



Staff Paper

March 2011, Joint Agenda Paper J10.4

IPSASB Conceptual Framework: Phase 2 – Elements & Recognition

Purpose of this Paper

1. This paper seeks feedback from the Boards regarding issues that could be raised in the Boards' submissions on the IPSASB's Consultation Paper *Conceptual Framework: Phase 2 – Elements & Recognition* (Elements CP).

Background

2. The Elements CP was issued in December 2010. Comments are due to the IPSASB by 15 June 2011. Staff presented education sessions on the CP at the Boards' respective meetings in December 2010. Comments from each meeting are set out in the Appendix to this paper.

IPSASB education session March 2011

3. At its meeting in 7-10 March 2011 the IPSASB will be receiving an education session on the two approaches to financial performance. The purpose of the education session is to give Board members a richer understanding of the two approaches, including contrasting the treatment of difficult items under the two approaches (including any parallels between the types of items treated as deferred revenue and expense under the revenue and expense led approach and items presented in other comprehensive income under the asset and liability led approach).
4. Staff will provide an update on this session at the joint meeting.

Specific matters for comment

5. The CP explores and seeks feedback on the following issues:
 - (a) information needed about a public sector entity's financial position;

- (b) characteristics of assets and liabilities, including which characteristics are essential to an asset's definition;
 - (c) different views of financial performance;
 - (d) characteristics of revenues and expenses;
 - (e) other possible elements (eg deferred outflows and deferred inflows); and
 - (f) recognition criteria.
6. The specific matters for comment follow. Feedback is requested on the discussion points to assist staff in developing comment letters to the IPSASB. Feedback is also requested on other matters which should be included in the comment letters.

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?

7. Discussion points:

- (a) Yes – support a definition of an asset that covers all three types of benefits.
- (b) Support treating the term economic benefits as including service potential and the way this has been given effect in drafting the CP (refer paragraph 2.24).

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?

8. Discussion points:
- (a) Support (i) Control or (iii) Access to rights. The explanation of access to rights (including the right to restrict or deny access to others) in the CP is not clearly distinguished from control (refer paragraph 2.38).
Do not support (ii) Risks and rewards.
 - (b) Support the asset definition requiring that an entity have an enforceable claim to the asset's benefits (refer paragraph 2.39).
 - (c) Feedback sought.

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?

9. Discussion point: Propose that a past transaction or event be regarded as "an indicator of evidence supporting the existence of a past resource" (as per paragraph 2.47).

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?

10. Discussion point: Such rights and powers are assets only when those powers are exercised. Do the Boards agree that the uncertainties surrounding such rights and powers differ from the recognition and measurement uncertainties surrounding other assets?

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?

11. Discussion points:
- (a) Feedback sought.
 - (b) Feedback sought.

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?

12. Staff consider that any response to this question should be linked with the response to the next question on enforceability.

Discussion points:

- (a)
 - (i) Yes.
 - (ii) Yes
 - (iii) Yes.
 - (iv) No – This issue is under discussion by the IPSASB in the context of service concession arrangements. Staff will provide an update on the IPSASB’s discussions at its March meeting.
- (b) A settlement date is not 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?

13. The three approaches in paragraph 3.28 are:
- (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.
14. Discussion points (*sub-paragraph letters below relate to Specific Matter for Comment 7*):
- (a) The ability to identify a specific party(ies) outside the reporting entity to whom the entity is obligated should be part of the supplementary discussion.
 - (b) Yes.
 - (c) Support option (b) in paragraph 3.28 of the CP (*i.e., paragraph 13(b) above*). Staff acknowledge that requiring a distinction between exchange and non-exchange transactions can be problematic and is contrary to the approach being considered by the AASB in relation to revenue of not-for-profit entities.

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?

15. Discussion points: A past event may indicate the existence of a present obligation but is not an essential component of the definition of a liability.

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 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?

16. Discussion points:
- (a) Propose supporting enforceable claims approach, mainly on the grounds that governments can and do change policies.
 - (b) Yes.
 - (c) Feedback sought.

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?

17. Discussion points: Feedback sought.

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?

18. Discussion points:

This response may be better informed by discussion at the IPSASB March meeting.

Propose to support an asset and liability approach, taking account of the Boards’ desire to explore the differences and try to find common ground. Material from the Boards’

December agenda papers has been repeated below.

