Exposure Draft 78

Proposed International Public Sector Accounting Standard

"*Property, Plant, and Equipment*"
REQUEST FOR COMMENTS

Task force IRSPM A&A SIG, CIGAR Network, EGPA PSG XII

October 21st 2021

The IPSASB has requested comments and answers to specific questions regarding ED 78. The objective of ED 78 is to propose improvements to the relevance, faithful representativeness, and comparability of the information that a reporting entity provides in its financial statements about property, plant, and equipment. The principal issues in accounting for property, plant, and equipment are: the recognition of the assets; the determination of their carrying amounts; and the depreciation charges and impairment losses to be recognized in relation to them.

The comments and responses prepared by the Task Force IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are presented below. The IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are three research networks that focus on Public Sector Accounting. The Task Force is made up of 17 researchers from these networks. The views expressed in this document represent those of the members of the Task Force and not of the whole research community represented by the networks, and neither of the Institutions/Universities with which they are affiliated.

Core assumptions

We are of the opinion that, in general, public sector entities require public sector specific principles and standards that properly accommodate public sector specificities. As such, when public sector transactions resemble those taking place in the private sector, then principles and standards may be kept as aligned as possible. However, for public sector specific transactions, we are in favour of standards that are not adapted artificially from private sector accounting and we think there is a need to seek options that best fit the public sector. This core thesis underpins our proposals and recommendations herein.

Accounting for heritage and infrastructure assets is a relevant issue in the literature (Adam et al., 2011)[1] that raises concerns about proper definition, processes for recognizing in financial reporting statements, measurement criteria and additional information to be

[1] Adam, B., Mussari, R. and Jones, R. (2011), "The diversity of accrual policies in local government financial reporting: an examination of infrastructure, art and heritage assets in Germany, Italy and the UK", *Financial Accountability & Management*, Vol. 27 No. 2, pp. 107-133.

disclosed for these types of assets. It should be noted that we have already participated to the comments of the consultation paper '*Financial Reporting for Heritage in the Public Sector*' in 2017, where we had proposed to improve the definition of the heritage items and to enrich the disclosure information for the heritage items not recognised in the financial statements[2].

We welcome the opportunity to comment on ED 78. **Our response is in two parts**. It consists of "**General Comment**" and the proper "**Specific Matter Comments**".

GENERAL COMMENT

The Specific Matters for Comment in the three EDs related to measurement, namely ED76, ED77 and ED78, do not cover some broader issues which we would like to highlight. These comments apply as well to our responses to ED76 and ED77.

In our opinion, the Conceptual Framework and/or the standards should provide structured guidance to orient (and even direct) the accounting policy choice concerning accounting measurement models and subsequent measurement bases and techniques. By avoiding providing such guidance, the IPSASB is allowing weak reporting and mismanagement.

A conceptual framework may and should provide guidance to preparers in order to choose between measurement models. The conceptual framework may even limit the choices available, according to a coherent set of consistent indications, and it should define conditions under which preparers of financial statements in the public sector may use different measurement models, providing full explanation on these motivations. While we appreciate that subjectivity is inherent in financial reporting, we point out how important it is to minimize the extent that subjectivity is required to be exercised in public sector financial reporting, due to the scope of such reports to provide accountability to the citizens.

The IPSASB should emphasize the fact that most of the physical capital goods are non-monetary items, which means that a government owning and using those goods is not the owner of monetary units, but it hold only certain rights on those capital goods. Generally speaking, these rights are such that governments have the custody rights but without having usufruct, and facing restrictions on alienation rights. The non-financial characteristics of these assets are the main cause for difficulties in applying various valuation models, bases and techniques in the public sector.

One issue that we identify is the very introduction of a current value model with several bases and techniques, without a clear view on when this model can and should be applied.

[2] https://www.ifac.org/sites/default/files/publications/exposuredrafts/comments/Comm_and_sugg_IPSAS_CP_HA_task_forcefinal.pdf

We agree that its usefulness is limited generally speaking, and its misrepresentation risks rank high in some circumstances.

In our responses concerning asset measurement, we tend to favour replacement cost as an alternative to current operational value because replacement cost is quite a straightforward value to determine. In fact, both seem to tend to increase the current resource needs (that is, current costs, supposed to be covered by current revenues) by the reporting entity, which is not being to renew those resources now and is not supposed to do it soon. When renewal occurs, the entity may have recourse to other sources than operational flows and related reserves, typically debt issuance. Therefore, the use of replacement cost or current operational value does violate intergenerational equity between current and future taxpayers.

