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PUBLIC SECTOR ACCOUNTING

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Chapter 4
Theoretical approaches to financial accounting purposes and principles

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Summary

The theories of accounting are described first, followed by the conventions and principles of accounting and their interpretation in the public sector. Public sector Conceptual Frameworks for financial accounting are outlined especially from the point of view of the primary users' needs, valuation and measurement principles. Different and competing theoretical approaches to public sector accounting frameworks are also explained.

Keywords

Financial accounting, accrual, cash and modified basis of accounting, accounting theories, conventions and principles, conceptual framework

1. Introduction

The aim of this chapter is to describe basic accounting theories, concepts and principles for public sector accounting (PSA). Theoretical

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accounting foundations and principles influence and interact with financial accounting standards and practices. The European Public Sector Accounting Standards (EPSAS) are still under preparation and are open to development. Therefore, it is important to relate this development to the basic theories, concepts and principles of financial accounting.

2. Accounting theories

What do we mean by accounting theory? According to the definition by Hendriksen (1982, p.1), accounting theory may be defined as logical reasoning in the form of a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures.

Accounting theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practices.[1]

Below, we briefly explain the following common accounting theories:

- Proprietary theory;
- Entity theory;
- Funds theory;
- Cameral theory.

In the private sector, entity and proprietary theories have been popular as frames for accounting approaches. In contrast, the cameral and funds theories have been targeted mainly at the public sector.[2]

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[1] Glautier and Underdown (1994), p. 23.

[2] Monsen (2002).

Proprietary theory

The proprietary theory of accounting emphasises that financial accounting must be structured in a way that satisfies the owner's interests. All accounting principles and concepts are defined from the owner's point of view.

The owner's purpose is assumed to be to increase his or her wealth. Revenue is defined as an increase in proprietorship wealth, and an expense is defined as a decrease in proprietorship wealth. The two key accounting equations are:

> Equity (wealth of owner) = Assets – Liabilities
>
> Result = Distribution of profit to owners + Earnings retained in the firm.

According to the private sector international standard-setter International Accounting Standards Board (IASB) and its draft conceptual framework:

> "The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit."[3]

Entity theory

The entity theory was developed by the critics of the proprietary view of accounting. Although this theory was developed for corporate

[3] IASB (2015), paragraph 1.2.

accounting, supporters of entity theory believe that it can be applied to proprietorships, partnerships and even non-profit organisations. The crucial question is whether accounts and transactions should be classified and analysed from the point of view of the operating entity unit or from the point of view of the proprietorship or other single interests.[4]

In this entity approach, an enterprise is understood as an entity separate from its owners. Principally, both equity and debts are seen as the financial capital of the entity. Share capital belongs to the entity. The two key accounting equations for entity theory are:

- Assets = Financial capital (all assets must be financed whether from own(er) capital or debt capital);
- Result = Distribution of profit to owners + retained earnings + share of lenders (debt interest).

Fund theory

Under fund accounting, funds have restrictions on the use of resources from the accounting entities. On the one hand, special funds can be established to account for revenues earmarked, for instance, for schools, museums or parks. A capital project fund is, on the other hand, established to account for funds to be used only for capital facilities, debt service funds etc.[5] Fund theory is mainly used in the public or not-for-profit sectors.

In this approach, the focus is on restrictions and the service potential of assets, not on their income earning capacity. Assets are acquired in order to contribute to increased service production by the fund.

[4] Monsen (2017), pp. 23-24.

[5] Monsen (2017), pp. 60-62.

Assets are not acquired in order to earn profit; any profit (or surplus) is not seen as belonging to the proprietor (proprietary theory) or to the organisation itself (entity theory) but is retained to further the objectives of the fund. In principle, this approach suits budget-linked governmental accounting. Here, budgetary decisions represent the authority to use and receive money and also to provide restrictions on the use of disposal of assets. Even though fund theory of accounting was originally developed for the business sector, it has not gained a stronghold there. Later was further developed and applied mainly in the governmental sector in the Anglo-Saxon countries.[6]

Funds accounting is also used in the US. Local governments and states have several separate public funds for different purposes. In funds accounting, financial statements present a short-term (annual) view of governmental fund activities.