Revenue and expense-led approach to revenue and expenses

- 1. Under the revenue and expense-led approach revenues and expenses are defined as flows that are “applicable to” the period. This approach is linked to the concept of inter-period equity – that is, the extent to which current year cost of providing services is borne by current year taxpayers and resource providers. The revenue and expense-led approach has been influential in the development of United States Governmental Accounting Standards Board (GASB) pronouncements. The GASB is currently undertaking a Conceptual Framework project, and, as part of that project, is considering the circumstances that may give rise to deferred inflows and outflows of resources under different models. The revenue and expense-led approach, on

which the IPSASB is seeking views, appears to be based on the developing GASB financial resources model.

2. Under the GASB financial resources approach the types of transactions that may be considered not applicable to the period and that therefore may give rise to deferred inflows or outflows include:¹
 - outflows of resources that are intrinsically related to future services but which do not meet the definition of an asset;
 - time restrictions on the application of inflows of resources when such application does not meet the definition of a liability (for example: (i) a property tax levied at the end of the current reporting period that is legally restricted for use in the next reporting period and does not have a return feature; and (ii) an asset which is financed by a grant (the deferred inflow) and to be used for specified services in the future);
 - a sale of resources that were not previously recognised in the financial statements (future resources); and
 - changes in the fair value of recognised assets when conditions exist such that there is little likelihood of realisation of the gain or loss.
3. Interestingly there has been debate in the private sector about how to present some of these items in the financial statements and, in particular, whether certain items should be presented as other comprehensive income. The two alternative approaches may merely have come up with different methods of dealing with such items.
4. The CP seeks feedback on which approach constituents support.
5. If the revenue and expense-led approach is adopted then it is necessary to decide whether deferred inflows and outflows (i) are separate elements; (ii) form part of the definition of an asset or liability or (iii) or are part of net assets/equity. The CP seeks feedback on these alternatives.

Preliminary Staff Views (as per December 2010 agenda papers)

6. The preliminary view of NZICA and AASB staff is not to support the 'revenue and expense-led approach' as we understand it. We disagree with mixing economic phenomena and accounting devices ('deferred outflows' and 'deferred inflows') as elements of the financial statements.
7. Staff are concerned that draft discussion of the 'revenue and expense-led approach' implies it is the only approach concerned with reporting periodic financial performance. That approach defines revenues and expenses as "flows that relate to efforts of the current period". The logical implication is that the 'asset and liability-led approach' is concerned predominantly with reporting financial position, with reported financial performance a by-product of that emphasis. However, staff consider that revenues and expenses comprise the financial effects of an entity's current period accomplishments and that the 'asset and liability-led approach' gives equal importance to the reporting of financial position and financial performance. The two views simply reflect different interpretations of the financial effects of an entity's current period accomplishments.
8. Staff are also concerned with the focus of the 'revenue and expense-led approach' on achieving 'inter-period equity', and its adoption of the view that "the principle that taxpayers pay only for the services they receive and not pass on obligations to

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

future taxpayers should ground any measure of financial performance”. Specifically, staff are concerned that this approach is based on a value judgement about who should pay for services rendered in a particular period and its direct link between funding decisions and recognition. If a decision were made that taxpayers of a different period should pay for current period services, should the recognition principles change accordingly? Staff think they should not, but adopting the ‘inter-period equity concept’ would create a precedent for public policy decisions to determine recognition principles.

9. Finally, staff are concerned the draft definitions of ‘deferred outflows’ and ‘deferred inflows’ potentially overlap the definitions of assets and liabilities (see the comment in paragraph 7 regarding the lack of a clearly articulated distinction between assets and liabilities and deferred outflows and deferred inflows). This makes it difficult to understand the essential nature of deferred outflows and deferred inflows. For example, the definition of ‘deferred outflows’ in the draft CP refers to “a consumption or reduction of net assets² that is applicable to a future reporting period”. If equipment is consumed in producing inventories, the measure of consumption of that equipment would appear to simultaneously qualify as part of the cost of an asset (inventory) and as a deferred outflow. Similarly, if, in obtaining access to mineral resources, a mining company creates a liability to remediate a mine site, the amount of that liability would appear to simultaneously qualify as part of the cost of an asset (the mine) and as a deferred outflow. These examples illustrate not only a lack of a clear distinction between these notions, but also that the notions of ‘deferred outflows’ and ‘deferred inflows’ are not unique to the PBE/NFP sector.

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?

19. Discussion points:

- (a) Yes.
- (b) No. Propose that gains and losses be incorporated in definitions.

