

Conceptual Framework Exposure Draft 2

November 2012

Comments due: April 30, 2013

*International Public Sector Accounting Standards
Board*

Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements

IPSASB

International Public
Sector Accounting
Standards Board

This document was developed and approved by the International Public Sector Accounting Standards Board (IPSASB).

The IPSASB sets International Public Sector Accounting Standards (IPSASs) for use by public sector entities, including national, regional, and local governments, and related governmental agencies.

The objective of the IPSASB is to serve the public interest by setting high-quality public sector accounting standards and by facilitating the adoption and implementation of these, thereby enhancing the quality and consistency of practice throughout the world and strengthening transparency and accountability of public sector finances.

The structures and processes that support the operations of the IPSASB are facilitated by the International Federation of Accountants (IFAC).

Copyright © November 2012 by the International Federation of Accountants (IFAC). For copyright, trademark, and permissions information, please see page 39.

REQUEST FOR COMMENTS

The proposals in Conceptual Framework Exposure Draft 2 (CF–ED2), *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements* may be modified in light of comments received before being issued in final form. **Comments are requested by April 30, 2013.**

Respondents are asked to submit their comments electronically through the International Public Sector Accounting Standards Board (IPSASB) website, using the “Submit a Comment” link. Please submit comments in both a PDF file and Word file. Also, please note that first-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website. Although IPSASB prefers that comments are submitted via its website, comments can also be sent to Stephenie Fox, IPSASB Technical Director, at stepheniefox@ipsasb.org.

This publication may be downloaded free of charge from the IPSASB website: www.ipsasb.org. The approved text is published in the English language.

Guide for Respondents

The IPSASB welcomes comments on all the proposals in CF–ED2. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for proposed changes to CF–ED2.

Specific Matters for Comment

The IPSASB would particularly value comments on the Specific Matters for Comment below.

Specific Matter for Comment 1

Do you agree with the definition of an asset? If not, how would you modify it?

Specific Matter for Comment 2

- (a) Do you agree with the definition of a liability? If not, how would you modify it?
- (b) Do you agree with the description of non-legal binding obligations? If not, how would you modify it?

Specific Matter for Comment 3

Do you agree with the definition of revenue? If not, how would you modify it?

Specific Matter for Comment 4

Do you agree with the definition of expenses? If not, how would you modify it?

Specific Matter for Comment 5

- (a) Do you agree with the decision to define deferred inflows and deferred outflows as elements? If not, why not?
- (b) If you agree with the decision to define deferred inflows and deferred outflows as elements, do you agree with the:
 - (i) Decision to restrict those definitions to non-exchange transactions? If not, why not?

(ii) Definitions of deferred inflows and deferred outflows? If not, how would you modify them?

Specific Matter for Comment 6

- (a) Do you agree with the terms net assets and net financial position and the definitions? If not, how would you modify the terms and/or definitions?
- (b) Do you agree with the decision to define ownership contributions and ownership distributions as elements? If not, why not?
- (c) If you agree with the decision to define ownership contributions and ownership distributions as elements, do you agree with the definitions of ownership contributions and ownership distributions? If not, how would you modify them?
- (d) Ownership interests have not been defined in this Conceptual Framework. Do you think they should be?

Specific Matter for Comment 7

Do you agree with the discussion on recognition? If not, how would you modify it?

BACKGROUND TO THE CONCEPTUAL FRAMEWORK

The *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (the *Conceptual Framework*) will establish and make explicit the concepts that are to be applied in developing International Public Sector Accounting Standards (IPSASs) and other documents that provide guidance on information included in general purpose financial reports (GPFRs).

IPSASs are developed to apply across countries and jurisdictions with different political systems, different forms of government and different institutional and administrative arrangements for the delivery of services to constituents. The International Public Sector Accounting Standards Board (IPSASB) recognizes the diversity of forms of government, social and cultural traditions, and service delivery mechanisms that exist in the many jurisdictions that may adopt IPSASs. In developing this *Conceptual Framework*, the IPSASB has attempted to respond to and embrace that diversity.

The Accrual Basis of Accounting

This Exposure Draft (ED) deals with concepts that apply to general purpose financial statements (financial statements) under the accrual basis of accounting.

Under the accrual basis of accounting, transactions and other events are recognized in financial statements when they occur (and not only when cash or its equivalent is received or paid). Therefore, the transactions, events and flows are recorded in the accounting records and recognized in the financial statements of the periods to which they relate.

Financial statements prepared under the accrual basis of accounting inform users of those statements of past transactions involving the payment and receipt of cash during the reporting period, obligations to pay cash or sacrifice other resources of the entity in the future and the resources of the entity at the reporting date. Therefore, they provide information about past transactions and other events that is more useful to users for accountability purposes and as input for decision-making than information provided by the cash basis or other bases of accounting or financial reporting.

Project Development

The IPSASB communicates *Conceptual Framework* developments to an advisory panel comprising a number of national standard setters and similar organizations with a role in establishing financial reporting requirements for governments and other public sector entities in their jurisdictions.

The purpose of the IPSASB's *Conceptual Framework* project is to develop concepts, definitions and principles that:

- Respond to the objectives, environment and circumstances of governments and other public sector entities; and therefore
- Are appropriate to guide the development of IPSASs and other documents dealing with financial reporting by public sector entities.

Many of the IPSASs currently on issue are based on International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), to the extent that the requirements of those IFRSs are relevant to the public sector. The IPSASB's strategy also includes maintaining the alignment of IPSASs with IFRSs where appropriate for the public sector.

The IASB has a project to update and refine its Conceptual Framework for profit-oriented entities. The IASB has recently reactivated this project following deliberations about its future work plan. Developments

in the IASB's Conceptual Framework are being monitored. However, development of the IPSASB's *Conceptual Framework* is not an IFRS convergence project, and the purpose of the IPSASB's project is not to interpret the application of the IASB Framework to the public sector.

The concepts underlying statistical financial reporting guidelines, and the potential for convergence with them, are also being considered by the IPSASB in developing its *Conceptual Framework*. The IPSASB is committed to minimizing divergence from statistical reporting guidelines where appropriate.

Consultation Papers and Exposure Drafts

Although all the components of the *Conceptual Framework* are interconnected, the *Conceptual Framework* project is being developed in phases. The components of the *Conceptual Framework* have been grouped as follows, and are being considered in the following sequence:

- Phase 1—the scope of financial reporting, the objectives of financial reporting and users of GPFRs, the qualitative characteristics of information included in GPFRs, and the reporting entity;
- Phase 2—the definition and recognition of the elements of financial statements;
- Phase 3—consideration of the measurement basis (or bases) that may validly be adopted for the elements that are recognized in the financial statements; and
- Phase 4—consideration of the concepts that should be adopted in deciding how to present financial and non-financial information in GPFRs.

The project initially involved the development and issue for comment of Consultation Papers (CPs) that drew out key issues and explored the ways in which those issues could be dealt with. The CP for Phase 1 (*The Objectives of Financial Reporting; The Scope of Financial Reporting; The Qualitative Characteristics of Information Included in General Purpose Financial Reports; The Reporting Entity*), was issued in September 2008. CPs dealing with Phase 2 (*Elements and Recognition in Financial Statements*) and Phase 3 (*Measurement of Assets and Liabilities in Financial Statements*) were issued in December 2010 and a CP dealing with Phase 4 (*Presentation in General Purpose Financial Reports*) was issued in January 2012. Following consideration of responses to these CPs, EDs are developed for each of the phases. The ED for Phase 1 was issued in December 2010 and, once finalized, will become the first four chapters of the Conceptual Framework. An ED, *Measurement of Assets and Liabilities in Financial Statements*, was also approved in September 2012 and was issued at the same time as this ED. A further ED will be issued on Phase 4.

CONCEPTUAL FRAMEWORK FOR GENERAL PURPOSE FINANCIAL REPORTING BY PUBLIC SECTOR ENTITIES: ELEMENTS AND RECOGNITION IN FINANCIAL STATEMENTS

CONTENTS

	Page
1. Introduction	8
Purpose of this Exposure Draft.....	8
Elements and their Importance.....	8
Elements Defined in the ED and Approach to Recognition.....	8
2. Assets	10
Definition.....	10
3. Liabilities	12
Definition.....	12
4. Revenue and Expenses	15
Definitions	15
Financial Performance.....	15
5. Deferred Inflows and Deferred Outflows	16
Definitions	16
6. Net Assets, Net Financial Position, Ownership Contributions, and Ownership Distributions	17
Net Assets and Net Financial Position	17
Ownership Contributions and Ownership Distributions	17
7. Recognition.....	18
Recognition Criteria and their Relationship to Disclosure	18
Existence Uncertainty.....	18
Measurement Uncertainty	18
Derecognition.....	19
Basis for Conclusions	
Alternative Views	
Appendix 1A The IASB Conceptual Framework (September 2010)	
Appendix 1B Statistical Reporting Guidelines of the 1993 System of National Accounts (updated 2008) and Other Guidance derived from it (ESA 95 and GFSM 2001)	

1. Introduction

Purpose of this Exposure Draft

- 1.1 This Exposure Draft (ED) proposes definitions of elements used in general purpose financial statements (financial statements) of governments and other public sector entities (public sector entities) and provides further explanation about these definitions. It also deals with recognition.