Alternatively, reference could be made to "renewal accounting" or "fixed cost depreciation method", in which the carrying value of the asset is kept constant because of its constant service potential. Accordingly, depreciations are not booked, but efforts are made (and resources are employed) to ensure that constant service potential is maintained. Related expenditures are directly charged as expenses in the Statement of Financial Performance. This model is not considered by the IPSAS framework, despite the many potential examples, such as fire departments, libraries, health care equipment, and so forth where a constant service potential is required.

Finally, we want to point out that the definition of an asset includes service potential which flows to the reporting entity, but the benefits of this service potential flow to the citizens and not to the governmental entity.

Governments act as stewards of public resources on behalf of citizens; therefore, these public resources should be properly recognised and accounted for. In this case, it is not their acquisition cost which matters, but their in-hand existence and attached management costs to be managed and reported.

Specific Matter for Comment 1:

[Draft] IPSAS [X] (ED 78), Property, Plant, and Equipment proposes improvements to the existing requirements in IPSAS 17, Property, Plant, and Equipment by relocating generic measurement guidance to [draft] IPSAS [X] (ED 77), Measurement; relocating guidance that supports the core principles in this Exposure Draft to the application guidance; and adding guidance for accounting for heritage assets and infrastructure assets that are within the scope of the Exposure Draft.
Do you agree with the proposed **restructuring of IPSAS 17 within [draft] IPSAS [X] (ED 78)? If not, what changes do you consider to be necessary and why**?

Comment:

Yes, we agree taking into account our general comments above and the following comments below.

Specific Matter for Comment 2 (paragraphs 29-30):

Do you agree that when an entity chooses the current value model as its accounting policy for a class of property, plant, and equipment, it should have the option of measuring that class of assets either at current operational value or fair value?
If not, please provide your reasons, stating clearly which current value measurement basis would best address the needs of the users of the financial information, and why.

Comment:

Concerning asset measurement, the Current Operational Value model may tend to indicate an increase the current resource needs (that is, current costs, supposed to be covered by current revenues) by the entity, which is not being to renew those resources now and is not supposed to do it soon. When renewal occurs, the entity may have recourse to other sources than operational flows and related reserves, typically debt issuance. The fair value model may also tend to decrease the current costs, if reference market prices are decreasing, then undermining the capacity of the entity to recover previously spent resources. Therefore, the use of current value models does violate intergenerational equity between current and future taxpayers.

Moreover, we shall take into account our comment to SMC3 on heritage assets and the following comments.

Specific Matter for Comment 3 (paragraph AG3):

Are there any additional **characteristics** of **heritage assets** (other than those noted in paragraph AG3) that present complexities when applying the principles of [draft] IPSAS [X] (ED 78) in practice? Please provide your reasons, stating clearly what further characteristics present complexities when accounting for heritage assets, and why.

Comment

The ED 78 presents three distinguishing characteristics (AG3), i.e. *(a) They have restrictions on their use; (b) They are irreplaceable; and (c) They have long and sometimes indefinite useful lives.* However, these characteristics do not represent a conceptual definition which determines the accounting policy.

The specific characteristic is the decision that heritage items are to be maintained/preserved, have no usufruct economic objectives, should not be alienated and should not be destroyed. This means that when a government recognizes an item as a heritage item, the government gives up the last three rights and becomes a guardian responsible for maintenance and custody of the heritage item.

It is important to emphasize the fact that a government takes a decision to define a heritage item, and this can be prescribed by legislation or by governmental regulations or other prescriptions. This implies that a government can change the "status" of certain goods into heritage, for instance the discovery of ancient foundations of a Roman building and the decision to define it as heritage. Vice-versa, it is also possible that a government withdraws the heritage aspect of a certain item, which implies that this item becomes a regular asset and can be sold, for instance, an immovable cultural monument with an attached bronze statue that has become less important and that has to be demolished because the government decided to build a new road across the monument.

Contrary to regular assets, heritage assets are special and unique and have to be preserved for the following generations. There are other important characteristics to consider, such as:

- heritage items may increase in cultural value over time even if their physical condition deteriorates;
- heritage value, which may be expressed in both monetary (if government considers changing its "status") and non-monetary terms;
- qualitative social, cultural and natural "values" that are more important and often significantly greater than economic accounting value (which may be nil or negative);
- heritage items can be held for social reasons to contribute to knowledge and culture.

Moreover, other specific categories should be considered (such as the ethnographic items, the archaeological items or street or mural art).

