

Consultation Paper

December 2010

Comments are requested by June 15, 2011

*International Public Sector Accounting Standards
Board*

Conceptual Framework for General
Purpose Financial Reporting by
Public Sector Entities:

Elements and Recognition in
Financial Statements



International Federation
of Accountants

REQUEST FOR COMMENTS

The International Public Sector Accounting Standards Board (IPSASB), an independent standard-setting body within the International Federation of Accountants (IFAC), approved for publication in December 2010 this Conceptual Framework Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements*.

The proposals in this Consultation Paper may be modified in light of comments received before being issued in final form. **Comments are requested by June 15, 2011.**

Respondents are asked to submit their comments **electronically** through the IFAC website (www.ifac.org), using the “Submit a Comment” link on the Exposure Drafts and Consultation Papers page. 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 IFAC website. Although IFAC prefers that comments be submitted electronically, e-mail may be sent to stepheniefox@ifac.org. Comments can also be faxed to the attention of the IPASB Technical Director at +1 (416) 204-3412, or mailed to:

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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 Consultation Paper (CP) deals with concepts that apply to general purpose financial reporting (hereafter referred to as financial reporting) 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 and events 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 is information provided by the cash basis or other bases of accounting or financial reporting.

Project Development

The IPSASB is developing the Conceptual Framework with input from 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 is currently developing an improved Conceptual Framework for private sector business entities in a joint project with the Financial Accounting Standards Board (FASB) of the USA. Development of the IASB's Conceptual Framework is being closely 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 models, 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 the statistical financial reporting models 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 involves the development and issue for comment of CPs that draw out key issues and explore the ways in which those issues could be dealt with. The CP dealing with Phase 1 was issued in September 2008,¹ the CP dealing with Phase 2 and the Exposure Draft (ED) dealing with Phase 1 are being issued at the same time as this CP and a CP dealing with Phase 4 is under development.

The IPSASB's current intention is to issue EDs dealing with each of Phases 2, 3 and 4 of the Conceptual Framework after consideration of responses to the CPs dealing with those Phases. The process for developing the finalized Conceptual Framework will be determined in light of

¹ Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: The Objectives of Financial Reporting; The Scope of Financial Reporting; The Qualitative Characteristics of Information Included in General Purpose Financial Reports; The Reporting Entity*.

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the responses received to CPs and EDs, and may include issue of an umbrella ED of the full Conceptual Framework.

Objective of the Consultation Paper

The Consultation Paper (CP) *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements* sets out the specific matters on which comments are requested. The IPSASB has not provided preliminary views on the issues so as to get the widest possible consultation. Respondents may choose to address all or just selected matters, and are welcome to comment on any other matter they think the IPSASB should consider in forming its views.

Guide for Respondents

The IPSASB would welcome comments on all of the matters discussed in this CP. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate and contain a clear rationale.

The Specific Matters for Comment requested in the CP are provided below.

Specific Matter for Comment 1:

- (a) Should the definition of an asset cover all of the following types of benefits—those in the form of:
 - (i) Service potential;
 - (ii) Net cash inflows; and
 - (iii) Unconditional rights to receive resources?
- (b) What term should be used in the definition of an asset:
 - (i) Economic benefits and service potential; or
 - (ii) Economic benefits?

Specific Matter for Comment 2

- (a) Which approach do you believe should be used to associate an asset with a specific entity:
 - (i) Control;
 - (ii) Risks and rewards; or
 - (iii) Access to rights, including the right to restrict or deny others' access to rights?
- (b) Does an entity's enforceable claim to benefits or ability to deny, restrict, or otherwise regulate others' access link a resource to a specific entity?
- (c) Are there additional requirements necessary to establish a link between the entity and an asset?

Specific Matter for Comment 3

Is it sufficient to state that an asset is a "present" resource, or must there be a past event that occurs?

Specific Matter for Comment 4

Recognition and measurement criteria aside, are public sector entity rights and powers, such as those associated with the power to tax and levy fees, inherent assets of a public sector entity, are they assets only when those powers are exercised, or is there an intermediate event that is more appropriate?

Specific Matter for Comment 5

- (a) Are there any additional characteristics that have not been identified that you believe are essential to the development of an asset definition?
- (b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of assets?

Specific Matter for Comment 6

- (a) Should the definition of a liability cover all of the following types of obligations?
 - (i) Obligations to transfer benefits, defined as cash and other assets, and the provision of goods and services in the future.
 - (ii) Unconditional obligations, including unconditional obligations to stand ready to insure against loss (risk protection).
 - (iii) Performance obligations.
 - (iv) Obligations to provide access to or forego future resources.
- (b) Is the requirement for a settlement date an essential characteristic of a liability?

Specific Matter for Comment 7

- (a) Should the ability to identify a specific party(ies) outside the reporting entity to whom the entity is obligated be considered an essential characteristic in defining a liability, or be part of the supplementary discussion?
- (b) Do you agree that the absence of a realistic alternative to avoid the obligation is an essential characteristic of a liability?
- (c) Which of the three approaches identified in paragraph 3.28 do you support in determining whether an entity has or has not a realistic alternative to avoid the obligation?

Specific Matter for Comment 8

Is it sufficient to state that a liability is a “present” obligation, or must there be a past event that occurs?

Specific Matter for Comment 9

- (a) Recognition and measurement criteria aside, are public sector entity obligations such as those associated with its duties and responsibilities as a government, perpetual obligations,

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obligations only when they are enforceable claims, or is there an appropriate intermediate event that is more appropriate?

- (b) Is the enforceability of an obligation an essential characteristic of a liability?
- (c) Should the definition of a liability include an assumption about the role that sovereign power plays, such as by reference to the legal position at the reporting date?

Specific Matter for Comment 10

- (a) Are there any additional characteristics that have not been identified that you believe are essential to the development of a liability definition?
- (b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of liabilities?

Specific Matter for Comment 11

- (a) Should revenues and expenses be determined by identifying which inflows and outflows are “applicable to” the current period (derived from a revenue and expense-led approach), or by changes in net assets, defined as resources and obligations, “during” the current period (derived from an asset and liability-led approach)?
- (b) What arguments do you consider most important in coming to your decision on the preferred approach?

Specific Matter for Comment 12

- (a) Should transactions with residual/equity interests be excluded from revenues and expenses?
- (b) Should the definitions of revenue and expense be limited to specific types of activities associated with operations, however described?

Specific Matter for Comment 13

- (a) Are there any additional characteristics that have not been identified that you believe are essential to the development of definitions of revenues and expenses?
- (b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the definitions of revenues and expenses?

Specific Matter for Comment 14

- (a) Do deferrals need to be identified on the statement of financial position in some way?
- (b) If yes, which approach do you consider the most appropriate? Deferred outflows and deferred inflows should be:
 - (i) Defined as separate elements;
 - (ii) Included as sub-components of assets and liabilities; or
 - (iii) Included as sub-components of net assets/net liabilities.

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- (c) If defined as separate elements, are the definitions of a deferred outflow and deferred inflow as set out in paragraph 5.8 appropriate and complete?

Specific Matter for Comment 15

- (a) Do you consider net assets/net liabilities to be a residual amount, a residual interest, or an ownership interest?
- (b) Should the concept of ownership interests, such as those that relate to minority or non-controlling interests in a GBE, be incorporated in the element definition?
- (c) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of net assets/net liabilities?

Specific Matter for Comment 16

- (a) Should transactions with residual/equity interests be defined as separate elements?
- (b) If defined as separate elements, what characteristics would you consider essential to their definition?

Specific Matter for Comment 17

- (a) Should recognition criteria address evidence uncertainty by requiring evidence thresholds; or by requiring a neutral judgment whether an element exists at the reporting date based on an assessment of all available evidence; or by basing the approach on the measurement attribute?
- (b) If you support the threshold approach or its use in a situational approach, do you agree that there should be a uniform threshold for both assets and liabilities? If so, what should it be? If not, what threshold is reasonable for asset recognition and for liability recognition?

Specific Matter for Comment 18

Do you support the use of the same criteria for derecognition as for initial recognition?

Specific Matter for Comment 19

Should the recognition criteria be an integral part of the element definitions, or separate and distinct requirements?

Executive Summary

The IPSASB has made a number of tentative decisions regarding the objectives and scope of financial reporting that will be important in making further decisions about the elements of financial statements. It has concluded that general purpose financial reports (GPFRs) are financial reports intended to meet the common information needs of users who are unable to require the preparation of financial reports tailored to meet their needs. The primary users of GPFRs have been identified as service recipients and resource providers and their respective representatives. The IPSASB expects that the scope of financial reporting will evolve over time in response to users' information needs. Further, GPFRs of public sector entities are broader than financial statements and their notes as currently dealt with in IPSASs. However, financial statements and their notes remain at the core of financial reporting.

This Consultation Paper (CP) discusses issues associated with the elements of general purpose financial statements (GPFSS, hereafter financial statements) of public sector entities and their recognition. Elements are the basic building blocks of financial statements needed to meet the information needs of the identified users of these financial reports. This paper considers both how these elements might be defined and what criteria might be established for their recognition.

The CP begins by identifying issues related to assets and liabilities: what the substance is of each, how to determine if it is the entity's asset or liability, and how to determine if the element exists at the reporting date. The CP suggests several characteristics and looks for input on those that might be critical to the element definitions.

The paper then discusses how IPSASB might approach reporting public sector financial performance, an issue that affects not only the revenue and expense elements, but also whether additional financial position elements (deferrals) are necessary. Two underlying approaches to financial performance are set out. One measures financial performance as the net result of all changes in the entity's economic resources and obligations during the period (asset and liability-led approach), and the other measures financial performance as the result of the revenue inflows and expense outflows more closely associated with the efforts of the current period (revenue and expense-led approach).

This discussion leads into issues associated with defining revenues and expenses in the public sector: whether they are based on changes in net assets/liabilities or an association with the services and programs provided in the period; whether transactions with residual/equity interests should be excluded from their definitions; and whether revenue and expenses should be restricted to the results of specific activities.

The CP next identifies other items that might be separately defined as elements in order to provide all the required building blocks for a public sector entity's financial statements. These include deferred outflows/deferred inflows, net assets/net liabilities, and transactions with residual/equity interests. The issues relevant to each are discussed.

The concluding section discusses recognition criteria; that is, those additional requirements that need to be met after an item has met an element's definition.

Respondents are directed to the "At a Glance" CP Summary located on the IPSASB website. This staff document provides a brief and useful overview of this CP.

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1. Introduction to Elements and Recognition

- 1.1 This Consultation Paper (CP) discusses issues associated with the elements of general purpose financial statements (GPFs, hereafter financial statements) of public sector entities and their recognition. Elements are the basic building blocks of financial statements needed to meet the information needs of their users. This CP considers both how these elements might be defined, and what criteria might be established for their recognition.
- 1.2 This CP is Phase 2 of the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. It builds on and is intended to be read within the context established in the Exposure Draft of Phase 1 of the Conceptual Framework.
- 1.3 The objectives of financial reporting by public sector entities are to provide information about the reporting entity useful to users for:
 - Accountability purposes; and
 - Decision-making purposes.

The primary users of general purpose financial reports (GPFRs) are service recipients and their representatives and resource providers and their representatives.

- 1.4 Users need information that will enable them to form judgments about such matters as (a) the extent to which the entity has discharged its responsibilities in safekeeping and managing public resources, (b) whether resources have been efficiently and effectively used in delivering services, and (c) compliance with relevant budgetary, legislative, and other controls regulating the raising and use of public monies. The discharge of accountability requirements for public sector organizations and the provision of decision-useful information about their financial position and performance require information beyond that contained in financial statements.

General Purpose Financial Statements within General Purpose Financial Reporting

- 1.5 To meet the objectives of financial reporting, information is needed that encompasses (a) financial and non-financial information, (b) past and prospective information, and (c) reporting on compliance. Accordingly, GPFRs, in addition to financial statements, could include other information about financial condition, the effect of financial performance on the long-term sustainability of the public finances, as well as the accomplishment of objectives.
- 1.6 Although the number, type, and format of financial statements evolve over time, most financial statements focus on the financial portrayal of past transactions and events that affect financial position at a point in time, and financial performance for a specified period.

The Need for and Nature of Elements

- 1.7 Elements are the basic building blocks from which financial statements are constructed, but could potentially apply more broadly to other types of information included in

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GPFs. These building blocks provide a common starting point for recording, classifying, and aggregating economic phenomena and activity in a way that enhances a user's understanding of the detailed data contained in an entity's financial reporting system. Because financial statements represent the effects of numerous transactions and events, they necessarily involve a high degree of summarization and classification.

- 1.8 Elements of financial statements are designed to provide useful categories of information necessary, at a minimum, for measuring financial position and financial performance. Their definitions are important because they reflect these relevant measures.
- 1.9 Elements are the broad classes of items that share the same characteristics (such as assets), not the individual items themselves (such as cash). Discipline is required in identifying the elements so as to limit the number of elements to the most basic distinctions that are essential for financial reporting purposes. Although subclassifications of individual items within an element (e.g., cash, receivables, property, equipment, and intangibles as assets) and aggregations or combinations of elements (e.g., combining revenue and certain expenses to show gross margin) may enhance the understandability of the financial statements, issues of display and presentation are addressed as separate matters in Phase 4 of the Conceptual Framework on Presentation and Disclosure.

Elements to be Considered

- 1.10 Elements identified in the reporting models of current standard setters include:

Elements	Public sector standards-setter					Private sector standards-setter						Both		GFS
	IPSASB	Can PSAB	SA ASB	US FASAB	US GASB	IASB	Can AcSB	US FASB	US FASB NFP	UK ASB	UK ASB PBE	Aus ASB	NZ FRSB	
Assets	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Deferred Outflow					X									
Liabilities	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Deferred Inflow					X									
Net Assets/Equity	X		X	X	X	X	X	X	X	X	X	X	X	
Contributions from Owners								X		X				
Distributions to Owners								X		X				
Revenues/Income	X	X	X	X	X	X	X	X			X	X		X
Gains								X	X	X				
Expenses	X	X	X	X	X	X	X	X			X	X		X
Losses								X	X	X				
Other economic flows														X
Comprehensive Income								X						

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- 1.11 From this summary, there appears to be general agreement that there are at least four key elements: assets, liabilities, revenues, and expenses. One standard setter has identified deferred outflows and deferred inflows as separate elements. The IPSASB observes, however, that deferred revenues and deferred expenses are a feature of financial statements in many jurisdictions. A key issue is whether such items should be defined as separate elements, with consequences for the definitions of other elements. This depends on the approach taken to reporting financial performance.
- 1.12 The CP begins by exploring issues related to the necessary characteristics of assets (Section 2) and liabilities (Section 3), the major components of financial position. It then explores different views of financial performance and, based on that, discusses the characteristics of revenues and expenses (Section 4). Other possible elements are then identified that may be needed to provide a complete set of financial statements (Section 5). The issues associated with recognition criteria are then discussed (Section 6).

