



## MEMORANDUM

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ITEM: AASB AGENDA PAPER 10.2; FRSB AGENDA PAPER B10.3

DATE: 24 November 2010

TO: MEMBERS OF THE AUSTRALIAN ACCOUNTING STANDARDS BOARD and the FINANCIAL REPORTING STANDARDS BOARD

FROM: JOANNE SCOTT

SUBJECT: *IPSASB Conceptual Framework Consultation Paper – Phase 2 Elements and Recognition*

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### Purpose

1. The purpose of this item is to provide the Board with an introduction to issues raised in the *IPSASB Conceptual Framework Consultation Paper – Phase 2 Elements and Recognition* (the CP). The CP is expected to be issued in December 2010 with the comment period expiring on June 30, 2011.

### Overview

2. The CP explores and seeks feedback on the following issues:
  - information needed about a public sector entity's financial position;
  - characteristics of assets and liabilities, including which characteristics are essential to an asset's definition;
  - different views of financial performance;
  - characteristics of revenues and expenses;
  - other possible elements (eg deferred outflows and deferred inflows); and
  - recognition criteria.
3. The CP does not put forward any preliminary views. Instead it seeks feedback on the issues identified in the paper. Despite not putting forward any preliminary views in the CP, the IPSASB is proposing to develop an ED for December 2011. This strategy is quite ambitious.

### Questions for Board members

4. In view of the absence of preliminary IPSASB views in the CP, staff suggests that the focus of discussion at this Board meeting could be on:
  - the asset and liability-led view versus the revenue and expense-led view to defining elements;
  - any difficulties associated with the IPSASB seeking feedback on elements before the IASB and FASB finalise their proposals for consultation. Is this likely to impede the ability of the AASB and FRSB (and other respondents) to provide considered views on the CP, especially those who would apply the *Process for Modifying IFRSs for PBE/NFP* (or similar) when considering the extent to which the definitions should be different in the public sector; and
  - any remarks about the issues on which the IPSASB will seek feedback.

## Asset and liability-led approach vs revenue and expense-led approach

5. The focus of the debate around revenue and expenses is determining which approach should underpin how those elements are defined. The CP discusses two approaches to measuring financial performance, being:
  - the asset and liability-led approach; and
  - the revenue and expense-led approach.
6. The paper notes that the choice between the two approaches directly affects the elements to be defined and the basis for their definition. Examples are used to illustrate the impact of the two approaches on the financial statements. Consistent with the current definition of revenue in IPSASs there would be no concept of gains and losses as elements under either approach, i.e., there would be no distinction between revenues and income.
7. Although these approaches are presented as two separate approaches in the CP, there have been difficulties in developing examples that clearly distinguish between them.

### Asset and liability-led approach to revenue and expenses

8. Under the asset and liability-led approach assets and liabilities are defined first and revenues and expenses are defined as the result of change in assets and liabilities. This is similar to the existing IASB Framework.

### Revenue and expense-led approach to revenue and expenses

9. Under the revenue and expense-led approach revenues and expenses are defined as flows that are “applicable to” the period. This approach is linked to the concept of inter-period equity – that is, the extent to which current year cost of providing services is borne by current year taxpayers and resource providers. The revenue and expense-led approach has been influential in the development of United States Governmental Accounting Standards Board (GASB) pronouncements. The GASB is currently undertaking a Conceptual Framework project, and, as part of that project, is considering the circumstances that may give rise to deferred inflows and outflows of resources under different models. The revenue and expense-led approach, on which the IPSASB is seeking views, appears to be based on the developing GASB financial resources model.
10. Under the GASB financial resources approach the types of transactions that may be considered not applicable to the period and that therefore may give rise to deferred inflows or outflows include:<sup>1</sup>
  - outflows of resources that are intrinsically related to future services but which do not meet the definition of an asset;
  - time restrictions on the application of inflows of resources when such application does not meet the definition of a liability (for example: (i) a property tax levied at the end of the current reporting period that is legally restricted for use in the next reporting period and does not have a return feature; and (ii) an asset which is financed by a grant (the deferred inflow) and to be used for specified services in the future);
  - a sale of resources that were not previously recognised in the financial statements (future resources); and
  - changes in the fair value of recognised assets when conditions exist such that there is little likelihood of realisation of the gain or loss.
11. Interestingly there has been debate in the private sector about how to present some of these items in the financial statements and, in particular, whether certain items should be presented as other comprehensive income. The two alternative approaches may merely have come up with different methods of dealing with such items.
12. The CP seeks feedback on which approach constituents support.

