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A consistent bottom-up approach for deriving a conceptual framework for public sector financial accounting

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ABSTRACT
Discussion to date has focused on whether business-style accrual accounting fits the public sector, rather than analysing which alternative options of accrual accounting best serve the needs of public sector stakeholders. This paper looks at what the primary users of government accounting information actually need and describes a new analytical approach that can be used to assess the existing public sector financial accounting standards. The author then presents the most suitable conceptual framework for the public sector. The paper argues that the income statement first approach is better than the balance sheet approach for the public sector.

IMPACT
This paper will help accountants and standard setters to improve public sector financial accounting. The transaction-led method presented is a realistic and practical way to implement current accounting in tax-financed public sector entities. It is closer to the traditional core of public sector accounting than the balance sheet approach promoted by the IPSASB. Based on a new framework, the author proposes a solution to the current problems of harmonization of accounting standards in EU countries via EPSAS: a general conceptual framework accompanied by practical guidance, and no separate binding standards.

Keywords
Bottom-up approach; conceptual framework; EPSAS; financial accounting; income-statement-first approach; IPSAS; public sector

Introduction
The International Federation of Accountants (IFAC) has published International Public Sector Accounting Standards (IPSAS) for all public sector entities from central governments to local governments. The IFAC’s IPSASB (International Public Sector Accounting Standards Board) created most of the first IPSAS standards based on the IAS/IFRS standards (International Accounting Standards/International Financial Reporting Standards) designed for the business sector (Müller-Marqués Berger, 2012). Later, the IPSASB issued standards specifically drawn up for the public sector together with a conceptual framework (CF) (IPSASB, 2014).

The IPSASB’s standards are based on the premise of minimum deviation from the IFRS. Several writers have questioned how well business accrual accounting fits the public sector (for example Biondi, 2017; Arnaboldi & Lapsley, 2009; Biondi, 2012b; Chan, 2003; GASB, 2006; Monsen, 2002; Pallot, 1992). Furthermore, many studies have highlighted practical difficulties in implementing accrual accounting in the public sector (for example Baker & Rennie, 2006; Barton, 2011; Christiaens et al., 2015; Christiaens & van Peteghem, 2007; Christiaens et al., 2010; Ernst & Young, 2012; Hepworth, 2017) or the nonprofit sector (Cordery et al., 2018).

Ellwood and Newberry raised the question of whether the IPSASB framework provides a satisfactory underpinning for public sector accounting. Even if the IPSASB recognizes specific public sector specific traits in its CF (2014), there is a danger the existing IPSAS standards may not have been designed with sufficient focus on public sector accountability needs. The CF may not really function as a conceptual underpinning and may turn out to be cosmetic (Ellwood & Newberry, 2016, pp. 321–233).

The problem is severe if the guiding CF is based on incorrect premises. The discussion has focused on whether business-style accrual accounting fits the public sector, rather than analysing which alternative principles of accrual accounting best serve the needs of public sector stakeholders (Biondi, 2012b; Oulasvirta, 2014a).

The purpose of this paper is to present a bottom-up approach based on primary users’ information needs. This approach emphasises accountability purposes rather than decision-making purposes regarding public sector financial accrual accounting. The end result was a CF that differs from the IPSAS CF.

Contribution of the paper
The novel contribution of this study is that it took bottom-up sequential approach starting from
primary users’ needs and ending up with a consistent CF for the public sector. It is a normative approach with a frame of reference and analysis derived from public sector tax-financed entities and their constituency-identified needs.

This paper considers general purpose financial statements (GPFS) under accrual accounting. Financial accrual accounting information reveals the achieved financial performance and position of an accountable public sector entity and is therefore an important class of information to be released after careful and professional auditing. The analysis proceeds stepwise adhering to a bottom-up approach starting from primary users’ needs for accrual accounting information (Mann et al., 2019). The logical chain ends up with a consistent CF.

The stepwise approach shows that the revenue-expense-led approach emphasising the income statement is better than the asset-liability-led approach which emphasises the balance sheet. This latter approach seems to have inspired the IPSAS and the current EPSAS CF. Public sector accounting scholars have not, with very few exceptions, explicitly compared these alternatives (Biondi, 2011, 2012a, 2012b; Oulasvirta, 2014a, 2014b).