2. Assets

Overview

This section begins by explaining what information is needed by users of traditional financial statements about a public sector entity's financial position. It then explains why assets are a necessary element of financial statements. It discusses a number of potential characteristics of assets as well as issues associated with unique public sector rights or powers. It then seeks feedback about which characteristics are essential to an asset's definition.

- 2.1 Users of a public sector entity's financial statements need the statement of financial position to assess the state of the entity's finances at a point in time. The statement is useful for this purpose, because it portrays the financial and operating capacity of the entity, represented by its resources and claims on those resources at the reporting date. Such information facilitates an assessment of the entity's financial viability, future tax and revenue requirements, and ability to maintain and expand the level and quality of its services. The net financial position provides a measure of the amounts available for future operations. The Conceptual Framework describes these resources, and claims on them, as assets and liabilities.
- 2.2 Assets of a government or other public sector entity are a key element of the entity's financial position. The recipients of goods and services and providers of resources (financial statement users) are interested in assessing whether the entity's assets are managed efficiently and effectively in providing public goods and services. Asset definition and recognition therefore also play an important role in reporting on financial performance. Users seek to understand the effects of decisions to retain, use, or sell the entity's resources on current and future resources available to provide public goods and services.

The Essential Characteristics of an Asset

- 2.3 An asset can be defined in terms of its essential characteristics. If any one of the essential characteristics is lacking, an item would not qualify as an entity's asset. The analysis that follows identifies three classes of characteristics necessary for a complete definition of an asset—those that relate to:
 - (a) The substance of an asset;
 - (b) How to determine if it is an asset of the reporting entity; and
 - (c) How to determine if it is an asset at the reporting date.
- 2.4 The classes of characteristics are inferred from definitions developed by a variety of standard setters that establish accounting standards in both the public and private sectors. The complete element definition is usually made up of a short definition, supplemented with guidance that more fully explains the meanings of the terms used.

Substance of an Asset

- 2.5 The view of an asset as a resource is consistent with the economic concept of a “stock.” The focus is on the resource. The resource generates the flow of future benefits to the entity and the services it will provide.
- 2.6 Referring to an asset as a “stock” may imply that the resource has physical substance; physical form is not, however, a necessary condition. Many assets, such as buildings and inventories, are tangible. However, items such as patents and mineral rights are not. Although distinguishing assets that have physical form (tangible assets) from those that do not (intangible assets) may provide useful information to users of financial statements, both may be resources.
- 2.7 The benefits provided by a resource can sometimes be distinguished from the resource itself. Some resources embody rights to a variety of benefits, for example: (a) the right to use the resource to provide services; (b) the right to convert it into cash and benefit from its capital appreciation; and (c) the right to a stream of cash flows generated from its use. Other resources may be rights to single economic benefits.
- 2.8 These benefits are sometimes described as “economic,” but use of this term can be problematic. If by “economic” the notion of scarcity is conveyed, then the term is more likely to be appropriate. However, if by “economic” the notion of profitability or cash benefit is conveyed, then the term is not likely to be useful in the public sector context. This use of the term fails to encompass non-cash generating resources that are nonetheless critical to a faithful representation of the operating capacity of public sector entities.
- 2.9 Other rights to benefits may not be associated with a particular tangible or intangible resource. An example is the right to require other parties to perform in a certain way, for example, by making payments, or rendering services.
- 2.10 Public sector entities may share in the benefits embodied in a resource, such as under a joint venture arrangement with another entity. Alternatively, the individual rights can be unbundled, such as in a lease arrangement where one entity, a lessor, may retain the rights to receive rentals and the property’s residual value through disposition, while another entity, perhaps a public sector lessee, has the right to hold and use the asset to provide services in meeting its objectives. Therefore, a single resource may give rise to assets on more than one entity’s statement of financial position, with each entity having rights to different benefits.
- 2.11 The benefits embodied in the resource may be critical to the definition of a resource.

A Resource

- 2.12 A common view is that an asset is an “economic” resource. An economic resource, by definition, is something of value. To embody value as an economic good, there must be some restriction on its availability. Items that are freely available to all, such as the air we breathe, are resources, but they are not economic resources unless they are “scarce.” A

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natural resource such as water can meet the definition of an economic resource if it is not freely available or if its supply is limited.

- 2.13 The substance of an asset may be identified in terms of the type of economic benefits provided by a resource. Three potential types of benefits are:
- (a) Service potential;
 - (b) Net cash inflows (or reduced net cash outflows); and
 - (c) Unconditional rights to receive resources.

Service Potential

- 2.14 Service potential is defined by the International Valuation Standards Council as:

The capacity of an asset to continue to provide goods and services in accordance with the entity's objectives. (International Valuation Application (IVA) 3, Valuation of Public Sector Assets for Financial Reporting (2007))

- 2.15 Although not included in the final definition, the 2006 exposure draft for this publication continued the definition with these words: "...whether those objectives are the generation of net cash inflows or the provision of goods and services of a particular volume, quantity and quality to beneficiaries thereof. In the public sector, the concept of service potential takes the place of adequate profitability applied in the private sector." Although this expanded version is not necessary for the definition of service potential, it does provide additional insight into how the definition might be interpreted.
- 2.16 Service potential and service capacity include the following notions:
- (a) A capacity to provide goods and services capable of satisfying the wants or needs of beneficiaries;
 - (b) The provision of means for entities to achieve their objectives but without directly generating net cash inflows;
 - (c) The capacity of the entity to provide services or achieve its objectives, enabling it to fulfill its mission; and
 - (d) The ability to be used, either directly or indirectly, to provide future goods or services to fulfill a need or want of the identified beneficiaries and to further the entity's objectives.
- 2.17 Public sector assets that exhibit service potential may include recreational, transportation, heritage, conservation, community, defense, social, and administrative structures and items, among others. Such assets are usually held by governments or other public sector entities and provide goods and services, often for general public consumption, in areas often where there is no market competition. Their use and disposal may be restricted. Many are specialized in nature. Heritage and conservation resources, for example, are likely to embody service potential to the community in excess of their fair or market-realizable values. This excess may increase with time, even with a deterioration in their

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physical condition. They may be irreplaceable, and their useful lives are likely to be difficult to determine.

Net Cash Inflows

- 2.18 Net cash inflows (or reduced net cash outflows) from an asset may be derived from:
- (a) Its use in the production and sale of goods and services;
 - (b) Its direct exchange for cash or other resources;
 - (c) Its use in satisfying a liability;
 - (d) Serving as a distribution to owners; or
 - (e) Holding cash itself because of universal acceptance of its capacity to acquire other resources.
- 2.19 Benefits in the form of net cash inflows apply to resources such as cash, loans and receivables, inventory for resale, and portfolio investments. Also, some public sector resources generate cash flows because of associated user fees. Whether many assets are cash-generating or not at any point in time depends on the choice the public sector entity makes, as it determines what services are tax-supported, and what services will be paid for through user fees.

Unconditional Rights to Receive Resources

- 2.20 Another concept of future economic benefits encompasses unconditional promises of others resulting from contracts or other binding arrangements that require provision of resources to the entity in the future, including risk protection. For example, an entity (a) that contracts with an insurance company to unconditionally receive protection against losses incurred by fire damage for the next two years, or (b) contracts with a supplier who promises to deliver a specified quantity of product in the future, is perceived as having rights to economic benefits. The future economic benefits are in the form of, respectively, unconditional risk protection services and the ability to unconditionally require delivery of another economic resource. Because public sector entities enter into similar contracts and agreements, this form of future economic benefit could be an equally valid inclusion in the definition of assets in the public sector.
- 2.21 Both private and public sector entities have supported the inclusion of such unconditional rights as assets to the extent that the entity has paid for the unconditional promise in such a contract, or the rights develop an acknowledged market value while being held. However, when the unconditional promise to receive benefits is matched with an equal unconditional promise to transfer economic resources to the supplier in the future, neither the asset nor the liability aspects of such executory contracts have generally been recognized.
- 2.22 For consistency of application of an asset definition, interpreting binding unconditional rights to receive resources in the future as future benefits, and therefore as resources, perhaps should not hinge on whether payment has been made or whether, at the reporting

date, the entity has a binding obligation to transfer resources in the future. The existence of all such rights may be relevant information for users.

Terminology

- 2.23 In describing the benefits that are derived from assets, some public sector standard setters differentiate between *economic benefits* and *service potential*. In one case, economic benefits are interpreted as resulting in inflows of cash or cash equivalents only, while other assets that deliver goods and services to beneficiaries to help meet the entity's objectives are said to embody service potential. Another standard setter defines an asset's economic benefits as those resulting in inflows of cash, cash equivalents, goods, or services to the government entity itself, and an asset's service potential as benefiting the entity in other ways. Examples include the provision of social, educational, transportation, shelter, or other opportunities at little or no charge to the public or other beneficiaries. Other standard setters, however, either define service potential as a form of economic benefit or use the two terms interchangeably.
- 2.24 If the potential to provide services provides benefits either directly to the entity or to its beneficiaries in meeting the entity's objectives, service potential may be considered a subset of economic benefits. Because the entity is transferring goods or services that are scarce in relation to the demand for them (i.e., they are not naturally occurring in abundant supply), and because the goods or services have a value to the entity in furthering its objectives, the service potential embodied in an asset can be considered a form of economic benefit. However, others believe that because a significant portion of government assets are employed to provide service and not to derive an economic benefit, the term "service potential" should be incorporated separately into the definition of an asset. In the remainder of this CP, the term benefit is considered to include both economic benefits and service potential benefits, and comment is requested on this approach.
- 2.25 Similar to economic benefits that generate net future cash flows, there is no requirement that service potential benefits flow in the immediate future, as long as they are held, and are useful in meeting the objectives of the entity.

Specific Matter for Comment 1:

Should the definition of an asset cover all of the following types of benefits—those in the form of:

- (a) Service potential;
- (b) Net cash inflows; and
 - (i) Unconditional rights to receive resources?
- (c) What term should be used in the definition of an asset:
 - (i) Economic benefits and service potential; or
 - (ii) Economic benefits?

Asset of the Reporting Entity

- 2.26 Because the financial statements of a government or other public sector entity can include only its own assets, one type of essential characteristic of an asset is how an entity determines whether or not the asset is its asset. The issue, therefore, is how to link the rights or other access to the future benefits to the specific entity that benefits from them.
- 2.27 An entity can obtain benefits from a resource without it being an asset of the entity. For example, a convention centre owned by an entity at a higher level of government may be located within a municipality’s boundary. The hundreds of conventions attracted to the municipality result in increased property assessments and higher tax revenues for the municipality. The fact that benefits flow to the municipality does not make the convention centre an asset of the municipality.

Control

- 2.28 One criterion used to link a resource to a specific entity in the past has been that of control. One standard setter has defined control of an asset as “the ability of the government to utilize the resource’s present service capacity and to determine the nature and manner of use of the present service capacity embodied in the resource.” Another standard setter indicates that control is “the means by which the entity ensures that the benefits accrue to itself and not to others.” Generally, the government or other public sector entity controlling the asset has the ability to determine whether to (a) directly use the present service potential to provide services to citizens; (b) exchange the present service capacity for another asset, such as cash; or (c) employ the asset in any of the other ways it may provide benefit.
- 2.29 For an asset that is provided for use by the citizenry and general public, control is held by the government that possesses the ability to control access to the present service potential embodied in the asset. This control may be demonstrated, for example, by determining the level of service the asset will provide, such as setting hours of operation and fee levels for a public park. Many assets, such as the investments of a trust or capital assets purchased with grant proceeds, are subject to legal or other external constraints.

- 2.30 Control also has been defined from an entity perspective. For example, the IPSASB has defined control as “the power to govern the financial and operating policies of another entity so as to benefit from its activities.” However, it should be noted that the reporting entity definition proposed in Phase 1 of the IPSASB’s Conceptual Framework project does not use the term control, so it could be considered in developing the definition of an asset. Not using the term in relation to defining the boundaries of group reporting entities avoids the risk of confusion of control being used in different contexts.
- 2.31 Some people consider that the concept of control may be difficult to apply in some cases because it requires considerable judgment to assess whether control in fact exists. In addition, control may be seen to apply to some assets only in their entirety and not to the individual rights that make up the whole; and recently, private sector standard setters are considering moving away from the use of the term “control” in determining rights to benefits for the definition of an asset.

Risks and Rewards

- 2.32 A common way to access the benefits provided by an asset is through legal ownership of the underlying resource, such as with many accounts receivable or land and buildings. Legal rights to benefits, however, can be obtained without ownership of the underlying property. As indicated above, the rights to the benefits (and the risks) attained by holding and using leased property are accessed without ownership of the leased asset itself. Therefore, ownership cannot be considered an essential characteristic of an asset because ownership is not always required.
- 2.33 The notions of “economic ownership” and “enforcing ownership rights” have been used by some in place of legal ownership. Economic ownership adopts a “risk and rewards” approach, whereby the entity has rights or access to the majority of the risks and rewards that ownership of that asset would ordinarily entail. Unlike the control approach that focuses on the power to direct how the resource is used, the risks and rewards approach focuses on an entity’s exposure to the underlying economic attributes that contribute to an asset’s value to the entity. The future economic benefits inherent in an asset are uncertain in amount. The actual benefits may be greater or less than expected, they may be realized sooner or later than expected, and their variability may be higher or lower than expected. The asset can, therefore, be linked to the entity that is exposed to these benefits and the related risks. When different entities have rights to different benefits and risk exposures related to a single resource, the rights can be allocated among the entities.
- 2.34 As with the concept of control discussed above, some people consider the concept of economic ownership to be difficult to apply because it requires considerable judgment to assess the relative risks and rewards.

Access to the Rights

- 2.35 As an alternative, the focus of an asset’s definition could be on the entity’s access to the rights to benefit from the resource in meeting its objectives. If that access exists, the entity can determine the nature and manner of use of the benefits embodied in the resource. As an example, an entity might decide to set an entrance fee to a museum, or

decide that there will be no such fee. Generally, the entity with the rights has the ability to determine whether to (a) directly use the resource's service capacity 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.