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<sup>1</sup> These examples have been taken from recent GASB discussions but they are also likely to be relevant to the IPSASB CP.

13. If the revenue and expense-led approach is adopted then it is necessary to decide whether deferred inflows and outflows (i) are separate elements; (ii) form part of the definition of an asset or liability or (iii) or are part of net assets/equity. The CP seeks feedback on these alternatives.

*Preliminary Staff Views*

14. The preliminary view of NZICA and AASB staff is not to support the 'revenue and expense-led approach' as we understand it. We disagree with mixing economic phenomena and accounting devices ('deferred outflows' and 'deferred inflows') as elements of the financial statements.
15. Staff are concerned that draft discussion of the 'revenue and expense-led approach' implies it is the only approach concerned with reporting periodic financial performance. That approach defines revenues and expenses as "flows that relate to efforts of the current period". The logical implication is that the 'asset and liability-led approach' is concerned predominantly with reporting financial position, with reported financial performance a by-product of that emphasis. However, staff consider that revenues and expenses comprise the financial effects of an entity's current period accomplishments and that the 'asset and liability-led approach' gives equal importance to the reporting of financial position and financial performance. The two views simply reflect different interpretations of the financial effects of an entity's current period accomplishments.
16. Staff are also concerned with the focus of the 'revenue and expense-led approach' on achieving 'inter-period equity', and its adoption of the view that "the principle that taxpayers pay only for the services they receive and not pass on obligations to future taxpayers should ground any measure of financial performance". Specifically, staff are concerned that this approach is based on a value judgement about who should pay for services rendered in a particular period and its direct link between funding decisions and recognition. If a decision were made that taxpayers of a different period should pay for current period services, should the recognition principles change accordingly? Staff think they should not, but adopting the 'inter-period equity concept' would create a precedent for public policy decisions to determine recognition principles.
17. Finally, staff are concerned the draft definitions of 'deferred outflows' and 'deferred inflows' potentially overlap the definitions of assets and liabilities (see the comment in paragraph 7 regarding the lack of a clearly articulated distinction between assets and liabilities and deferred outflows and deferred inflows). This makes it difficult to understand the essential nature of deferred outflows and deferred inflows. For example, the definition of 'deferred outflows' in the draft CP refers to "a consumption or reduction of net assets<sup>2</sup> that is applicable to a future reporting period". If equipment is consumed in producing inventories, the measure of consumption of that equipment would appear to simultaneously qualify as part of the cost of an asset (inventory) and as a deferred outflow. Similarly, if, in obtaining access to mineral resources, a mining company creates a liability to remediate a mine site, the amount of that liability would appear to simultaneously qualify as part of the cost of an asset (the mine) and as a deferred outflow. These examples illustrate not only a lack of a clear distinction between these notions, but also that the notions of 'deferred outflows' and 'deferred inflows' are not unique to the PBE/NFP sector.

**IASB/FASB definitions of income and revenue (as at June 2010)**

18. The joint FASB and IASB Revenue Recognition project is developing guidance for revenue recognition. This standards level guidance is expected to inform work on the conceptual project. Proposed definitions in the IASB ED *Revenue Recognition* (June 2010) are shown below.