This paper aims at stimulating wider scientific debate on public sector accrual accounting research and discussion about a solid theoretical basis. The study is a springboard to further debate (Bergmann et al., 2019), which is very important before looking in the contents of the EPSAS CF principles.

**Literature review and the primary users’ approach**

Discussions about financial accounting in the public sector have concentrated on whether cash-based or accrual-based accounting suits the sector better. A discussion continuing from this, which would confront two basic theoretical alternative approaches for the public sector, the asset-liability-led approach emphasising the balance sheet and the transaction-based revenue-expense led approach, is almost completely lacking (Biondi, 2011, 2012a, 2012b). This debate features widely in the private sector accounting literature and increased when standards moved from a transaction-based historical cost approach towards the present approach emphasising current values allegedly serving the information needs of investors in financial markets (for example Hendriksen, 1982; McCullers & Schroeder, 1982; Pirinen, 2005; Power, 2010). The older view was that the best purpose of financial reporting was to represent performance, and that reporting unrealized gains involved an element of subjectivity that could impair the usefulness of financial statements (McCullers & Schroeder, 1982, p. 72). Biondi makes a comprehensive analysis (2011) of the fair (current) value and historical cost and revenue accounting models. Biondi shows the superiority of the historical cost and revenue perspective over the fair value perspective in making an accounting representation of a firm as an ongoing business entity. The cost and revenue accounting perspective presents the actual economic and monetary process in a way that satisfies the criteria of accountability, reliability and relevance (Biondi, 2011, pp. 31–33).

As a starting point, and from a rational point of view, accounting information should be useful for those who need that information. This usefulness can be divided into information useful for accountability and decision-usefulness purposes (Caruana et al., 2019; Mann et al., 2019). The emphasis on decision usefulness is typical of private sector accounting. Both the FASB and the IASB have opted for investors as the main users of financial information of corporations (Naciri & Hoarau, 2001; Rutherford, 2000; Whittington, 2008).

According to Barton (2005, p. 146) ‘the requirement for public accountability is a fundamental difference between the environment of business and the government which must be reflected in the form of financial reporting to stakeholders’. A government’s financial reporting purpose is not to focus on providing decision-useful information for potential investors. Furthermore, the decision-making information role is largely fulfilled by the publication of budgets, unlike in the business world, where budgets are confidential to the entity and are generally not published (Barton, 2011, p. 424; Van Helden & Reichard 2018; Warren, 2015).

In a bottom-up approach, the development of a framework should be based on identifying the users of accounts (Caruana et al., 2019, p. 5; Lewis & Pendrill, 1994, pp. 6–7). Accounting research on the factual use of accounting information in practice is still scarce, and more empirical investigations of user opinions are needed (Van Helden, 2016). However, Mann et al. (2019) found in a literature review that accountability is the preferable key objective for a public sector CF. Therefore, the principal starting points for creating a public sector CF for accrual financial accounting presentation are primary user needs that, in the public sector context, stem from the public sector’s accountability to its principals—namely the citizens who have the right to reliable and transparent information about the performance the administration.

The starting point was with the primary users because the different purposes of private and public sector entities and the different users of accounting information should translate into the development of CFs and standards (Ellwood & Newberry, 2016; Mann et al., 2019). Figure 1 presents the logical chain surrounding the development of a consistent CF.
The next section continues with the steps in Figure 1, referencing the IPSASB CF and the US Governmental Accounting Standards Board’s (GASB) CF. The GASB establishes accounting and financial reporting standards for US states and local governments. The GASB was chosen because it has been the forerunner in the search for a sound financial accounting framework, and it published its first conceptual statement in 1987—long before the IPSASB. Established in 1984, the GASB is the independent, private sector organization that establishes accounting and financial reporting standards for US state and local governments that follow Generally Accepted Accounting Principles (GAAP). Both the GASB (2006) and IPSASB (2014) frameworks set out the main environmental differences:

- Organizational purposes.
- Sources of revenue.
- Potential for longevity.
- Relationship with stakeholders.
- The role of the budget.