- 2.36 The advantage of a "right of access" approach is that it links the asset to the entity in terms of the entity's ability to access the benefits of the resource. If given too much prominence, however, it could result in a definition of an asset that is too broad. For example, an entity may have access to a fiber optic cable, but the cable is not that entity's asset. Further, the general public has access to many public sector assets, such as museums, but those assets do not belong to the individuals who access them.
- 2.37 The concept of access to rights may be difficult to apply to a historical cost-based model. For example, if a government sells certain rights to an asset, but retains other rights, determining the historical value of the transferred and retained rights can be problematic.

Restrict or Deny Access of Others

- 2.38 In addition to being able to access benefits, the entity must also be able to control others' access to them by denying, restricting, or otherwise regulating their access. One standard setter illustrates this by contrasting the examples of outer space and natural resources under government land. The government can obtain benefits from using the outer space resource, but it is not an asset of the government because the government cannot restrict or regulate the access of others. The government also has the benefits of the natural resource under government land, but, in this case, the entity is able to regulate and restrict the access of others to the benefits. In this latter example, the natural resource might qualify as an asset of the government.

Enforceable Claim to Benefits

- 2.39 Requiring an entity to have an enforceable claim to an asset's benefits, such as through contractual rights, has also been suggested as a criterion to link the asset to the entity. Enforceability can be represented not only by holding title to the resource, but also by being a party to a contractual arrangement, as this usually entitles an entity to access such benefits.
- 2.40 The rights to specific benefits offered by a property may be supported by several contractual rights, such as (a) the right of road access over the property, (b) a right to benefit from the land through its agricultural use, and (c) a right to explore for mineral deposits. In this case, the legally enforceable claims to each of the types of benefits could represent an asset to the holder of each specific right. However, an entity may be able to access the benefits associated with a resource in ways other than by having legal rights. For example, an entity may have developed an unpatented secret process from which it expects to access future benefits. Alternatively, an entity may be able to ensure continuing access to specific rights by imposing effective economic or social sanctions on other parties. Therefore, the requirement for an entity to have a legally enforceable claim in order to control access to the benefits may not, of itself, be considered an essential

characteristic of an asset. However, the enforceability of the rights may be an appropriate indicator for linking a resource and a specific entity.

Specific Matter for Comment 2:

- (a) Which approach do you believe should be used to associate an asset with a specific entity:
 - (i) Control;
 - (ii) Risks and rewards; or
 - (iii) Access to rights, including the right to restrict or deny others' access to rights?
- (b) Does an entity's enforceable claim to benefits or ability to deny, restrict, or otherwise regulate others' access link a resource to a specific entity?
- (c) Are there additional requirements necessary to establish a link between the entity and an asset?

Asset at the Reporting Date

2.41 The third class of characteristic of an asset relates to requiring the other essential characteristics to be met at the reporting date. Two issues are discussed that relate to this class of characteristic:

- (a) Existence at the reporting date—definition, or recognition criterion; and
- (b) Necessity of identifying a past transaction of event.

Existence at the Reporting Date—Definition, or Recognition Criterion?

2.42 Two different views are held about whether the existence of the required characteristics of the asset at the reporting date should be part of the element's definition, or be identified as a separate recognition criterion. Regardless of positioning, the issue concerns whether a probability threshold should be set on (a) the likelihood of receiving the expected inflows of benefits, or (b) whether a firm judgment is required that future benefits do or do not exist.

2.43 A fuller discussion of existence uncertainty is found in Section 6 of the CP, and specific matters for comment about a preferred approach are left to this later section.

Past Transaction or Event

2.44 Most current definitions of assets specify that an asset results from a past transaction or event. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets.

2.45 The close association between incurring expenditures and generating assets might be put forward as an essential characteristic of an asset, but the two do not necessarily coincide.

Although many public sector assets result from incurring expenditures, not every incurred expenditure gives rise to rights to future benefits.

- 2.46 Those who contend that a past transaction or event is not a necessary condition for an asset point out the following:
- (a) Past transactions or events may have resulted in assets that no longer exist; and
 - (b) The inability to identify a past transaction or event may lead to non-recognition of an asset. Many place undue emphasis on identifying the past event that gave rise to an asset. Although this may be helpful, it 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.
- 2.47 Some consider that the notion of an asset being a “present” resource is an essential characteristic rather than the requirement for a past transaction or event, as in some existing definitions. If a past transaction or other event is not considered to be an essential characteristic, it may be an indicator of evidence supporting the existence of a present resource.
- 2.48 Regardless of how this is characterized, implicitly, to be an asset, the benefits embodied in a resource must exist at the reporting date and they must be resources of the entity at that time.

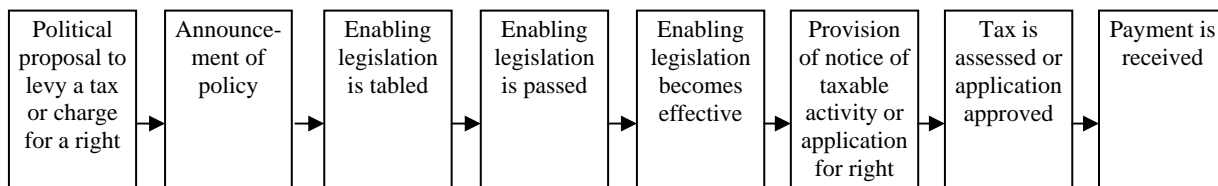
Specific Matter for Comment 3:

Is it sufficient to state that an asset is a “present” resource, or must there be a past event that occurs?

Unique Public Sector Rights or Powers

- 2.49 Governments have unique powers and rights. As a result, assets may be created in non-exchange transactions, and by virtue of exercising sovereign powers. The power to tax and issue licenses, and other rights or powers to access or to regulate access to the benefits embodied in intangible resources like the electromagnetic spectrum, are rights or powers that others do not have. Given the significant powers that accrue to sovereign governments and other public sector entities, it is often difficult to determine when such rights or powers meet the requirement of being a present resource and an asset of the entity.
- 2.50 Political proposals to exercise the government’s right or power to levy a tax or fee, for example, often begin a sequence of events that ultimately results in the flow of cash resources to the government. This is illustrated in the sequence in the diagram below. Note that each step that results in the flow of resources may occur at any time, or may occur incrementally over time. For example, it is common for a government to demand a fee in advance for a right or power that can be exercised over a number of future years (such as electromagnetic spectrum fees), or for indefinite periods (such as a lifetime motor driver’s licence). Conditions may be contingent on future events or may be fully crystallized early in the process.

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2.51 The crucial issue in determining whether the power to tax or license is an asset at the reporting date is one of identifying the conditions that must be satisfied for it to be considered a resource of the government at the reporting date. There are at least two views of when such rights are present resources, and therefore at least two views of when there is an asset:

- (a) A government entity's right to future benefits from taxes and fees, for example, is always inherent in the government's power (a rights view).
- (b) A government entity's power to levy a tax or impose fees meets the definition of an asset only when the government has exercised that power by levying the tax or assessing a fee (a power view).

There may be other points on the spectrum between these two views as the point at which an asset is considered to exist.

2.52 The first view considers the inherent right to tax as an asset at every reporting date—it is a perpetual asset. Although political, social, and economic realities may limit these powers, the right to tax is a right to future benefits that the entity is able to access and use and limit or preclude others' access at each reporting date. Therefore, such rights meet the definition of an asset. The rewards (and risks) associated with the right to tax accrue to the government entity, the future benefits are controlled by the entity at the reporting date, and the entitlement to the rights is enforceable. Benefits can be obtained by assigning such rights to other entities for a fee, or levying the tax directly. This view depends only on the condition that the rights to the benefits exist at the reporting date. It does not require a past transaction or event to have occurred to crystallize the rights as an asset.

2.53 This view is consistent with recognizing the rights inherent in an intangible asset as an asset. At the reporting date, there may not be a claim on a specific party based on the asset, but the right of the entity to access and restrict others' access to the future benefits associated with the intangible asset at the reporting date qualify it as an asset of the entity. Under this approach, there is no need to identify the point in the process—such as a political promise or the enactment of legislation—that gives rise to an asset. Although identified as a resource, these rights would still have measurement hurdles to overcome before being included in the financial statements of a government entity.

2.54 The second view holds that the power must be exercised or exercisable by the government before future benefits are considered to exist. This view relies on an action by the government to evidence the existence of the right of access to the benefits.

2.55 This approach sees the power to obtain additional assets by imposing taxes or licensing fees as a necessary but not a sufficient condition for identifying such a power as an asset.

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For example, it holds that although the power to tax is a means that can be drawn on, that power is not a right to future benefits at the reporting date unless and until it is exercised. In the sequence in the diagram above, the necessary condition would be to the right, that is, when the taxable transaction takes place or a fee is levied.

- 2.56 Supporters of this view do not believe that these powers are the same as rights inherent in intangible assets. Those assets are acquired or created by an entity, whereas these powers are inherent in a government. The perpetual nature of most governments presents a recognition issue for those who hold the first view. Supporters of the second view believe that even if the benefits associated with such a power could be measured (for example, a power that is provided for a limited period of time that may or may not be exercised) that power still does not constitute an asset.
- 2.57 Issues associated with unique public sector obligations to provide social benefits and programs are addressed in Section 3 of the CP.

Specific Matter for Comment 4:

Recognition and measurement criteria aside, are public sector entity rights and powers, such as those associated with the power to tax and levy fees, inherent assets of a public sector entity, are they assets only when those powers are exercised, or is there an intermediate event that is more appropriate?

Specific Matter for Comment 5:

- (a) Are there any additional characteristics that have not been identified that you believe are essential to the development of an asset definition?
- (b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of assets?

3. Liabilities

Overview

The second key element is liabilities. This section explains why liabilities are a necessary element of financial statements, and identifies issues that are related to this element, including those associated with unique public sector obligations. After discussing their potential characteristics, questions are asked to determine which characteristics are considered essential to a liability definition.

- 3.1 Governments exist to provide a wide range of public services, and are responsible for the ongoing provision of health, welfare, safety, education, and other services. They offer a number of social programs, such as public benefit and public pension programs, and public sector entities provide a variety of other goods and services. Public sector operations entail a variety of obligations to others. The point of demarcation between a statement of intent, a commitment, and a liability is often unclear, and may differ based on the circumstances of the transaction or other event. The absence of a robust definition of a liability can cause inconsistencies in the accounting treatment of such obligations.
- 3.2 Public sector entities also react to events such as natural disasters and epidemics to assist those in need. Some have established a pattern of past practice of fulfilling obligations related to such events, making it difficult to determine whether a government has a liability when such events occur, or even in the expectation of this type of event.
- 3.3 The way in which programs and services are carried out varies from country to country, and often from government to government within a country. Users of financial statements need to understand the effects that past and current operating, financing, capital, and investment decisions, and unexpected events have on claims of others to the entity's resources. This, in turn, affects the ability of the entity to provide future programs, goods, and services. Therefore, liabilities are a key element of the statement of financial position.

The Essential Characteristics of a Liability

- 3.4 A liability can be defined in terms of its essential characteristics. The analysis that follows distinguishes three classes of characteristics necessary for a complete definition of a liability—those that relate to:
 - (a) The substance of a liability;
 - (b) How to determine if it is a liability of the reporting entity; and
 - (c) How to determine if it is a liability at the reporting date.
- 3.5 The classes of characteristics are inferred, for the most part, from existing liability definitions developed by current standard setters.

Substance of a Liability

An Obligation

- 3.6 The terms liability and obligation are often used as synonyms, but the existence of an obligation is only one of several essential characteristics that could be used to define a liability. An obligation is generally viewed as a duty or responsibility to act or perform in a particular way to another party.
- 3.7 An obligation may be settled in a variety of ways, usually by giving up something of value to the entity—the transfer or use of cash or other assets, the provision of goods or services, or the incurrence of another obligation or liability. Obligations may also be settled through conversion of the obligation to a residual claim on the public sector entity’s net assets (similar to equity).
- 3.8 Some believe that the primary emphasis should be on the outflow or transfer of benefits, and that the emphasis on the obligation characteristic should be reduced. This position is based on the view that discharging an organizational need has the same effect on an organization’s assets as discharging an enforceable claim. From that perspective, it is the outflow of benefits from the entity and not the obligation that takes precedence.
- 3.9 Others believe that the outflow of benefits should not be over-emphasized. Although settlement by a sacrifice of benefits may be a requirement in most circumstances, it is not always present. A public sector entity, for example, may have a loan payable that is subsequently forgiven by the lender, normally another government entity; hence, there may be no outflow or sacrifice of future benefits. In other cases, a liability may be settled by replacing it with another liability. For example, governments often refinance outstanding debt when it is to their economic advantage (e.g., lower interest rates) or when cash requirements require them to refinance. In these cases, there may be no net sacrifice of benefits. However, in such a situation, two transactions have actually taken place. The entity settles the original obligation and acknowledges a new one. If only the terms of the original debt are changed, the entity still has an obligation to transfer resources in the future.
- 3.10 Regardless of how the obligation is satisfied, the entity has an obligation to transfer benefits to another party until it is settled. An obligation can be defined in a number of ways in addition to the more conventional requirement to transfer cash or other assets, or to provide goods and services. Obligations could include the following concepts that are not included in many current definitions of liabilities:
 - (a) Unconditional obligations, including stand-ready obligations to ensure against loss (risk protection);
 - (b) Performance obligations; and
 - (c) Obligations to provide access to or forego future resources.