Cameral accounting theory

This theory was developed for use in the public sector. It has a money and budget control purpose. Budget control in public sector entities ensures that public (tax) revenues are managed (money management) according to the politically adopted budget (budgetary control). Cameral accounting was developed originally as single-entry bookkeeping.[7]

In cameral accounting, no cash can be received or paid by an organisational unit without receiving a previous or simultaneous payment instruction from another higher organisational unit having this competence (payment control). Cameral accounting is explained further in Chapter 2 of this book.

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[6] Monsen (2017), p. 77.

[7] Monsen (2002, 2011, 2014).

Bookkeeping models

As introduced in Chapter 1, the two basic alternatives in current bookkeeping are single-entry or double-entry bookkeeping.

Cash-based single-entry bookkeeping involves recognising money outflows and inflows in the cash/bank account. Within modern commercial accounting, the principle of single-entry bookkeeping has been replaced by that of double-entry bookkeeping. The money (cash) focus has been replaced with a financial performance (profit accruals) focus. We can call this commercial double-entry bookkeeping for profit accounting purposes.[8]

Cameral single-entry bookkeeping does not have the purpose of profit accounting, but fulfils the purpose of money accounting and budget control. In the government sector, both cameral accounting and fund accounting have a strong link with the budget. It is important to realise that both are not only based on actual cash receipts and payments. The money accrual principle includes, in addition to realised cash movements, payments that become due later in the short term.

The double-entry bookkeeping was developed to measure commercial profit. Each entry has two aspects, the debit and the credit.

Cash-based accounting is comparatively simple and objective, and suites in the public sector to fulfil the needs of money-usage control. Accrual-based commercial bookkeeping is more complicated, but offers information on service costs (depreciation costs included), assets and liabilities to assist resource management. On the other hand, accrual-based commercial bookkeeping may lead in the public sector to decisions on accounting treatment being made on doubtful grounds and to loss of control.[9]

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[8] Monsen (2011).

[9] Wynne (2007).

3. Accounting conventions and principles

Several accounting principles and conventions have been developed in the accounting literature. A possible systematisation of these can be arranged according to a three-level structure:

- pervasive principles (conventions);
- broad operating principles;
- detailed principles.

Theoretically, the principles of each level should interrelate with the principles at the other two levels. However, many accounting practices have not been based on higher principles, but have simply evolved from experience.[10]

If accounting rules are *principles-based*, they do not have to be very detailed (as with accounting law in the European Union, IFRS and IPSAS). If accounting standards are *rules-based*, standards are written in a very detailed manner to encompass a wide variety of practical situations (as with the US approach to accounting standard setting). We will now explain briefly some important concepts and principles.

Accounting principles/concepts	
1. Accounting entity	6. Consistency
2. Money measurement	7. Prudence
3. Going concern	8. Accruals principle
4. Cost concept	9. Matching
5. Realization principle	10. Periodicity

[10] McCullers and Schroeder (1982), p. 27.

Accounting entity

The purpose of the **entity** concept is to make a clear distinction between the economic affairs of the accounting entity and other entities.

The difficulty comes in defining what constitutes the government accounting entity and what off-budget entities should be consolidated into it. Several criteria could be used:

- government ownership and control of the entity;
- the entity's dependence on government transfers;
- the legal form of the entity.

General government as a whole is **divided into several levels of government** (central/federal, regional/state and local/municipal).

Furthermore, central, regional, and local governments may consist of sub-organisations, and there are many and varied criteria which determine which of these sub-organisations form accounting sub-entities that maintain their own separate accounting books. This may not be determined simply by legal ownership.

Defining the **demarcation lines between accounting entities** and the extent to which the consolidation should be done determines the sphere of annual financial reporting. Questions related to consolidation are handled in the Chapters 11 and 12 of this book. Consolidation is an approach that originated from the private sector and has only really been applied in the public sector over the last 20 years or so. The accounts of several subsidiary entities are combined to produce the accounts of one larger combined (economic or service-providing) entity.

Money measurement

The business accounting convention is to measure all transactions with (constant) monetary units.