Elements and their Importance

- 1.2 Financial statements portray the financial effects of transactions and other events by grouping them into broad classes which share common economic characteristics. These broad classes are termed the elements of financial statements. Elements are the building blocks from which financial statements are constructed. These building blocks provide an initial point for recording, classifying and aggregating economic data and activity in a way that provides users with information that meets the objectives of financial reporting¹ and contributes to the qualitative characteristics (QCs) of financial reporting.² The elements in the statement of financial position are assets, liabilities, deferred inflows, deferred outflows, ownership contributions and ownership distributions. The elements in the statement of financial performance are revenue and expenses. Determining which definition an item meets will, subject to the satisfaction of recognition criteria, also determine the financial statement in which the item is displayed.
- 1.3 The elements defined in this ED determine which information is presented in the financial statements and the generic types of such information. They are not the individual items themselves. Sub-classifications of individual items within an element and aggregations of combinations of items are used to enhance the understandability of the financial statements. Issues of presentation are addressed in Phase 4 of the *Conceptual Framework*.

Elements Defined in the ED and Approach to Recognition

- 1.4 The elements that are defined in this ED are:
- (a) Assets;
 - (b) Liabilities;
 - (c) Revenue;
 - (d) Expenses;
 - (e) Deferred inflows;
 - (f) Deferred outflows;
 - (g) Ownership contributions; and
 - (h) Ownership distributions.
- 1.5 Net assets is the aggregate of an entity's assets less liabilities at the reporting date and can be represented by:

$$\text{Assets} - \text{Liabilities} = \text{Net Assets}$$

¹ The objectives of financial reporting, as stated in Phase 1 of the Framework, are accountability and decision making.

² The QCs are relevance, faithful representation, comparability, verifiability, timeliness and understandability.

- 1.6 Net financial position is the aggregate of an entity's assets and deferred outflows less an entity's liabilities and deferred inflows at the reporting date and can be represented by:

$$\text{Assets} + \text{Deferred Outflows} - (\text{Liabilities} + \text{Deferred Inflows}) = \text{Net Financial Position}$$

- 1.7 The relationship between net assets and net financial position is represented by:

$$\text{Net Assets} + \text{Deferred Outflows} - \text{Deferred Inflows} = \text{Net Financial Position}$$

- 1.8 While net assets and net financial position are defined, neither are elements. Section 6 discusses net assets and net financial position in more detail.
- 1.9 Recognition is a separate process after a transaction or other event has met the definition of an element. Recognition is addressed in Section 7.
- 1.10 The Appendices include boxed comparisons with the International Accounting Standards Board's (IASB) Framework and Statistical Reporting Guidelines.

2. Assets

Definition

2.1 An asset is a resource, with the ability to provide an inflow of service potential or economic benefits that an entity presently controls, and which arises from a past event.

A Resource

2.2 A resource is an item with the ability to provide an inflow of service potential or economic benefits. That resource must be controlled by the entity (see paragraph 2.6.) Physical form is not a necessary condition of an asset. The benefits can arise directly from the resource itself or from the rights to the resource. Some resources embody an entity's rights to a variety of benefits including, for example, the right to:

- (a) Use the resource to provide services;
- (b) Use an external party's resources to provide services, for example, leases;
- (c) Convert the resource into cash through its disposal;
- (d) Benefit from the resource's appreciation in value; and
- (e) A stream of cash flows.

Service Potential or Economic Benefits

2.3 The benefits provided by a resource are service potential or economic benefits. Service potential is the capacity of an asset to be used by the entity to provide goods and services that contribute to achieving the entity's objectives. Service potential enables an entity to achieve its objectives without necessarily generating net cash inflows.

2.4 Public sector assets that embody service potential may include recreational, heritage, community, defense and other assets which are held by governments and other public sector entities and provide goods and services to third parties. Such goods and services may be for collective or individual consumption. Many goods and services may be provided in areas where there is no market competition or limited market competition. The use and disposal of such assets may be restricted. As highlighted in the ED, *Key Characteristics of the Public Sector with Potential Implications for Financial Reporting (Key Characteristics)*,³ many assets that embody service potential are specialized in nature in order to meet specific objectives.

2.5 Economic benefits take the form of cash inflows or a reduction in cash outflows. Cash inflows (or reduced cash outflows) may be derived from:

- (a) An asset's use in the production and sale of goods and services;
- (b) The direct exchange of an asset for cash or other resources; or
- (c) Holding cash itself because of its capacity to acquire other resources.

In addition, an asset may be used to settle a liability or to make an ownership distribution.

³ Issued in April 2011.

An Entity Presently Controls

- 2.6 An entity must have control of the resource at the reporting date. Control of the resource entails:
- (a) The ability of the entity to use the asset's benefits, in the form of service potential or economic benefits, flowing from the resource; or
 - (b) The ability of the entity to direct other parties on the nature and manner of use of the benefits embodied in the resource.
- 2.7 In assessing whether it controls a resource, an entity assesses whether the following indicators of control exist:
- (a) Legal ownership;
 - (b) Access to or, conversely, the ability to deny or restrict access to the resource;
 - (c) The means to ensure that the resources are used to achieve its objectives; and
 - (d) The existence of an enforceable right to service potential or economic benefits arising from a resource.

While these indicators are not conclusive determinants of whether control exists, identification and analysis of them can inform that decision. For example, if an entity cannot deny the access of certain external parties to a resource it is questionable whether the entity has an asset.

Past Event

- 2.8 The definition of an asset requires that an asset arises from a past transaction or other event. Entities can obtain assets by purchasing them in an exchange transaction or producing them. In such cases, identification of the past transaction or other event is straightforward. Assets may also arise through non-exchange transactions, including by exercising of sovereign powers. The power to tax or to issue licenses, and to access or restrict or deny access to the benefits embodied in intangible resources like the electromagnetic spectrum, are examples of powers and rights that other non-public sector entities do not have. It is essential to determine the point or event at which such rights or powers give rise to an asset of the entity. There are a number of potential points at which such events may occur. Taking the example of a tax, the following points in the process may be identified: (a) a general ability to tax, (b) establishment of a power through a statute, (c) exercising the power to create a right, or (d) the taxable event which gives rise to an obligation of another party to pay the tax. When the power is exercised and the rights exist to receive service potential or economic benefits, an asset arises.

3. Liabilities

Definition

- 3.1 A liability is a present obligation that arises from a past event where there is little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity.

A Present Obligation

- 3.2 A present obligation is a legal or non-legal binding requirement, which an entity has little or no realistic alternative to avoid, that requires an entity to deliver services or economic benefits to another party.

Past Event

- 3.3 The complexity of public sector programs and activities means that, particularly for non-legal binding obligations, there are a number of potential points in the development, implementation and operation of a program at which a present obligation may arise. It is therefore essential to identify a past event in order to determine whether an obligation is a present obligation. Where an arrangement has a legal form a past event may be straightforward to identify, such as when a contract is entered into. In other cases it may be more difficult to identify the past event and identification involves analysis of when an entity has little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity.

Little or No Realistic Alternative to Avoid

Legal and Non-Legal Binding Obligations

- 3.4 Binding obligations can be legal or non-legal and arise from both exchange and non-exchange transactions. An obligation must be to an external party in order to give rise to a liability. An entity cannot be obligated to itself, even where it has publicly communicated an intention to behave in a particular way. Identification of the external party to which the obligation is owed is an indication of the existence of an obligation giving rise to a liability. However, it is not essential to know the identity of the external party before the time of settlement in order for a present obligation and liability to exist.
- 3.5 Many arrangements that give rise to an obligation include settlement dates. The inclusion of a settlement date may provide an indication that an inflow gives rise to a liability and is not an ownership contribution (see Section 6). However, there are many agreements that do not contain settlement dates. The absence of a settlement date does not preclude an obligation giving rise to a liability.

Legal Obligations

- 3.6 A legal obligation is enforceable in law. Such enforceable obligations may arise from a variety of legal constructs. Exchange transactions are usually contractual in nature and therefore enforceable through the laws of contract or equivalent. There are jurisdictions where government and public sector entities cannot have legal obligations because, for example, they are not permitted to contract in their own name, but where there are alternative processes with equivalent effect. Obligations that are binding through such alternative processes are considered legal obligations in this Framework. For some types of non-exchange transactions, judgment will be necessary to

determine whether an obligation is enforceable in law. Where it is determined that an obligation is enforceable in law there can be no doubt that an entity has no realistic alternative to avoid the obligation and that a liability exists.

- 3.7 Enforceability does not include “economic coercion,” where, although the public sector entity is not under a legal obligation to settle, the economic consequences to the entity of refusing to do so are such that the entity may not have a realistic alternative but to settle an obligation. Economic coercion may, however, lead to a liability arising from a non-legal binding obligation (see paragraphs 3.10–3.12).
- 3.8 Some obligations related to exchange transactions are not strictly enforceable by an external party at the reporting date, but will be enforceable with the passage of time without the external party having to meet further conditions—that is to say having to take any further action—prior to settlement. Claims that are unconditionally enforceable subject to the passage of time therefore are enforceable obligations in the context of the definition of a liability.
- 3.9 Sovereign power is the ultimate authority of a government to make, amend and repeal legal provisions. Sovereign power is not a rationale for the non-recognition of obligations that, otherwise, meet the definition of a liability in this Framework. The position should be assessed at each reporting date to consider if the legal position has changed and to determine whether a liability still exists.

