Australian Government
Australian Accounting Standards Board

Level 7, 600 Bourke Street
MELBOURNE VIC 3000
Postal Address
PO Box 204
Collins Street West VIC 8007
Telephone: (03) 9617 7600
Facsimile: (03) 9617 7608

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Ms Stephenie Fox
Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
277 Wellington Street West
Toronto
Ontario M5V 3H2
CANADA

Dear Ms Fox

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

The Australian Accounting Standards Board (AASB) is pleased to provide its comments on the above named Exposure Draft (ED). In formulating its comments, the AASB considered the views received from Australian constituents.

General Comments

Due process

The AASB recommends that the IPSASB issues an omnibus ED incorporating its proposed Conceptual Framework after it has redeliberated all of its Conceptual Framework EDs, rather than finalising its Conceptual Framework without further consultation. An omnibus ED would enable the IPSASB's constituents to comment on the IPSASB's latest thinking on all of its proposals in its Conceptual Framework project, and to have regard to recent developments in financial reporting (including developments in the IASB's Conceptual Framework project).

Subsequent review and update of the IPSASB Conceptual Framework

The AASB recommends that the IPSASB should regard its Conceptual Framework as a living document, and thus should commit to reviewing and updating it from time to time in light of subsequent developments in financial reporting, the timing of which should reflect its resources and priorities. This approach would be beneficial, for example, in respect of concepts of presentation and disclosure. The AASB considers that thinking on these concepts is still in the early stages of development, on the part of the IPSASB, the IASB and the international financial reporting community generally. Therefore, it seems likely that thinking on concepts of presentation and disclosure will continue to evolve further. This illustrates the importance of not treating the IPSASB Conceptual Framework as an immutable document.

Relationship between the IPSASB and IASB Conceptual Framework projects

The AASB recommends that the IPSASB maximises its liaison with the IASB regarding those Boards' respective Conceptual Framework projects, in the context of the Memorandum of Understanding between the International Federation of Accountants and the IASB dated 22 November 2011.

Ideally, the IPSASB and IASB Conceptual Frameworks would be complementary, where differences (if any) exist only to the extent warranted by differences in circumstances. This would support the development of International Public Sector Accounting Standards and International Financial Reporting Standards that differ only where necessary to deal with different economic phenomena or with economic phenomena that are much more pervasive in one sector than the other. This approach is also likely to assist users of general purpose financial reports who read financial reports across all sectors in the economy.

In the context of the IPSASB's ED, the AASB recommends that differences between the IPSASB and IASB Conceptual Frameworks in relation to the definitions of, and recognition criteria for, the elements of financial statements should occur only when there is a public sector not-for-profit entity-specific reason for those differences. This is on the basis that the AASB supports transaction neutrality[1] and the ultimate development of a single converged Conceptual Framework for all entities (regardless of their sector).

Despite this recommendation, the AASB's arguments in relation to the IPSASB ED in this submission are mainly focused on technical reasons, and not primarily on whether the IPSASB's proposals are consistent with the tentative thinking of the IASB in its Conceptual Framework project.

Specific Comments

The AASB's most significant specific comments regarding the issues in the ED are in respect of 'deferred inflows' and 'deferred outflows' (see below).

Deferred inflows and deferred outflows

The AASB does not support identifying 'deferred inflows' and 'deferred outflows' as elements of financial statements. The AASB is of the view that assets and liabilities should be defined in relation to economic resources and economic obligations, that revenues and expenses should reflect changes in those economic resources and economic obligations, and that (apart from net assets/equity) only assets and liabilities should be recognised in the statement of financial position.

An important reason why the AASB does not support identifying 'deferred inflows' and 'deferred outflows' as elements of financial statements is because that approach appears to mix economic phenomena and accounting devices ('deferred outflows' and 'deferred inflows') as elements of the financial statements.

[1] Under 'transaction neutrality', a given transaction or other event is accounted for the same way, regardless of the nature of the entity (whether for-profit or not-for-profit) and the sector in which the entity operates.

Consistent with this view, the AASB also does not support consequently identifying net financial position in addition to net assets.

The AASB's concerns regarding 'deferred inflows' and 'deferred outflows' are elaborated in its comments on Specific Matter for Comment 5, set out in Appendix A.

The AASB's responses to all of the specific matters for comment in the ED are set out in Appendix A.

AASB staff's editorial comments on the ED will be provided separately to IPSASB staff.