Unconditional Obligations, including Stand-Ready Obligations

- 3.11 An *unconditional* obligation or other requirement is one that stands on its own, independent of future events. A *conditional* obligation, on the other hand, is one that relies on the possible occurrence of a future event. Those who distinguish between conditional and unconditional obligations do not consider that a conditional obligation gives rise to a liability at the reporting date.
- 3.12 An unconditional obligation includes stand-ready obligations where, although there may be uncertainty about the future outflow of benefits, there is no uncertainty about whether an obligation in fact exists. This includes obligations resulting in guarantees against loss in case of flood, public sector crop or export receivable insurance obligations, and derivative contracts in loss positions. In these examples, because the entity *unconditionally* stands ready to provide resources, these obligations fall within this concept of a liability. The obligation to compensate a specific future loss is a *conditional* obligation (contingent on the future occurrence of an insurable loss event) that falls outside the definition of an existing obligation until that future loss occurs. Some consider that the nature of a government's obligations to provide social benefits and programs to citizens and other eligible residents may also be considered unconditional obligations. These unique public sector obligations are addressed separately later in this section.
- 3.13 The requirement that the obligation be unconditional may be useful in determining whether other obligations, such as those under many executory contracts should be considered liabilities. If a government entity signs a contract for delivery of a given quantity of material in the following year, past practice has been to not recognize a liability because there has been no performance by either party to the contract. This contract could be excluded instead on the basis that it is a conditional contract—one that is contingent on future deliveries as specified. However, a similar contract that entails a “take-or-pay” feature (i.e., the entity takes delivery of some material and pays for it, and also pays for contracted amounts not taken) would be an unconditional obligation that may give rise to a liability.
- 3.14 Alternatively, issues may arise when applying an “unconditional” obligation requirement to conditional liabilities associated with both exchange and non-exchange transactions. For example, a pension obligation with a vesting provision is contingent on future events (employees remaining in the entity's employ until the vesting period is attained), although there may be a stand-ready obligation to meet that commitment. In addition, governments and other public sector entities, by their nature, stand ready to provide cash or other goods and services under law, regulation, or past practice where sectors of the population experience extreme hardship. In the public sector particularly, it may be difficult to draw the distinction between a conditional obligation and a stand-ready unconditional obligation.

Performance Obligations

- 3.15 A performance obligation is an obligation in an agreement between the government or other public sector entity and another party to transfer a resource to the other party. These

obligations represent performance obligations of the government and are sometimes referred to as “deliverables.”

- 3.16 The obligation within a contract or other agreement for a government to provide a service is also considered a performance obligation. The obligation underpinning a performance obligation is typically explicitly stated in the agreement itself. For example, a government entity may enter into an agreement to provide specific community services during the year. Such explicit obligations within a contract or other agreement generally can be easily identified.
- 3.17 However, an obligation may also arise when entering into a contract or other agreement even though the agreement itself makes no mention of the obligation. For example, a statutory requirement imposed on a public sector entity is an implicit obligation that is added to an agreement between the government entity and the other party. This implicit obligation may give rise to a performance obligation just as an explicit obligation would. Whether by the explicit terms of the agreement or by requirements imposed by legislation, any obligation to transfer resources to another party that arises as a result of entering into the agreement could be considered a “performance” obligation of the government.

Obligations to Provide Access to or Forgo Future Resources

- 3.18 Complexities may arise when the service is to be provided by the other party to the contract, and the government grants that party, for a fee, the right to use a government asset that the government continues to recognize. If the services continue to be provided to the government’s constituents as in the past, questions arise as to how and whether a performance obligation associated with the granted rights should be reported. In this situation, some believe agreeing to provide access to the asset could be viewed as a stand-alone performance obligation or a liability. In contrast, if the government has added no new obligations to perform, the granting of access to an asset that will continue to be used to provide services to the government’s constituents does not require the government to perform. Based on this scenario, others believe that there may be no performance obligation or liability.
- 3.19 As indicated, there is some question as to whether providing a right of access actually entails a transfer of resources and, therefore, an obligation or liability. For example, assume that a government entity contracts with a private sector entity to construct a highway, with the government maintaining ownership of the asset. The private sector entity agrees to maintain the highway under a 20-year contract that permits it to charge a toll that will more than compensate it for any maintenance costs. On entering into the contract, the service provider pays a lump sum to the government that represents the net value of the contract. What is the public sector entity’s obligation? Is it the requirement to allow the contracting party access to the future benefits of the highway? Some will conclude that the government has no further responsibility or obligation as long as the other party to the contract abides by the terms of the contractual arrangement. Is the obligation the requirement for the government to refrain from charging tolls (netted against the reduction in government-incurred maintenance costs), and therefore to forgo

net resources in the future? Governments still have the right to increase taxes, even though they may agree not to levy direct charges for the use of the asset. Is a non-competition agreement that is similar in substance an obligation (a liability) of a public sector entity entering into such a contract?

- 3.20 In addition, if that approach is ultimately adopted, accepting the view that a requirement to provide a right of access is a transfer of resources appears to be inconsistent with a rights approach to asset definition. Under a rights approach, an asset such as the highway is a combination of the rights to the various benefits it provides, such as (a) the rights to access the benefits associated with its service potential over its useful life, (b) the rights to levy fees and generate cash flows from its use, and (c) its residual value when it is no longer serviceable. Because the government entity disposed of the rights to 20 years of the cash flow potential of the road for a lump sum payment under the contract, these rights are no longer held by the public sector entity. In concept, they should be derecognized. Accepting that assets are restricted rights to benefits would require derecognition of the asset rights, not the incurrence of an obligation to supply those rights to another party. Such rights were transferred under the contract. This transaction is similar to the securitization and sale of rights making up an accounts receivable portfolio. In that case, the accounts receivable are broken into their various rights and obligations, and only the remaining rights and obligations are determined to be assets and liabilities.

Settlement Date

- 3.21 Some believe that including the notion of a settlement date should be considered to determine whether an item is a liability or a contribution from an owner. They note that although “owners” have claims on the residual interest of an entity, those claims have no time element. Further, in some instances a public sector entity may have created a valid expectation, but there is no time element and the public sector entity may be able to put off settlement indefinitely. A claim or obligation that is not payable on demand, on a specified date, or on the occurrence of a specified future event, may be subject to doubt as to whether the item meets the definition of a liability.
- 3.22 Others do not support the need for a settlement date as an essential characteristic. They note cases, such as lawsuits, where the entity may not know the timing of any settlement. From this perspective, if the existence of a settlement date was identified as a fundamental characteristic, such items would not be classified as liabilities until the settlement date was known. Alternatively, a settlement date with a definition that included “on the occurrence of a specified future event” might alleviate this concern.

Specific Matters for Comment 6:

- (a) Should the definition of a liability cover all of the following types of obligations?
- (i) Obligations to transfer benefits, defined as cash and other assets, and the provision of goods and services in the future.
 - (ii) Unconditional obligations, including unconditional obligations to stand ready to ensure against loss (risk protection).

- (iii) Performance obligations.
- (iv) Obligations to provide access to or forego future resources.
- (b) Is the requirement for a settlement date an essential characteristic of a liability?

Liability of the Reporting Entity

- 3.23 A second class of characteristics relates to aspects that link the obligation to the specific entity. The entity is obligated if (a) it is required to bear the obligation resulting from an exchange or non-exchange transaction, and (b) this obligation is enforceable.
- 3.24 Most current definitions of a liability include the phrase “of the entity,” “of a government,” “of the federal government,” or “of a particular entity” to link the liability to a particular entity. Such phrases imply that the entity referred to is the party that has the obligation and will bear the burden.

Entity’s Duty or Responsibility to Others

- 3.25 An entity’s duty or responsibility to others is another potential essential characteristic of a liability. Supporters of this characteristic believe that there is a benefit in linking the obligation to a specific recipient entity. They note that obligations are usually documented and the obligations of each party are set out. For example, a construction contract to build a new water treatment facility usually specifies the names of the parties to the contract and its terms and conditions. However, it may not be necessary to know the identity of the other party before the time of settlement in order to qualify as an obligation and a liability. For example, a government may have an environmental liability without knowing the identity of the contractor who will be hired to carry out the work.
- 3.26 Supporters of this characteristic also believe that a public sector entity cannot be both the entity that is obligated and the entity to which settlement will be made. The obligation must be to an individual, organization, or other party external to the reporting entity. For example, a government has a policy and a duty to maintain its roads to a specified standard of condition. Until services are performed by others to maintain the road’s condition, the entity has no responsibility to an external party and, therefore, there cannot be a liability. Although uncommon in the public sector, individuals with ownership-type interests acting in their capacity as owners are not considered “other parties.” Under this approach, claims to an entity’s residual interest that are capable of settlement only as a result of actions by the entity, are not liabilities of the entity.
- 3.27 Others believe that this characteristic is not essential to the definition of a liability. They consider that a discussion of this characteristic is useful only to clarify the definition.

Enforceability on the Entity

- 3.28 The absence of a realistic alternative to avoid the obligation is another potential essential characteristic in developing the link between the entity and the obligation. There are several approaches to identifying transactions and other events that would meet this characteristic:

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- (a) Enforceable contractual, constructive, and equitable obligations.
 - (b) Enforceable contractual, constructive, and equitable obligations and other constructive and equitable obligations associated with exchange transactions.
 - (c) Enforceable contractual, constructive, and equitable obligations and all other constructive and equitable obligations from which the public sector entity cannot realistically withdraw.
- 3.29 The **first approach** uses enforceability to determine whether an entity has no realistic alternative to avoid the obligation. Many liabilities arise from contractual obligations resulting from deliberate actions of the entity, such as exchange transactions with other parties. For example, borrowing cash requires an entity to repay the amount borrowed; acquiring assets on credit obliges an entity to repay the credit. These obligations are based on written or oral agreements that set out the requirement to transfer cash or other assets, or to provide services to specified or determinable other parties. In other cases, an entity has the ability to make choices, judgments or decisions. For example, budgeting for the purchase of a fire truck and commitments for future ongoing program expenditures are possible future obligations that a government can avoid through its own actions. The entity is not bound to a particular course of action. It has the discretion to change or avoid the possible future obligation through its own actions.
- 3.30 Enforceable obligations include those that are established by contract or that are otherwise enforceable by a court of law. In some cases, constructive obligations—those that are created, inferred, or construed from the facts in a particular situation—may also be enforceable by the operation of various legal doctrines. Such doctrines can be considered part of the law, and thus are also legally enforceable. In some jurisdictions, equitable obligations—those that stem from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right—might also be legally enforceable when they are supported by courts of equity. Such courts resolve disputes between parties through applying principles of fairness and justice.
- 3.31 Obligations of a government entity might also arise from actions taken by others that are binding on it, such as legislative actions (based on statutes such as those requiring income and sales taxes), judicial actions (such as court awards for damages), or executive actions (for example, regulatory requirements or fines). Even if the public sector entity has some discretion in how it responds to such actions, as long as the entity is required to take some action that necessitates an outflow of economic benefits, it has an obligation. For example, the entity might have a choice of remedying a breach of legislation or paying a fine. As long as others can legally enforce the action, the entity is obligated.
- 3.32 Supporters of this approach believe that moral compulsion differs in substance from legal compulsion. They believe constructive obligations that are not legally enforceable should not be included in the definition of a liability because of the judgment required in determining if the entity is socially, morally, or economically compelled. For example, a government may decide whether it is “compelled” to carry out a program based primarily on economic conditions at one time, and may decide differently under other conditions.

- 3.33 The **second approach** recognizes that, in addition to legally enforceable obligations, obligations arise because of a government's own actions or conduct. In these cases, social, moral, or economic consequences leave the government no realistic alternative to avoid the future sacrifice of resources. Under this approach, such additional constructive obligations arise only from exchange transactions. When parties complete an exchange transaction, they do so after evaluating their understanding of what is given and received under the terms of the transaction. This exchange may not be legally enforceable. Examples include obligations in certain circumstances to an employee who has provided services, in part in expectation of receipt of a certain level of bonus.
- 3.34 Supporters of this approach believe that when one party has transferred resources to the government, the government has an obligation to fulfill its side of the transaction. Even if the agreement is not legally enforceable, the government may have an obligation because of social, moral, or economic consequences if it does not initially fulfill its agreement. The supporters of this approach, however, do not believe that the constructive obligation provisions should be extended to non-exchange transactions because of the significant discretion that exists in administering transactions that are not legally enforceable.
- 3.35 The **third approach** extends the application of constructive obligations to non-exchange transactions from which the public sector entity cannot realistically withdraw. For example, a government entity may announce the terms of a new program, the intended recipients are aware of the program, and they qualify under its terms. In this case, the entity creates a valid expectation among the recipients and a reliance by them on the government meeting its obligation. As a result, the government cannot realistically withdraw from that obligation. Examples of evidence that support the existence of an obligation might include an announcement of the amount to be provided, the time frame for implementation, and identification of the individuals, organizations, or groups affected by the decision. Intentions and individual items of evidence on their own may not be sufficient to determine whether a government has created a valid expectation. Announcements of decisions and other types of communication must be considered together. Each situation needs to be judged on its own merits, and would likely require substantial guidance to ensure consistent application of this approach.
- 3.36 When the evidence as a whole raises a valid expectation for the entity to perform, the entity cannot realistically withdraw from it. Supporters of the third approach believe that non-exchange transactions should not be treated differently from exchange transactions in linking the entity and the obligation.

Specific Matter for Comment 7:

- (a) Should the ability to identify a specific party(ies) outside the reporting entity to whom the entity is obligated be considered an essential characteristic in defining a liability, or be part of the supplementary discussion?
- (b) Do you agree that the absence of a realistic alternative to avoid the obligation is an essential characteristic of a liability?
- (c) Which of the three approaches identified in paragraph 3.28 do you support in determining whether an entity has or has not a realistic alternative to avoid the obligation?

Liability at the Reporting Date

3.37 A third class of characteristics relates to requiring the obligations of the entity to be considered liabilities at the reporting date. Two related issues are discussed:

- (a) Existence at the reporting date—definition, or recognition criterion; and
- (b) Necessity of identifying a past transaction or event.

Existence at the Reporting Date—Definition, or Recognition Criterion

3.38 Two different views are held about whether the existence of the characteristics of the liability at the reporting date should be a part of the element’s definition, or separately identified as a recognition criterion. This issue centers on whether a probability threshold should be identified for the likelihood of having to transfer benefits to others, or whether a firm judgment is required that the obligation does in fact exist at the reporting date.

3.39 Section 6 of the CP provides a fuller discussion of existence uncertainty, and questions about a preferred approach are left to this later section.

Necessity of Identifying a Past Transaction or Event

3.40 As with assets, there may be difficulties in requiring the occurrence of a past transaction or event as an essential characteristic:

- (a) The liability resulting from a past transaction may no longer exist;
- (b) The inability to identify a past transaction or event may lead to present obligations not being identified. Although an observed transaction or other event might signal that a liability exists, the failure to identify a past event may not negate the existence of a liability at the reporting date; and
- (c) In a public sector context, there may be many possible related past events, making it difficult to identify the key past event. This approach may deflect the discussion away from whether it is an obligation at the reporting date to determining what the past transaction or event was.