Non-Legal Binding Obligations

- 3.10 Liabilities can also arise from non-legal binding obligations. A non-legal binding obligation differs from a legal enforceable obligation in that the party to whom the obligation exists cannot take legal action to enforce settlement. A non-legal binding obligation that gives rise to a liability has the following attributes :
 - (a) The entity has indicated to other parties by an established pattern of past practice, published policies, or a sufficiently specific current statement that it will accept certain responsibilities;
 - (b) As a result of such an indication, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities; and
 - (c) The entity has little or no realistic alternative to avoid settling the obligation arising from those responsibilities.
- 3.11 It is essential to determine the point at which a non-legal obligation becomes binding and gives rise to a liability. In the public sector obligations may arise at a number of points. For example, there are a number of early points in implementing a program or service, including:
 - (a) Making a political promise such as an electoral pledge;
 - (b) Announcement of a policy;
 - (c) Introduction (and approval) of budget (which may be two distinct points); and
 - (d) Budget becoming effective (in some jurisdictions the budget will not be effective until an appropriation has been effected).
- 3.12 These early stages are unlikely to give rise to obligations that meet the definition of a liability. Later stages, such as claimants meeting the eligibility criteria for the service to be provided, may give rise to obligations that meet the definition of a liability. The point at which a non-legal binding obligation

gives rise to a present obligation critically depends on the nature of the obligation. Indicators that are likely to impact on judgments whether the obligation is one that other parties can validly conclude that the entity has little or no realistic alternative to avoid an outflow of service potential or economic benefits include:

- (a) The nature of the past event or events that give rise to the obligation. For example, a promise made in an election is unlikely to give rise to a present obligation because an electoral pledge very rarely creates a valid expectation on the part of external parties that the entity has an obligation that it cannot avoid settling. However, an announcement made in the legislature by a majority government, particularly one with all party support, in relation to an event or circumstance that has occurred, and where the government has committed to introduce and secure passage of the necessary budgetary provision may give rise to a non-legal binding obligation.
- (b) The ability of the entity to modify or change the obligation before it crystallizes. For example, the announcement of policy will generally not give rise to a non-legal binding obligation which cannot be modified before being implemented. Similarly, if an obligation is contingent on future events occurring, there may be discretion to avoid an outflow of service potential or economic benefits before those events occur.
- (c) There may be a correlation between the availability of funding to settle a particular obligation and the creation of a present obligation. For example, where both a budget line item has been approved and linked funding is assured through an appropriation, the availability of contingency funding or a transfer from a different level of government, there is a presumption that a present non-legal binding obligation exists. However the absence of a budgetary provision may not, by itself be a reason for not recognizing a liability.

An Outflow of Service Potential or Economic Benefits from the Entity

3.13 A liability must involve an outflow of service potential or economic benefits from the entity in order to settle it. An obligation that can be settled without an outflow of resources is not a liability.

4. Revenue and Expenses

Definitions

4.1 Revenue is:

- (a) Inflows during the current reporting period, which increase the net assets of an entity, other than:
 - (i) Ownership contributions; and
 - (ii) Increases in deferred inflows; and
- (b) Inflows during the current reporting period that result from decreases in deferred inflows.

4.2 Expenses are:

- (a) Outflows during the current reporting period which decrease the net assets of an entity, other than:
 - (i) Ownership distributions; and
 - (ii) Increases in deferred outflows; and
- (b) Outflows during the current reporting period that result from decreases in deferred outflows.

During the Reporting Period

4.3 Revenue and expenses relate to the current reporting period. This distinguishes them from deferred inflows and deferred outflows that relate to a specified future reporting period. Inflows and outflows relating to unspecified future reporting periods are attributed to revenue and expenses of the current reporting period. A reduction in liabilities can also give rise to revenue.

Increases and Decreases in Net Assets

- 4.4 Revenue and expenses can arise from exchange and non-exchange transactions, other events such as price changes, unrealized increases and decreases in the value of assets and/or liabilities, and the consumption of assets through depreciation and erosion of service potential and economic benefits through impairments. They may arise from individual transactions or groups of transactions.
- 4.5 The definitions of revenue and expenses encompass all increases and decreases in net assets other than ownership contributions, deferred inflows, ownership distributions and deferred outflows. The definition of revenue includes inflows during the current reporting period that result from decreases in deferred inflows. The definition of expenses includes outflows during the current reporting period that result from decreases in deferred outflows.
- 4.6 Section 6 discusses ownership interests and provides definitions of ownership contributions and ownership distributions. Section 5 provides definitions of deferred inflows and deferred outflows.

Financial Performance

4.7 All items that meet the definition of revenues and expenses and the recognition criteria set out in Section 7 are reported on the Statement of Financial Performance. The difference between revenue and expenses is the entity's surplus or deficit for the period, which is the primary indicator of financial performance.

5. Deferred Inflows and Deferred Outflows

Definitions

- 5.1 A deferred inflow is an inflow of service potential or economic benefits provided to the entity for use in a specified future reporting period that results from a non-exchange transaction and increases net assets.
- 5.2 A deferred outflow is an outflow of service potential or economic benefits provided to another entity or party for use in a specified future reporting period that results from a non-exchange transaction and decreases net assets.

Specified Future Reporting Period

- 5.3 A deferred inflow is to be used by the entity in one or more specified future reporting periods. An example of a deferred inflow is a multi-year grant transferred to the entity that does not meet the definition of a liability, but includes a stipulation by the transferor that it is to be used to finance the general activities of the entity over one or more specified future reporting periods.
- 5.4 A deferred outflow is to be used by the transferee in one or more future reporting periods. An example of a deferred outflow is a multi-year grant transferred by the entity that contains no conditions, but a stipulation by the transferor that it is to be used for the general activities of the recipient entity or party over one or more specified future reporting periods.
- 5.5 When the specified future reporting period occurs, the flows are no longer deferred. A decrease in a deferred inflow would be recognized as revenue. A decrease in a deferred outflow would be recognized as an expense.

Non-Exchange Transactions

- 5.6 Deferred inflows and deferred outflows arise only from non-exchange transactions. Increases or decreases in net assets related to exchange transactions are accounted for as revenue and expenses, ownership contributions or ownership distributions.

6. Net Assets, Net Financial Position, Ownership Contributions, and Ownership Distributions

Net Assets and Net Financial Position

- 6.1 Net assets is the difference between assets and liabilities. Net financial position is the difference between assets and liabilities after deducting deferred inflows and adding deferred outflows. Neither net assets nor net financial position are elements.
- 6.2 All items that meet the definition of assets, liabilities, deferred inflows, deferred outflows, ownership contributions, and ownership distributions, and satisfy the recognition criteria set out in Section 7 are reported on the Statement of Financial Position. Net financial position can be a positive or negative residual amount.

Ownership Contributions and Ownership Distributions

Definitions

- 6.3 Ownership contributions are inflows of resources to an entity, contributed by external parties that establish or increase an interest in the net assets of the entity.
- 6.4 Ownership distributions are outflows of resources from the entity, distributed to external parties that return or reduce an interest in the net assets of the entity.
- 6.5 It is important to distinguish inflows of resources from owners and outflows of resources to owners, in their role as owners, from revenue, expenses, deferred inflows and deferred outflows. In addition to the injections of resources and dividend payments that may occur, in some jurisdictions it is relatively common for assets and liabilities to be transferred between public sector entities for no consideration.
- 6.6 Ownership interests may arise on the creation of an entity when another entity contributes resources to provide the new entity with the capacity to commence operational activities. In the public sector, contributions to, and distributions from, entities are sometimes linked to the restructuring of government and will take the form of transfers of assets and liabilities rather than cash transactions. Ownership interests may take different forms, which may not be evidenced by an equity instrument.
- 6.7 Ownership contributions give a right to a return or increased return to owners, and may take the form of an initial injection of resources at the creation of an entity or a subsequent injection of resources, including injections in the event of the entity being restructured. The return to owners may be either a) a return on investment; b) a return of investment; or, c) in the event of the entity being wound up or restructured, a return of any net assets.

7. Recognition

Recognition Criteria and their Relationship to Disclosure

- 7.1 Recognition is the process of incorporating in the appropriate financial statement an item that meets the definition of an element and can be measured in a way that meets the QCs. Recognition is a distinct stage in the accounting process. Therefore the definitions of the elements do not include recognition criteria. Recognition involves an assessment of existence uncertainty and measurement uncertainty. The conditions that give rise to uncertainty can change. Therefore it is important that uncertainty is assessed at each reporting date.
- 7.2 The failure to recognize items that meet the definition of an element and the recognition criteria is not rectified by the disclosure of accounting policies, notes or other explanatory detail. However disclosure can provide information on items that meet many, but not all the essential characteristics of the definition of an element. Disclosure can also provide information on items that meet the definition of an element but cannot be measured in a manner that is sufficiently representationally faithful to meet the objectives of financial reporting. Disclosure is appropriate when knowledge of the item is considered to be relevant to the evaluation of the net financial position of the entity and therefore meets the objectives of financial reporting.