If you have any queries regarding matters in this submission, please contact me or Jim Paul (jpaul@aasb.gov.au).

Yours sincerely

K.M. Stevenson

Kevin Stevenson
Chairman and CEO

APPENDIX A

AASB's response to the Specific Matters for Comment on the CP

Specific Matter for Comment 1

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

The AASB generally agrees with the proposed definition of an asset. Its suggestions for modifying the definition (and related guidance) are set out below.

"Service potential or economic benefits"

The definition of an asset in paragraph 2.1 of the IPSASB ED refers to "an inflow of service potential or economic benefits". In this regard, the AASB would prefer only using the phrase 'inflow of economic benefits' in the definition of an asset, with clarifying guidance that service potential is a sub-set of economic benefits. This is because the AASB considers that, for any entity, whether for-profit or not-for-profit, in the public sector or private sector, stocks of economic benefits ('future economic benefits') are the scarce capacity of a resource to provide goods or services and thus assist the entity in achieving its objectives, regardless of whether those objectives are directed primarily at generating net cash inflows. Consistent with that view, all inflows of service potential would be encompassed by inflows of 'economic benefits'.

The AASB notes that some commentators regard 'economic benefits' as synonymous with net cash inflows, and are concerned that 'economic benefits' would therefore not encompass all resources deployed by not-for-profit entities. The AASB regards this concern as misplaced. Resources deployed by not-for-profit entities to provide services would generally also be held to generate net cash inflows, either directly through user charges or indirectly in the form of transfers from government and/or taxes. Sometimes a cash inflow may be in the form of an explicit subsidy of the cost of services provided, or implicit in the raising of revenue at an entity-wide level (for example, in the form of some taxes). The fact that some net cash inflows are more difficult than others to relate to particular assets does not necessarily mean the assets are not cash-generating.

The relationship between service potential and economic benefits in the IPSASB ED seems unclear from paragraphs 2.3 – 2.4 of that ED. Paragraph 2.3 describes service potential so broadly as to be likely to encompass all assets; whilst economic benefits, being equated with an ability to generate net cash inflows (see second sentence of paragraph BC8), seems intended to be a subset of service potential (given that IPSASs distinguish 'cash-generating' and 'non-cash-generating' assets). However, the last sentence of paragraph 2.4 refers to "many assets that embody service potential", which implies some assets do not embody service potential and consequently that economic benefits complement service potential. Related to this issue, the AASB disagrees with the implication in paragraph BC9 of the Basis for Conclusions on the IPSASB ED that an asset may generate net cash inflows without providing goods or services, given the broad meaning of 'goods and services'.

Association of an element with the entity

The AASB notes that some assets, by their very nature, would be automatically associated with a particular entity and therefore would not require the specification of factors that associate the asset with the entity. For other assets, the AASB considers that, ideally, the definition of an asset should be broad, and (unlike the IPSASB's proposed definition) should exclude factors that associate the element with an entity, such as control. Consistent with this, the AASB considers that such factors should form part of the recognition criteria instead.

This is because the AASB considers it is useful to focus on the nature of economic phenomena (economic benefits and claims to economic benefits) that affect various entities, without restricting definitions of assets and liabilities only to phenomena that affect the reporting entity. This approach has the advantages of:

(a) keeping the definitions relatively simple and readily understandable; and

(b) helping minimise the risk that standard setters and others will 'peek ahead' to consider whether consequences of the definitions for the recognition of assets and liabilities will be desirable and/or consistent with existing conventions. Developing definitions that do not necessarily affect reporting entities should help in focusing on the economic phenomena to be identified as the elements of financial position (and, by derivation, the elements of financial performance).

However, the AASB notes that the latest tentative thinking of the IASB in its Conceptual Framework project[2] is (consistently with the IPSASB's proposal) to include factors that associate the element with an entity (such as control) in the definition of an asset. The AASB suggests monitoring the outcome of the IASB's further deliberations on this issue. If the IASB's forthcoming Conceptual Framework Discussion Paper were to reflect the above-mentioned tentative thinking, the AASB would intend to disagree with that proposal. However, because the AASB would not consider such a proposal to be a fundamental concern, it would consider it more important that the IPSASB's proposed definition of an asset is consistent in this respect with the IASB's conclusion on this issue, if known when the IPSASB finalises its chapter on Elements and Recognition. (This comment is made in the context of the AASB's view, as expressed in the covering letter in this submission, that differences between the IPSASB's and IASB's Conceptual Frameworks should be limited to issues that specifically affect public sector not-for-profit entities and warrant a different treatment.)

