandates or permits the use of IFRS. Throughout the history of the IASB, different countries made different commitments regarding international financial reporting reaching from a full adoption of IFRS as issued by the Board, over adopting a modified version of IFRS, to developing national accounting standards that are substantially converged with IFRS (for an overview of different endorsement mechanisms in different jurisdictions refer to Pacter, 2017). In 2002, the European Parliament (EP) (by approving EC No. 1606/2002) decided to require the use of IFRS for the consolidated financial statements of all listed companies in the EU starting from 2005.[6] However, in order to maintain legislative power the EU authorities decided to implement an endorsement mechanism to assess each new IFRS in regard to the criteria specified in the IAS Regulation and in regard to European interests.[7] Therefore, only the IFRS as adopted by the EU have to be mandatorily applied for the preparation of consolidated financial statements by listed companies in the EU.

The **EU endorsement mechanism** (see Figure 6.2) starts with the publication of a new IFRS/IFRIC (or amendment) by the IASB. The new standard is then assessed by technical experts within the European Financial Reporting Advisory Group (EFRAG). EFRAG is a private association that is tasked with providing advice to the European Commission (EC) on whether a new IFRS/IFRIC should be endorsed. The three main endorsement criteria EFRAG has to consider are:

- if the new standard fulfils the "true and fair view" principle,
- if the standard is conducive to the European public good and
- if the standard meets the four qualitative criteria of understandability, relevance, reliability and comparability.

Although the ultimate reason for establishing EFRAG was providing endorsement advice, the technical experts of EFRAG also serve the purpose to consult and provide the European perspective on financial reporting issues to the IASB.[8]

Based on the endorsement advice given by EFRAG, the EC can submit a draft regulation to the Accounting Regulatory Committee (ARC). The committee is comprised of representatives from all EU member states and is chaired by the EC. If the ARC opinion on the proposal is positive, the EC submits the draft regulation to the EP and the Council for a three-month scrutiny period. If there are no objections from the EP or the Council, the proposed standard will be adopted and published in the official journal.[9]

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6 For further information refer to Camfferman and Zeff (2015), pp. 57-65.

7 European Commission (2000), pp. 7-8.

8 Van Mourik & Walton, 2018, pp. 10-13.

9 Council Decision 1999/468/EC Article 5a(3).

However, if the ARC disagrees with the proposal, the EC has to submit the proposal to the Council and to forward it simultaneously to the EP. If the Council envisages the adoption or does not act within two months, the proposal has to be submitted to the EP, which has another two months to oppose the proposal. If the EP does not oppose, the proposal has to be adopted (regardless of the opposing ARC vote). However in any case, if the EP or the Council opposes with the draft submitted by the EC, the draft shall not be adopted and the Commission may submit an amended or new draft to the Committee.[10] Although by applying these endorsement procedures the EU can adopt a modified version of IFRS, in practice, these modifications will be limited to rare cases, as otherwise IFRS as adopted by the EU would not be comparable to full IFRS.

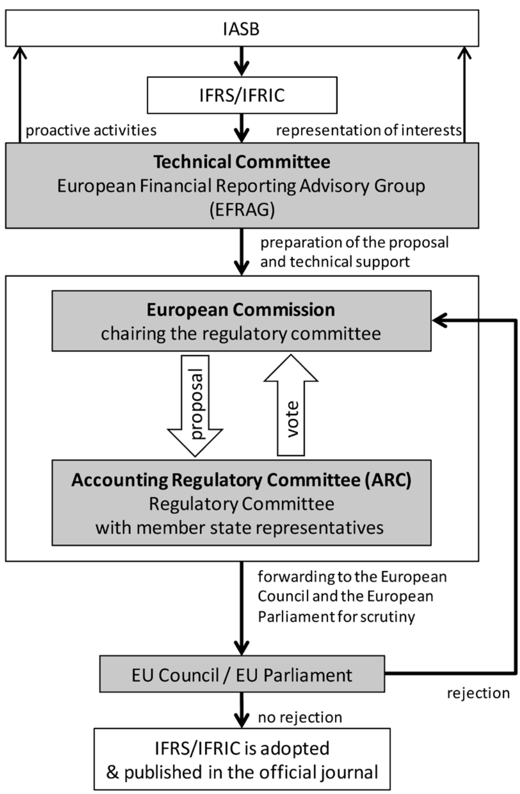

Figure 6.2: EU endorsement mechanism
(Based on Oversberg, 2007, p. 1599f.; Pellens et al., 2017, p. 83)