Existence Uncertainty

- 7.3 Determining whether the definition of an element has been satisfied requires judgment. Although the occurrence of a transaction is not necessary in order for an element to exist, transactions are the most common basis for recognizing and derecognizing items as elements. For example, the acquisition of medical equipment normally provides sufficient information to justify the recognition of an asset; similarly an employee providing services in accordance with a contract of employment gives rise to a liability and an expense of the employer. In other cases, it may be more difficult to determine whether an economic event creates an item that meets the definition of an element, because entities operate in uncertain environments.
- 7.4 Uncertainty is addressed by assessing the available evidence in order to make a neutral judgment about whether an element exists, taking into account all available facts and circumstances at the reporting date. If it is determined that an element exists, uncertainty about the flows of service potential or economic benefits related to that element are taken into account in the measurement of that element. Preparers should review and assess all available evidence in determining whether sufficient evidence exists that an element should be recognized initially, whether that element continues to qualify for recognition (see paragraph 7.7), or whether there has been a change to an existing element.

Measurement Uncertainty

- 7.5 In order to recognize an item in the financial statements, it is necessary to attach a monetary value to the item. This entails choosing an appropriate measurement basis and determining whether the measurement is sufficiently relevant and faithfully representative for the item to be recognized in the financial statements. The selection of an appropriate measurement basis is considered in the ED, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements* (CF–ED3).

- 7.6 There may be uncertainty associated with the measurement of many amounts presented in the financial statements. The use of estimates is an essential part of the accrual basis of accounting. A decision about the relevance and faithful representativeness of measurement involves the consideration of techniques, such as using ranges of outcomes and point estimates; and whether additional evidence is available about economic circumstances that existed at the reporting date.

Derecognition

- 7.7 Derecognition is the process of evaluating whether changes have occurred since the previous reporting date that warrant removing an item that has been previously recognized from the financial statements. In evaluating existence uncertainty the same criteria are used for derecognition as at initial recognition.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the Conceptual Framework.

Section 1: Introduction

BC1. When the IPSASB initiated Phase 2 of the Framework project, the IPSASB decided that the initial focus should be on the financial statements. Respondents to Conceptual Framework, Consultation Paper, *Elements and Recognition in Financial Statements* (CF–CP2) questioned why the IPSASB was only addressing elements for the financial statements in this phase of the Framework and suggested that IPSASB should also develop elements for economic phenomena in the “more comprehensive” areas of financial reporting outside the financial statements, as outlined in Phase 1 of the Framework. The IPSASB acknowledged the merits of these views and agrees that there is a need to develop such elements in the future. The IPSASB, however, decided that in order to put its future standard-setting activities for the financial statements on a sound and transparent footing it is important to deal firstly with the development of elements for the financial statements.

Elements

BC2. As a result of the nature of activities undertaken in the public sector, the IPSASB formed a view that a focus on the current year activities of a public sector entity is important in providing information for the users of financial statements and thereby in achieving the objectives of financial reporting. In order to distinguish between those transactions that relate to the reporting period and those that relate to a specified future period, the IPSASB concluded that those non-exchange transactions that are specified for use in a different reporting period should be shown as separate elements, described as deferred inflows and deferred outflows. The introduction of these separate elements has led to the need to distinguish between net assets which is the difference between assets and liabilities, and net financial position which is assets plus deferred outflows less liabilities and deferred inflows.

Section 2: Assets

A Resource

BC3. In the public sector, assets are a resource with the ability to provide services or economic benefits. In stating in paragraph 2.2 that physical form is not a necessary condition of an asset, the IPSASB acknowledged that many assets, such as buildings, equipment and inventories are tangible, while others, such as current rights are intangible. Financial assets, such as bonds and derivatives are a further category of assets that do not have physical form.

BC4. The IPSASB recognized that other rights to benefits may not be directly associated with a particular tangible, intangible or financial resource. An example is the right to require other parties to perform in a certain way, by, for example, making payments or providing goods and services in a manner specified by the entity. One or more public sector entities may also share in the benefits under a joint venture arrangement with another entity.

BC5. The IPSASB then considered whether a resource arises from the following arrangements:

- Unconditional rights.

- Executory contracts.

Unconditional Rights

BC6. The unconditional rights of external parties typically result from contracts or other binding arrangements that require provision of resources to the entity in the future. The IPSASB noted that there can be a large number of such rights and concluded that such unconditional promises may give rise to assets, if the entity has paid for them or if the unconditional right has acquired an identifiable value in an open, active and orderly market. The identification of circumstances where unconditional rights may give rise to an asset is a standards-level issue.

Executory Contracts

BC7. Executory contracts are binding arrangements, where there is an unconditional promise to receive benefits and an equal promise to transfer resources to the counterparty in the future. Public sector entities are likely to engage in a large number of such arrangements. The IPSASB acknowledged the view that such arrangements may give rise to both assets and liabilities, as the promise to receive benefits is likely to have value and the promise to transfer benefits involves a present obligation to sacrifice resources, which the entity has no realistic alternative to avoid. The IPSASB also acknowledged the view that recognizing assets and liabilities from executory contracts would involve the inclusion of potentially very large offsetting amounts in the statement of financial position and the statement of financial performance and that this may conflict with the QC of understandability. The IPSASB therefore concluded that determining whether the rights and obligations related to executory contracts should be recognized as elements is a standards-level issue.

Service Potential and Economic Benefits

BC8. The term “service potential” has been used to identify the capacity of an asset to provide goods and services in accordance with an entity’s objectives. The term “economic benefits” has been used to reflect the ability of an asset to generate net cash inflows. Some argue that economic benefits includes service potential, others argue that service potential includes economic benefits, and still others consider that the terms can be used interchangeably. The IPSASB considered whether in the context of the substance of an asset the definition should include a reference to both service potential and economic benefits. The IPSASB acknowledged the view that economic benefits includes service potential and also considered the converse view that because the primary objective of public sector entities is the delivery of goods and services, generally in non-exchange transactions, that service potential should be separately identified. The IPSASB noted that many respondents to CF–CP2 supported a specific reference to service potential on the grounds noted above.

BC9. The IPSASB therefore concluded that because the primary objective of most public sector entities is to deliver goods and services, but also in acknowledgment of the fact that public sector entities may carry out activities with the sole objective of generating net cash inflows, the definition of an asset should include both the terms service potential and economic benefits.

An Entity Presently Controls

- BC10. Control entails (a) the ability of an entity to use the asset's benefits in the form of service potential or economic benefits flowing from the resource, and (b) the ability to direct other parties on the nature and manner of use of the benefits embodied in the resource.
- BC11. The IPSASB considered whether "control" is an essential characteristic in the definition of an asset or whether other indicators such as (a) legal ownership, (b) the ability to allow access to or, conversely, to restrict or deny the access of external parties to the resource or benefits, (c) the means to ensure that the resources are used to achieve its objectives, and (d) the existence of enforceable rights to service potential or economic benefits arising from a resource, are essential characteristics of an asset that should be included in the definition. The IPSASB acknowledged the views of those who argue that control may be difficult to apply in some cases because it requires judgment to assess whether control exists. In addition, control can be erroneously applied to a resource in its entirety and not to the individual benefits that accrue from the resource. However, notwithstanding such difficulties, the IPSASB concluded that control is an essential characteristic of an asset because the presence of control facilitates the association of an asset with a specific entity, particularly in the public sector environment.
- BC12. Legal ownership of the underlying resource, such as a property or item of equipment, is one method of accessing the benefits provided by an asset. However, rights to benefits may exist without legal ownership of the underlying resource. For example, the rights to the benefits through the holding and use of leased property are accessed without legal ownership of the leased asset itself. Therefore, legal ownership is not an essential characteristic of the definition of an asset. Legal ownership is, however, an indicator of control.
- BC13. The right to access a resource may give an entity the ability to determine whether to (a) directly use the resource's service potential to provide services to beneficiaries, (b) exchange the benefits for another asset, such as cash, or (c) use the asset in any of the other ways that may provide benefits. While it might be questionable whether a resource that cannot be used to meet an entity's objectives gives rise to an asset, it is possible that such a resource could be exchanged for an alternative and more appropriate resource.
- BC14. While access to a resource is crucial there are resources to which an entity has access which do not give rise to assets, such as air. Therefore, the ability to access a resource must be supplemented by the ability to deny or restrict the access of others to that resource. For example, (a) an entity might decide whether to set an entrance fee to a museum, and (b) government may control a natural resource under its land to which it can restrict the access of others. Legally enforceable claims to specific benefits such as right of road access or to explore land for mineral deposits could represent an asset to the holder. However an entity may be able to access the benefits associated with a resource in ways other than legal rights. For example, an entity may be able to ensure continuing access to specific rights by imposing effective economic or social sanctions on other parties.
- BC15. The IPSASB took the view that the factors identified in paragraphs BC13 and BC14 are likely to be persuasive indicators of the existence of control rather than essential characteristics. For example, the inability of an entity to restrict or deny access of some external parties to a resource may question whether the resource constitutes an asset of the entity.