However, only the GASB document explains how the differences relate to standards (for example on capital assets and pensions) (Ellwood & Newberry, 2016, p. 232).

**Approach steps and CF evaluation**

**Step 1: Primary users of general purpose financial statements (GPFS)**

A recent literature review (Van Helden & Reichard, 2019) of user needs and the usability of accounting information in the public sector shows a picture of diverging user groups and different preferences for accounting information. It argues that politicians, citizens and the media have almost similar interests regarding accounting information issues.

However, not all possible users can be satisfied with the same intensity regarding financial accrual accounting information (Naciri & Hoarau, 2001, pp. 238–239). Therefore, the focus was on primary users’ needs. This focus steered the objectives and critical general principles in this paper’s approach. In the democratically steered public sector, primary users’ needs focus on accountability. Hence, the accountability purpose should be given preference over the future-oriented decision-usefulness purpose (Ellwood & Newberry, 2016; Laughlin, 2008, 2012; Mann et al., 2019). Furthermore, it is important to remember that accountability purposes in the public sector can only partly be satisfied with accrual GPFS (Laughlin, 2008, p. 253; Moretti, 2018).

In public sector budget-linked organizations, the most important reporting modes are budgets and budget statement reports prepared with budgetary accounting for parliamentary and public scrutiny. Budget control is the traditional essence of public sector accountability (Monsen, 2019). GPFS without a linkage to budget follow-up are not able to satisfy public sector budgetary control and accountability purposes.

IPSASB includes budgets in General Purpose Financial Reporting (GPFR). However, the IPSAS are focused on GPFS. IPSASB pays little attention to the budget (there is just one budget standard: IPSAS 24 —*Presentation of Budget Information in Financial Statements*), although it explains in its CF that budgets are an important part of GPFR (IPSASB, 2014, pp. 16–17). If budgetary accounting and financial accounting are incorporated on the same basis, these two accounting systems can be merged into one serving both budget reporting and GPFS reporting purposes (Oulasvirta, 2019).

GASB, on the other hand, explicitly states that budgets belong to ‘other types of financial reporting’ and not to general purpose financial external reporting (GASB, 1987, pp. 2–3).

The IPSASB (2014) mentions that primary users are ‘service users and their representatives and resource providers and their representatives’. The GASB is more precise—citizens are at the top of the list. The GASB (2014b) believes there are three groups of primary users of external state and local governmental financial reports:

- Those to whom government is primarily accountable (the citizenry).
- Those who directly represent the citizens (legislative and oversight bodies).
- Those who are creditors.

Considering GPFS, creditors may emphasise reliable information on solvency, compliance with debt...
covenants and liquidity, and donors may value information on compliance with donation rules. The fact that creditors have the possibility of getting special-purpose financial reports for their particular needs means that the most important (potential if not often factual) users are the citizenry and the legislature representing them. Creditors and donors can get tailor-made special-purpose financial reporting information; they do not have to rely only on GPFS (Mann et al., 2019). Lenders and donors typically require—based on their special needs—information packages provided separately before they make their lending or donation decisions.

Recipients that are using special services and providing service payments mainly resort to specific budget and service availability and quality information. However, people as citizens in their roles of paying general taxes and voting in general elections may turn their information interests to the government’s overall success in accountability and financial performance matters. In practice, citizens probably seldom invest their time in reading and directly interpreting GPFS. However, they have the right to know how resources have been used by public sector entities (Mann et al., 2019). Citizens typically rely on information mediators and those who represent them in legislative bodies. In a democracy, representatives have a responsibility to steer public financial matters and have an accountability relationship towards citizens. In these roles, they must be able to read, understand and interpret accounting information in their constituencies. Hence, the main objective of GPFS would be to fulfil the information needs of the citizenry and the legislature representing citizens.

**Step 2: Objectives of GPFS**

It is not practicable to construct financial statements without giving priority to one perspective or the other: polymorphic approaches should be avoided (Naciri & Hoarau, 2001, p. 237; Vehmanen, 2008). According to Vehmanen (2008, pp. 1–2), it should be explicitly stated which perspective is used in preparing ‘general purpose’ financial statements and which perspective is then accounted for by supplying additional information.

