IPSASB ED: *Elements and Recognition in Financial Statements*

AASB staff comments on 'deferred inflows' and 'deferred outflows'

Introduction

AASB staff consider the principal concern with the IPSASB ED on Elements and Recognition is its proposal to identify 'deferred inflows' and 'deferred outflows' as elements of financial statements and, consequently, to identify 'net financial position' in addition to net assets (see Sections 5 and 6 of the ED).

AASB members are requested to consider the draft comments below on those IPSASB proposals, which staff propose including in the Board's submission on the IPSASB ED.

Draft Comments for Board Submission

Economic phenomena

The AASB considers that assets and liabilities should be defined in relation to economic resources and economic obligations, that revenues and expenses should reflect changes in those economic resources and economic obligations, and that (apart from net assets/equity) the statement of financial position should report only assets and liabilities.

The AASB does not support identifying 'deferred inflows' and 'deferred outflows' as elements of financial statements because doing so appears to mix economic phenomena and accounting devices ('deferred inflows' and 'deferred outflows') as elements of the financial statements.

Rationale for deferred inflows and deferred outflows

The key reason for identifying deferred inflows and deferred outflows as elements seems to be set out in paragraph BC35 of the Basis for Conclusions on the IPSASB ED, which says: "The IPSASB took the view that the definitions of revenue and expenses should reflect the inflows of resources used to finance such[1] goods and services and the outflows of resources related to providing goods and services in the reporting period." This rationale is elaborated in paragraph BC40, which says:

> "Information on the extent to which the cost of providing services has been financed by revenue of the same reporting period is highly useful for accountability and decision-making purposes. It is therefore important to be able to show separately flows that relate to specified future reporting periods, instead of including them in the Statement of Financial Performance of the current reporting period."

The AASB has the following concerns with this rationale for identifying deferred inflows and deferred outflows as elements of financial statements:

[1] This paragraph does not explain which goods and services "such" refers to. It seems to mean the goods and services provided by the public sector entity during the reporting period.

(a) it emphasises financing the provision of goods and services; however, financing pertains to funds flows and not when revenue is generated;

(b) without applying definitions of assets and liabilities, it seems nebulous to determine when flows "relate" to future reporting periods (this contradicts the virtue of transparency [in defining deferred inflows and deferred outflows as separate elements] claimed in paragraph BC43);

(c) when inflows of resources are not stipulated to be used to finance particular costs of services, attributing those inflows to particular costs of services would involve arbitrary allocations. For example, inflows of resources from general purpose taxes and grants without stipulations can be applied to meet costs of current period services, repay debts incurred in providing services in previous periods or meet the costs of providing services in future periods. Because cash is fungible, any allocation of those inflows to particular outflows would be arbitrary and intent-driven. The IPSASB ED does not propose allocating inflows without stipulations to future reporting periods, but this means its proposals for deferrals are an incomplete attempt to meet their stated rationale;

(d) the extent to which the cost of providing outputs is recovered by revenue of the same reporting period is useful for users of financial statements of reporting entities in the private and public sectors; therefore, a reason is not apparent for identifying 'elements' that are not identified in the IASB Conceptual Framework; and

(e) it does not logically lead to a conclusion that deferred inflows and deferred outflows may only arise in respect of non-exchange transactions (as is specified in the definitions of 'deferred inflow' and 'deferred outflow' in paragraphs 5.1 and 5.2). The last sentence of paragraph BC45 speaks to this scope limitation, but is merely an assertion. It seems unclear how the IPSASB will deal with hedging and other non-conceptual debits and credits arising from exchange transactions.

In relation to (a) above [regarding the ED's emphasis of funds flows], the AASB observes that the third sentence of paragraph BC45 of the ED refers to stipulations regarding the *expenditure* of a property tax. This focus on stipulated expenditure, in relation to when deferral of revenue ceases, does not seem consistent with the implied goal (in paragraphs BC35 and BC40, quoted above) of recognising revenue when related goods and services are provided. Arguably, the approach in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* (namely, recognising 'tied' grant income when related assets are consumed, e.g. when depreciation of related assets is recognised—see paragraph 12 of IAS 20) would be more consistent with the rationale for deferrals in paragraphs BC35 and BC40. However, the AASB does not support IAS 20, either. It supports using a 'performance obligations' approach—consistent with the principles of the forthcoming IFRS on Revenue from Contracts with Customers—to determine when income is recognised in respect of meeting stipulations attached to inflows of resources. The corollary of that view is that, if performance obligations or other liabilities (e.g. loans) do not arise in relation to an inflow of resources, the inflow should be recognised as income immediately.

Impact on the definitions of ‘revenue’ and ‘expenses’

Part (b) of the ED’s proposed definitions of ‘revenue’ and ‘expenses’, in paragraphs 4.1 and 4.2, respectively, refer to inflows/outflows during the current reporting period that result from decreases in deferred inflows/outflows. These cater for reversals of deferrals (referred to in paragraph 5.5). However, they raise the question: “Inflows/outflows of what?” Ceasing to defer an inflow or outflow does not necessarily involve an inflow or outflow of service potential or economic benefits; it results from the expiry of a stipulation. For example, expiry of a stipulation over the manner in which a recipient of assets transferred by the reporting entity should use those assets does not involve a transfer of service potential or economic benefits to the reporting entity.