- BC16. The IPSASB examined whether the economic ownership approach is a viable alternative to the control approach. The economic ownership approach focuses on an entity's exposure to the underlying economic attributes that contribute to an asset's value to the entity. Some respondents to CF–CP2, in supporting the control approach, commented on the complexity of the economic ownership approach. The IPSASB concluded that the economic ownership approach is subjective and difficult to operate and therefore rejected this approach. The IPSASB then considered whether an analysis of exposure to the risks and rewards of ownership is a useful indicator of control. The IPSASB decided not to include such an indicator of control, because it is not compatible with the control approach.

Past Event

- BC17. Some argue that identification of a past event is an essential characteristic of an asset. Others take the view that the identification of a past transaction or event is of less significance and should not therefore be an essential characteristic of an asset. They consider that such a requirement places undue emphasis on identifying the past event that gave rise to an asset. Such a focus may be a distraction and lead to debates about which event is the triggering event instead of focusing on whether the rights to benefits exist at the reporting date. Those who take this view consider that the essential characteristic should be the existence of a present resource. Some may accept that a past transaction might provide useful supporting evidence of the existence of a present resource.
- BC18. Many respondents to CF–CP2 took the view that a past event should be an essential characteristic of the definition of an asset. The IPSASB agreed with these respondents. In particular, the IPSASB considered that the complex nature of many public sector programs and activities means that there are a number of points at which a present resource might arise and therefore identification of the appropriate past event is crucial in identifying whether an asset exists.
- BC19. As highlighted in *Key Characteristics* the powers and rights of government are particularly significant in the recognition of assets. Assets may be created in non-exchange transactions, and by virtue of the exercise of sovereign powers. The power to tax and issue licenses, and other powers to access or to deny or restrict access to the benefits embodied in intangible resources like the electromagnetic spectrum are examples of powers that private sector entities do not have. Given the significant powers that accrue to sovereign governments, and, in certain circumstances, other public sector entities, it is often difficult to determine when such powers give rise to a right that is a present resource and asset of the entity.
- BC20. A government's power to establish a right to levy a tax or fee, for example, often begins a sequence of events that ultimately results in the flow of economic benefits to the government. The IPSASB considered two views of when an asset arises from the powers and rights of government. The first view is that the government has an inherent power to tax at every reporting date and therefore that the general ability to levy taxes or fees is an asset. Proponents of this view accept that such an asset is unlikely to be capable of faithfully representative measurement, but argue that this should not deflect from the view that government has a perpetual asset. The countervailing view is that the power to levy taxes and fees must be converted into a right by legal means and that such a right must be exercised or exercisable in order for an asset to come into existence. Many respondents to CF–CP2 supported this latter view. The IPSASB agreed with these respondents. In

particular, the IPSASB considered that a government's inherent powers do not give rise to assets until these powers are exercised and the rights exist to receive service potential or economic benefits.

Section 3: Liabilities

A Present Obligation

BC21. In considering when obligations are present obligations the IPSASB accepted that a legal obligation gives rise to a present obligation. What is binding may vary between jurisdictions but there is usually general agreement that those obligations that are recognized in law in a jurisdiction give rise to a present obligation. In some jurisdictions public sector entities are not permitted to enter into certain legal arrangements, but there are equivalent mechanisms. Such mechanisms are considered legally binding. The IPSASB then considered how to classify other obligations. The IPSASB noted that "constructive obligations" is a term embedded in standard setting literature globally and has been used in IPSASs. However, it has proved difficult to interpret and apply in a public sector context. Therefore, the IPSASB considered alternative terminology, for example the term "a social or moral duty or requirement." The IPSASB was concerned that the term "social" might be confused with political values and that the term "moral obligations" risks a perception that standard setters and preparers are arbiters of morality. The IPSASB therefore decided that making a distinction between legal and non-legal binding obligations was the most straightforward and understandable approach. Paragraph BC31 discusses non-legal binding obligations.

Conditional and Unconditional Obligations

BC22. An unconditional obligation is one that stands on its own, independent of future events. A conditional obligation relies on the possible occurrence of a future event. The IPSASB concluded that distinguishing between conditional and unconditional obligations is not useful for the purpose of defining a liability because it is possible for conditional obligations to give rise to liabilities. The identification of circumstances where conditional obligations may give rise to liabilities is a standards-level issue.

Stand-Ready Obligations

BC23. Stand-ready obligations are obligations that require an entity to be prepared to fulfill an obligation if a specified uncertain event occurs (or fails to occur). The liability is the unconditional obligation to provide a service, which results in an outflow of economic benefits. CF-CP2 included a discussion of stand-ready obligations. Many respondents indicated that the distinction between a conditional obligation and a stand-ready obligation is ambiguous.

BC24. The IPSASB formed a view that the notion of a stand-ready obligation is workable and valuable in certain contractual circumstances, such as those related to insurance, certain financial instruments such as a derivative contract in a loss position, and for warranties. In such circumstances there may be an identifiable past event and an outflow of resources, although the exact identity of the party to whom settlement will be made will not generally be known. However, the notion of a stand-ready obligation does not work well in a public sector non-exchange context where it is very difficult to distinguish a stand-ready obligation from

other conditional obligations. The IPSASB was concerned that the use of the term stand-ready obligations could give rise to assumptions about the recognition of liabilities related to the ongoing provision of social benefits. The IPSASB did not wish this to occur, and considered that the issue of liabilities arising from social benefits should be considered at the standards level. On balance, the IPSASB decided that use of the term stand-ready obligations in the Framework would not provide a sound basis for future standard setting.

Performance Obligations

- BC25. A performance obligation is an obligation in a contract or other binding arrangement between a public sector entity and an external party to transfer a resource to that other party. Performance obligations are often explicitly stated in a contract or other agreement and may vary between jurisdictions. Not all performance obligations are explicit. For example, a statutory requirement may give rise to an implicit performance obligation on a public sector entity that is additional to the terms of an agreement or contract.
- BC26. A performance obligation also arises when an entity enters into an arrangement whereby it receives a fee and, in return, provides an external party with access to an asset of the government. The IPSASB concluded it is not necessary to identify a specific external party but it is important to analyze such obligations in order to determine whether they include a requirement to sacrifice resources. Obligations that require an entity to provide access to a resource, but do not entail an outflow of resources are not performance obligations and do not give rise to liabilities. However, obligations that require an entity to forgo future resources may be liabilities. The IPSASB concluded that, because performance obligations are normally conditional obligations and because the issues in determining whether such obligations give rise to liabilities is dependent upon the terms of particular binding agreements and may vary between jurisdictions, it would not be appropriate to use the term “performance obligation” in the Framework.

Past Event

- BC27. The IPSASB considered whether the definition of a liability should require the existence of a past event. Some contend that identification of a past event is not an essential characteristic of a liability and that there is consequently no need for the definition of a liability to include a reference to a past event. These commentators argue that there may be many possible past events and that establishing the key past event is likely to be arbitrary. They suggest that the existence of a past event is irrelevant in determining whether a present obligation exists at the reporting date.
- BC28. The IPSASB acknowledged this view, but also noted that many respondents to CF–CP2 considered it necessary to include a specific reference to a past event. The IPSASB agreed with the view that the complexity of many public sector programs and activities and the number of potential points at which a present obligation might arise means that, although challenging, identification of the key past event that gives rise to a liability is critical in determining when public sector liabilities should be recognized.

Little or No Realistic Alternative to Avoid

- BC29. Interpreting the term “little or no realistic alternative to avoid” in the context of a liability is a crucial issue in public sector financial reporting. In particular the IPSASB considered the issue of whether liabilities can arise from obligations that are not enforceable by legal or equivalent means. The IPSASB acknowledged that determining when a present obligation arises in a public sector context is complex and, in some cases, could be considered arbitrary. In the context of programs to deliver social benefits there are a number of stages at which a present obligation can arise and there can be significant differences between jurisdictions, even where programs are similar, and, over time, within the same jurisdiction. For example, different age cohorts are likely to have different expectations about the likelihood of receiving benefits under a social assistance program. Such variation does not promote consistency and can mean that information reported on liabilities does not meet the QC of understandability. This view suggests that an essential characteristic of a liability should be that it is enforceable at the reporting date by legal or equivalent means.
- BC30. A converse view is that where a government has a record of honoring obligations, failing to recognize them leads to an understatement of that government’s liabilities. For example, if a government has a consistent record of meeting publicly-announced obligations to provide financial support to the victims of natural disasters, a failure to treat such obligations as liabilities is not in accordance with the objectives of financial reporting and, in particular, does not meet the QCs of faithful representation and relevance.
- BC31. On balance, the IPSASB agreed with those who argue that, in the public sector, liabilities can arise from non-legal binding obligations. However, the IPSASB acknowledged the views of those who are skeptical that liabilities can arise from other than legally enforceable obligations. The IPSASB considers that a non-legal binding obligation which gives rise to a liability has the following attributes:
- (a) The entity has indicated to other parties by an established pattern of past practice, published policies, or a sufficiently specific current statement that it will accept certain responsibilities;
 - (b) As a result of such an indication, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities; and
 - (c) The entity has little or no realistic alternative to avoid settling the obligation arising from those responsibilities.
- BC32. The wide variation in the nature of public sector programs and operations and the different political and economic circumstances of jurisdictions globally means that categorical assertions of the circumstances under which non-legal obligations become binding and give rise to present obligations are inappropriate. However, the IPSASB concluded that present obligations are extremely unlikely to arise from election promises. This is because electoral pledges will very rarely (a) create a valid expectation on the part of external parties that the entity will honor the pledge, and (b) create an obligation which the entity has no realistic alternative but to settle. Therefore the Framework includes a presumption that liabilities do not arise from electoral pledges or promises. However, it is accepted that in practice a government with a large majority will be better placed to enact intended legislation than a minority government and that there may be infrequent circumstances where a government

announcement in circumstances like those in BC 30, might give rise to a liability. In assessing whether a non-legal obligation gives rise to a liability the availability of funding to settle the obligation may be a persuasive indicator.