The objectives of general purpose financial reports by public sector entities are in the IPSASB CF (2014), providing information about the reporting entity useful to users of general purpose financial reports for two purposes: accountability and decision-making. The extensiveness of these objectives are a problem, although the IPSASB explains the mutual interfaces and that information provided in general purpose financial reports for accountability purposes will also contribute to, and inform, decision-making (2014, p. 15).

The GASB emphasises that financial reporting should assist in fulfilling a government’s duty to be publicly accountable and should enable users to assess that accountability. The duty to be publicly accountable is more significant in governmental financial reporting than in business enterprise financial reporting (GASB, 1987, pp. 22–23). Users of governmental financial reports must assess accountability by evaluating performance through a variety of measures. This implies that governmental accountability requires means of financial reporting that differ from private sector business enterprise financial reporting (GASB, 1987, pp. 6–7).

One reason for the confusion over IPSASB’s priority of objectives is the wide scope of the CF. The IPSASB relates its CF to all GPFR modes, not only to GPFS. The scope of GPFR in the public sector is large, encompassing the provision of both financial and nonfinancial information—for instance, reporting the entity’s compliance with relevant legislation and authoritative budgets and achievement of its service delivery objectives. For example, objectives included in ex ante budgets are oriented towards decision-making to steer the budget entity in the future, while the ex post reports are accountability-oriented.

IPSASB CF Chapter 8 explains the principles for allocation of information between different reports belonging to the group of general purpose financial reports. The principles for selecting and locating information in different reports are reasonable. However, the problem is that the CF avoids any conclusions on how this allocation of information may affect the objectives of GPFS. For instance, it may be that other reports than the financial statements tackle decision usefulness in a way that leaves the accountability purpose the most important purpose regarding the GPFS.

According to the GASB, due to their unique operating environment, governments have a responsibility to be accountable for the use of resources that is significantly different from that of business enterprises (GASB, 2006, p. 1). In the public sector, assets do not, as a rule, have the purpose of creating cash flows or being valued in the marketplace. Barton (2005, pp. 149–150) divides assets between normal commercial-type assets used for administrative purposes in providing public and social welfare services, and social and environmental assets held in trust. The first category of assets brings economic benefits or service potentials that benefit citizens. These assets, like land, buildings, schools, kindergartens and healthcare equipment, may be sold only in special situations at a commercial price. Social and environmental assets include assets that are to be conserved and maintained by a government for the benefit of current and future generations and may not be sold. Both categories of
assets create benefit flows to citizens rather than to the government (Barton, 2005, p. 149). Pallot (1992, pp. 47–48) uses the concept of common or public property that includes, for instance, public libraries, public parks and public highways. In particular, heritage assets, like national parks and historical monuments, are public properties that have no meaningful prices at all because they are invaluable.

The IPSASB is not clear enough in its CF (2014) about the priority order of the income statement and the balance sheet, not to mention the cash flow statement that also forms part of the GPFS. It seems that the GASB in the US emphasises the costs of current-year services disclosed in the income statement (GASB, 2014a, p. 25, 40; GASB, 2015, p. 4).

It can be concluded that the information needs of the most important users form the first step. Their needs should have a decisive impact upon the determination of the objectives of the GPFS (step 2). In a public, democratically steered economy, accountability is the most important objective for ex post financial accounting information (Ellwood & Newberry, 2016; Mann et al., 2019). This leads to the CF’s objectives needing to be derived from the information needs of citizens and their representatives on political bodies.

This normative choice leads to a third step—the qualitative characteristics that must satisfy the needs of the primary users. The citizenry and legislature should be supplied with accrual financial statement information that is useful for them in assessing the performance of the administrators and deciding about the discharge of accountability for them. For information to be useful, it must be relevant, reliable and understandable.