Guidance on control

Regardless of whether the IPSASB treats control as part of the definition of an asset or of the recognition criteria for an asset (see comments immediately above), the AASB suggests merging parts (a) and (b) of paragraph 2.6 of the ED (on the meaning of control). This would avoid the problem that sub-paragraph 2.6(b), which is set out as an alternative to sub-paragraph 2.6(a), does not require the entity to obtain benefits from directing other

2 As set out in *IASB Update* for April 2013.

parties regarding the use of a resource, in order to qualify as controlling the resource. For example, the second sentence of paragraph 2.6 could be reworded along the following lines:

> "Control of the resource entails the ability of the entity to use the resource (or direct other parties regarding its use) in order to derive the [service potential or[3]] future economic benefits embodied in the resource."

<u>Risks and rewards of ownership</u>

The fifth and sixth sentences of paragraph BC16 of the Basis for Conclusions on the IPSASB ED say the IPSASB decided exposure to the risks and rewards of ownership should not be an indicator of control "because it is not compatible with the control approach". The AASB:

(a) disagrees with that comment because it seems to be too categorical. That is:

  (i) the AASB would agree that exposure to the risks and rewards of ownership should not be an essential characteristic of control, because exposure to the risks and rewards of ownership might not be clearly identifiable or might be a less appropriate indicator of control than other indicators; however,

  (ii) the AASB would not agree that in every instance control would be incompatible with exposure to the risks and rewards of ownership. In some cases, identifying exposure to the risks and rewards of ownership might be useful in assessing whether a resource is controlled; and

(b) for the reasons given in (a) immediately above, recommends instead that the IPSASB Framework says that, in some instances, exposure to the risks and rewards of ownership might not be clearly identifiable or might be a less appropriate indicator of control than other indicators.

Past event

The AASB considers that every asset of a reporting entity that qualifies for recognition is the result of a past event.[4] However, the AASB considers that *identification* of a past event of the reporting entity should not be necessary for an asset to qualify for recognition (and, consequently, should not be an essential characteristic of an asset). This is because the AASB agrees with the arguments in paragraph 2.46 of the IPSASB's Consultation Paper (CP) *Elements and Recognition in Financial Statements* (December 2010: see quote below), albeit in the context of recognition criteria for an asset rather than the definition of an asset (because a past event would be one way of associating an asset with a particular reporting entity). Paragraph 2.46 of the IPSASB's Consultation Paper (CP) said:

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[3] These words in parentheses would apply if the reference to 'service potential' in the definition of an asset were retained.

[4] Note that these AASB views refer to assets that qualify for recognition, rather than items that meet the definition of an asset, because, as mentioned above, the AASB considers that factors (such as a past event) that associate an item with an entity should ideally be treated as recognition considerations.

> "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."

Although the AASB thinks a past event should not be an essential characteristic of an asset, it would support:

(a) emphasising the importance of a past event of the reporting entity as an indicator that an asset of the reporting entity would, subject to meeting other recognition criteria, qualify for recognition; while

(b) noting that the existence of a past event does not guarantee that an asset continues to qualify for recognition.

However, the AASB notes that the latest tentative thinking of the IASB in its Conceptual Framework project is (consistently with the IPSASB's proposal) to include a reference to a 'past event' in the definition of an asset. The AASB suggests monitoring the outcome of the IASB's further deliberations on this issue. If the IASB's forthcoming Conceptual Framework Discussion Paper were to reflect the above-mentioned tentative thinking, the AASB would intend to disagree with that proposal. However, because the AASB would not consider such a proposal to be a fundamental concern, it would consider it more important that the IPSASB's and IASB's definitions of an asset are consistent in this respect.

Other aspects

Assets as stores of wealth

An articulation of the stock of an entity's wealth (or capital) is important for defining the elements of its financial statements. This is because assets are stores of wealth. Unless the meaning of an entity's wealth (e.g. invested money capital, current cash equivalents or operating capability) is specified in the Conceptual Framework, the meaning of 'service potential[5] or future economic benefits' will not be identified; consequently, the economic substance of an entity's assets will not be identified. This point is reiterated here as a reminder of the link between the measurement and elements components of a Conceptual Framework.

[5] Here, 'service potential' refers to a stock, not an inflow, and accordingly its counterpart is described here as 'future economic benefits' (rather than 'economic benefits').