Sovereign Power to Avoid Obligations

BC33. The sovereign power to make, amend and repeal legal provisions is a key characteristic of governments. Sovereign power potentially allows governments to repudiate obligations, arising from both exchange and non-exchange transactions. Although in a global environment, such a power may be constrained by practical considerations, there are a large number of examples of governments defaulting on financial obligations over the last century. The IPSASB considered the impact of sovereign power on the definition of a liability. The IPSASB concluded that failing to recognize obligations that otherwise meet the definition of a liability on the grounds that sovereign power enables a government to walk away from such obligations would be contrary to the objectives of financial reporting and, in particular, may conflict with the QCs of relevance and faithful representation. Many respondents to CF–CP2 supported this position. The IPSASB therefore concluded that the determination of whether a liability exists should be by reference to the legal position at the reporting date.

Section 4: Revenue and Expenses

Nature of Revenue and Expenses

- BC34. One approach to defining revenue and expenses is to take the view that they can be derived from changes in assets and liabilities. The IPSASB acknowledged that this approach has been adopted by many standard-setters globally. Another view is that revenue and expenses are flows that relate to the current period. There was considerable support for both positions by respondents to CF–CP2.
- BC35. The IPSASB formed a view that a focus on the current year activities of a public sector entity is important in providing information for the users of financial statements and thereby in achieving the objectives of financial reporting. Including flows as revenue and expenses in one reporting period where there are timing restrictions specifying their use in future periods would be misleading. This led to the conclusion that, in precisely defined circumstances, certain flows do not meet the definition of revenue and expenses, but rather are deferred inflows and deferred outflows. The rationale for defining deferred inflows and deferred outflows as elements is further considered in BC40–BC43. The IPSASB took the view that the definitions of revenue and expenses should reflect the inflows of resources used to finance such goods and services and the outflows of resources related to providing goods and services in the reporting period.
- BC36. The IPSASB considered whether the definition of revenue should be the “net” or “gross” increase in “net” assets. The IPSASB recognized that a “gross” approach would create problems in areas such as the disposal of property, plant, and equipment where such a definition would require the full disposal proceeds to be recognized as revenue, rather than the difference between the disposal proceeds and the carrying amount. Therefore the IPSASB considered that the gross approach is not ideal. The IPSASB acknowledged that standards may require the gross presentation of the relevant flows on the face of the financial statements in certain circumstances, for example, the sale of inventory.

- BC37. Some standard setters have structured their definitions of elements so that, for example, inflows and outflows arising from transactions and events relating to activities in the ordinary course of operations are distinguished from inflows and outflows that relate to activities outside the ordinary course of operations. An example of this approach is the definition of revenue, expenses, gains and losses as separate elements, where revenue and expenses relate to entity's "ongoing major or central operations", and gains and losses relate to all other transactions, events and circumstances giving rise to increases or decreases in net assets.⁴
- BC38. The IPSASB acknowledged that distinguishing transactions and events related to the ordinary course of operations from transactions and events outside the ordinary course of operations can provide useful information for users of the financial statements. It may be useful therefore to adopt the terms gains and losses to reflect inflows and outflows from transactions and events outside the ordinary course of operations. However, the IPSASB took the view that, conceptually, gains and losses do not differ from other forms of revenue and expenses, because they both involve net increases or decreases of assets and/or liabilities. The IPSASB also noted that many respondents to CF-CP2 shared this view. Therefore the IPSASB decided not to define gains and losses as separate elements.
- BC39. As discussed in more detail in BC48-BC50, the IPSASB considered whether, and, if so, under what circumstances, ownership interests exist in the public sector. In the context of revenue and expenses the IPSASB considered whether transactions related to ownership interests should be excluded from the definitions of revenue and expenses. Because transactions with owners, in their role as owners, are different in substance to other inflows and outflows of resources the IPSASB concluded that it is necessary to distinguish flows relating to owners from revenue and expenses. Therefore ownership contributions and ownership distributions are defined as elements.

Section 5: Deferred Inflows and Deferred Outflows

Nature of Deferred Inflows and Deferred Outflows

- BC40. As identified in *Key Characteristics* a highly important characteristic of the public sector is the prevalence of non-exchange transactions. Such transactions include (a) involuntary transfers of resources, notably taxation, and grants, which may be received prior to the period in which they are intended to finance the provision of goods and services, and (b) transfers of resources with timing restrictions or expectations and no performance or return obligations. 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. There are a number of ways in which user needs can be satisfied. The IPSASB identified and considered:

⁴ See for example Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 6: Elements of Financial Statements.

- Broadening the asset and liability definitions to include deferred inflows and deferred outflows⁵;
- A presentational approach along the lines of “other comprehensive income” (OCI) in International Financial Reporting Standards (IFRSs) would have to be developed and adopted;
- Dealing with deferred inflows and deferred outflows through note disclosure or other forms of communication; and
- Defining deferred inflows and deferred outflows as separate elements.

BC41. The IPSASB considered that broadening the definition of an asset and liability distorts the essence of these elements, because, in the case of assets, it would lead to including resources that an entity does not, in substance, control and in the case of liabilities obligations that are not present obligations. Such an approach would not be easily understandable to many users and may conflict with the QC of faithful representation. A sub-classification of net assets would only partially compensate for this, because it relegates the results of potentially major flows to a sub-category of the residual amount.

BC42. The use of a presentational approach would have to be considered on an issue-by-issue basis at the standards level, which might lead to inconsistency. The IPSASB considered that dealing with deferred inflows and deferred outflows through note disclosure is contrary to the principle that disclosure is not a substitute for recognition, which is stated in Section 7.

BC43. The IPSASB therefore concluded that the most transparent approach is to define deferred inflows and deferred outflows as separate elements. In coming to this view the IPSASB considered it likely that, if separate elements are not defined, the treatment of flows that are considered applicable to future reporting periods is likely to be addressed on an issue-by-issue basis at the standards level, using ambiguous and potentially conflicting principles.

Specified Future Period and Non-exchange Transactions as an Essential Characteristic of Deferred Inflows and Deferred Outflows

BC44. The IPSASB acknowledged reservations about defining deferred inflows and deferred outflows (for example, that such elements might be used inappropriately or that usage of such elements would be determined at the standards level). It has been suggested that broad definitions of deferred outflows could be used to spread certain costs inappropriately (for example, redundancy costs) over several reporting periods, based on an assertion that these costs will produce savings and therefore a reduction of outflows of resources over a number of subsequent reporting periods.

BC45. Such concerns led the IPSASB to narrow the application of deferred inflows and outflows to public sector circumstances. Deferred inflows and deferred outflows are therefore restricted to certain non-exchange transactions, because they do not meet the definition of revenue or expenses as they relate to a specified future reporting period, and they do not give rise to assets, liabilities, ownership contributions or ownership distributions. Based on this approach, a property tax levied and collected in one period that is required by law to be spent in a

⁵ This approach could be supplemented by sub-classifying net assets/net liabilities to include information about deferred inflows and deferred outflows.

specified future period would be reported as a deferred inflow. Multi-year grants with no substantive performance obligations and no return obligations would only be presented as deferred inflows or deferred outflows if the period over which those resources can be used is documented and recorded and the resources are actually used in those periods, as specified in the grant agreement. Exchange transactions give rise to revenue, expenses, assets, liabilities, ownership contributions or ownership distributions in the period of the exchange and the IPSASB considered that it is therefore not appropriate to include these transactions in the definitions of deferred inflows or deferred outflows.

- BC46. Recognizing deferred inflows and deferred outflows is not the same as the matching concept used in earlier private sector frameworks. The IPSASB agreed that when the time restriction associated with a deferred inflow or deferred outflow comes to an end, the deferred inflow or outflow must be reassessed. A reduction in a deferred inflow would be recognized as revenue at that point and a reduction in a deferred outflow would be recognized as an expense at that point. The IPSASB noted that limiting the use of these elements to clearly specified circumstances is consistent with the objective of providing information to users about the impact of external restrictions on an entity's ability to use resources in a period.