Thus, the AASB is concerned that part (b) of each of the definitions of ‘revenue’ and ‘expenses’ incorrectly assumes an inflow or outflow of service potential or economic benefits occurs upon the expiry (reversal) of deferrals. This concern seems closely related to the concern in paragraph AV2 of the Alternative View of Prof. Mariano D’Amore, and demonstrates the difficulty of articulating in the same set of financial statements a deferrals model and a model based on reporting economic phenomena.

Ambiguities and other substantive issues with the definitions of ‘deferred inflow’ and ‘deferred outflow’

Specified by whom?

The definitions of ‘deferred inflow’ and ‘deferred outflow’ in paragraphs 5.1 and 5.2 of the ED refer to “benefits provided … for use in a specified future reporting period”, without indicating by whom such a future reporting period is specified. For example, the definition of ‘deferred inflow’ could conceivably include economic benefits specified by the entity to be used in a future reporting period, and the definition of deferred outflow could conceivably include economic benefits specified by a recipient to be used in a future reporting period. To reflect the apparent intention of the IPSASB, the AASB recommends that, if the definitions were retained:

(a) the definition of ‘deferred inflow’ should refer to “use in a future reporting period specified by an external party”; and

(b) the definition of ‘deferred outflow’ should refer to “use by that other entity or party in a future reporting period specified by the reporting entity”.

Use of an outflow

Paragraph 5.2 defines a ‘deferred outflow’ as an “outflow … provided to another entity or party for use …”. It is confusing to refer to another entity using an outflow; entities use assets. Building on the suggestion in (b) immediately above, the AASB recommends that, if the definition of ‘deferred outflow’ were retained, it should refer to “use <u>of the transferred asset(s)</u> by that other entity or party in a future reporting period specified by the reporting entity” (additional words underlined).

Potentially asymmetric definitions

In the context of paragraph 5.3 of the ED, the definition of 'deferred inflow' in paragraph 5.1 seems to refer to a transferor's stipulations regarding the future use of assets transferred to the reporting entity. The apparent thinking implicit in the notion of 'deferred inflow' is that a party external to the reporting entity constrains the reporting entity in relation to assets it holds, without giving rise to a liability of the reporting entity.

At first blush, this aspect of the definition of 'deferred inflow' seems to be mirrored in the definition of 'deferred outflow'. However, as explained below, in substance the definitions of 'deferred inflow' and 'deferred outflow' seem asymmetric.

The definition of 'deferred outflow' in paragraph 5.2 seems to refer to the reporting entity's stipulations regarding the future use of assets transferred by it to another entity. The apparent thinking implicit in the notion of 'deferred outflow' is that the reporting entity constrains an external party in relation to assets held by that external party, without giving rise to an asset of the reporting entity.

Whilst a 'deferred inflow' (apparently) represents a stipulation over the reporting entity's assets, a 'deferred outflow' (apparently) represents a stipulation over an external party's assets (specifically, assets that have been sacrificed by the reporting entity). These are substantively different notions, because only one pertains to the reporting entity. Once assets have been sacrificed by the reporting entity, stipulations over another entity's assets do not pertain to the reporting entity unless they give rise to rights that qualify as assets of the reporting entity (in which case, the question of deferral would not arise).

Other concerns with the Basis for Conclusions

The AASB is concerned that the second sentence of paragraph BC35 says:

> "Including flows as revenue and expenses in one reporting period where there are timing restrictions specifying their use in future periods would be misleading."

In the context of the qualitative characteristics of financial information set out in Chapter 3 of the IPSASB Conceptual Framework (January 2013), if information were 'misleading' it would not be "a faithful representation of the economic or other phenomena that it purports to represent" (paragraph 3.10 refers). However, paragraph BC35 of the Elements ED is discussing the *relevance* of different treatments of timing restrictions. If revenues and expenses were (consistent with the IASB Conceptual Framework) purported to be limited to certain changes in assets and liabilities, it could not be misleading to apply those definitions. In other words, disagreement with a treatment does not make that treatment misleading. Therefore, the AASB thinks it is pejorative to describe an approach that does not include deferrals as 'misleading'.

Assisting the pursuit of common ground

In its comments on the IPSASB CP, the AASB said it did not consider the so-called 'revenue and expense-led approach' (under which deferred inflows and deferred outflows are identified as elements) to be articulated clearly enough to enable proper comparison with the so-called ‘asset and liability-led approach’ (under which deferred inflows and deferred outflows are not identified as elements). The AASB said that:

(a) if the ‘revenue and expense-led approach’ were articulated more clearly, it may be feasible to identify the conceptual differences between the approaches and reduce the risk of disagreements based on misunderstandings about what each approach entails; and

(b) a ‘revenue and expense-led approach’, properly developed and in a form the AASB would find acceptable, might complement an ‘asset and liability-led approach’.

Unfortunately, the approach involving deferrals is not fleshed out in the ED, which includes less explanation of the proposed approach and its implications than in the CP. The AASB is concerned that, due to the lack of articulation of the approach proposed in the ED, respondents to the ED might provide feedback based on misapprehensions regarding the IPSASB’s proposals. Including such an approach in the completed IPSASB Framework could lead to differing interpretations of when deferred inflows and deferred outflows arise.

Alternative View of Ms. Jeanine Poggiolini

In relation to the foregoing comments, the AASB agrees with this Alternative View, set out in paragraphs AV7 – AV11.

Implications for the Future

If the IPSASB were to identify deferred inflows and deferred outflows as elements in its completed Framework, recognition of such deferrals should be required by IPSASs when they arise, and not simply an option. That is, the IPSASB could be expected to develop and amend IPSASs to require that treatment. Does the IPSASB have that in mind?