The power to tax or to issue licences

The AASB notes that, in relation to the power to tax or to issue licences, and to access or restrict or deny access to the benefits embodied in intangible resources, paragraph 2.8 of the IPSASB ED proposes that an asset arises when the power is exercised and the rights exist to receive service potential or economic benefits.

As indicated above, the AASB's view is that assets should be defined without limiting them to items that would necessarily be recognised in financial statements. In addition, the AASB is of the view that the recognition criteria should be separate from definitions of the elements of financial statements. Accordingly, the AASB considers that a government's power to tax or to issue licences, and to access or restrict or deny access to the benefits embodied in intangible resources, should be identified as assets, although assets associated with those powers might not qualify for recognition in the financial statements until an event (such as the exercise of the powers) occurs and the rights can be reliably measured.

The AASB supports the IPSASB's decision not to retain in the ED the CP's reference to a right to tax as a 'perpetual asset'.

Unconditional rights

The AASB notes that the first two sentences of paragraph BC6 of the Basis for Conclusions on the IPSASB ED indicate that unconditional rights "may give rise to assets, if the entity has paid for them or if the unconditional right has acquired an identifiable value in an open, active and orderly market". The AASB disagrees with this statement because:

(a) all unconditional rights that represent service potential or future economic benefits should be identified as assets (whether recognised or not); and

(b) having a cost or strong market evidence of its value is not an essential characteristic of assets, either for assets generally in the IPSASB ED or in the IASB *Framework*.

Specific Matter for Comment 2
(a) Do you agree with the definition of a liability? If not, how would you modify it?
(b) Do you agree with the description of non-legal binding obligations? If not, how would you modify it?

<u>Specific Matter for Comment 2(a)</u>

The AASB generally agrees with the proposed definition of a liability. Its suggestions for modifying the definition (and related guidance) are set out below.

Association of an element with the entity

Consistent with its views regarding the definition of an asset, the AASB considers that, ideally, the definition of a liability should be broad, and (unlike the IPSASB's proposed definition) should exclude factors that associate the element with an entity (such as whether there is little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity) – such factors should form part of the recognition criteria instead. The reasons for this view of the AASB are given in the comments above on Specific Matter for Comment 1, in the context of the definition of an asset.

However, the AASB notes that the latest tentative thinking of the IASB in its Conceptual Framework project is (consistently with the IPSASB's proposal) to include factors that associate the element with an entity in the definition of an asset. Although the latest draft definition of a liability tentatively decided by the IASB does not refer to a particular factor associating that element with an entity—namely, whether there is little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity (or some other factor compelling such an outflow from the entity)—it might be argued that adding such a reference would be a logical consequence of the above-mentioned tentative IASB decision regarding the definition of an asset. The AASB suggests monitoring the outcome of the IASB's further deliberations on this issue. If the IASB's forthcoming Conceptual Framework Discussion Paper were to propose including factors that associate the element with an entity in the definition of a liability, the AASB would intend to disagree with that proposal. However, because the AASB would not consider such a proposal to be a fundamental concern, it would consider it more important that the IPSASB's and IASB's definitions of a liability are consistent in this respect.

Past event

The AASB considers that every liability of a reporting entity that qualifies for recognition is the result of a past event. However, consistent with its view regarding assets, the AASB considers that *identification* of a past event of the reporting entity should not be necessary for a liability to qualify for recognition. This is because the AASB agrees with the arguments in paragraph 3.40 of the IPSASB's CP *Elements and Recognition in Financial Statements* (December 2010: see quote below), albeit in the context of recognition criteria for a liability rather than the definition of a liability (because a past event would be one way of associating a liability with a particular reporting entity). Paragraph 3.40 of the IPSASB's Consultation Paper (CP) said:

> "As with assets, there may be difficulties in requiring the occurrence of a past transaction or event as an essential characteristic:
>
> (a) The liability arising 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."

Although the AASB thinks a past event should not be an essential characteristic of a liability, it would support:

(a) emphasising the importance of a past event of the reporting entity as an indicator that a liability of the reporting entity would, subject to meeting other recognition criteria, qualify for recognition; while

(b) noting that the existence of a past event does not guarantee that a liability continues to qualify for recognition.