The main difference in the public sector regarding this convention is that many transactions are non-exchange transactions. These include non-exchange inflows such as tax revenues or non-exchange expenses such as grants and social benefits. Furthermore, many assets including human resources and heritage assets, both cultural and natural, are difficult to value in money terms. Groundless monetisation of heritage assets in financial statements may cause misapprehensions and biased judgments.[11]

In the public sector, expenses are usually not related to future revenues. Usefulness (consumers' utility) of free and tax-financed services cannot be measured directly with prices. Hence, non-financial and efficiency reporting[12] of the services provided by a public sector entity is at least as important (in terms of public accountability) as traditional financial reporting.

In some cases, even if money measurement is possible, for instance, information on military assets, may be sensitive and may not be willingly disclosed publicly.

Going concern

The **going concern** principle is based on the assumption that the business is a continuing one, at least in the near future not on the verge of cessation and bankruptcy. Many assets in a business entity derive their value from their employment in the profit-creation process

[11] Carnegie et al. 2022.

[12] Chapter 14 of this book explains different non-financial reporting formats.

and are therefore generally carried at amortised cost. Should the firm cease to operate, the value which could be obtained from these assets on a (maybe forced) sale basis would be an appropriate measurement basis and probably be much less than their accounting or book value. Independent countries normally have a good foundation for continuity, so the going concern as a postulate is generally correct in the public sector. Governments have sovereign power, tax financing and statutory functions that do not abruptly cease in a bankruptcy-like situation. However, they may in practice fall into a financial crisis and lose their loan payment capacity. Furthermore, a hostile neighbouring country may try to occupy an independent country and remove its legitimate government.

On the other hand, many kinds of accounting entities inside the government, agencies and so on can cease to exist on the basis of administrative or political decisions. In this case, the going concern principle is not guaranteed.

However, and this is important, although public entities may sometimes be dissolved, the rights and obligations entrusted in them by the sovereign power are not cancelled as a result, unlike business entities for which the amounts due on liquidation are limited to existing net assets.[13] So the debts of a cancelled subnational government would become those of the national government. In addition, public sector entities are rarely abolished purely for financial reasons. This issue was discussed more in Chapter 2.

Cost concept

In PSA, cost measurement has been based typically on **historical costs** rather than on **current costs**. Historical cost is based on reference to the cost of acquisition or construction of assets.

[13] CNOCP (2014), paragraph 34.

While the historical cost concept may raise many problems for the business accountant, it raises far fewer such problems for the public sector accountant. In the public sector, accounting for historic or actual costs is more important than indicating what profits may have been earned.

The historical costs of acquisition or production of assets do not take into consideration changes in the purchasing power of money. Some assets face abnormal inflation and rising prices, which means, among other things, that depreciation calculated from historical asset values will not finance replacement costs. The historical cost approach is not always followed consistently, because in some cases revaluations are accepted in the public accounting tradition, for instance, regarding real estate, if the reassessed value is considered reasonably permanent.

Realisation concept

The **realisation** concept refers to the point in time at which the accounting entity realises an asset through sale or other way of disposal. The realisation price compared to the book value reflects the profit earned or loss incurred by this disposal. The realisation principle has been criticised, and commercial accounting standards accept revaluations and holding gains or holding losses that are included in the profit of the period.

In the public sector, holding gains and holding losses are less useful concepts, because assets are kept for service and goods provision for citizens, and it may be more meaningful to account for only realised transactions that have money and budget effects. The accountability purpose of PSA requires reliable information on past performance, based on realized transactions rather than speculative or subjective information.

Consistency is important for making relevant comparisons between accounting periods. If there is no continuity of accounting methods and rules, using the information becomes difficult.

Comparability between accounting entities and consistency in accounting methods over time increase the value of accounting information. According to this principle, it is advantageous if accounting standards do not change continuously, causing the need for constant and costly training and changes in accounting technology.

Prudence is a general guiding principle for financial statements. Prudence means, among other things, that all costs must be recognised fully and that only realised profits are recognised in the income statement. Provisions providing for future costs are shown both in the income statement (expenses) and in the balance sheet (liabilities). Prudence in the public sector means care in estimating budget incomes so that they are not exaggerated and care in estimating **all** budget expenditures so that they are not underestimated.