- 3.41 The current definition of a liability developed by most standard setters includes the requirement that a liability arise from a past transaction or event. Some believe that this characteristic provides additional context and clarification. They believe that, although identifying an obligating event may be difficult, such a past event is essential to the definition of a liability. It eliminates any uncertainty about whether transactions or other events expected to occur in the future do not, in themselves, give rise to present obligations. It does this by making explicit that the event giving rise to the entity's obligation has already occurred. They believe it is a foundation on which any definition should be built.
- 3.42 Requiring a liability to be a "present" obligation as an essential characteristic in the definition may capture the same intent as the "past transaction or event" requirement in existing definitions. Even if not included as an essential characteristic, the occurrence of a past transaction or event can indicate the existence of a present obligation.
- 3.43 This issue is particularly relevant in the case of executory contracts, where the reporting entity may enter into a non-cancellable obligation—suggesting a present obligation, but the other party has material unperformed obligations—suggesting a future obligation.

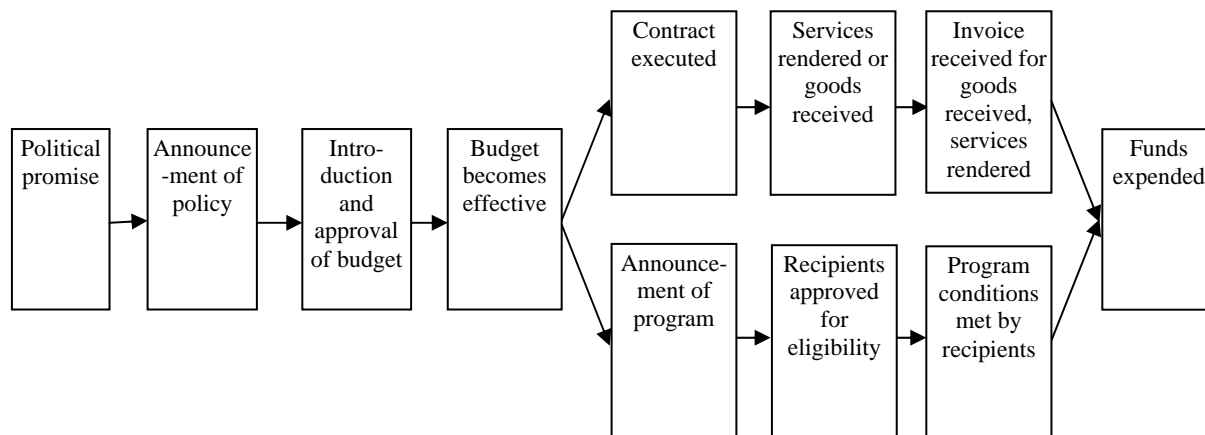
Specific Matter for Comment 8:

Is it sufficient to state that a liability is a "present" obligation, or must there be a past event that occurs?

Unique Public Sector Obligations

- 3.44 Similar to the issue of when a government's power to levy taxes and impose fees gives rise to an asset, questions arise about when a government's obligations to provide social benefits and programs to citizens and other eligible residents are considered liabilities. One view holds that these obligations are similar in nature to unconditional obligations, including stand-ready obligations, discussed earlier in this section of the CP.
- 3.45 Forming a conceptual basis to determine when public sector obligations give rise to a liability has its challenges. As general government responsibilities and duties become plans, and plans become commitments and then are ultimately carried out, the events that unfold can be viewed along a sequence (see below). Preceding the political promise at the left end of the diagram are general government obligations; at the other end is the receipt of an invoice for goods provided or services rendered or, in the case of a non-exchange transaction, the satisfaction of conditions for payment.

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3.46 Not all the processes illustrated apply to all transactions or other events. For example, some transactions may not be budgeted, and in some countries the budget must receive two or more approvals, such as from Parliament and from the Ministry of Finance. In addition, not all phases will occur in the same sequence. For example, an announcement of policy under a specific program may occur after the budget has been approved. However, the sequence does provide a broad overview of how a government's obligations are carried out throughout the system.

3.47 The critical issue in determining whether general government obligations are liabilities at the reporting date is the identification of the conditions that must be satisfied for there to be no realistic alternative to avoid the obligation. Three views are discussed:

- (a) A government's responsibilities are perpetual obligations.
- (b) A government's responsibilities are considered obligations of the entity only when they lead to enforceable claims.
- (c) A government may have sovereign power to unilaterally avoid its obligations.

Perpetual Obligations

3.48 One view holds that, similar to the power to tax being a perpetual asset, the inherent responsibilities of governments result in the existence of perpetual obligations. A government cannot avoid its obligations to provide security, education, health, and other services to its citizens. These obligations require the transfer of resources (cash, other assets, goods, and services) in the future. Although not contractual in form, they are constructive obligations in nature, and the government has no realistic alternative except to fulfill these obligations. This view would not require the occurrence of a past transaction or event for the obligation to meet the definition of a liability.

3.49 At the reporting date, there is no claim to the entity's resources by a specific party; however, future events will crystallize the timing and the claimants. This is analogous to other types of recognized obligations, such as retirement, health care, and environmental obligations. Under this approach, there is no need to identify the point in the process—such as meeting the stipulations for a grant—that gives rise to a liability, and, as such, a liability would exist far to the left on the above diagram. If they are defined as

liabilities, these obligations would likely encounter measurement hurdles before being included in the financial statements of a government entity.

Obligations only when they lead to Enforceable Claims

- 3.50 The second view holds that the parties to whom the obligations are made must presently be able to enforce their claims. The parties may be specific individuals or organizations, or groups of individuals or organizations who can justify their claims on some basis, such as on contractual, constructive, or moral grounds.
- 3.51 This approach sees the obligation to transfer resources as a necessary but not a sufficient condition for identifying such responsibilities as liabilities. It holds that enforceability occurs only when events have occurred that obligate and commit the government to act in a particular way. Under this view, an obligation would meet the definition of a liability only towards the right-hand side of the above diagram.
- 3.52 The unique role of the budget for some government entities may play a part in determining if an obligation exists. The budget may be based on stated management policies, be approved by the legislature, and it, along with the government's policies, and programs, may have the force of law or regulation when the budget becomes effective. Does the approval of the budget transform such plan, policies, and programs into enforceable obligations at the date the budget is approved?
- 3.53 Although the program is enacted and spending has been approved, the question arises whether the government at this point has an enforceable obligation to parties outside the entity. If programs will be carried out through exchange transactions, agreements with parties external to the entity may not have been entered into and, therefore, enforceable obligations may not exist. To the extent that the programs will be carried out through non-exchange transactions, conditions required of others external to the entity may not have been met at the reporting date; or the reporting entity may unilaterally be able to deviate from the plan by organizing its activities in a different way.
- 3.54 Accepting legislatively approved budget items for all policies and programs as liabilities may be tantamount to defining all budgetary appropriations as liabilities. Some might consider that this would be similar to recognizing as liabilities obligations the entity has to itself, or to those with a residual interest in the entity, i.e., the general public.
- 3.55 What gives rise to a liability at the reporting date may depend on the facts and circumstances associated with the particular situation. In most exchange transactions, an obligating action can be clearly identified. In this case, and as captured in the "services rendered or goods received" box in the above diagram, the obligation becomes enforceable when the underlying exchange takes place, that is, on receipt of the goods or services.
- 3.56 Identifying the event that gives rise to an enforceable obligation for non-exchange transactions by a grantor (transferor) is more difficult. When a transferor agrees to provide assets or services to an individual or other entity under certain conditions, and those conditions have been met, some believe that the transferor has a duty and a present

obligation. This is portrayed in the “program conditions met by recipients” box in the diagram above.

- 3.57 If the transferor has agreed to provide assets or services and there are no conditions imposed, the enforceability of the obligation at the reporting date comes into play in determining if the transferor has a liability. An enforceable obligation may not exist if the transferor has a realistic alternative to avoid the transfer of benefits. Identifying when obligations crystallize is often problematic, and relies on the principles underlying the liability definition and the exercise of judgment.
- 3.58 The recipient in a non-exchange transaction also must resolve the issue of when it has a liability related to assets and other benefits received under laws, regulations, or other binding agreements (including conditions imposed in the grant agreement). Such non-exchange transfers often impose stipulations on the recipient. Stipulations have previously been defined by the IPSASB as terms in laws, regulations, or other binding arrangements that are imposed on the use of the benefits transferred to another entity or individual. Some stipulations require the return of the transferred benefits if the recipient does not comply with the terms of the agreement, while others do not require their return. When does a recipient have a liability related to the transferred assets?

Sovereign Power to Avoid Its Obligations

- 3.59 Some suggest that sovereign power—the ultimate authority of a government to make, amend, and repeal legal provisions—enables a government to walk away from many of its obligations, including social benefit obligations. On the other hand, this power is usually constrained, as there are likely to be economic, social, or political consequences of exercising such power.
- 3.60 The existence of such a power introduces complexity into the discussion of which obligations should be defined as liabilities. Although the existence of this right alone may influence the “enforceability” condition, it is not reasonable to exclude all obligations as liabilities on this basis. At a minimum, any discussion supporting the definition of a liability should specify what underlying assumption is made about this specific power of government. One approach may be to base the determination of whether a liability exists by reference to the legal position at the reporting date, rather than whether sovereign powers may give it the absolute or conditional ability to repudiate an obligation.

Specific Matter for Comment 9:

- (a) Recognition and measurement criteria aside, are public sector entity obligations such as those associated with its duties and responsibilities as a government, perpetual obligations, obligations only when they are enforceable claims, or is there an intermediate event that is more appropriate?
- (b) Is the enforceability of an obligation an essential characteristic of a liability?
- (c) Should the definition of a liability include an assumption about the role that sovereign power plays, such as by reference to the legal position at the reporting date?

Specific Matter for Comment 10:

- (a) Are there any additional characteristics that have not been identified that you believe are essential to the development of a liability definition?
- (b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of liabilities?

4. Financial Performance: Revenue and Expense

Overview

This section begins by setting out two approaches to measuring financial performance, including the effect of each on financial position elements. The section then addresses specific issues associated with revenue and expense definitions. Choices of potential essential characteristics are identified, with the most critical—whether the elements are based on revenue and expense-led, or asset and liability-led, definitions—discussed first.

Approaches to Reporting Financial Performance

- 4.1 Governments and other public sector entities raise resources from taxpayers, service users, and other resource providers, to help provide services to citizens and other service recipients for a variety of social and economic purposes. The entities are accountable to those who provide them with the resources, and to those who depend on them to use the resources to deliver necessary services and fulfill existing obligations.
- 4.2 To fulfill the accountability objective and meet user needs for information for decision-making purposes, financial statements need to provide the following information about both financial position and financial performance:
 - The amount and type of resources raised by a government or other public sector entity during the reporting period, the resources available to support future operations, and the obligations to be met in future periods; and
 - The amount and type of resources used in providing services, the acquisition of capital assets, the repayment of debt, or for other purposes during the period.
- 4.3 Users of financial statements are interested in the financial performance of the entity's management. The statement of financial performance facilitates assessments of the entity's resource requirements, the purposes to which resources were used, and the nature and extent of its revenue-raising activities. The net results over the period provide a measure of whether the revenues recognized were sufficient to meet the costs incurred during the period.
- 4.4 There are two different approaches as to what is meant by financial performance. These result in possible different definitions of the elements related to financial performance and financial position. One approach measures financial performance as the net result of all changes in the entity's resources and obligations during the period (asset and liability-led approach), while the other measures financial performance as the result of the revenue inflows and expense outflows more closely associated with the operations of the current period (revenue and expense-led approach).
- 4.5 The proponents of both approaches to financial performance support the importance of the statement of financial performance in meeting the objectives of financial reporting; and agree that financial performance excludes transactions with owners, and that the approaches are not directly associated with particular measurement choices.

Revenue and Expense-Led (R&E) Approach

- 4.6 Under the R&E approach, revenues and expenses are identified and defined as the primary elements—basically as flows that relate to the efforts of the current period.
- 4.7 Financial performance under this approach is measured based on flows that relate directly to current period operations. This requires the deferral of some flows and the recognition of deferred items (deferred inflows and deferred outflows) in the statement of financial position. This approach, therefore, sees accounting as a process of allocating inflows and outflows to particular periods. The principal building blocks of such a system are events, transactions, and the resource flows they entail, rather than resources and obligations.
- 4.8 A public sector application of this approach attributes the costs of services to the period in which the services are provided, and attributes tax and other revenue to the period in which they were intended to finance the related costs. Users of financial statements are then able to assess whether the taxes and other revenues recognized in the period were sufficient to finance the recognized costs of providing programs and services during that period.

Asset and Liability-Led (A&L) Approach

- 4.9 Under the A&L approach, assets and liabilities are identified and defined first—basically as resources and obligations. Revenues and expenses are then defined as the result of changes in assets and liabilities. In fact, assets are the starting point for determining all of the other elements, as liabilities are defined with reference to their being claims on assets.
- 4.10 This approach views financial performance as the change in net financial position over the reporting period. All items that represent increases or decreases in the recognized net resources of the entity between financial reporting dates are included in this measure.
- 4.11 To give meaning to financial performance and, therefore, to the elements comprising financial performance, the elements constituting financial position—assets and liabilities—must first be given meaning. For this reason, assets and liabilities are the principal building blocks of such a system, and are defined in terms of resources and obligations, that is, in terms of real economic phenomena. Revenues and expenses are then defined in terms of changes in the net resources.

Illustrating the Approaches

- 4.12 The choice between the two approaches directly affects the elements to be defined and the basis for their definition. The following examples illustrate the basic differences between the two approaches. Other examples using specific public sector situations could be used, but the variability of such arrangements internationally combined with unresolved liability definition issues, increase their complexity and limit their usefulness in explaining the two approaches.
- 4.13 *Example 1:* In Year 20X1, public sector entity X receives a CU2,000 grant to finance the construction of a public library. The grant requires repayment of the full amount only if the funds are not used to construct the library; the grant does not relate to the library's

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operations. The entity recognizes obligations from a non-exchange transaction as a liability until the conditions imposed on the entity have been met. The library is completed and paid for at the end of 20X2, is expected to have a 40-year useful life, and its costs are recognized as expenses over the periods benefitting from use of the library services. The table below illustrates how financial performance and financial position differ under the two approaches to element definition for public sector entity X.