However, the AASB notes that the latest tentative thinking of the IASB in its Conceptual Framework project is (consistently with the IPSASB's proposal) to include a reference to a 'past event' in the definition of a liability. The AASB suggests monitoring the outcome of the IASB's further deliberations on this issue. If the IASB's forthcoming Conceptual Framework Discussion Paper were to reflect the above-mentioned tentative thinking, the AASB would intend to disagree with that proposal. However, because the AASB would not consider such a proposal to be a fundamental concern, it would consider it more important that the IPSASB's and IASB's definitions of a liability are consistent in this respect.

Other aspects

Conditional and unconditional obligations

The AASB is not convinced by the statement in paragraph BC22 of the Basis for Conclusions on the IPSASB ED that:

> "distinguishing between conditional and unconditional obligations is not useful for the purpose of defining a liability because it is possible for conditional obligations to give rise to liabilities".

The AASB notes that the IASB has tentatively decided (in its projects on a review of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and on revenue recognition and insurance contracts) that only unconditional obligations are liabilities, although some unconditional obligations (i.e. obligations to stand ready to transfer economic benefits if an uncertain future event occurs) would be accompanied by conditional obligations to transfer economic benefits. The AASB notes that, in the IASB's Conceptual Framework project, the IASB has tentatively reassessed its previous tentative decision that only unconditional obligations are liabilities (see *IASB Update*, April 2013), and suggests monitoring the outcome of the IASB's further deliberations on this issue and liaising with the IASB with a view to reaching a common conclusion.

Performance obligations

The AASB is not convinced by the statement in paragraph BC26 of the Basis for Conclusions on the IPSASB ED that:

> "because performance obligations are normally conditional obligations and because the issues in determining whether such obligations give rise to liabilities is (sic)

> dependent upon the terms of particular binding agreements and may vary between jurisdictions, it would not be appropriate to use the term 'performance obligation' in the Framework".

The AASB notes that the notion of performance obligations is fundamental to the upcoming IFRS on revenue recognition, and that this aspect will be an issue for the IPSASB if and when it revises its Standards (e.g. IPSAS 9 *Revenue from Exchange Transactions*) in light of that IFRS. Indeed, the AASB is developing an exposure draft (ED) of a Standard for not-for-profit entities based on the IFRS on revenue recognition, and would be willing to share the outcome of that ED with the IPSASB. The AASB recommends that the IPSASB reviews the statement quoted above when finalising its Conceptual Framework chapter on Elements and Recognition.

Specific Matter for Comment 2(b)

As noted above in its comments on Specific Matter for Comment 2(a), the AASB considers that, ideally, the definition of a liability should exclude factors that associate the element with an entity (such as whether there is little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity). 'Non-legal binding requirements' (as referred to in paragraph 3.2 of the IPSASB ED) are another example of factors that associate the obligation with an entity, because they are a mechanism for enforcing performance of the entity's obligation.

Therefore, the AASB's comments below on the description of 'non-legal binding obligations' [as referred to in Specific Matter for Comment 2(b)][6] are conditioned by the caveat above.

The AASB generally supports the description of 'non-legal binding obligations' in paragraphs 3.10 – 3.12 of the ED. Its main concern is in relation to the related comment in the sixth sentence of paragraph BC32 that:

> "In assessing whether a non-legal obligation gives rise to a liability the availability of funding to settle the obligation may be a persuasive indicator."

The AASB disagrees with that comment. The AASB acknowledges that, in some contracts, the receipt of payment in respect of a promise to perform can be the event that makes that promise unconditional – however, it considers that, even in such cases, it would be unnecessary and inappropriate to focus on funding. Instead, one should focus simply on whether an unconditional promise exists. Moreover, for 'non-legal obligations', which need not involve an identified counterparty, it is not clear why funding would be a persuasive indicator of a liability's existence. (The AASB notes that related paragraph 3.12(c) of the IPSASB ED also discusses the relationship between funding and present obligations, but seems much more equivocal than paragraph BC32 on this issue.)

As a matter of drafting, the AASB suggests referring to 'binding obligations that are not legally binding' instead of 'non-legal binding obligations'. This is because:

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6 The AASB notes that the wording of the question in Specific Matter for Comment 2(b) differs from the wording of paragraph 3.2, which describes a present obligation.

(a) ‘non-legal’ literally means illegal. ‘Illegal’ is apparently not the intended meaning; however, ‘non-legal’ might be translated as ‘illegal’; and

(b) if the intended meaning is ‘not legally binding obligations’, ‘non-legal’ is less clearly (than ‘legally’) an adjective that pertains to ‘binding’, and thus is less easy to read than the alternative wording suggested above.