**Step 3: Qualitative characteristics of the CF**

The next logical step was to derive the qualitative characteristics of financial statement information. According to Vehmanen (2008, pp. 10–15), the criteria of qualitative characteristics should be organized in hierarchical order, starting from the basic two fundamental qualitative characteristics, then moving down to enhancing qualitative characteristics and moderating factors. The two fundamental qualitative characteristics of reliability and relevance encompass several enhancing qualitative characteristics. Relevance requires that the information has either confirmatory accuracy or some predictive accuracy. Furthermore, if the information is not understandable, published too late to be useful, or is not comparable to anything, it cannot be relevant.

The primary users in the public sector need information related to accountability and discharging accountability for those responsible for public spending. The accountability function requires reliable information on past performance. Accountable administrators cannot be judged based on speculative or prospective nonreliable information. This is also a question of the legal protection of accountable officials. Therefore, reliability is a fundamental characteristic.

For reliability, the enhancing qualitative characteristics are verifiability and supportability. Information that can be empirically verified, for instance the executed transaction price in question, can be found. If verification is not possible, information can still be supported, for instance from known similar transactions and assets. However, estimation makes the accounting representation of financial statements sensitive to errors and biases (Biondi, 2011, pp. 33–34).

The two fundamental qualitative characteristics are not absolute but show by degrees. Therefore, the general constraint of sufficiency must be introduced and adopted. It consists of the requirement to achieve a balance between the ideal requirement of completeness and the following moderating elements: neutrality (not biased), materiality and cost-benefit-reasonableness.

The IPSASB is of the opinion that all qualitative characteristics are important and work together to contribute to the usefulness of information. It waives the need for a hierarchical order by saying that balancing or trade-off between qualitative characteristics may be necessary to achieve the objectives of financial reporting. The IPSASB thinks that the importance of the qualitative characteristics in each situation is a matter of professional judgement (IPSASB, 2014, p. 34, 40). However, in order to logically derive this paper’s CF, the qualitative characteristics cannot be in a random order. The GASB (1987, p. 19) and FASAB (2015, p. 35) also do not put characteristics into a clear hierarchical order. However, the first characteristic in the GASB list is understandability.

The principle of prudence (conservatism) fits public sector purposes well as an enhancing qualitative characteristic. ‘Prudence’ means reasonable assessments where assets and revenues are not overstated and liabilities and expenses are not understated (Lorson & Haustein, 2019; Whittington, 2008, pp. 500–501).

As an example, in contrast to these nonhierarchical listings, the FGAB in Finland (2009) and the EPSAS Task Force in the Ministry of Finance (Oulasvirta, 2015) emphasise a hierarchical order, in which reliability and relevance are the first-order qualitative characteristics and prudence is an enhancing second-order qualitative characteristic.

To summarise: qualitative characteristics should be organized hierarchically to keep them consistent for their primary users’ needs and objectives. Reliability and relevance are key fundamental factors, while
understandability is an important enhancing characteristic in the public sector context. Other enhancing traits follow, for example comparability and timeliness, further supporting the fundamental characteristics. In the public sector, understandability is important because the primary users are politicians who should be able to understand and use the supplied financial reporting information. Overly technical financial information is not relevant to decision-making; furthermore, too detailed and complicated disclosures are difficult to understand and use for non-technical readers (Moretti, 2018). Too far-reaching and radical accruals are not suitable for public sector entities (Chan, 2006).

**Step 4: Definition of elements and basis of valuation**

Step 4 involved logically deriving solutions based on the former steps regarding the definitions of basic elements and principles of valuation. In the private sector, current value accounting stemming from the interests of investors and shareholders can be seen to lead to a balance sheet approach, in which assets and liabilities are primary elements from which other elements are derived. However, these standpoints are not unanimous in private sector accountancy. For example Deloitte (2015) commented on the Exposure Draft to the IASB’s CF:

> We think the Board is unnecessarily exposing itself to the criticism that it gives primacy to assets and liabilities and therefore favors the balance sheet and current values. We suggest that the Board ensure that CF explain more clearly that asset and liability measurement is often determined by focusing initially on the appropriate measurement of financial performance. We also suggest that when giving examples of measuring items as much emphasis should be given to income and expense items.