Section 6: Net Assets, Net Financial Position, Ownership Contributions, and Ownership Distributions

- BC47. The IPSASB's decision to propose the elements of deferred inflows and deferred outflows means that both net assets and net financial position have to be distinguished. Net assets is the difference between assets and liabilities before taking into account deferred inflows and deferred outflows. Net financial position is the aggregate of an entity's assets and deferred outflows less an entity's liabilities and deferred inflows at the reporting date. A positive net financial position represents the net resources available for providing goods or services in future periods. A negative net financial position indicates that insufficient revenues have been generated at the reporting date to meet the expenses of the entity in the provision of services and should raise the question about how this shortfall will be addressed in future periods, whether from increased revenue, a reduction in expenses, or a combination of both.
- BC48. The IPSASB considered whether net financial position is a residual amount, a residual interest or an ownership interest. The IPSASB acknowledged the view that the interest of resource providers and service recipients in the long-term efficiency of the entity, its capacity to deliver goods and services in the future and in the resources that may be available for redirection, restructuring or alternative disposition is similar to an ownership interest. The IPSASB also accepted that the terms residual interest and ownership interest have been used in some jurisdictions to characterize third parties' interests in net assets. The term residual interest indicates that service recipients and resource providers have an interest in the capability of the entity to finance itself and to resource future operations. The term ownership interest is analogous to the ownership interest in a private sector entity and, for some, indicates that the citizens own the resources of the public sector entity and that government is responsible to the citizens for the use of those resources. Some argue that this emphasizes the democratic accountability of governments.
- BC49. The IPSASB took the view that the term residual interest may suggest that service recipients and resource providers have a financial interest in the public sector entity. Similarly the term

ownership interest suggests that citizens are entitled to distributions from the public sector entity and to distributions of net assets in the event of the entity being wound up. The IPSASB therefore concluded that the terms residual interest and ownership interest can be misunderstood or misinterpreted, and that net financial position is a residual amount that should not be defined. Treating net financial position in such a way is more straightforward and understandable.

- BC50. However, the IPSASB acknowledged that part of net financial position can in certain circumstances be an ownership interest. Such instances may be evidenced by the entity having a formal equity structure, but there may be instances where an entity is established without a formal equity structure, with a view to sale for operation as a commercial enterprise or by a private sector not-for-profit entity. An ownership interest can also arise from the restructuring of government or public sector entities, such as when a new government department is created. The IPSASB therefore considered whether “ownership interests” should be defined as an element. The IPSASB acknowledged the view that identifying the resources (or claims on future resources) attributable to owners provides information useful for accountability and decision-making purposes. The IPSASB concluded that such interests can be identified through the sub-classification of net financial position. However, the IPSASB also concluded that it is important to distinguish inflows of resources from owners and outflows of resources to owners, in their role as owners, from revenue, expenses, deferred inflows and deferred outflows. Therefore ownership contributions and ownership distributions are defined as elements.

Section 7: Recognition

Recognition and its Relationship to Disclosure

- BC51. The IPSASB considered whether recognition criteria should be integrated in definitions. The IPSASB acknowledged the view that the inclusion of recognition criteria in definitions enables preparers to consider all the factors that must be taken into account in evaluating whether an item of information is recognized in the financial statements. However, the IPSASB took the view that recognition is a distinct phase in the financial reporting process. The IPSASB also noted that few respondents to CF–CP2 supported the integration of recognition criteria in element definitions. After considering this feedback, the IPSASB concluded that element definitions should not include recognition criteria.

Assessing Recognition

- BC52. In determining whether an element should be recognized there are two types of uncertainty that need to be considered. The first is existence uncertainty—whether an item meets the definition of an element? The second is to consider measurement uncertainty—whether the element can be measured in a representationally faithful manner? The second aspect is only considered if it is determined that the definition of an element has been met.

Existence Uncertainty

- BC53. The IPSASB also considered whether, in dealing with existence uncertainty, (a) standardized threshold criteria should be adopted, or (b) whether all available evidence should be used to make neutral judgements about an element’s existence.

- BC54. Standardized evidence thresholds filter items that have a low probability of resulting in an inflow or outflow of service potential or economic benefits. Such items may have high monetary values and therefore lead to the recognition of elements with significant amounts, even though the probability of existence may be low. Some consider that it would be more appropriate to disclose such items rather than recognize them. Threshold criteria are also justified on cost grounds, because only after a preparer has formed an initial judgement whether those threshold criteria have been met does the preparer consider how that element should be measured.
- BC55. The IPSASB formed a view that, while the adoption of thresholds for recognition purposes may produce information that is understandable, such an approach risks omitting information that is relevant and faithfully representative. Approaches to existence uncertainty based on thresholds may also not meet the QC of comparability, because similar information items may be treated in different ways dependent upon relatively small differences in the probability of a flow of benefits. The IPSASB therefore concluded that, on balance, all available evidence should be assessed in determining whether an element exists and that uncertainty about the flows of service potential or economic benefits should be taken into account in measurement.
- BC56. The IPSASB explored whether existence uncertainty is specific to certain components of assets and liabilities, in particular for assets whether an entity controls a resource or a right to a resource and for liabilities whether an entity has little or no realistic alternative to avoid an outflow of service potential or economic benefits. The rationale for this approach is that these are the essential characteristics of an asset and a liability where existence uncertainty is likely to arise.
- BC57. The IPSASB took the view that, in the context of assets and liabilities, existence uncertainty relates to more than just these characteristics. Existence uncertainty might also relate to the existence of a present obligation and a past event for liabilities and, in particular, whether a present resource that generates future economic benefits or service potential exists rather than a future resource or future right to a resource in the context of an asset.
- BC58. The IPSASB also took the view that existence uncertainty is not restricted to just assets and liabilities. While changes in other elements are normally accompanied by changes in assets and liabilities, this may not always be the case. The IPSASB therefore rejected an approach whereby discussion of existence uncertainty is restricted to assets and liabilities.

Derecognition

- BC59. The IPSASB considered the view that different criteria should be used for initial recognition and derecognition. Many of the respondents to CF–CP2 supported the use of the same criteria for derecognition as for initial recognition. The IPSASB concluded that adopting differential recognition criteria would conflict with the QC of consistency as it would lead to the recognition of items with different standards of evidence for their existence.

Alternative Views

Alternative View of Prof. Mariano D'Amore

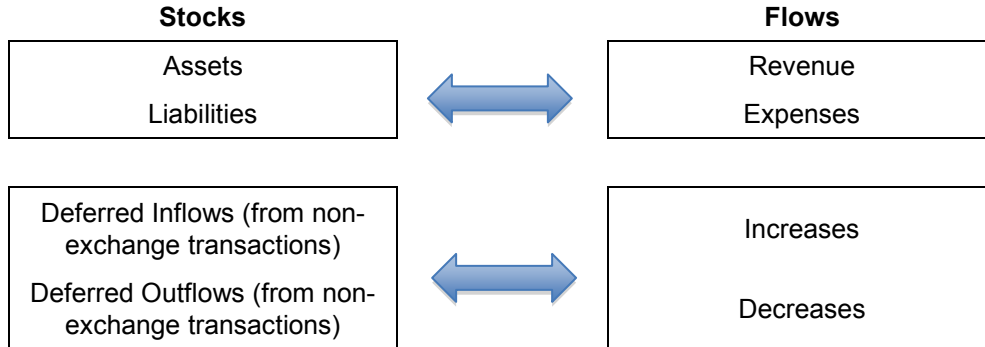
- AV1. This AV does not question the rationale for recognizing deferred inflows and deferred outflows as elements in the financial statements of a public sector entity. Rather, it debates

the treatment of deferred inflows and deferred outflows and their related increases and decreases. This member believes that the treatment proposed in the Exposure Draft (ED) substantially modifies the generally understood concepts of revenue and expenses as changes in net assets, and this may have a negative impact on the users' understanding of the entity's financial performance. This AV is based on the assumption that departure from these concepts is not a necessary consequence of the definition of deferred inflows and deferred outflows as separate elements, and that an alternative option may be considered in order to meet the objectives and qualitative characteristics of financial statements. Finally, this AV provides a discussion of the concept of net financial position, since, in this member's opinion, the ED does not give a satisfactory description of the difference between net assets and net financial position, or the relevance of the latter to meeting users' needs.