[10] Council Decision 1999/468/EC Article 5a(4).

Even though IFRS can be seen as an important and successful tool for achieving the objective of private sector accounting harmonisation, there are still several challenges to overcome in the future:

- Even though the CF is designed to provide a consistent foundation for further standard setting, several requirements in the standards are actually not in line with aspects of the CF and with other standards, leading to **inconsistencies in financial reporting**.
- Complexity and extensive disclosure requirements make financial reports based on IFRS **more error prone** as compared to national accounting guidelines. This issue is of particular importance considering that there are no globally accepted enforcement mechanisms in place to ensure full compliance with IFRS requirements.
- IFRS often include estimates based on the judgement of financial statement preparers. This leads to considerable **management discretion** and reduces the reliability of financial reports.
- Finally, IFRS is still **lacking international acceptance**. Even though a large number of jurisdictions has made public commitments to IFRS as the single set of globally accepted financial accounting standards, IFRS are still not applied in several notable economies (e.g., China, India, Japan and the United States), which does not imply that IFRS are not important in these countries, as they are, for example, granting access to the stock markets. Furthermore, several countries only apply modified versions of IFRS, which decrease international comparability and, therefore, limit the objective of international accounting harmonisation.

3. Harmonisation of the Government Finance Statistics

Government Finance Statistics (GFS) encompass statistics that enable to analyse financial operations, financial position and liquidity situation over time. GFS provide financial statistics in a consistent and systematic manner, and should reflect decisions, taken on the interpretation of the European System of National and Regional Accounts (ESA 2010). They are developed by the International Monetary Fund (IMF), and especially relevant for the general government sector of the public sector (Figure 6.3).

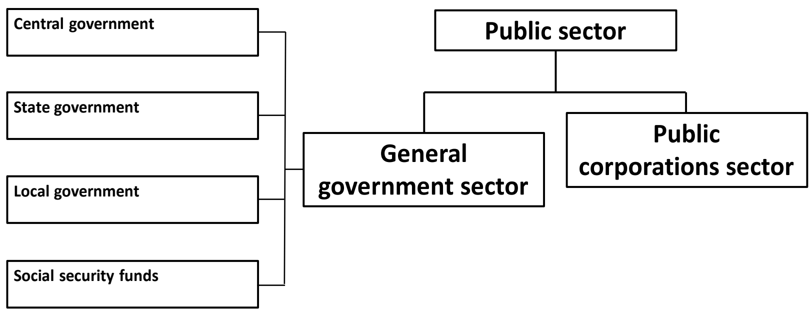

Figure 6.3: Structure of the public sector

The **general government sector** comprises non-market producers creating output for individual and collective consumption. They are financed by compulsory payments from units belonging to other sectors. The sector's main functions consist of satisfying collective needs (e.g., defense) and household's needs (e.g., state health care). In order to finance these needs, it redirects money, goods and services among units (e.g., redistribution of national income). The general government sector can be divided into:

- Central government: Responsibilities cover the whole economic territory of a country;
- State government: Separate institutional units responsible for exercising various government functions;
- Local government: Provision of services to local residents;
- Social security funds: Includes all social security units, regardless of the level of government.

In 1970, "A Manual on Government Finance Statistics" was drafted to collect first comments of government, central banks, central statistic offices etc. Based on their feedback, "A Manual on Government Finance Statistics 1986" (GFSM 1986) was published that provides a guidance to compile GFS.