Furthermore, according to this paper’s approach, instead of the balance sheet approach and current value accounting, the expenditure-revenue-led approach and transaction-based historical costs should be strongly emphasised (Biondi, 2013; Oulasvirta, 2014a, 2014b) in the public sector.

The fundamental characteristics of reliability, freedom from errors, and the public sector accountability purposes of reporting can be seen to emphasise that financial statements should contain information on realized expenditure and revenue transactions (income statement) and acquisition costs of assets (balance sheet) rather than speculative information on holding gains and losses and revaluations of assets and liabilities. If the choice is firmly on the accountability side, the historical costs used in putting revenues and expenses in relation to each other and to legally binding budgets are more appropriate than other valuation principles.

The income-statement and transaction-based approach logically leads to different element definitions than those the IPSASB. For instance, the IPSAS CF (p. 55) defines ‘expense’ as follows: ‘Expense is decreases in the net financial position of the entity, other than decreases arising from ownership distributions’. This definition is derived from the net financial position in the balance sheet.

According to the GASB, the resource flows statement (income statement) is not solely derived from changes in assets and liabilities reported in the financial position statement. Consequently, the GASB approach recognises that there are circumstances under which it is appropriate to defer reporting outflows and inflows of resources on the income statement (GASB, 2007). This is compatible with principles that the GASB acknowledges: the realization principle and the principle of measuring the cost of current-year services based on the initial amounts.

This paper’s approach also emphasises the transaction-based approach. An expense is that part of an expenditure that will no longer bring benefits and therefore belongs to the present accounting period’s income statement. The other part of expenditure that is expected to bring benefits in future periods belongs to the balance sheet, i.e. as a carry-over calculation from one accounting flow period to the next.

The FGAB (2009, p. 4), in its comment to the IPSASB, criticises the balance sheet approach and clearly supports the income-statement and monetary process approach:

> The view copied from the IASB Framework, the central idea of financial reporting by public sector entities would be to provide information about economic resources of the reporting entity at the reporting date and claims to those resources, is defective and tends to lead to development of an unrealistic CF. Understanding the financial accounting of public sector entities to be the description of their monetary process is a much more useful starting point, than the one in the consultation paper. For the preparation of financial statements the items recorded in the accounts of a public sector entity are, in this case, grouped according to their economic substance to expenditures, revenues and (pure) financial transactions.

The choice of the historical cost method of valuation in financial accounting compromises two fundamental characteristics: relevance and reliability. In practice, one cannot obtain all the possible good features of these two characteristics without a trade-off. Some relevance may be lost with the historical cost method of valuation compared to current value accounting that gives information on the current price of owned assets.

If a government plans to sell its property, the historical cost method of valuation may give a
distorted result, especially during times of inflation (or deflation). When property is planned to be sold, current values are naturally relevant for budget plans. In the case of realization of non-current assets, preparers of budget plans must find a reasonable liquidation price in advance in order to be able to draw up a qualified budget for the decision-makers. This necessity of finding a relevant liquidation price for planning purposes does not require that the government must have a financial statement based on re-measured asset values.

In some circumstances it is impossible to find historical acquisition costs or production costs of present assets (very old buildings are an example) and, in some situations, assets may have been donated to the public entity. Furthermore, the major part of public sector property is not meant to be sold to outside parties, and hence selling seldom happens and exit price information is not relevant. If a public entity sells its property, the realized transaction will reveal the price and the book-keeping entries will show either a profit or a loss compared to the book values based on the historical cost method of valuation.

On the liabilities side of the balance sheet, long-term debts have traditionally been valued at nominal values. Economically the relevant value of a bond is the present value (market price), with the book entries based on the effective rate of interest method. The present value of the issued bond increases or decreases with the difference between the coupon rate (paid at interim dates) and the market interest rate. This method is difficult to understand and sensitive to market interest rate changes compared to the traditional straight-line method (see Biondi, 2013).