The main objective of heritage items is that they are held for 'social purposes' with the possibility of handing down a particular cultural richness to future generations. Moreover, the heritage items give visibility to the country holding them, increasing the attractiveness of the country and culture tourism, which will certainly generate treasure for the nation.

As the ED specifies under the AG 10-12, heritage items are typically resources that are used purely for the benefit of the public and not to provide service potential and/or economic benefits to the government itself. In fact, this is quite true for most public sector capital goods whose service potential is delivered to citizens through public service provision.

As such, the benefits (e.g. cultural, educational, etc.) provided by heritage items are not in favour of the government as an accounting entity, but flow back to the citizens who are different entities and which are not included in a government's general ledger (Christiaens et al. 2012, p. 437-438)[3]. In other words, capital goods that *per se* provide cultural and social benefits for current and future generations are not assets in accounting terms and do not belong on the balance sheet, but need to be disclosed off-balance sheet.

Differently, items of property, plant and equipment that a public sector entity uses in order to provide services for citizens (for example, office furniture, fixtures and fittings; motor vehicles; university computers available to students; energy-generating plant and machinery) should be categorized as assets. The same reasoning applies to the example of the ticketing equipment for a historic building, which would have nothing to do with the heritage item itself.

The Exposure Draft should indicate that, in line with the definition, heritage items being given a societal status, cannot and should neither be recognized nor measured in monetary terms, but should be disclosed adequately off-balance sheet.

[3] Christiaens, J., Rommel, J., Barton, A. and Everaert, P. (2012), "Should all capital goods of governments be recognised as assets in financial accounting?" *Baltic Journal of Management*, Vol. 7 No. 4, pp. 429-443.

Specific Matter for Comment 4 (paragraph AG5):

Are there any additional **characteristics** of **infrastructure assets** (other than those noted in paragraph AG5) that present complexities when applying the principles of [draft] IPSAS [X] (ED 78) in practice? Please provide your reasons, stating clearly what further characteristics present complexities when accounting for infrastructure assets, and why.

Comment

AG5 remains very general when defining infrastructure assets as *(a) They are networks or systems and (b) They have long useful lives*. Before going into the question of defining infrastructure assets, it is important to highlight a misconception in the recognition of property, plant, and equipment. AG9 is in line with the definition in ED 78, par. 7 and determines that *"An item of property, plant, and equipment is recognized … it should be probable that future economic benefits or service potential associated with the item will flow to the entity, and the cost or current value of the item can be measured reliably."* Apart from the fact that ED 78 does not discuss the valuation of the infrastructure assets, it is important to mention that many infrastructure assets were constructed under a (former) budgetary/cash accounting regime and therefore their historical costs are mostly not available[4].

In the previous comment, we have already mentioned that the **service potential will flow directly to the citizens and not to the governmental entity itself**. This means that a government does not get any direct benefits from the service potential it provides for its citizens, unless citizens have to pay a commercial price for using such a potential. Only in the latter unusual situation does the government realize economic benefits and then the resource belonging to the property, plant and equipment class is really an asset.

The following examples can clarify this reasoning:

Firstly, a local government is the owner of the local road network and is responsible for the maintenance of the road surface. The roads are free to use by anyone without any contribution or toll. This infrastructure item is very welcome for the citizens, visitors, drivers, but does not result in any economic or other benefit for the government as a reporting entity. Therefore, literature many times refers to Mautz[5] who called these kinds of items "liabilities" instead of "facilities" because the government only has to pay for its maintenance without receiving any funds from the users.

Secondly, a national government is the proprietor of a large highway whereby each user should pay a toll in order use the highway (e.g. the "Autoroute du soleil" in France). It is

[4] Pallot, J. (1997). Infrastructure accounting for local authorities: technical management and political context. *Financial Accountability & Management*, *13*(3), 225-242

[5] Mautz (1988), R. K., Editorial: Monuments, mistakes, and opportunities, *Accounting Horizons*, 2(2), pp. 123-128, 1988.

obvious that this kind of infrastructure facility generates some revenues for the government as a reporting entity. Despite its revenue potential, and thus its recognition as an asset, it is still important to report off-balance sheet its service potential to the citizens. Since the public service provision is not expected to be fully gathered by the tariff charged to the users.

Infrastructure assets require ongoing maintenance, which is crucial to the quality of infrastructure service delivery. Therefore, some relevant non-financial information should be disclosed for this type of assets. Information about maintenance expenditure and deferred maintenance, physical condition of infrastructure, asset planning and management and performance measures, are considered highly relevant to users[6]. Also the accounting policy applied by the governments in its annual reports should be disclosed.