Asset and Liability-Led Approach

	20X1	20X2	20X3
Statement of Financial Performance:			
Revenue	-0-	2,000	-0-
Expense	-0-	-0-	50
Surplus (deficit)	-0-	2,000	-50
Year-end Financial Position:			
Asset	2,000	2,000	1,950
Liability	2,000	-0-	-0-
Net assets (net liabilities)	-0-	2,000	1,950

Revenue and Expense-Led Approach

	20X1	20X2	20X3
Statement of Financial Performance:			
Revenue	-0-	-0-	50
Expense	-0-	-0-	50
Surplus (deficit)	-0-	-0-	-0-
Year-end Financial Position:			
Asset	2,000	2,000	1,950
Liability	2,000	-0-	-0-
Deferral		2,000	1,950
Net assets (net liabilities), including deferrals	-0-	-0-	-0-

- 4.14 Under the A&L approach, public sector entity X reports a CU2,000 liability only until the conditions of the grant are met. When met, the entity has no further obligation to the grantor and the CU2,000 is recognized as revenue. This amount is included in the measure of financial performance in 20X2, and is included in the net assets of public sector entity X in the same year. The library asset is a resource, and it continues to be recognized as an asset with its cost allocated to expense for each period it is used to provide services.
- 4.15 Under the R&E approach, the CU2,000 inflow from the grantor cannot be associated with the operations of public sector entity X until 20X3, when the benefits associated with the

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grant begin. Because it does not meet the definition of revenue until 20X3, the full CU2,000 inflow is recognized as a liability (in 20X1) or deferred inflow (in 20X2 and 20X3) until that time on the statement of financial position. The benefits associated with the grant are recognized as revenue and included in the measure of financial performance over the useful life of the asset it helped to finance, beginning in 20X3, and the deferred inflow is reduced in the same pattern. Under this approach, the library is recognized as an asset on the basis that it is a resource that will benefit future periods, and its cost is recognized as an expense over the period it is used to provide services.

- 4.16 *Example 2:* Based on law, on January 1, Year 20X1, 20X2, and 20X3, Government Y levies a property tax of CU100 each for the years 20X1, 20X2, and 20X3 respectively. In 20X3, the law is changed so that a CU100 tax for 20X4 is levied on December 1, 20X3 instead of January 1, 20X4. Government Y follows a policy of recognizing the tax asset (taxes receivable) in the period the tax is levied.

The table below illustrates how the major elements, and the statements of financial performance and financial position differ under the two approaches to element definition.

Asset and Liability-Led Approach

	20X1	20X2	20X3
Statement of Financial Performance:			
Revenue	100	100	200
Expense	-0-	-0-	-0-
Surplus (deficit)	100	100	200
Year-end Financial Position:			
Asset	100	200	400
Liability	-0-	-0-	-0-
Net assets (net liabilities)	100	200	400

Revenue and Expense-Led Approach

	20X1	20X2	20X3
Statement of Financial Performance:			
Revenue	100	100	100
Expense	-0-	-0-	-0-
Surplus (deficit)	100	100	100
Year-end Financial Position:			
Assets	100	200	400
Deferral	-0-	-0-	100
Net assets (net liabilities), including deferrals	100	200	300

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- 4.17 For the first two years, both approaches report the same amounts for revenues, surplus, and net assets. In 20X3, however, the revenue, surplus, and net asset amounts differ. Under the A&L approach, the full CU200 of 20X3 asset inflows are recognized and reported as revenue. This result is reported because the CU100 asset inflow related to 20X4 does not result in an obligation that is recognized as a liability at December 31, 20X3. Because the net assets increased by CU200 in the year, that is the measure of financial performance for 20X3.
- 4.18 Under the R&E approach, the accounting decision reflects a judgment about the inflows that should be reported on the period's statement of performance. Because only CU100 of the asset inflows in 20X3 are considered attributable to the provision of 20X3 services and programs, the other CU100 asset inflows (for 20X4 services and programs) are recognized as deferrals on the statement of financial position at December 31, 20X3. The measure of financial performance for each period therefore represents the net asset inflows over time that are attributable to the period's programs and services.
- 4.19 As the examples provided illustrate, the two approaches to financial performance and revenue and expense definition result in recognition of different items on the statement of financial position. Therefore, depending on the conceptual approach that is supported, the implications for the statement of financial position are that either:
- (a) Two elements are identified: assets and liabilities as resources and obligations (A&L approach), or
 - (b) Four elements are identified: assets and liabilities as resources and obligations, and deferred inflows and deferred outflows (R&E approach).
 - (c) These choices are explored in more detail in Section 5 of this CP.

Advantages of Each Approach to Element Definition

Revenue and Expense-Led Approach

- 4.20 In the public sector, the budget plays an important role in the accountability cycle of the entity. It is the publicly communicated document against which results are measured, the basis upon which taxes are levied, and the basis for planning the resources needed for the goods and services to be provided for a predetermined period, usually a year. The focus on current operations in the R&E approach therefore is seen to increase the relevance of the statement measuring financial performance.
- 4.21 It is argued that, because a public sector entity is accountable for raising revenue and the uses to which it is put, this should be the primary indicator of the financial performance of the entity. Further, the principle that taxpayers pay only for the services they receive, and not pass on obligations to future taxpayers, should underlie any measure of financial performance. The R&E approach may better align with these features.
- 4.22 Supporters contend that the surplus/deficit is a measure of the performance of the entity and its management. Therefore, measuring revenue and expenses and the timing of their recognition should be the focus of financial reporting. Since revenues and expenses are

the key measures of financial performance, net financial position should be determined as a result of this process.

- 4.23 In addition, a statement of financial position that includes deferred items reduces volatility in reported financial performance. Because there is an appropriate allocation of flows to future periods that are not associated with the current period, users can better assess the financial impact of current period services.

Asset and Liability-Led Approach

- 4.24 The predominant thinking behind this approach is that the measure of financial performance should be grounded in real economic phenomena. Assets and liabilities represent resources and obligations that can be observed and verified directly. Using asset and liability definitions as anchors imposes limits or restraints on what can be included in assets and liabilities (financial position), and also in the directly related aspect of financial performance. All items that represent changes in the net resources of the entity between the financial reporting dates are included in the measure of financial performance, ensuring a high level of reliability, understandability, consistency, and comparability of the information, and resulting in a relevant metric to assess accountability.
- 4.25 Because this approach includes all changes in assets and liabilities in one statement, and produces one “bottom line” for explaining the change in net assets/net liabilities, it does not require judgment to determine which transactions and events that affect financial position are included or excluded from any specific period’s measure of financial performance. Artificial smoothing of periodic results is avoided. Proponents of the A&L approach argue that unless critical terms such as “applicability to the current period” and “non-distortion” of surplus/deficit can be precisely defined, surplus/deficit calculations that result from other approaches are largely subjective. Past experience and attempts to define revenue and expense independently as the primary foundation of financial statements have generally not been successful.
- 4.26 Proponents of this approach also suggest that the need to focus on a public sector entity’s resources, such as its physical assets available to provide future services, and obligations to be settled in the future, supports taking an A&L approach. For example, because public sector entities function to provide public goods and services, it can be argued that the conceptual underpinning of financial statements should be the resources available to provide those services, obligations to transfer those resources to others, and the net resources available to finance future operations. From this point of view, it is important to determine whether the extent of the resources available for future periods, or the obligations arising from past periods, have increased or decreased. Measuring financial performance on this basis provides this information.

Summary

- 4.27 Regardless of whether an A&L approach or a R&E approach is taken, the asset and liability elements can be defined in the same way (i.e., as resources and obligations) if new elements are identified to capture the deferred outflows and deferred inflows that result from applying the R&E approach. To develop the revenue and expense elements

portion of the Conceptual Framework, however, it is necessary to decide on the concept of financial performance that should underlie financial statements. The approach chosen, therefore, influences (a) the characteristics that are required in the definitions of revenues and expenses, discussed next, and (b) whether deferred outflows and deferred inflows need to be defined as separate elements.

Essential Characteristics of Revenue and Expense

- 4.28 Revenues and expenses can arise from transactions (whether exchange or non-exchange) and from other events, such as price changes or impairments and their reversal. Some standard setters refer to the positive results of such transactions and events as “income,” using the term “revenue” more narrowly for specific types of income. This paper uses “revenue” as the broader term. Standard setters have established definitions of revenue and expense, setting out a number of characteristics in those definitions.
- 4.29 Recognizing that slightly different terms are used in these definitions, they nevertheless provide a basis for identifying the issues that need to be resolved in determining the essential characteristics of revenue and expense before developing a definition of each element. The most critical issue is how revenues and expenses should be associated with the reporting period: an association based on changes in assets and liabilities during the period; or an association with the goods and services provided in the period, and the taxes levied and other inflows generated to cover the cost of those goods and services. Other issues that need to be resolved before developing satisfactory definitions of these two elements are:
- (a) Whether transactions with residual/equity interests (owners) should be excluded from the definitions; and
 - (b) Whether revenue and expenses should be restricted to the results of specific activities.

Association with the Reporting Period

- 4.30 The first issue is how revenue and expenses should be associated with the reporting period. Are revenues and expenses recognized as flows that are “applicable to” the reporting period, or are they a result of flows “during” the period that change the stock of assets and liabilities? Flows include both cash and non-cash items. Which approach is more appropriate follows logically from the conclusion as to whether a R&E approach or an A&L approach should predominate, as explained above.

Flows Applicable to the Period

- 4.31 Those who support a R&E approach to financial performance favor the description of revenues and expenses as “applicable to” the period. Transactions that may be considered *not* applicable to the period and that, therefore, may give rise to deferred outflows or deferred inflows could include:
- (a) Outflows of resources related to future services which do not meet the definition of an asset.

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- (b) Time restrictions on the application of inflows of resources when such application does not meet the definition of a liability.
 - (c) The sale of resources not previously recognized in the financial statements (future resources).
 - (d) Changes in the fair value of recognized assets when there is little likelihood of realization of the gain or loss.
- 4.32 For non-exchange inflows such as taxation, the association might be directly with the period in which the taxable events or transactions occur. Other non-exchange revenues and other events could be considered “applicable to” the reporting period on different bases, such as when the benefits (including service potential) transferred were to be used.
- 4.33 Expenses applicable to a period can be described as those outflows directly or indirectly associated with the goods and services provided in the period.
- 4.34 Supporters of this approach to associating revenues and expenses with the reporting period separately identify and define deferred outflow and inflow elements in the statement of financial position as outflows and inflows that are not “applicable to” the current period (further discussion of this issue is in Section 5 of the CP). The statement of financial performance then provides information on the extent to which the costs of current period programs and services were financed by current year tax and other revenues.
- 4.35 Those who support this approach contend that it results in the most relevant financial performance information to users of the financial statements.

Flows during the Period

- 4.36 In contrast, others favor definitions of revenue and expense elements based on asset and liability flows or changes “during” the reporting period. Increases in resources and decreases in obligations during the period that increase net assets are considered revenues, while decreases in resources and increases in obligations that reduce net assets during the period are considered expenses.
- 4.37 Supporters of basing revenue and expense elements on asset and liability flows “during” the reporting period prefer the discipline inherent in having the revenue and expense definitions based on real economic phenomena that can be observed and verified directly, such as economic resources and obligations. They argue that this provides a framework for reporting those elements according to their economic substance, and limits the scope for bias, intentional or otherwise, in the reporting of revenues and expenses. They highlight the potential for preparers to have too much latitude in assigning revenues and expenses to particular periods under other approaches. Accounting conventions, such as inter-period equity that require judgment about which flows are “applicable to” a specific period, are not compatible with element definitions and recognition criteria that need to be specific in nature.
- 4.38 Those who support this approach contend that it results in the most relevant and reliable measure of financial performance.

- 4.39 As indicated above, this fundamental issue of how cash and non-cash flows are associated with the reporting period determines both how revenues and expenses should be defined, in part, and also whether deferred outflows and deferred inflows are necessary elements of financial statements.

Specific Matter for Comment 11:

- (a) Should revenues and expenses be determined by identifying which inflows and outflows are “applicable to” the current period (derived from a revenue and expense-led approach), or by changes in net assets, defined as resources and obligations, “during” the current period (derived from an asset and liability-led approach)?
- (b) What arguments do you consider most important in coming to your decision on the preferred approach?

Exclusion of Transactions with Residual/Equity Interests

- 4.40 This section considers whether transactions with residual/equity interests should be excluded from the definitions of revenue and expense. Equity interests in the public sector differ from private sector ownership interests in that they generally do not relate to exchangeable equity holdings. Such interests and transactions are discussed in Section 5. Until the approach to ownership-type interests in the public sector is resolved, the CP refers to the holders of such interests as residual/equity interests.
- 4.41 In a model that views a residual/equity interest as an equity interest similar to the private sector, contributions intended to be an investment in the initial operating capacity of the entity or, subsequently to increase it, are excluded from revenues and are considered direct ownership contributions. Similarly, distributions intended to reduce operating capacity, or those intended to be a return on the owner’s investment, are excluded from the definition of expenses.
- 4.42 Some agree that this approach might be appropriate when the net assets/net liabilities are similar to a private sector equity interest. If (a) those holding the equity interest expect to earn a return on the funds invested, and (b) the reporting entity is assessed on the returns earned primarily from business-type exchange transactions, contributions from and distributions to its owners might be properly excluded from revenues and expenses in order to represent the performance transactions faithfully.
- 4.43 The nature of the transaction may also indicate whether it should be included or excluded from the revenue and expense definition. A residual/equity interest may be a customer of the reporting entity, and the transaction may be an exchange transaction. For example, a water or power utility in a community may supply its related municipal government with water or electricity on the same basis as it supplies these services to other customers. In such a case, and to the extent that the terms of the transactions are reasonably comparable to those of other customers with whom the utility deals at arm’s length, many consider that it may be more relevant to recognize the new asset inflows as revenue and as an operating rather than a financing inflow.

- 4.44 Similarly, an entity may transfer benefits to a holder of a residual/equity interest in exchange for supplying goods and services during the period. It may also be more relevant to report this transaction as an expense.
- 4.45 The issue is more complex for non-exchange transactions, and for exchange transactions where the consideration paid or received by the reporting entity does not reflect the value of what was exchanged. If (a) the entity's purpose is to provide public sector goods and services, and (b) the entity is not assessed on its return on investment, then it may be very difficult to distinguish contributions intended to support increased capacity from those that support current and future period operations. In such cases, whether an item is revenue or a direct increase in the residual interest may only be evaluated, in practice, on the stated intent of the contributor, or on existing relationships between the entities, rather than on criteria that are independent of the transacting parties.
- 4.46 Those who support the position that all transactions with holders of a residual/equity interest should be included as revenues and expenses contend that, in the absence of a conceptual basis for distinguishing between financing and operating flows, all should be reported as revenues and expenses. Supporters also contend that without a need to assess return on investment, the importance of differentiating between the two forms is not an issue. All such transfers should be reported on the statement of financial performance, and affect the surplus/deficit and the residual interest in net assets in this way. They contend that the resulting financial statements are more transparent, relevant, comparable from period to period, and understandable.