Accruals principle

The accrual concept is described in Chapters 1 and 2. In commercial accounting, accruals are required to match income and expenditure in the calculation of profit. This is the normal basis of the preparation of accounts for commercial undertakings.[14] Furthermore, the accrual basis of financial accounting serves the information needs of cost and management accounting.

According to Chan,[15] accruals can be practised in the public sector with different strengths. Furthermore, it must be understood that implementing accrual accounting is not only a technical accounting

[14] Brockington (1993), p. 6.

[15] Chan (2003), p. 17.

exercise. To work well, a cultural change is needed, which should be linked to broader public management reforms in governments that may not be used to the accrual mindset. According to Hepworth (2017), if financial accrual accounting is not used for managerial purposes, its advantages get lost at the entity level. Merely making information available achieves nothing unless someone uses that information. Again, according to Hepworth, technical training for preparers of financial statements and potential users is not enough. Managers must have an interest in using accrual information and must have managerial discretion powers that motivate them to use the accrual information for making better decisions. Politicians must be willing to support accrual reform.[16]

Furthermore, the capacity of citizens and parliamentarians to assess general purpose financial reports independently is limited. From the citizens' and politicians' point of view, financial statements derived from on a less complicated modified cash basis may be preferable to those prepared on a more complicated and stronger accrual basis.

Matching is a fundamental accounting principle in the private sector, which means that when computing profit, all costs are matched against the revenues to which they relate. Many practical difficulties arise to hinder perfect matching. Depreciation is one of the most important means of allocating costs of assets to accounting periods. This means allocating asset costs to those accounting periods in which the asset is used.

Theoretically, matching in the public sector does not fit non-exchange transactions. These form the major part of governmental transactions. In non-exchange transactions (for instance, transfers to enterprises and households or tax revenues) one cannot find a direct causal relationship between expenditures and tax revenues.

[16] Hepworth (2017).

When services are delivered free of charge to inhabitants, direct matching of expenditures and revenues is not possible. However, the public sector income statement refers to revenues earned and expenses incurred during the accounting period and shows a balance or lack of balance between them. In the public sector, non-exchange transactions are common, which makes matching, in the private sector sense, impossible (for instance, general taxes are not earmarked for specific expenditures). When direct reverse matching is not possible accountants have to recourse to matching expenditures and incomes to the proper time period.[17]

Costs of production factors can be matched with the usage (consumption) of those same production factors. For instance, if a total investment cost of 8 million € of a school building is spread over its useful life of 40 years, this means a 200,000 € depreciation expense per year using the straight-line method of write-offs.

Depreciation can be interpreted in the public sector *as a means* for distributing the investment expenditure over the whole use-period of the investment, so that only the costs of goods and services used in providing services during the year should be included in the financial performance statement. However, this depends on whether the performance or efficiency of the government is to be indicated by such statements, or merely how the money was used.

Periodicity means that the life of an accounting entity must be divided into constant periods **for reporting purposes.** Matching makes it possible to match revenues and expenses for the accounting period. However, in PSA, profitability is not the aim of matching. The income received in a year must simply be matched with the expenditure in the same year.

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[17] Biondi & Oulasvirta (2023).

Conventions/ principles	Public sector Applications	Explanations
1. Accounting entity	Demarcation lines between the whole government and other sectors (consolidation principles)	Demarcation lines outside and inside the multi-level public sector (division into sub-entities doing separate book closures).
2. Money measurement	Not entirely valid	Often one-sided actions, non-exchange transactions.
3. Going concern	Partly valid	Abrupt dismantling possible at the agency/organisational level.
4. Cost concept	Historical cost	Less use of changing current values compared to the private sector.
5. Realisation concept	Emphasised in the public sector	Revaluations and holding gains and holding losses less useful compared to the private sector.
6. Accruals concept	Money accruals, nowadays also modified profit accruals	In the not-for profit sector, modified cash basis common, accruals pushed less far than in the private sector.
7. Matching concept	Valid but not usually in the same way as in business accounting	Direct matching of incurred expenses to earned revenues not possible in non-exchange transactions. Time period matching of expenses and revenues is frequently valid in tax-financed public sector entities.
8. Periodicity	Valid as such	Technically the entity's lifetime must be divided into accounting periods.
9. Consistency	Valid as such	Constant changes of rules problematic, especially in poor jurisdictions with low accounting resources.
10. Prudence principle	Emphasised	Favoured in the public sector, based on strict end-of-year cut-off rules.