Specific Matter for Comment 3

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

The AASB’s main concern with the proposed definition of revenue is with its exclusion of ‘increases in deferred inflows’ and inclusion of ‘inflows … that result from decreases in deferred inflows’ (in parts (a)(ii) and (b), respectively, of the proposed definition). The AASB fundamentally disagrees with identifying deferred inflows as elements of financial statements; if its view were accepted, parts (a)(ii) and (b) of the proposed definition would become irrelevant. The AASB’s reasons for fundamentally disagreeing with identifying deferred inflows as elements of financial statements are set out in its comments on Specific Matter for Comment 5, and are not repeated here. Except for the concerns noted in this paragraph, the AASB generally agrees with the proposed definition of revenue.

For completeness and clarity, the AASB suggests that the definition of revenue specifies the nature of the inflows to which it refers, and that these should be described as ‘inflows of economic benefits’ (as mentioned in its comments above on Specific Matter for Comment 1, the AASB would prefer that ‘service potential’ is not explicitly referred to in the definition of an asset).

Specific Matter for Comment 4

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

Similarly to its main concern with the proposed definition of revenue, the AASB’s main concern with the proposed definition of expenses is with its exclusion of ‘increases in deferred outflows’ and inclusion of ‘outflows … that result from decreases in deferred outflows’ (in parts (a)(ii) and (b), respectively, of the proposed definition). The AASB fundamentally disagrees with identifying deferred outflows as elements of financial statements; if its view were accepted, parts (a)(ii) and (b) of the proposed definition would become irrelevant. The AASB’s reasons for fundamentally disagreeing with identifying deferred outflows as elements of financial statements are set out in its comments on Specific Matter for Comment 5, and are not repeated here. Except for the concerns noted in this paragraph, the AASB generally agrees with the proposed definition of expenses.

For completeness and clarity, the AASB suggests that the definition of expenses specifies the nature of the outflows to which it refers, and that these should be described as ‘outflows of economic benefits’.

> **Specific Matter for Comment 5**
>
> (a) Do you agree with the decision to define deferred inflows and deferred outflows as elements? If not, why not?
>
> (b) If you agree with the decision to define deferred inflows and deferred outflows as elements, do you agree with the:
>
> (i) Decision to restrict those definitions to non-exchange transactions? If not, why not?
>
> (ii) Definitions of deferred inflows and deferred outflows? If not, how would you modify them?

Specific Matter for Comment 5(a)

The AASB does not support identifying 'deferred inflows' and 'deferred outflows' as elements of financial statements. Its reasons are discussed below.

Economic phenomena

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

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

Rationale for deferred inflows and deferred outflows

The key reason for identifying deferred inflows and deferred outflows as elements seems to be set out in paragraph BC35 of the Basis for Conclusions on the IPSASB ED, which says: "The IPSASB took the view that the definitions of revenue and expenses should reflect the inflows of resources used to finance such[7] goods and services and the outflows of resources related to providing goods and services in the reporting period." This rationale is elaborated in paragraph BC40, which says:

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

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

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

(a) it emphasises financing the provision of goods and services; however, financing pertains to funds flows and not when revenue is generated (see the next paragraph below for an elaboration of this concern);

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

(c) when inflows of resources are not stipulated to be used to finance particular costs of services, attributing those inflows to particular costs of services would involve arbitrary allocations. For example, inflows of resources from general purpose taxes and grants without stipulations can be applied to meet costs of current period services, repay debts incurred in providing services in previous periods or meet the costs of providing services in future periods. Because cash is fungible, any allocation of those inflows to particular outflows would be arbitrary and intent-driven. The IPSASB ED does not propose allocating inflows without stipulations to future reporting periods, but this means its proposals for deferrals are an incomplete attempt to meet their rationale stated in paragraph BC35;

(d) the extent to which the cost of providing outputs is recovered by revenue of the same reporting period is useful for users of financial statements of reporting entities in the private and public sectors; therefore, a public-sector-specific reason for identifying such 'elements' is not apparent; and

(e) it does not logically lead to a conclusion that deferred inflows and deferred outflows may only arise in respect of non-exchange transactions (as is specified in the definitions of 'deferred inflow' and 'deferred outflow' in paragraphs 5.1 and 5.2). The last sentence of paragraph BC45 speaks to this scope limitation, but is merely an assertion. It seems unclear how the IPSASB will deal with hedging and other non-conceptual debits and credits arising from exchange transactions. However, extending the scope of 'deferred inflows' and 'deferred outflows' to include exchange transactions would appear likely to extend the scope of the concern [noted in (b) above] that, without applying definitions of assets and liabilities, it seems nebulous to determine when flows "relate" to future reporting periods. For example, in relation to redundancy payments made pursuant to exchange transactions for the provision of employee services, it could be particularly difficult to determine to which periods the payments relate. Some might treat redundancy payments as an additional cost of services already received, while others might treat them as a cost incurred to reduce future costs. Either treatment would seem arguable under a deferrals approach.