<sup>2</sup> The reference to 'net assets' is made to cover increases in liabilities, which were specifically mentioned in an earlier draft of the CP. Staff observe that, if that reference were read literally, 'deferred outflows' would be a null set because deferral of an expense would not reduce net assets. This is clearly not the intention of those advocating that approach.

- Income    Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decrease in liabilities that result in increase in equity, other than those relating to contributions from equity participants.
- Revenue    Income arising in the course of an entity's ordinary operations.

19.    The differences between the FASB and IASB definitions of expenses have not been publicly addressed at this stage.

### **Assets and liabilities**

20.    The IPSASB CP discusses a number of potential characteristics of assets and liabilities that mostly also are being considered by the IASB and FASB in their work on the elements. The IPSASB also discusses some public-sector-specific issues to test the appropriateness of these notions in the public sector.
21.    The IPSASB has identified three classes of characteristics necessary for a complete definition of an asset and a liability:
- the substance of an asset/liability;
  - how to determine if it is the reporting entity's asset/liability; and
  - how to determine if it is an asset/liability at the reporting date.

### Assets

#### Substance of an asset

22.    The CP does not put forward any preliminary views on the substance of an asset. The IPSASB suggests that there are three potential types of benefits that give rise to an asset, being:
- future service potential,
  - net future cash inflows, and
  - unconditional promises and other abilities to require provision of resources in the future.<sup>3</sup>
23.    The IPSASB is seeking feedback on:
- whether respondents support including all three types of benefits as characteristics of an asset; and
  - whether the term "economic benefits" or "economic benefits and service potential" should be used.

#### Asset of the reporting entity

24.    The IPSASB has identified various approaches to associating an asset with a specific entity and discusses some of the features and limitations of these approaches.
25.    The IPSASB will be seeking feedback on:
- which of the following approaches should be used to associate an asset with a specific entity
    - control
    - risks and rewards
    - access to rights including the right to deny access to rights;
  - whether an entity's legal or other enforceable claim to benefits or ability to deny, restrict or otherwise regulate the access of others links a resource to a specific entity; and
  - whether there are any additional requirements necessary to establish a link between the entity and an asset.

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<sup>3</sup> The discussion of "unconditional promises" may be reviewed prior to publication.  
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### Asset at the reporting date

26. The IPSASB will be seeking feedback on:
- whether existence at the reporting date should be part of the definition of an asset, or a recognition criterion;
  - whether the existence of an asset is dependent on the occurrence of a past transaction or event; and
  - whether unique public sector entity rights and powers (such as the power to tax) must be exercised in order for there to be an asset.

### Liabilities

#### Substance of a liability

27. The CP does not put forward any preliminary views on the substance of a liability. The CP notes that some consider an obligation is an essential characteristic of a liability whilst others consider the primary emphasis should be on the outflow or transfer of benefits.
28. The CP discusses aspects of some broader obligations in the public sector setting including:
- unconditional promises including stand-ready obligations;
  - performance obligations; and
  - obligations to provide access to resources, or forego future inflows of resources. This section of the CP discusses whether granting a right of access creates an obligation. It uses service concession arrangements to illustrate that there might be a conflict between the view that a promise to provide a right of access is a promise to perform (i.e., to transfer or sacrifice resources) by ensuring the other party has future access to the resources and the view that the entity has sold some of the economic benefits/service potential embodied in the related resource (the CP describes this latter view as a rights approach to asset definition, but more commonly it would be described as a components approach to assets).
29. The IPSASB will be seeking feedback on:
- characteristics that respondents consider are essential to the substance of a liability;
  - whether various promises and obligations result in obligations for the purpose of defining a liability (for example, unconditional promises to stand ready to insure against loss (risk protection); performance obligations; and obligations to provide access to resources or forego resources in the future); and
  - whether having a settlement date is an essential characteristic of a liability.