Table 4.1: Summary of Section 3

4. Conceptual frameworks

This section discusses theoretical approaches that may lie behind accounting standards and their conceptual frameworks.

Users of general purpose financial statements

Accounting approaches and conceptual frameworks usually start with the objectives and purposes of accounting and financial statements. The information needs of users of financial information should have a crucial impact upon the conceptual framework of accounting. Two main concepts in conceptual frameworks are accountability and decision usefulness, demonstrating the usefulness of financial information. Information should serve the control purpose of making an assessment of the behaviour of the accountable administration that used the collective resources. Furthermore, information should be appropriate for making decisions regarding the future usage of collective resources in the best possible way.

Accountability is related to the past, with the control of the managerial actions (agents) taken in the past on behalf of the principals. Information for this purpose serves the principal's decisions regarding the agents; for instance, discharge of liability, need to change the manager, ways to develop steering and incentive systems, etc.

Decision usefulness is related to the future and the usefulness of information in forecasting the economic viability of the entity, whether it is a going concern or not, capacity to cope with obligations, medium- and long-term sustainability, etc.

The most common international framework for financial statement presentation is the conceptual framework of the IASB, which issues International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). The IASB emphasises shareholders and

creditors as primary users, and hence their needs regarding financial reporting information.

The conceptual framework of the IASB assumes that financial accounting information that satisfies the needs of shareholders and creditors also satisfies the information needs of other users of the financial statements. According to IASB, the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.[18]

Primary users in the public sector

The interpretations of accountability and decision usefulness are different in the public sector because of different user needs. The primary users are the citizens. The **primary users** of state and local governmental financial reports are those to whom government is primarily accountable, the citizenry and the legislative and oversight bodies that directly represent the citizens.

Elected politicians have a responsibility to steer public financial matters and have an accountability relationship towards their electorate, citizens. In these roles, they must be able to read, understand and interpret accounting information in their constituencies. Hence, the main objective of GPFS is to fulfil the information needs of the citizenry and the legislature representing citizens.[19]

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[18] IASB (2015).

[19] Mann et al. (2019), Oulasvirta (2021).

Valuation and measurement of financial statement elements

Historical costs and current costs

There are two main alternatives regarding the valuation method in financial accounting. The first is the historical cost method of valuation. This refers to the amount of money for which an asset was originally acquired or produced.

The other main alternative is the current cost method of valuation. This uses current values, not historical values from the original transactions and events. As the basis of valuation of an asset, it uses the amount which it would currently cost to obtain. This may be interpreted as the cost of replacement or the opportunity cost of the asset.[20]

The opportunity cost is the cost of an action in terms of the value of the best alternative opportunity thereby forgone,[21] for instance, the value of the opportunity forgone by using a certain asset in service provision instead of selling it.

The Governmental Accounting Standards Board (GASB) divides valuation into four approaches[22]

1. **Historical cost** is the price paid to acquire an asset or the amount received pursuant to the incurrence of a liability in an actual exchange transaction.
2. **Fair value** is the price that would be received from selling an asset or paid to transfer a liability in an orderly

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[20] Brockington (1993), p. 66.

[21] Brockington (1993), p. 161.

[22] Concepts Statement No. 6 Measurement of Elements of Financial Statements (2014).

transaction between market participants at the measurement date.

3. **Replacement cost** is the price that would be paid to acquire an asset with equivalent service potential in an orderly market transaction at the measurement date.
4. **Settlement amount** is the amount at which an asset could be realised or a liability could be liquidated with the counterparty, other than in an active market.

The settlement amount can be used in either an initial measurement approach or in a remeasure approach

Initial and subsequent measurement

a) Initial amounts

Initial measurement reflects the value at the transaction date (when the asset was acquired/produced or liability incurred).