Result of Specific Activities

- 4.47 A number of standard setters limit their definitions of revenue and expense by restricting them to specific types of activities. Revenues and expenses may arise, for example:
- (a) From ordinary revenue-generating or service delivery activities;²
 - (b) From providing and paying for goods or services, receiving donations, or any other activity performed (excluding borrowing and its repayment);
 - (c) From delivering or producing goods, rendering services, or other activities that constitute the entity's major or central operations; or
 - (d) From operations, transactions, or events.
- 4.48 Such approaches have a common objective of distinguishing transactions and events relating to activities in the normal course of operations from other transactions and events. As such, they differentiate between revenues and expenses, and gains and losses. The latter tend to be identified with changes in net assets from transactions and events peripheral or incidental to the entity's central operations. These are likely to be interpreted differently from recurring events in any assessment of the future of the entity.

² The IASB has a broad definition of "income," but makes a reference to "ordinary activity" in its narrower definition of revenue.

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Therefore, gains and losses are identified as separate elements, and not as revenues and expenses.

- 4.49 Other standard setters make clear that the definitions of revenue and expense include gains and losses, as they are considered to be subsets of the primary elements. This is similar, for example, to tangible capital assets and financial assets being considered subsets of assets, and performance obligations and financial obligations being subsets of liabilities. They contend that gains and losses are similar in nature to revenues and expenses, as both sets of items result from increases and decreases in net benefits. Which items are revenues and expenses, or gains or losses, and whether they pertain to transactions or to other flows, to operations or to asset and liability management, or to other classifications are issues of financial statement presentation, not of element definition.
- 4.50 Distinctions between non-exchange and exchange transactions and events, for example, or the effect of transferor intent, do not affect the revenue and expense definitions. Such distinctions are matters for consideration when developing approaches for recognition, measurement, presentation, and disclosure.

Specific Matters for Comment 12:

- (a) Should transactions with residual/equity interests be excluded from revenues and expenses?
- (b) Should the definitions of revenue and expense be limited to specific types of activities associated with operations, however described?

Specific Matters for Comment 13:

- (a) Are there any additional characteristics that have not been identified that you believe are essential to the development of definitions of revenues and expenses?
- (b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the definitions of revenues and expenses?

5. Other Potential Elements

Overview

Aside from the four fundamental elements discussed in Sections 2, 3, and 4, three other types of items are considered as potential elements. These are deferred outflows and deferred inflows, net assets/net liabilities, and transactions with residual/equity interests. The decision to be made is whether each of the items discussed should be separately identified as an element in order to provide all the required building blocks for a public sector entity's financial statements.

5A. Deferred Outflows and Deferred Inflows

- 5.1 Earlier sections of this paper indicate that some support a measure of financial performance that reports on the extent to which the burden of the current year cost of providing programs and services is borne by current year taxpayers and revenue providers. Under this approach, the concept of inter-period equity is considered to be a relevant metric for assessing accountability. It also provides decision-useful information about whether, and the extent to which, the government has deferred costs or resources to future periods.
- 5.2 This approach defines the elements of revenue and expense on the basis of their applicability to the current period. This is derived from the revenue and expense-led approach to elements and financial performance. Both the concept of inter-period equity and the traditional private sector matching concept associate accounting events with periods; however, the criteria for associating events with periods and the objectives of the related financial reporting are different.
- 5.3 The private sector concept attributes costs to the revenues recognized during a period for the purpose of measuring earnings. In contrast, inter-period equity attributes costs of the services to the period in which those services are provided, and attributes revenues provided by taxpayers and other revenue providers to the appropriate period for the purpose of assessing whether those revenues were sufficient to finance the costs of providing services during that period.
- 5.4 For example, assume that a government imposes (levies) a property tax at the end of the current reporting period that is legally restricted for use in the next reporting period, and the tax does not have a return feature. Those who support the inter-period equity approach do not believe that the recognition of revenue related to this tax levy in the current period faithfully represents the results of the current reporting period. In the absence of a performance obligation with a definition broad enough to capture such a transaction as a liability at the end of the current year, there is a need to recognize a deferral element on the statement of financial position.
- 5.5 Supporters of the inter-period equity view suggest that all four major elements (assets, liabilities, revenues, and expenses) can be defined according to their inherent

characteristics if the deferred outflows and inflows are identified either as *separate* elements or are *incorporated into* other elements.

Alternatives

- 5.6 If revenues and expenses are to be defined with a characteristic that indicates they are “applicable to” the reporting period, as explained in Section 4, and the financial position and financial performance statements are to articulate, then one of the following approaches is required:
- (a) Define deferred outflows and deferred inflows as separate elements on the statement of financial position;
 - (b) Broaden the definitions of asset and liability elements to encompass items that are deferrals; or
 - (c) Describe the deferred outflows and deferred inflows as subclassifications of net assets/net liabilities.
- 5.7 Each of the alternatives has its advantages and disadvantages. Recognizing the deferrals as separate elements allows the asset and liability element definitions to continue to represent what assets and liabilities are understood to be in the private sector. This is beneficial for something as basic to financial reporting as assets and liabilities, and increases the understandability of public sector financial statements.
- 5.8 The first approach maintains a flow of resources approach and defines deferred items as follows:
- (a) Deferred outflow (of resources): an entity’s consumption or reduction of net assets that is applicable to a future reporting period; and
 - (b) Deferred inflow (of resources): an entity’s increase or acquisition of net assets that is applicable to a future reporting period.
- The term “net assets” (assets less liabilities) is used in these definitions to differentiate these items from the results of transactions and events such as the repayment of debt or the acquisition of property, plant, and equipment with a cash payment, where there is no change in the net asset amount.
- 5.9 The first approach also articulates the elements on the statement of financial position with the statement reporting on financial performance. That is, the net financial position at the beginning of the period (assets + deferred outflows – liabilities – deferred inflows), plus revenues less expenses for the period, equals the net financial position at the end of the period.
- 5.10 Incorporating deferred outflows and deferred inflows into the definitions of the asset and liability elements, respectively, reduces the number of key elements making up financial statements, making it easier to understand how the major financial statements articulate with each other. However, faithful representation would not be met by including such items as deferred exchange losses, for example, as entity assets.

- 5.11 If deferred outflows and deferred inflows are reported instead as subclassifications of the net financial position, no new elements need to be added, and assets and liabilities continue to be defined in terms of resources and obligations. On the other hand, transparency is reduced because the results of major flows in the period are relegated to a sub-category of residual interest or “equity” represented by net assets/net liabilities. Again, the articulation of the statements representing financial position and financial performance is not so clearly evident, nor are the deferrals themselves.

Specific Matter for Comment 14:

- (a) Do deferrals need to be identified on the statement of financial position in some way?
- (b) If yes, which approach do you consider the most appropriate? Deferred outflows and deferred inflows should be:
 - (i) Defined as separate elements;
 - (ii) Included as sub-components of assets and liabilities; or
 - (iii) Included as sub-components of net assets/net liabilities.
- (c) If defined as separate elements, are the definitions of a deferred outflow and deferred inflow as set out in paragraph 5.8 appropriate and complete?

5B. Net Assets/Net Liabilities

Essential Characteristics of Net Assets/Net Liabilities

- 5.12 Reporting the net financial position of a public sector entity provides valuable information to the primary users of the entity’s financial statements. Service recipients and resource providers and their respective advisors use information about the net position at the reporting date to help them in assessing the management of the entity’s short-term financial capacity, and its capacity to sustain on a longer term basis the level of programs and services it provides. Users, therefore, use this information to assess the related aspects of the entity’s financial and operating capability.
- 5.13 Standard setters have established definitions of net assets/net liabilities (or equity), setting out a number of characteristics in those definitions. They suggest a number of issues that need to be resolved in determining what characteristics of net assets/net liabilities are essential to their definition:
- (a) Do net assets/net liabilities simply represent a residual amount?
 - (b) Is there an interest?
 - (c) If there is an interest, is it an ownership interest?
- 5.14 In particular, whether an “ownership interest” exists in the public sector is important, because transactions with owners acting in their capacity as owners can only be

distinguished from transactions with owners acting in other capacities, (e.g., as suppliers or customers) if the concept of an ownership interest exists in the public sector.

Is Net Assets/Net Liabilities Simply a Residual Amount?

- 5.15 The residual amount is the difference between assets and liabilities (or assets and liabilities and deferred outflows and deferred inflows) and results solely from accumulated revenues and expenses, and the net amount of any separately recognized contributions from, or distributions to, owners in the past. It represents the net resources available for providing future goods or services or, alternatively, if the balance is negative, the future resources necessary to meet claims from the past provision of goods or services. If deferred inflows and outflows are recognized as separate elements, in addition to representing the net positive or negative resources available to be carried forward, net assets/net liabilities would also include the net deferral of inflows and outflows to be recognized in future operations.
- 5.16 One of the reasons that some standard setters limit net assets/net liabilities to a residual is that trying to define both liabilities and “equity” items separately can lead to intermediate items being presented in the statement of financial position that are neither one nor the other. These standard setters focus on defining a liability, and define the residual amount as a calculation of the difference between assets and liabilities, and deferred flows, if applicable.
- 5.17 To the extent that net assets/net liabilities is defined simply as a residual amount, there may be no need to consider it further as an element of financial statements. It is simply the accumulation of all flows that affect the already defined elements in the statement of financial position.

Is There an Interest?

- 5.18 Some argue that the residual could have economic substance, in the form of an interest in the net assets/net liabilities of public sector entities. That interest could be described as an interest in the entity’s operating capability. It exists because the financial expectations of resource providers and service recipients of public sector entities are directly affected by the ability of such entities, at any given time, to carry out their activities at the scale determined by its then-existing resources. Others have described this residual interest as an interest in the capability of the entity to finance itself and to resource future operations. Both concepts of residual interest are reflected by net assets/net liabilities and are analogous to, but different from, the ownership interest in a business entity.
- 5.19 For example, in the case of agency operations or semi-autonomous entities created by government, financial entitlements of the government may not be provided for, but the government has still provided the capital of the entity, and has the authority to direct the operating and financing activities of the entity in pursuit of the desired public policy objectives of the government. The government has an interest in the residual, more because of the impact on future resource provision and the ability of the entity to provide services, than because of any residual entitlement.

- 5.20 Transfers between levels of government could also usefully be tested against such criteria, thereby allowing both the transferor and transferee to differentiate between capital injections and withdrawals, and revenue and expenses.
- 5.21 A formulation of “residual interest” in the public sector could be the interest of the members/government/community/owner/equity participants in the public sector entity’s operating capability. Alternatively, it could be expressed as their interest in the capability of the entity to finance itself and resource future operations, so far as it reflects the financial expectations of resource providers and service recipients of those entities. For example, the latter description may be appropriate for describing the interest of the government in public sector entities that lack the ability to generate resources through levying taxes or issuing debt, but are financed exclusively by government transfers.

Is There an Ownership Interest?

- 5.22 In some jurisdictions, explicit ownership interests may exist in the public sector. For example, at the whole of government level, a government business enterprise (GBE) included in the whole of government entity may have been partially privatized, which means that third parties have a financial interest in the residual amount of that GBE, i.e., an ownership interest. This ownership interest represents the portion of the surplus or deficit for the period and residual amount at the reporting date of a controlled entity attributable to a third party.
- 5.23 Generally in the public sector, however, the net assets of a government do not represent an “ownership” interest in the same sense as in a business entity. Usually, the net assets of a government reflect the resources available to finance or deliver future operations and, as such, could be interpreted as an ownership interest of the community in general. No explicit outside ownership interest other than this may exist.
- 5.24 A government’s net assets are increased (net liabilities decreased) primarily by receipts of assets from resource providers who do not expect to receive either repayment or benefits proportionate to their contributions. Its net assets are decreased (net liabilities increased) primarily by providing goods and services. Therefore, it may not be appropriate to represent the residual net assets of governments as an ownership interest.

Alternative Conceptual Approaches

- 5.25 A number of alternative conceptual approaches could be adopted. These include:
- (a) Defining “net assets/net liabilities” and treating any specific ownership interest as a subclassification of net assets;
 - (b) Defining “ownership interest” as a separate element; and
 - (c) Defining one or more components of net assets/net liabilities as elements.
- 5.26 Defining “net assets/net liabilities” and treating any specific ownership interest as a subclassification reflects an approach that recognizes that third parties may have a financial interest in some part of net assets, and that separately recognizing that financial interest is both necessary and relevant. Accumulated surplus/deficit does not represent an

outside claim, but rather net resources at the disposal of the government. This approach allows other “items” to be presented in the net assets/net liabilities section of the statement of financial position. For example, items such as capital maintenance adjustments and fair value changes would be treated as subclassifications of net assets/net liabilities, and would not need separate element definitions. Although it may be necessary to define these items, it is not necessary to define them as elements.

- 5.27 Defining ownership interest as a separate element characterizes net assets/net liabilities as a residual amount that can be interpreted both as an amount available for financing future operations and ownership interests. This approach acknowledges that ownership does exist in the public sector, both at the whole of government level, but more clearly at the entity level. An ownership interest, such as specified minority interests, can exist separately from the residual amount. From this perspective, ownership interest could be defined as an element because that ownership is an “outside” claim that does not share the same common characteristics of a liability.
- 5.28 Typically the components of the net assets/net liabilities section of the statement of financial position could include:
- (a) Contributions from owners;
 - (b) Distributions to owners;
 - (c) Capital maintenance adjustments;
 - (d) Fair value changes; and
 - (e) Operating results.
- 5.29 A further approach could be to define each of these components as a separate element. It might be argued that each component shares common characteristics but warrants being identified separately.

Specific Matter for Comment 15:

- (a) Do you consider net assets/net liabilities to be a residual amount, a residual interest, or an ownership interest?
- (b) Should the concept of ownership interests, such as those that relate to minority or non-controlling interests in a GBE, be incorporated in the element definition?
- (c) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of net assets/net liabilities?

5C. Transactions with Residual/Equity Interests

- 5.30 Pending the outcome of the debate on issues associated with the concept of net assets/net liabilities, this section of the CP uses the term “transactions with residual/equity interests” in place of the more common description “contributions/distributions from owners.”