- AV2. This member believes that the treatment of deferred inflows and deferred outflows stated in the ED implies a misalignment between revenues and increases in net assets on one side, and expenses and decreases in net assets on the other. Based on the definitions given in the ED, a deferred inflow increases net assets in the year in which the inflow is received and subsequently deferred to future periods (in other words, an increase in deferred inflows is an increase in net assets in the current period). In the year in which a decrease in deferred inflows occurs, this is recognized as revenue, although it is not an increase in net assets in the current period. A deferred outflow decreases net assets in the year in which the outflow occurs and is subsequently deferred to future periods (in other words, an increase in deferred outflows is a decrease in net assets in the current period). In the year in which a decrease in deferred outflows occurs, this is recognized as an expense, although it is not a decrease in net assets in the current period. As a consequence, the difference between revenues and expenses (surplus or deficit for the year) is not intended to equal the change that has occurred in net assets in the reporting period. This member questions whether such a misalignment may mislead users, at least in some jurisdictions.
- AV3. In this member's opinion, the effects on the concept and display of financial performance which arise from the proposed treatment of deferred inflows and outflows, and from the new definition of revenue and expenses, are not fully explained in the ED. Indeed for the ED, revenue and expenses are the only two elements in the Statement of Financial Performance. These are used to aggregate and show under the same headings items which share the feature of being flows related to the reporting period, but which are dissimilar in some other relevant respects. Based on the definition provided in the ED, revenues include inflows which are changes in net assets occurring in the reporting period together with others which are solely movements in deferred inflows. Similarly, some of the expenses are outflows which change net assets in the reporting period while some others are simply movements in deferred outflows. All these flows together are balanced to measure the surplus or deficit for the year. This member thinks that such an approach has a negative effect on faithful representation and the ability of users to assess financial performance by considering its different components, i.e. the elements as defined in the ED.
- AV4. It is a generally understood concept that revenue and expenses are flows linked to changes in the stocks of assets and liabilities. So, in this AV, revenues are regarded as aggregating and displaying all, and solely, increases in net assets occurring in the reporting period other than contributions from owners. Similarly, expenses should aggregate and display decreases in net assets occurring in the reporting period other than distributions to owners. Deferred

inflows and deferred outflows are still defined as elements in the Statement of Financial Position; thus, they are treated as “stocks” at the end of the reporting period. Increases and decreases in such stocks can be identified as related “flows” occurring in the period. Since deferred inflows and deferred outflows are defined as separate elements from assets and liabilities, increases and decreases in the former should be considered as separate elements from revenue and expenses in the Statement of Financial Performance. Visually (and setting aside ownership contributions/distributions):

Table 1: Elements



AV5. As the ED makes a distinction between net assets and net financial position, it should follow that changes in both these stocks be distinguished. Nevertheless, the ED only focuses on the entity’s surplus or deficit for the year as the “primary indicator” of financial performance. In this member’s opinion, change in net assets and surplus/deficit for the year are both relevant performance indicators for accountability and decision-making purposes. Since elements are the basic reference for recording, classifying and aggregating economic data, the approach of defining increases and decreases in deferred inflows/outflows as distinct elements is intended to keep items contributing to different indicators of financial performance separate. Given that how items are displayed is basically a matter of presentation, from a conceptual point of view the relationship between the elements affecting financial performance can be shown as follows:

Table 2: Relationship between the Elements affecting Financial Performance

	Revenue
Minus	Expenses
Equals	Change in Net Assets
Minus	Increases in Deferred Inflows
Plus	Increases in Deferred Outflows
Plus	Decreases in Deferred Inflows
Minus	Decreases in Deferred Outflows
Equals	Surplus or deficit for the year

AV6. Net assets and net financial position differ only because of the deduction from net assets of deferred inflows and the addition of deferred outflows. Deferred inflows are the result of past increases in net assets; specifically, they can be regarded as the part of the net assets which is to be used by the entity under specified timing restrictions. Thus, it may be argued that deducting deferred inflows from net assets shows the net resources available to the entity with no definite timing restrictions. As for deferred outflows, their addition to net assets provides an indicator of the total net resources available to the entity or which have been provided to third parties for the delivery of future services. Taking into account the combined effects of deferred inflows and deferred outflows on the net financial position, the sense of this indicator seems to be unclear, as it may not include net assets which are still available to the entity (in the case of deferred inflows) while encompassing resources which are no longer under the entity's control (in the case of deferred outflows). Finally, in this member's opinion, net financial position does not substitute net assets nor is it the primary indicator for the assessment of the net resources available to the entity for the provision of services in the future. Disregarding ownership contributions/distributions, net financial position may however be understood as an accumulated surplus or deficit which gives information about the past capacity of an entity to finance the services it has provided through related revenues.

Alternative View of Ms. Jeanine Poggiolini

AV7. Due to the nature of the activities undertaken in the public sector, there is a high prevalence of non-exchange transactions, which are often significant in individual entities. In exchange transactions, the recognition of revenue and expenses is, in most instances, related to the performance by the parties to the transaction. Due to the inherent nature of non-exchange transactions, there is often no performance required by, or imposed on, the parties to the transaction. To ensure that users of the financial statements have relevant information for decision-making or accountability purposes, these types of transactions require specific consideration by the Board.

AV8. The ED identifies deferred inflows and deferred outflows as separate elements. These elements result from inflows and outflows in non-exchange transactions, where the flows relate to a future period. This member disagrees with the view that deferred inflows and deferred outflows should be identified and recognized as separate elements. Instead, these flows should be included in the definitions of revenues and expenses.

- AV9. From a revenue and deferred inflow perspective, when an entity demonstrates control over a resource, and the inflow is not an ownership contribution and no related obligation exists, then revenue should be recognized. Where an entity controls the underlying resource and has no related obligation, it has the ability to direct the nature and manner of use of the resulting economic benefits or service potential. As the entity has the ability to control the resource by deciding how, for what and when it can use the associated benefits, it should recognize revenue at that point. The opposite is true for expenses and deferred outflows. If an entity has an outflow of resources over which it has no further control, through, for example, the existence of rights, then an expense should be recognized. In this member's view, this position more appropriately demonstrates the resources for which the entity is accountable.
- AV10. In addition, the existence of other elements in the Framework is based on the occurrence of a past transaction or event. Deferred inflows and deferred outflows, and their subsequent recognition as revenues or expenses, however arise as a consequence of time or the passage of time. In this member's view, this is not a sound basis for delaying the recognition of revenues and expenses. One of the reasons for delaying the recognition of these revenues and expenses is so that they are used in the period stipulated by the transferor. However, an entity need not use the resources in that period for revenue or expenses to be recognized in that period. This reinforces the view that control either existed or was lost in earlier reporting periods.
- AV11. It is however acknowledged that, in certain instances, this approach may result in large surpluses or deficits being reflected in the statement of financial performance. This could be addressed through developing appropriate presentation and disclosure requirements at standards level which would provide relevant information to users of the financial statements. At a more fundamental level, the concepts outlined in the Conceptual Framework should be based on principles that can be applied to a range of transactions and events. As a consequence, these principles should be transaction neutral and, should not distinguish between exchange and non-exchange transactions. Moreover, the principles should not be designed and defined in a way so that a specific outcome is achieved for a specific group of transactions.

Appendix 1A

The IASB Conceptual Framework (September 2010)

Elements and Recognition in Financial Statements

The International Accounting Standards Board (IASB) develops and publishes International Financial Reporting Standards (IFRSs). IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities.

The IASB Conceptual Framework (issued in 1989 and updated in part in September 2010)⁶. It explains:

- The underlying assumption that financial statements are prepared on a going concern basis.
- Financial statements portray the financial effects of transactions and other events by grouping them into broad classes, termed the elements, according to their economic characteristics.
- The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. Equity is the residual interest in the assets of the entity after deducting all its liabilities.
- The elements directly related to the measurement of performance in the income statement are income and expenses.
- Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition namely it is probable that any future economic benefit associated with the item will flow to or from the entity and the item has a cost or value that can be measured with reliability.

⁶ The IASB has recently reactivated its Conceptual Framework project. Elements and Recognition is under consideration as part of that project.

Appendix 1B

Statistical Reporting Guidelines of the 1993 System of National Accounts (updated 2008) and Other Guidance derived from it (ESA 95 and GFSM 2001)

Flows and Stocks

The 1993 System of National Accounts (SNA) – as updated in 2008 (SNA 2008):

- Describes the flows and stocks that are recorded in the national economy, including the general government sector and other sectors of the economy. For Government Finance Statistics (GFS) the system explains that all data on units of the general government sector are either flows (mostly transactions) or stocks (assets, liabilities and net worth) before summarizing the accounting rules to record the stocks and flows.
- Covers concepts, definitions, classifications and accounting rules.
- The elements directly related to the measurement of performance in the income statement are revenue and expenses.
- Defines the assets and liabilities included in the system, provides a classification of types of assets and liabilities, and describes the content of each classification category.
- Defines revenue, provides a classification of types of revenue and the contents of each classification category.
- Defines expense and explains the classification between functional and economic expense and the contents of each category.

The GFSM 2001 and ESA 95 are consistent with the principles of the 1993 SNA. However, at a detailed level, some reporting differences may arise as a result of differences in purpose and specific data needs.

The GFSM 2001 and ESA 95 are currently under revision to bring them into line with the 2008 SNA.

International Public Sector Accounting Standards, Exposure Drafts, Consultation Papers, and other IPSASB publications are published by, and copyright of, IFAC.

The IPSASB and IFAC do not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

The IPSASB logo, 'International Public Sector Accounting Standards Board', 'IPSASB', 'International Public Sector Accounting Standards', 'IPSAS', the IFAC logo, 'International Federation of Accountants', and 'IFAC' are trademarks and service marks of IFAC.

Copyright © November 2012 by the International Federation of Accountants (IFAC). All rights reserved. Permission is granted to make copies of this work to achieve maximum exposure and feedback provided that each copy bears the following credit line: *"Copyright © November 2012 by the International Federation of Accountants (IFAC). All rights reserved. Used with permission of IFAC. Permission is granted to make copies of this work to achieve maximum exposure and feedback."*

IPSASB

**International Public
Sector Accounting
Standards Board**

529 Fifth Avenue, 6th Floor, New York, NY 10017
T + 1 (212) 286-9344 F +1 (212) 286-9570
www.ipsasb.org