This manual is, however, no direct alignment with other macroeconomic statistics. In 2001, the "Government Finance Statistics Manual 2001" (GFSM 2001) was published to accomplish harmonisation with standards of other internationally recognised macroeconomic statistic guidelines. The "Government Finance Statistics Manual 2014" (GFSM 2014) was adapted to up-dated statistic manuals, the System of National accounts 2008 (SNA 2008) and two specialised manuals (BPM6 and MFSM).

The **GFSM 2014** outlines the GFS framework and contains guidelines for presenting fiscal statistics. In addition, the Manual covers the economic and statistical reporting principles. The Manual is harmonised with other macroeconomic statistical guidelines (e.g., System of National Accounts 2008, Balance of Payments and International Investment Position Manual 6, Monetary and Financial Statistics Manual) and explains the relationship of GFS to internationally accepted accounting standards such as IPSAS.

Table 6.1 summarises the **differences of GFS and IPSAS**. To illustrate some differences, GFS aims at evaluating the outcomes of fiscal policy decisions, the impact on the economy, and the national and international outcomes. In contrast, IPSAS aim at evaluating financial performance and financial position, enhancing management accountability, and improving decision making. Next to different aims, GFS and IPSAS differ in terms of the reporting entity. The statistical reporting unit is *an institutional unit, defined as an entitity that is capable, in its own right, of owning assets, incurring liabilities, and engaging in economic activities in its own name*[11]. Although the reporting entity is an institutional unit, the focus of GFS is on a group of units such as a subsector. The reporting entity for financial statements represents an economic entity, defined as a group of entities that includes one or more controlled entities.[12]

[11] IMF (2014), p. 343.

[12] IMF (2014), p. 341-343.

	GFS	IPSAS
Objectives	Evaluate the outcome and the economic impact of fiscal policy decisions	Evaluate financial performance and position to hold management accountable and to inform decision-making institutions
Reporting entity	Institutional units and sectors	Government or other public sector organisation, program or identifiable activity
Recognition criteria	Economic events	Past events with probable outflows
Valuation (measurement)	Current market prices	Fair value, historical cost and other bases
Revaluations	Record all revaluations and changes	Realized and unrealized gains and losses

Table 6.1: **GFS versus IPSAS** *(IMF (2014), pp. 341 ff.)*

In the following, the **GFSM implementation plan** is outlined. Government activities are supposed to be presented in the framework of a government balance sheet (accrual accounting). The following key steps have to be considered when implementing accrual accounting and GFSM:[13]

(1) Take stock: Review existing source data, approve classifications according to international guidelines and improve existing recording methods;

(2) Adopt new presentation: Rearrange existing data to the GFSM framework, identify and plan how to fill data gaps;

(3) Improve coverage: Expand coverage to include all relevant institutional units and transactions;

[13] Jones (2013), p. 3 ff.

(4) Compile Financial Balance Sheet: Add data on financial assets and liabilities;
(5) Estimate non-cash items: Add data on receivable and payable accounts, etc.;
(6) Estimate other economic flows: Add data on holding gains/losses and other volume changes;
(7) Compile full balance sheet: Add data on nonfinancial assets.

With regard to the **implementation of the GFS framework**, some countries are not able to compile the full GFS framework, for example, due to their economic situation. The implementation of the fully integrated GFS framework takes time and resources. Most countries have to adapt their underlying accounting system in order to compile the GFS framework, applying accrual basis for reporting and the classifications of the GFS framework.

Harmonising GFS also involves numerous **challenges** that restrain from comparing data across countries in an economic and monetary union (e.g., EU).[14] First, additional guidelines might be provided for regional arrangements such as “rulings” or “fiscal policy rules” on specific transactions, aggregates, or balancing items (e.g., Manual on Government Deficit and Debt of the EU). Second, existing guidelines on concepts and definitions might be clarified in order to avoid misinterpretations and solve practical problems. Third, it is not always clear which units belong to the general government sector so that more detailed guidelines for the classification and sectorisation of units are necessary in order to provide comparable data. Furthermore, it should be transparent which units are included and which are not part of GFS. Fourth, harmonisation is challenged by different times of recording economic events across countries. Whereas some countries apply the cash basis of accounting, others adopt the accrual basis of accounting. Although there is a trend towards accrual accounting,[15]

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[14] IMF (2014), p. 339.