[6] Walker, R. G., Clarke, F. L., & Dean, G. W. (2000), "Options for infrastructure reporting", *Abacus, Vol. 36, No. 2, pp.* 123-159; Lee, J., & Fisher, G. (2004), "Infrastructure assets disclosure in Australian public sector annual reports", *Accounting Forum*, Vol. 28, No. 4, pp. 349-368.

Specific Matter for Comment 5 (paragraphs 80-81 and AG44-AG45):

This Exposure Draft proposes to **require disclosures** in respect of **heritage** property, plant, and equipment that is **not recognized** in the financial statements because, at initial measurement, its cost or current value cannot be measured reliably. Do you agree that such **disclosure should be limited to heritage items**? If not, please provide your reasons, stating clearly the most appropriate scope for the disclosure, and why.

Comment

The disclosure requirements indicated in the ED (paragraphs 80-81 and AG44-AG45) may be applied to every type of tangible item not recognized in the financial statements as property, plant, and equipment because, at initial measurement, its cost or current value cannot be measured reliably.

Specifically for heritage assets items, the ED should request to the governments to disclose in the notes to their financial statements or in a separate report (equally part of the GPFR and subject to audit), the following information about their heritage items: an overview and listing of the different heritage items; together with the budgets the government spends yearly for acquisitions, maintenance, preservation, archaeological and historical examinations; and the actual amounts spent in the reporting year.

It is possible that the government defines a certain fund for heritage items, and it would be good practice to show the contributions and spending together with documenting and clarifying the changes in heritage items. This is not at all a kind of a profit/loss statement for heritage items; the key concern is to enable and preserve resources for the maintenance of heritage items. This enables the government to provide an accountable view on the service efforts and accomplishments regarding the governmental heritage items. For an example of this sort on how these efforts and resources in kind can be disclosed apart from the balance sheet and profit/loss statements, reference can be made to the French accounting regulation "N° 2018-06 du 5 décembre 2018" for non-profit organizations.

Aversano et al. (2014)[7] examined user needs regarding the reporting on heritage items and recommends certain quantitative and qualitative information, which should be disclosed off-balance sheet, in the notes to the financial statements or in a separate report. In this respect, the papers of Adam et al. (2011)[8] and of Biondi and Lapsley (2014)[9] can also offer some suggestions.

[7] Aversano N., Christiaens J. (2014), "Governmental Financial Reporting of Heritage Assets from a User Needs Perspective", *Financial Accountability & Management,* Vol. 30, No. 2, p. 150-174.

[8] Adam B., Mussari R, Jones R. (2011), "The Diversity of Accrual Policies in Local Government Financial Reporting: an Examination of Infrastructure, Art and Heritage Assets in Germany, Italy and the UK", *Financial Accountability & Management*, Vol. 27, No. 2, p. 107-133.

[9] Biondi L, Lapsley I. (2014), "Accounting, Transparency and Governance: the Heritage Assets Problem", *Journal of Qualitative Research in Accounting & Management*, Vol. 11 No. 2/2014, p.146–164.

The accounting policy related to heritage applied by the government should also be disclosed in the annual reports.

Since heritage items are relevant not only for the local community where the item is located, but also for the citizens of a whole region or nation (and in most cases, of world-wide concern), attention should also be paid to nation-wide heritage reporting, including mutations e.g. as a consequence of destruction or certain disasters.

Furthermore, it is important that the specific heritage report is certified by an independent auditor in order to guarantee its usefulness to external stakeholders. In fact, if a "separate heritage report" is prepared, it should nevertheless be part of the financial report, thus (i) forcing the auditors to assess it; and (ii) reducing the possibility for laggard governments to just ignore the whole matter.

Specific Matter for Comment 6 (paragraphs IG1-IG40):

Do you agree with the **Implementation Guidance developed** as part of this Exposure Draft for **heritage assets**? If not, please provide your reasons, stating clearly what changes to the Implementation Guidance on heritage assets are required, and why.

Comment:

Yes, we agree.

Specific Matter for Comment 7 (paragraphs IG1-IG40):

Do you agree with the **Implementation Guidance developed** as part of this Exposure Draft for **infrastructure assets**? If not, please provide your reasons, stating clearly what changes to the Implementation Guidance on infrastructure assets are required, and why.

Comment:

Yes, we agree.

Date: 21st October, 2021 Signed on behalf of the persons listed below:

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