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?

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

20. Discussion points:
Feedback sought.

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?

21. Discussion points:
Propose not to respond to this question, based on the response to specific matter for comment 11.

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?

22. Discussion points:
- (a) Residual amount.
 - (b) No.
 - (c) Feedback sought.

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?

23. Discussion points:
- (a) No.

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?

24. Discussion points:

- (a) Support requiring a neutral judgment whether an element exists at the reporting date based on an assessment of all available evidence (refer paragraphs 6.4 to 6.19). This approach does raise the issues that have been discussed in relation to the revision of *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*.
- (b) Not applicable based on response to (a).

25. As at March 2010 the IASB and FASB had initially decided to address element uncertainty in the guidance accompanying the definitions of an asset and a liability. If an entity is uncertain about whether a liability exists, that entity should make a neutral judgment based on its understanding of the facts and circumstances at the end of the reporting period. If it were judged that a liability exists, uncertainty about the amount of the liability would be taken into account in measurement.

26. In the context of discussions on the Liabilities project (November 2010) the IASB decided tentatively to specify that, in situations of uncertainty, this criterion (existence of the obligation) is met if the available evidence indicates that it is *more likely than not* that a liability exists. This more-likely-than-not threshold is applied in *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* at present.

Specific Matter for Comment 18

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

27. Discussion point: Yes, support same criteria.

Specific Matter for Comment 19

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

28. Discussion points: Recognition criteria should be separate and distinct requirements.

Other comments

29. The CP refers to the possibility of issuing an umbrella ED of the full conceptual framework (refer page 5 of the CP). However the most recent IPSASB project timetable does not allow for the issue of an omnibus Exposure Draft. The current project timetable proposes that an Exposure Draft be issued in late March 2012, with a final Framework being issued in May 2013.

Recommendations

30. AASB and NZICA staff recommend that the Boards:
- (a) agree to draft separate comment letters on the Elements CP;
 - (b) provide feedback on the specific matters for comment in the CP; and
 - (c) identify other matters to be included in the comment letters.

APPENDIX: Summary of AASB and FRSB preliminary discussions of the Elements CP

Staff presented education sessions on the IPSASB Elements CP at the Boards' respective meetings in December 2010. Comments from each meeting are set out below.

AASB views

- 1 In relation to the 'revenue and expense-led approach' discussed in the IPSASB CP on 'Elements and Recognition', the AASB directed staff to:
 - (a) develop arguments to refute aspects of that approach with which the AASB and FRSB disagree. For example, without basing revenue recognition on changes in economic phenomena that can be observed from time to time (assets and liabilities), revenues might be arbitrarily determined;
 - (b) identify which aspects of that approach could be re-expressed consistently with an 'asset and liability-led approach', for the purposes of:
 - (i) finding common ground between the approaches and thereby helping reduce resistance to an 'asset and liability-led approach'. For example, some 'deferred inflows' under a 'revenue and expense-led approach' might qualify as 'advance receipt' obligations or performance obligations under an 'asset and liability-led approach';
 - (ii) identifying the essential differences between the approaches and thereby facilitating more targeted comments in the AASB's and FRSB's submissions on the CP; and
 - (iii) finding common ground on public sector-specific issues such as 'social benefit obligations', which may provide a better understanding of both the 'asset and liability-led approach' and the 'revenue and expense-led approach'. For example, the focus on 'intergenerational equity' in the 'revenue and expense-led approach' is not on 'matching' in the sense in which a 'matching' notion has been used in the private sector; and

- (c) confirm whether the USA Federal Accounting Standards Advisory Board adopts an asset and liability-led approach, or a revenue and expense-led approach, in its pronouncements, and identify its reasons for adopting that approach.

FRSB views

2 In considering the Elements CP in December 2010 the FRSB:

- (a) expressed a preference for the asset and liability approach to financial performance. The FRSB agreed that in order to refute the alternative revenue and expense led approach the FRSB will need to understand the revenue and expense led approach (and deferred inflows and outflows). The FRSB noted that the Financial Accounting Standards Advisory Board (FASAB) has adopted an asset and liability led approach; and
- (b) noted that the IPSASB is releasing its proposals on elements before the IASB and FASB have completed their proposals but did not regard this as a matter for concern. The FRSB acknowledged that there may be some differences between the proposals of the IPSASB and the IASB but indicated that its main desire would be not to have a direct conflict between the two Frameworks.