[15] IFAC/CIPFA (2018), p. 4.

there are various mixed accounting systems. Finally, the measurement of gross and net debt has to be comparable across all countries of an economic and monetary union so that national definitions have to be adapted to international agreed definitions of debt.

4. Harmonisation of the public sector accounting system

The public sector is reforming its accounting system due to several reasons. The first aim is to provide a fair view of public finances. This is related to assessing the full costs of government operations. A new accounting style is associated with enhanced transparency and accountability, strategic resource management, and improved awareness and management of costs. In general, public management should be modernised by introducing a performance culture. Besides, financial crises and high levels of public debts underline the importance of harmonised accounting standards to provide timely and reliable financial and fiscal data and enable complete and comparable financial reporting.

Figure 6.4 gives an overview on **government debts** as percentage of gross domestic product (GDP) in European countries. It is shown that most European countries exceed the Maastricht criteria, as they display government debts of more than 60 percent of GDP. Furthermore, the figure indicates great heterogeneity between member countries. Whereas Estonia, Luxembourg, or Bulgaria have comparatively low levels of government debt, Greece, Italy, and Portugal are heavily indebted countries.

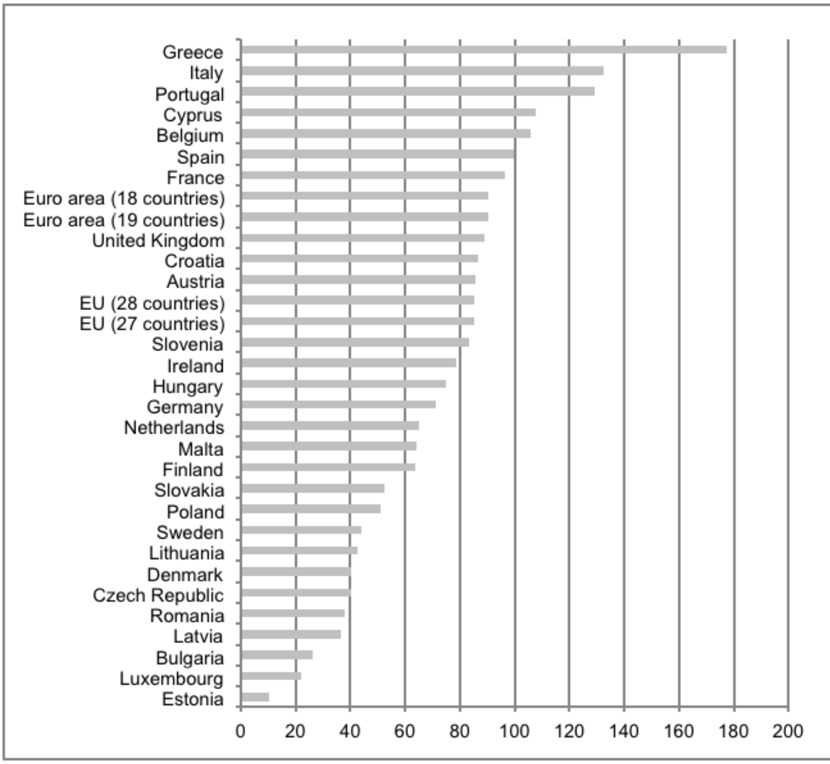

Figure 6.4: Government debt in % of GDP in Europe, 2016 (Eurostat, 2017)

A more "true and fair view" of government finances should be provided by **applying accrual-based accounting standards**. Accrual-based accounting means that transactions are budgeted or recognised in the financial reports at the time at which the underlying economic event occurs, regardless of when the related cash is received or paid. Assets and liabilities are then budgeted or reported in a balance sheet. In contrast, cash-based accounting means that transactions are budgeted or recognised in the financial reports only when cash is received or paid.