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

Impact on the definitions of 'revenue' and 'expenses'

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

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

Potentially asymmetric definitions

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

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

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

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

Ambiguities regarding the definitions

Specified by whom?

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

Use of an outflow

Paragraph 5.2 defines a ‘deferred outflow’ as an “outflow … provided to another entity or party for use …”. It is confusing to refer to another entity using an outflow; entities use assets.

Other concerns with the Basis for Conclusions

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

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

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

Assisting the pursuit of common ground

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

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

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

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

Consistent with the views expressed above on deferred inflows and outflows, the AASB also does not support consequently identifying net financial position in addition to net assets.

Alternative View of Ms. Jeanine Poggiolini

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

Implications for the future

Given that Chapter 1 of the IPSASB’s Conceptual Framework says the IPSASB will apply the concepts in that Framework in developing IPSASs, if the IPSASB were to identify deferred inflows and deferred outflows as elements in its completed Framework, that decision would imply the IPSASB would give consideration to amending IPSASs to require recognition of such deferrals. If the IPSASB then decided not to amend IPSASs in that manner, it would need to explain that decision.

Alternatively, the IPSASB could amend IPSASs to permit optional recognition of deferred inflows and deferred outflows as elements. Although such a move might be well received in some jurisdictions considering the adoption of IPSASs, it would undermine the stature of IPSASs in fostering international convergence in public sector financial reporting.

For these reasons, the AASB considers that a decision by the IPSASB to identify deferred inflows and deferred outflows as elements in its completed Framework would have profound implications for that Framework and for IPSASs generally.

<u>Specific Matter for Comment 5(b)</u>

Because the AASB does not support identifying (and defining) 'deferred inflows' and 'deferred outflows' as elements of financial statements, it has no additional comments on the questions in Specific Matter for Comment 5(b). The AASB's comment on Specific Matter for Comment 5(b)(i) is given above in paragraph (e) on page 14.

Specific Matter for Comment 6

(a) Do you agree with the terms net assets and net financial position and the definitions? If not, how would you modify the terms and/or definitions?

(b) Do you agree with the decision to define ownership contributions and ownership distributions as elements? If not, why not?

(c) If you agree with the decision to define ownership contributions and ownership distributions as elements, do you agree with the definitions of ownership contributions and ownership distributions? If not, how would you modify them?

(d) Ownership interests have not been defined in this Conceptual Framework. Do you think they should be?

<u>Specific Matter for Comment 6(a)</u>

Net assets

The AASB agrees with the IPSASB ED's proposals to not define net assets as an element of financial statements and to describe net assets as a residual amount rather than a residual interest. The AASB considers that, in some circumstances, it would be inappropriate to describe 'net assets' as an ownership or residual interest because there are no specifically identified parties to whom the interest would be attributable. Accordingly, its view is that the more inclusive notion of a residual amount should be applied generally in relation to an entity's net assets, and, as a residual of other elements (namely, assets and liabilities), 'net assets' would not represent an element of financial statements in its own right.

Net financial position

As explained in the comments above on Specific Matter for Comment 5(a), the AASB does not support identifying 'deferred inflows' and 'deferred outflows' as elements of financial statements and, consequently, does not support identifying net financial position in addition to net assets.

<u>Specific Matter for Comment 6(b)</u>

The AASB agrees with the proposal to define ownership contributions and ownership distributions as elements of financial statements. This is because reference is made to those transactions in the proposed definitions of revenue and expenses.

Specific Matter for Comment 6(c)

The AASB generally supports the proposed definitions of 'ownership contributions' and 'ownership distributions' in paragraphs 6.3 and 6.4, respectively, of the ED.

Those proposed definitions, and paragraph 6.5, say 'ownership contributions' and 'ownership distributions' establish/increase or return/reduce an interest in the entity's net assets and acknowledge that not all transactions with owners are undertaken in their capacity as owners (i.e. affect their interest in the entity's net assets). The AASB suggests strengthening that point to provide a more robust reference point by providing examples of transactions with owners that are not undertaken in their capacity as owners, for example, in acting as a lender or customer.