In the assessment of whether current-year revenues cover the cost of the government's services, the most relevant cost associated with these assets is the cost that has been incurred by the government – the cost based on the initial amount.

b) Remeasured amounts

Subsequent measurement reflects the conditions in effect at the financial statement date. Re-measurement changes the amount reported for an asset or liability from an initial amount or previous remeasured amount to an amount indicative of

the value at the financial statement date, providing information to assess the financial position, including the service potential of assets and the ability to meet obligations when due. When remeasured amounts are used in a statement of financial position, those assets and liabilities may have more meaning because they reflect a value as of a common date.[23] However, this is because private sector financial statements are indicative of future profitability, which is not the case in the public sector.

Balancing competing objectives of financial reporting

According to the GASB, the statement of financial position and the resource flows statement are both important, yet because a single measurement approach is required to be selected for a particular transaction, the choice may indicate which financial statement is more important in that circumstance.

According to the GASB, "initial amounts generally have less relevance than remeasured amounts when evaluating the statement of financial position to assess the level of services that can be provided by a government. However, initial amounts generally have more relevance than remeasured amounts when evaluating the cost of services information that is presented in a resource flows statement."[24]

[23] GASB (2014).

[24] GASB (2014), p. 20.

Date of acquisition 1.1.XX Beginning of usage 1.1.XX Straight-line depreciation	**Historical cost – remeasured value at 1.1.XX+5**	**Replacement cost – remeasured value at 1.1.XX+5**	**Realisable value Potential sale of asset at market value at 1.1.XX+5**	**Net present value of future income at 1.1.XX+5**
Not-for-profit entity Initial asset acquisition cost 1,000,000 € (municipal day care facility)	500,000 € (1,000,000 less depreciation for half its estimated life)	600,000 €	400,000 € (No active markets, estimation of a settlement amount)	The asset generates no or insignificant cash flows. However, the asset's ability to provide future services may have a greater value than the sale of the asset now.
For-profit entity Initial asset acquisition cost 1,000,000 € (production equipment)	500,000 € (1,000,000 – depreciation for half its estimated life)	700,000 €	700,000 € Market price in active markets	1,200,000 € Estimation of discounted present value of future cash inflows (from year X+5 to the end of the useful life of the asset)

Table 4.2: Examples of valuation alternatives: 1 million € investment for a day care facility and 1 million € investment for production equipment, useful life for both is (for reasons of simplicity) 10 years.

Historical costs often are reliable and verifiable. Furthermore, this approach facilitates a comparison of actual financial results and the approved budget prepared on a historical cost basis. This is essential in the public sector where officials are accountable for the amounts that are spent compared to the agreed budget.

According to Glautier and Underdown, current value accounting consists of three forms[25]: Replacement cost accounting (entry price), realisable value accounting (exit price), and net present value of future income generated from the asset.

[25] Glautier and Underdown (1994), p. 346.

Current replacement costs are relevant to assessments of the current cost of services and operational capacity, but are not relevant for assessing financial capacity.

Realisable value is relevant when assets are used to provide services measured at market value. However, relevance decreases or vanishes if services are provided in non-exchange transactions or on subsidised terms. It is relevant for assessing financial capacity because it gives information on the amounts that would be received on the sale of an asset. Observe here that the net selling price, which is entity-specific and includes the entity's costs of sale, differs from the market value concept.[26]

Net present value relates to the concept of value in use (the asset's remaining service potential or ability to generate economic benefits). In the public sector context, it is generally inappropriate because most assets are not generating economic benefits measured in cash. In addition, the calculation of value in use can be very complex.

Public sector-specific non-exchange transactions require their own recognition criteria: a) non-exchange revenues, taxes, and b) and non- exchange expense transactions, such as grants, social benefits and other contribution transfers. These are often recognised either based on the pure cash movements they cause or based also on their short-term obligations causing due payments in near future.

The GASB requires **(only) government investments** to be measured at fair value. An *investment* is defined as a security or other asset that (a) a government holds primarily for the purpose of income or profit and (b) has a present service capacity based solely on its ability to generate cash or to be sold to generate cash.

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[26] Glautier and Underdown (1994), p. 346.