When it comes to the IPSASB CF, it is a hybrid regarding valuation and measurement. The IPSASB is of the view that there is no single measurement basis that will maximize the extent to which financial statements meet the objectives of financial reporting and achieve the qualitative characteristics (IPSASB, 2014, para. BC7.3). In a 2019 consultation paper, Measurement, the IPSASB (IPSASB, 2019) states that measurement requirements in IPSAS are partly inconsistent and should be clarified in a new special measurement standard. In the consultation paper, assets are divided into assets held to provide services (non-cash-generating assets), cash-generating commercial assets and assets for trading or sale. Assets and liabilities held for operational capacity (not for financial capacity) may favour as a measurement basis costs or depreciated replacement costs, however, after acknowledging numerous other criteria and circumstances.

According to the IPSASB (2014, para. BC7.7), the measurement objective is ‘to select those measurement bases that most fairly reflect the cost of services, operational capacity and financial capacity of the entity in a manner that is useful in holding the entity to account, and for decision-making purposes’. The IPSASB also notes (para. BC7.8) the disadvantages of using different measurement bases but explains that it is possible to minimise disadvantages by ensuring that assets and liabilities are reported on the same basis where circumstances are similar. According to the IPSASB, the different measurement bases used must be reported transparently. However, it would be better to first choose a single, most important measurement basis and then add any exceptional situations to it, i.e. where other measurement bases are sufficiently reliable, but more relevant and informative, to information users.

The GASB in its final Concepts Statement No. 6 (GASB, 2014b, pp. 10–11) explains that the cost of current-year services and initial amounts are appropriate measurement bases for assets that are used directly in providing services. The GASB strictly limits the use of fair values. It proposes the application of fair value only to certain assets; namely, those investment assets that are kept primarily for future income or profit, and where the asset’s present service capacity is based solely on its ability to generate cash or to be sold to generate cash (GASB, 2014a, p. 25, 40; GASB, 2015, p. 4). (Compare Hitz, who claims that fair value disclosures receive support only for traded financial instruments [2007, pp. 354–355].)

According to the GASB (2014b, p. 7):

… when only one measurement approach is applied for a specific asset or liability, one objective will necessarily be given priority over the other. In these circumstances, the cost-of-services information has greater relevance in the governmental environment than the service-potential information because of the importance of providing information that can be used to assess inter-period equity.

Biondi points, in this context, to an important matter: that a generic reference to an accrual basis of accounting does not consider the variety of accounting models and approaches that belong to the accrual-basis family (Biondi, 2012a, 2012b). This is a major problem in the present discussion on financial accounting principles in the public sector because it does not analyse sufficiently the variety of accounting approaches that belong to the accrual-basis family (see also Chan, 2003, 2006). The entity theory of accounting moves the accounting basis from the balance sheet, understood from an owner’s perspective, towards a flow basis of accounting, in which transactions concerning revenues and costs form the essential core of the business cycles of production. For accounting representation, then, the
business cycle of the firm is more important than the valuation of the firm (Biondi, 2011, 2012a). Furthermore, accounting focused on the provision of information useful to investors and creditors precludes reporting developments that might help enact the accountability relationships that exist between a corporate entity and its other stakeholders (Young, 2006).

Moving from firms to tax-financed public sector entities, the control of the flow of transactions and their adherence to authoritative budget regulations and goals that are both financial and nonfinancial (Monsen, 2002) are more relevant than asset valuation of the entity and its ability to generate cash inflows.

To summarize step 4: the definitions of elements and measurement principles for financial statement presentations should firmly follow the transaction-based, historical costs and income-statement-first approach. This approach is more realistic and easier to implement in daily current accounting compared to the balance sheet approach. The result is accrual financial statements that are compatible with the true nature of tax-financed public sector entities and their primary users’ needs.

Summary and concluding remarks

Summary of the bottom-up stepwise approach

This paper’s stepwise analysis starting from primary users’ needs gave support for the outline elaborated in Figure 2. A systematic approach was constructed that started from primary users and their needs regarding financial statement reporting in the public sector. The approach can be used in deriving logically standard principles for the public sector and was used to evaluate the IPSASB and GASB CFs.

CFs should be constructed very carefully to suit the public sector context. The information needs of the most important users form the first step guiding the following steps. Primary users’ needs should have a designed impact upon the determination of the objectives of the GPFS. In a public, democratically steered economy, accountability is the most important objective for ex post financial accounting information (Ellwood & Newberry, 2016; Mann et al., 2019). This leads to the CF’s objectives needing to be derived from the information needs of citizens and their representatives in political bodies.