#### Liability of the reporting entity

30. Potential essential characteristics of a liability include:
- an entity's duty or responsibility to others; and
  - the absence of a realistic alternative to avoid the obligation – the paper explores legal enforceability, constructive exchange obligations and constructive non-exchange obligations.
31. The IPSASB will be seeking feedback on:
- whether the ability to identify a specific party(ies) outside the reporting entity to whom the entity is obligated should be considered an essential characteristic in defining a liability, or be part of the supplementary discussion;
  - whether the absence of a realistic alternative to avoid the obligation is an essential characteristic of a liability; and
  - which approach respondents support in determining whether an entity has or has not a realistic ability to avoid the obligation.

### Liability at the reporting date

32. The IPSASB will be seeking feedback on whether:
- the occurrence of a past transaction or event is an essential characteristic of a liability and whether there are other criteria that are helpful in determining if an obligation is "present";
  - recognition and measurement criteria aside, a public sector entity's obligations such as those associated with its duties and responsibilities as a government<sup>4</sup>, are liabilities of the entity;
  - the enforceability of an obligation through legal or other means is an essential characteristic of a liability; and
  - any discussion of liabilities must include an assumption about the role that sovereign power plays in that definition.
33. In considering unique public sector obligations such as social policy obligations, the CP sets out three views:
- A government's responsibilities are perpetual obligations. The CP notes there would be measurement difficulties with this approach.
  - A government's responsibilities are considered obligations of the entity only when they are enforceable claims.
  - A government may have sovereign power to unilaterally avoid the outflow of resources.

### **IASB/FASB tentative definitions of assets and liabilities (as at March 2010)**

34. At this stage, and given the lack of preliminary views in the IPSASB CP, it is not possible to directly compare the IPSASB and IASB definitions of assets and liabilities. Neither the IASB project plan (as of 12 October 2010) or the FASB project plan (updated as of November 23, 2010) show an estimated date for consultation on elements and recognition.
35. The Boards have tentatively adopted the following working definition of an asset:
- An *asset* of an entity is a present economic resource to which the entity has a right or other access that others do not have.
- *Present* means that on the date of the financial statements both the economic resource exists and the entity has the right or other access that others do not have.
  - An *economic resource* is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources that arise from contracts and other binding arrangements are unconditional promises and other abilities to require provision of economic resources, including through risk protection.
  - A *right or other access that others do not have* enables the entity to use the economic resource and its use by others can be precluded or limited. A right or other access that others do not have is enforceable by legal or equivalent means.
36. The Boards have tentatively adopted the following working definition of a liability:
- A *liability* of an entity is a present economic obligation for which the entity is the obligor.
- *Present* means that on the date of the financial statements both the economic obligation exists and the entity is the obligor.
  - An *economic obligation* is an unconditional promise or other requirement to provide or forgo economic resources, including through risk protection.
  - An entity is the *obligor* if the entity is required to bear the economic obligation and its requirement to bear the economic obligation is enforceable by legal or equivalent means.

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<sup>4</sup> Staff observe this question is vague.

37. As at March 2010 the Boards had decided to address element uncertainty in the guidance accompanying the definitions of an asset and a liability. If an entity is uncertain about whether a liability exists, that entity should make a neutral judgment based on its understanding of the facts and circumstances at the end of the reporting period. If it is judged that a liability exists, uncertainty about the amount of the liability would be taken into account in measurement.
38. However, in the context of discussions on the Liabilities project (November 2010) the IASB decided tentatively to specify that, in situations of uncertainty, this criterion (existence of the obligation) is met if the available evidence indicates that it is *more likely than not* that a liability exists. This more-likely-than-not threshold is applied in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* at present.

#### **Net assets/net liabilities and transactions with residual/equity participants**

39. The CP seeks feedback on whether net assets/net liabilities is merely a residual amount, whether it has economic substance, and finally whether it represents an ownership interest.

#### **Next steps**

40. Staff will seek further feedback from the Board prior to drafting a submission on the IPSASB CP on Elements and Recognition.