73 % of OECD countries (national government) and 35% of EU countries currently use accrual-based accounting for annual financial reports. For example, Austria, Finland, or the United Kingdom are among those countries. 9 % of OECD countries and 32% of EU countries use cash transitioning to accrual, which means that some transactions are budgeted or recognised in the financial reports using the cash basis and some

transactions on accrual basis. 18 % of OECD countries as well as 18% of EU countries use cash basis such as Germany.[16]

The accounting basis for annual financial reports, however, differs from the preparation basis for budgets of national governments. The great majority of countries use cash as a preparation basis of budgets (e.g., Germany, Portugal, Greece), whereas only 29 % use accruals (e.g., Austria, UK, Switzerland). 9 % of countries use cash transitioning to accruals (i.e. Sweden, Finland, Estonia).[17]

These great differences in accounting bases for annual financial reports and preparation bases for budgets are linked to the status of accrual reforms. 57% of countries have already completed reforms (e.g., Austria, Finland, UK, Switzerland), 22% have ongoing reform efforts, 12 % are planning an accrual reform, and 9 % do not plan an accrual reform.[18]

Furthermore, there are large differences concerning the type of standards used. Only 3 % of OECD countries use IPSAS standards, 57 % use national standards, and 28 % use national standards based on IPSAS. The remaining countries use other standards such as national standards based on IFRS.[19] **Chapter 7** refers to IPSAS, their use and spread in more detail.

There are **numerous challenges of implementing public sector accounting reforms**:[20]

- Adapting existing laws and regulations
- Adapting the IT systems to the new requirements
- Identification and valuation of assets and liabilities as part of the opening balance sheet
- Developing guidance and training material
- Preparing consolidated financial statements
- Preparing financial statements in a timely manner

[16] OECD/IFAC (2017),13; IFAC/CIPFA (2018), p. 2.

[17] OECD/IFAC (2017), p. 20.

[18] OECD/IFAC (2017), p. 27.

[19] OECD/IFAC (2017), p. 24.

[20] OECD/IFAC (2017), p. 30.

- Preparing for audit requirements and addressing audit qualifications
- Estimating, monitoring, and controlling the costs of the reform

Next to harmonising public sector accounting by IPSAS, there are recent public sector reform efforts especially in Europe. In more detail, EU member states intend to implement a set of accrual-based standards, namely the **European Public Sector Accounting Standards**, shortly **EPSAS**. Similar to IPSAS, EPSAS should strengthen the harmonisation of accounting standards and stimulate transparent, credible and comparable financial statements. Furthermore, the accountability and decision-making should be improved at the macro level and at the entitity level.[21] **Chapter 14** outlines in more detail the European efforts for PSA, describes EPSAS and also refers to challenges and risks of EPSAS implementation.

5. Conclusion

The increasing use of IFRS standards illustrates efforts toward standardisation of accounting over the last two decades. This development results in an improved comparability of financial statements across firms, which in turn supports decision-making of investors and capital market decision-making. The current debt situation in EU member states and fiscal pressures call for a reform of PSA in Europe. The public sector is thus following the reform path of the private sector in implementing accrual accounting practices into public sector accounting regimes. At the global level, harmonisation of public sector accounting should be realised by adopting the IPSAS, a welldeveloped set of accounting standards for use by public sector entities. In Europe, the EPSAS are currently developed in order to harmonise public sector accounting in EU member states and create a uniform accrual-based accounting system for use by all public entities in the EU.

[21] PwC (2014), pp. 4 ff.

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Discussion topics

– Why is public sector accounting harmonisation important?

– Discuss how the member states of the European Union can achieve accounting harmonisation.

– Discuss the conceptual differences between IFRS and IPSAS.