A fair value measurement of a liability would assume that the liability would be transferred to the market participant and not settled with the counterparty.[27]

Theoretical approaches to PSA frameworks

Broadly, we can discern two different accounting methods as reference frames that have an impact upon the determination of elements of financial statements, recognition and measurement criteria. These are the revenue-expense-led approach and the asset and liability-led approaches. The former represents a dynamic view and the latter a static view. These views may have an influence on the contents of conceptual frameworks (adapted from Biondi 2012 and 2013):

Accounting views	Static	Dynamic
Method	Stock method of accounting (assets-liabilities approach)	Flow method of accounting (revenues-expenses approach)
Measurement	Fair value	Historical cost
Focus	Net worth of the entity at a specific moment in time	Resource outflows and inflows Resources mobilised and utilised by the activities (matching)

Table 4.3: Comparison of the static and dynamic views

The **revenue-expense-led approach** is based on the dynamic view and the flow method of accounting. The matching of periodic expenses and revenues to the income statement is emphasized. Furthermore, the realisation principle is applied, that is why it is transaction-based and uses historical costs rather than fair value

[27] GASB (2015). Observe also that IPSASB has issued 2021 an Exposure Draft (ED) 77, Measurement, it will be explained in the book later in another chapter.

measurements. Realisation occurs mainly when flows are generated through transactions which have occurred with independent third parties. The historical cost accounting approach is based upon these transactions of the accounting entity with independent third parties. According to Biondi accounting is not made dynamic by taking into account the current value of an imagined future (as the static model would do), but by referring to the accrual of actual expenditures related to the ongoing productive process of the accounting entity over time and circumstances.[28]

The **asset and liability-led approach** focuses on the balance sheet. Neutrality rather than prudence is emphasised. Furthermore, because fair values and market values are used, holding gains and losses are recognised. In order to create a consistent and coherent framework, there are arguments for not mixing the two different approaches. When we take into consideration specific public sector characteristics, arguments favour the revenue-expense-led approach. However, many consider this to be a controversial statement and, at the same time, may stress that public sector entities should follow as much as possible the private sector approach, which has been developing in the direction of the asset and liability-led approach with a focus on the balance sheet.

Some argue that the revenue-expense–led approach is a better choice for the public sector than the asset and liability-led approach. According to Biondi, a dynamic entity view is preferable to a static proprietary view in the public sector.[29]

These different approaches create discussion, for instance, about the recognition and valuation of fixed assets in governments. One argument for the revenue-expense model is that public sector assets are often maintained only to provide social benefits. In business

[28] Biondi (2012), p. 606.

[29] Biondi (2012), p. 611.

accounting, all assets are kept for reasons of economic benefit and one can argue that therefore recognising and valuing fixed assets in the public sector should not be copied from the IFRS. In the public sector, most of the property and equipment is not intended to yield economic benefits, especially regarding heritage assets, of which the economic objectives are very limited.

Accounting views	Private sector Applications	Public sector applications
Primary users of GPFRs Especially GPFSs	Owners, investors and creditors	Citizens and their representatives (parliaments and other representative bodies) Resource providers and service recipients – as secondary users
Purpose and objectives	Decision usefulness regarding buying/selling/ holding equity and debt instruments, lending decisions	Discharge of liability for accountability purposes, also prospective financial and non-financial information for prospective decision-making purposes
Statement emphasised	Balance sheet	Income statement
	Net worth of entity	Balance of budget
Accounting method	Stock method of accounting	Dynamic method of accounting
Measurement	Current value	Historical cost

Table 4.4: Summary

5. Conclusion

In this chapter, we have described the normative approach containing several principles and conventions of accounting developed for the for-profit sector. Then we analysed how we may interpret these conventions and principles in the context of tax-financed public sector organisations. We also analysed how the accounting

theories and principles are reflected in the possible conceptual frameworks of public sector financial accounting. The analysis shows that principles and concepts in conceptual frameworks for the public sector cannot be directly taken from the corresponding private sector principles and concepts.

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Discussion topic

– What is your judgement on the two different approaches presented here: the revenue-expense-led approach (income statement emphasised) vs. the asset and liability-led approach (balance sheet emphasised), and their suitability for government accounting?

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