Essential Characteristics of Transactions with Residual/Equity Interests

- 5.31 A few standard setters have established definitions of transactions with residual/equity interests, setting out a number of characteristics in those definitions, while others have not defined contributions and distributions related to these interests.
- 5.32 Some public sector standard setters do not have a definition for transactions with residual/equity interests because they consider ownership interests to be rare; and some private sector standard setters do not define contributions from and distributions to owners despite having definitions for equity instruments and equity interests.
- 5.33 If the view is taken that net assets/net liabilities is a residual amount and does not represent an interest, then it would be inappropriate to separately identify and represent the existence of transactions that impact on that residual. If, however, it is accepted that a residual or equity interest exists, and there are transactions that directly affect that interest and not financial performance, this may necessitate the identification of other elements.
- 5.34 Those who separately define transactions with residual/equity interests tend to identify these common characteristics:
- (a) The contribution or distribution is from or to a party external to the entity;
 - (b) The contribution or distribution establishes or reduces a financial interest in the net assets of the entity;
 - (c) A contribution conveys entitlement to distributions of future benefits or service potential, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and
 - (d) The interest can be sold, exchanged, transferred, or redeemed.
- 5.35 The first two characteristics have been referred to by one standard setter as "...increases in residual interest resulting from transfers from parties that establish a financial interest in that residual interest."³ It further explains that the "financial interest in the residual interest" is an interest that conveys a right to participate in the residual interest, either on an ongoing basis or in a winding-up, and therefore also incorporates characteristic (c) as well. The definition of contributions from owners for for-profit entities includes the same characteristics. However, the terminology differs, to take into account the differences between for-profit entities and public sector entities.
- 5.36 The fourth characteristic above is not unique to residual/equity interests, as it can also apply to other elements, such as liabilities. This suggests that it is not a characteristic that is essential to the definition of contributions from owners. The actual definitions, however, indicate that this characteristic refers to the associated financial interest, and that it relates only to non-liability financial interests.
- 5.37 It was suggested in the section on net assets/net liabilities that a residual interest in the public sector represents an interest in the entity's operating capability. Such an interest is

³ Interpretation of the Statement of Principles for Financial Reporting: Interpretation for Public Benefit Entities, UK ASB (2007).

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unlikely to be able to be sold, exchanged, transferred, or redeemed. This type of interest may lead to entitlements in the event of an entity being wound up, although this may not be explicitly stated.

- 5.38 Not all standard setters' definitions of distributions mirror their definition of contributions. Some describe a distribution from the viewpoint of the entity, i.e., as being a decrease in residual interest or equity. Other standard setters describe what is distributed, i.e., future economic benefits or service potential, either as a return on investment or as a return of investment.
- 5.39 As discussed in the section on net assets/net liabilities, an ownership interest as commonly understood in the private sector may not exist in many public sector entities. In some cases however, such an ownership interest may arise. For example, there may be public sector entities in which a private sector entity has a financial interest.
- 5.40 It may be possible to fairly reflect such items without creating the need for a separate element. One approach could be to include this as a component of the residual or residual interest amount, and describe it as "minority" or "non-controlling" interest. This refers to the portion of the net assets of the consolidated entity representing the ownership interest attributable to a third party. The advantage of this method is that all of the assets and liabilities of the consolidated investment controlled by the entity are included in the financial statements.

Specific Matter for Comment 16:

- (a) Should transactions with residual/equity interests be defined as separate elements?
- (b) If defined as separate elements, what characteristics would you consider essential to their definition?

6. Recognition

Overview

Section 6 discusses issues related to element recognition: (a) why recognition criteria are needed, (b) how existence and measurement uncertainty affect recognition, (c) whether the criteria apply equally to the derecognition of elements, and (d) whether the criteria should be separate requirements or an integral part of the element definitions.

The Need for Recognition Criteria

- 6.1 Recognition is the process of incorporating an item that meets the definition of an element and can be measured reliably in the relevant financial statement. Recognition involves the depiction of the item in words and by a monetary amount, and the inclusion of the item's value (that amount) in aggregates or, on rare occasions, as a discrete line item on the face of a financial statement. To be recognized, an item must meet both the definition of a particular element and the recognition criteria.
- 6.2 There is general acceptance that the disclosure of accounting policies used and information in notes to the financial statements do not compensate for the failure to recognize items that meet definitions and specified recognition criteria. Such items should be recognized in the financial statements. Although disclosure in the notes is not a substitute for recognition, disclosure in the notes about how uncertainty has been approached can enhance information needed for evaluating accountability and for decision making.

Uncertainty

- 6.3 Accrual accounting recognizes transactions and events when they occur, subject to meeting definition and recognition criteria, rather than when the transactions and events are realized or settled. Uncertainty is therefore inherent and unavoidable under the accrual basis of accounting. Two areas of uncertainty are addressed in this section:
 - (a) Uncertainty about whether assets, liabilities, revenue, and expenses meet element definitions (existence uncertainty); and
 - (b) Uncertainty about the reliability of the amount associated with those elements (measurement uncertainty).

Existence Uncertainty

- 6.4 It is often clear whether the definition of an element has been satisfied. Although the occurrence of a transaction may not be necessary for an element to exist, transactions are the most common basis for recognizing and derecognizing items as elements. For example, the rendering of services by an employee in accordance with a contract of employment gives rise to a liability and an expense of the employer, the acquisition of medical equipment normally provides sufficient information to justify the recognition of

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an asset, and the destruction of a building in a natural disaster leads to the derecognition of that asset.

- 6.5 In other cases, it is more difficult to determine whether a transaction or event creates an item that meets the definition of an element. Entities operate in uncertain environments. Evaluating whether an item meets the definition of an asset may require an assessment of an entity's legal position at the reporting date to determine whether there is a present entitlement to future benefits. Existence uncertainty demonstrates the tension between faithful representation and relevance.
- 6.6 Uncertainty can be countered by assessing the available evidence. The more evidence there is about an item and the better the quality of that evidence, the less uncertainty there will be whether an item meets the definition of an element. Recognition criteria therefore should require preparers to review and assess all available evidence in determining whether sufficient evidence exists that an asset or liability should be recognized initially, whether it continues to qualify for recognition, or whether there has been an addition to an existing asset or liability.
- 6.7 Many standard setters address existence uncertainty by requiring evidence thresholds as recognition criteria. For example, an item is recognized only if it is "probable" or "more likely than not" that future economic benefits associated with the item will flow to or from the entity.
- 6.8 Standard setters have commonly set different thresholds for assets and liabilities. For example, while some assets, such as property, plant, and equipment, may be recognized when the future benefits are "probable," the threshold for liabilities may be "probable" or "more likely than not," and the criterion for recognition of other items, such as a contingent asset, may require a higher standard of evidence—perhaps "virtual certainty."
- 6.9 In the past, the main rationale for the use of different threshold criteria has been prudence: a higher level of evidence is required for an item where previous uncertainty over its existence indicates that its recognition has not been justified. However, requiring a particular item to be recognized as an asset only if its realization is "virtually certain," while liabilities and other assets are recognized when an outflow or inflow of resources is "probable," introduces bias into financial statements. Such bias may be contrary to the qualitative characteristic of faithful representation. In accordance with the proposals in the Exposure Draft on Phase 1 of the Conceptual Framework, the IPSASB considers that prudence should not be a factor in determining threshold criteria.
- 6.10 Some standard setters have become wary of using specific evidence thresholds at all. Instead, they rely on a more general assessment of available evidence to resolve element uncertainty. In accordance with this approach, some private sector standards (e.g., IFRSs) are being changed to require a firm judgment to be made about the element's existence. Evidence thresholds are removed from the definition and recognition criteria, and are incorporated instead in measurement considerations.

- 6.11 There are three approaches to dealing with existence uncertainty:
- (a) Standardize threshold criteria, such as recognition only if it is “probable” that future economic benefits associated with the item will flow to or from the entity;
 - (b) Use all available evidence to make neutral judgments about the element’s existence; and
 - (c) Use threshold criteria or neutral judgments, depending on the underlying measurement basis of the element.
- 6.12 The main advantage of the *first approach*, which uses and standardizes evidence threshold criteria for all elements, is that such criteria are understandable and act as filters, screening out items that have a low probability of resulting in inflows or outflows of benefits. They therefore contribute to understandability by not recognizing items that have a low or even remote likelihood of occurrence in the financial statements. Such items may have high monetary values and therefore lead to the recognition of assets and liabilities with significant carrying values, even though the probability of existence may be very low. Some consider that it would be more appropriate to disclose such items rather than recognize them.
- 6.13 Threshold criteria can also be justified on cost grounds. Only after a preparer has formed an initial judgment whether the threshold criterion has been met does that preparer consider how that element should be measured. Measurement can be an expensive process, particularly where there is a significant level of measurement uncertainty, and the benefit of information to users may not be commensurate with the measurement cost for items that have only a small possibility of occurring.
- 6.14 The *second approach* requires an entity to make a neutral judgment about whether an element exists. This is based on its understanding of all available facts and circumstances at the reporting date. If it is determined that an element exists, uncertainty about the flows associated with that element is taken into account in measurement. The major argument in favor of this approach is that it provides better information, because the recognized elements better meet the qualitative characteristics of faithful representation, relevance, and comparability. Supporters contend that the evidence threshold approach disregards items that are below such thresholds, perhaps by very small margins, but which, in all other ways, meet the definition of an element.
- 6.15 It has been suggested that the phrase “expected to flow” used in many current frameworks and element definitions has been misinterpreted to mean that there must be a high expectation of an inflow or outflow of future benefits to justify recognition. Based on this, items with a lower likelihood are not recognized. To avoid this common misinterpretation, either the element definitions could exclude reference to the “expected” inflow or outflow of benefits, or the discussion of each element could explain that this characteristic should be interpreted to mean that there must be some expectation of future inflows or outflows, and that the phrase does not imply a need to meet a particular threshold level.

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- 6.16 The *third approach* to dealing with existence uncertainty is situational. Because recognition criteria apply equally well to both initial and subsequent recognition, different requirements could apply to an element depending on its measurement basis. After an element has been recognized initially, it must pass recognition tests again at each reporting date in order to continue being reported.
- 6.17 In accordance with this view, if the measurement basis of an element incorporates a current assessment at each reporting date of the probability of the inflows or outflows of benefits, an evidence threshold should not be included as a recognition criterion. This may happen, for example, when measurement is based on a current market value.
- 6.18 Conversely, if the measurement attribute applied to an element does not incorporate a current assessment of the probability of the inflows or outflows of benefits at the reporting date, an evidence threshold should be required. Measurement attributes that do not incorporate a current assessment are historical cost and market values determined by reference to depreciated replacement cost.
- 6.19 It could be argued, however, that even elements measured at historical cost are reviewed regularly for impairment, on the basis of a current assessment of the probability of inflows or outflows of benefits. Therefore, a threshold test for continued recognition of an element measured on a basis such as historical cost may not be required. This argument is perhaps less forceful in the public sector where non-financial assets do not usually generate future benefits in the form of cash flows. As a result, a probabilistic measure of service potential benefits expected from such assets may be difficult to implement. In this case, threshold criteria may be easier to apply.

Measurement Uncertainty

- 6.20 Measurement uncertainty may arise even though existence uncertainty has been overcome. An item may meet the definition of an element, but cannot be measured in monetary terms, or a reasonable estimate of the amount cannot be made.
- 6.21 To recognize an item in the financial statements, it is necessary to attach a monetary value to it. This entails two different aspects: the first is choosing an appropriate measurement basis (cost, market value, depreciated replacement cost, etc.); and the second is the reliability of the measurement itself. The selection of an appropriate measurement basis is considered in the CP *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements*.
- 6.22 There is inevitably a degree of uncertainty associated with the measurement of many financial statement amounts. The use of estimates is an essential part of the accrual basis of accounting. A decision about measurement reliability is a matter of professional judgment. Management considers information, such as (a) what amounts are reasonably possible, (b) whether additional evidence is available about conditions that existed at the reporting date, and (c) the impact of other reasonably possible amounts on the recognized resources, obligations, and net assets, and the possible timing of that impact.

Specific Matter for Comment 17:

- (a) Should recognition criteria address evidence uncertainty by requiring evidence thresholds; or by requiring a neutral judgment whether an element exists at the reporting date based on an assessment of all available evidence; or by basing the approach on the measurement attribute?
- (b) If you support the threshold approach or its use in a situational approach, do you agree that there should be a uniform threshold for both assets and liabilities? If so, what should it be? If not, what threshold is reasonable for asset recognition and for liability recognition?

Derecognition Criteria

- 6.23 Recognition also includes timing considerations: it involves recording an element at the time of an initial transaction or event, or subsequently, if the required recognition criteria are not met until later. Recognition also entails an evaluation of whether changes have occurred that warrant removing a previously recognized item from the financial statements. This latter process is called derecognition.
- 6.24 One aspect of recognition is whether the same principles dealing with existence and measurement uncertainty should apply equally to both initial and subsequent recognition. Some consider that “recognition” refers to initial recognition only, and that an item, once recognized, should only be derecognized when separate and explicit criteria for derecognition are met. Under this view, the explicit criteria for derecognition may, but need not be, the obverse of recognition criteria. For example, some argue that the criteria for derecognizing a liability should be more stringent than the criteria for initially recognizing the liability.
- 6.25 Such an approach does not appear to be in accordance with the qualitative characteristic of faithful representation. For the same reasons that the IPSASB supports uniform evidence thresholds at initial recognition, the IPSASB also favors the use of the same thresholds for derecognition as those for initial recognition.

Specific Matter for Comment 18:

Do you support the use of the same criteria for derecognition as for initial recognition?

Should Definitions Incorporate Recognition Criteria

- 6.26 At present, some standard setters incorporate recognition criteria in element definitions. The issue of whether definitions should include recognition criteria is a matter of location rather than substance. Those who favor the inclusion of recognition criteria within definitions consider it appropriate for preparers to be able to consider all the factors that must be taken into account in evaluating whether an item is recognized. Others consider that recognition is a distinct stage in the accounting process that takes place only after an item meets an element definition. This latter view makes a clearer distinction, resulting in

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less confusion about what should be captured. Such confusion can be seen in how the current phrase “expected to flow” has led to different interpretations.

Specific Matter for Comment 19:

Should the recognition criteria be an integral part of the element definitions, or separate and distinct requirements?



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