The superiority of the transaction-based approach that puts the income statement first is a consequence of bottom-up approach logics. The transaction-led method of presenting financial statement information is simpler and easier to understand than the asset and liability-led approach that increasingly uses fair value measurement methods. See Hitz (2007), Power (2010) and Biondi (2011) for explanations of the deficiencies and problems involved in fair value measurement.

The transaction-led method is a realistic and practical way of implementing current accounting in tax-financed public sector entities. It is closer to the traditional core of public sector accounting: the budgets and budget-linked budgetary accounting capable of processing budget outcome reports.

The more the accounts in the financial statements and budget statements consist of doubtful and subjective items, the less the assessors’ ability to do their assessments. This is why a transaction-based approach with historical costs best informs politicians’ decision-making regarding discharging the administration from liability for the accounts. Historical costs are more reliable than revaluations based on current costs or fair value measurements, and are therefore more suitable for the evaluation of accountable agents in the public sector. Accountable administrators cannot be judged based on speculative or unreliable, prospective information.

Other decision-usefulness matters than those connected to discharging from liability are, in the public sector, primarily connected to ex ante budget plans, fiscal forecasts and multi-year budgets and reports, which necessarily use historical ex post financial statement and budget statement information as a template (Oulasvirta, 2019). Furthermore, the historical cost approach remains the most consistent with the ex post control needs of budgets and with the accountability objective in the CFs for public sector entities’ GPFS (Mann et al., 2019). An optimal balance of accountability and decision-usefulness objectives requires a parallel assessment of both ex ante planning and ex post accounting calculations and reporting, which should be consistent and complementary.

Figure 2. Consistent GPFS CF outline for tax-financed public sector entities.
**Lessons for the IPSAS and the EPSAS**

When the model was used to assess the IPSASB CF (2014), that CF was shown not to focus sufficiently on the primary users of information. The IPSASB does not organize qualitative characteristics in a clear hierarchical order. The hierarchical order in this paper’s approach recommends two fundamental qualities—reliability and relevance with the important enhancing trait of understandability—and leads in the context of tax-financed public sector entities to a transaction-based, income-statement-first approach, instead of the asset-liability and balance-sheet-first approach embedded in the IPSASB CF.

When it comes to the EPSAS, the European Commission wants the project to take ‘indisputable reference’ from the IPSAS. Therefore there is a real danger that the deficiencies of the IPSAS could be transferred to the EPSAS. It is essential that the core purposes of financial accounting information in the public sector are discussed by academics and practitioners and politicians, together with how these should affect the EPSAS framework. The adoption of public sector accounting standards in Europe is not just a technical question; it is first and foremost a socio-economic and political issue (Mussari, 2014, p. 309). Accounting standards contribute to setting the ‘rules of the game’ that inform public policies (Biondi, 2014, p. 173).

If the EPSAS are going to be mandatory in Europe, it is essential to look at how the CF is being constructed. Under the umbrella of two incompatible purposes (accountability and decision usefulness), combined with the heterogeneous mix of primary users, the EPSAS CF must not open the door, as feared by Mann et al. (2019, p. 211) to arbitrary, inconsistent standard-setting.

The forces underlying the EPSAS proposal emanate from the EU’s supranational information needs (Jones & Caruana, 2014; Oulasvirta & Bailey, 2016). However, the more the EPSAS framework is based on inappropriate accounting principles, the less it will be appreciated, especially in those EU member states that have developed their own budgeting and accrual accounting systems serving well their national and micro-level accounting and budgeting interests.

Finally, an option that serves harmonization purposes and recognizes the EU’s own subsidiarity principle needs serious discussion: a general CF accompanied by practical guidance supplementing this CF, rather than separate, binding EPSAS standards. Detailed supervision is perfectly possible with non-binding practical guidance based on a consistent public sector CF. A consistent CF would guide member states through their own national standard setting. Step 5 in Figure 2 would then relate to national standard setting, and not to supranational standard setting.

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