The AASB recommends clarifying the comment in the second sentence of paragraph 6.5 that: "… in some jurisdictions it is relatively common for assets and liabilities to be transferred between public sector entities for no consideration." In the context of the preceding words in that paragraph, the words quoted above seem to imply these transfers would not be treated as 'ownership contributions' and 'ownership distributions' (and therefore, by implication, would be identified as revenue, expenses, deferred inflows or deferred outflows of the public sector entity). The AASB recommends that, regarding this important issue, the IPSASB Conceptual Framework should either:

(a) clarify whether these transfers would be identified as revenue, expenses, deferred inflows or deferred outflows of the public sector entity; or

(b) indicate that the treatment of these transfers will be addressed at a Standards level. This alternative is the AASB's preference.

Specific Matter for Comment 6(d)

The AASB considers that the most important aspect of a public sector Conceptual Framework regarding ownership interests is that it acknowledges those interests may arise in relation to (non-GBE) public sector entities, as occurs in paragraph 6.6 of the IPSASB ED. Accordingly, the AASB is not strongly concerned that ownership interests have not been defined in the IPSASB's Conceptual Framework ED. However, the AASB notes that because 'ownership contributions' and 'ownership distributions' are defined as inflows and outflows of resources affecting interests in the entity's net assets, it would be logical to also define those interests in the entity's net assets.

Specific Matter for Comment 7

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

The AASB notes that, although Section 7 of the ED is headed 'Recognition Criteria', no explicit recognition criteria are set out. The AASB recommends including explicit recognition criteria in the IPSASB Conceptual Framework that are neutral, both in:

(a) requiring a neutral judgement of whether an element exists at the reporting date; and

(b) specifying the same recognition threshold for all assets and liabilities.

The AASB recommends applying the same criteria to both recognition and derecognition of each element. However, at this stage, the AASB considers it is premature, without further proposals by the IPSASB, to indicate how those recognition criteria should be worded.

In relation to 'measurement uncertainty', paragraphs 7.5 – 7.6 of the ED do not indicate whether it is possible that no measure of an asset or a liability would result in a sufficiently faithful representation of that element for it to warrant recognition. The AASB recommends clarifying the position of the Conceptual Framework on this issue. It would prefer that the Conceptual Framework indicates that, in rare circumstances, such as some legal disputes for unspecified amounts of damages, no measure of an asset or a liability would result in a sufficiently faithful representation of that element for it to warrant recognition.

Other Matter

Remeasurements of assets and liabilities excluded from surplus or deficit for the period

The AASB recommends amending, or adding to, the proposed definitions of the elements of financial statements to explicitly cater for remeasurements of assets and liabilities that are adjusted directly to net assets, that is, without being recognised in surplus or deficit for the period. This recommendation is explained below.

Because the IPSASB ED's proposed concept of 'revenue' equates to the concept of 'income' in the IASB Conceptual Framework, some might expect the definition of revenue to cover asset revaluation increases credited directly to revaluation surplus.[8] However, the ED's definition of revenue in paragraph 4.1 does not mention 'enhancements' (it only includes 'inflows'). An increase in the fair value of an item of property, plant or equipment or an intangible asset does not seem to qualify as an 'inflow' of an asset because no transaction or growth (for example, as occurs with biological assets) has occurred.

Some others might regard revaluation increases or decreases excluded from surplus or deficit for the period as capital maintenance adjustments, because they do not view those revaluation increases or decreases as representing inflows/outflows or enhancements/diminutions of service potential or economic benefits. Instead, they view those revaluation increases or decreases as representing a repricing of the same service potential (i.e. the same capacity to provide services). For them, extending the definition of revenue to include 'enhancements' of assets would not cater for these revaluation increases, because they do not think the assets have been enhanced. They argue that the treatment of revaluations of property, plant and equipment and intangible assets under IPSASs and IFRSs implicitly treats the entity's capital[9] (as reflected, in part, in the service potential of

8 For example, those increases in the carrying amounts of property, plant and equipment or intangible assets upon revaluation that are credited directly to revaluation surplus under paragraph 54 of IPSAS 17 *Property, Plant and Equipment* or paragraph 84 of IPSAS 31 *Intangible Assets*.

9 As mentioned above in the AASB's comments on Specific Matter for Comment 1, an entity's 'capital' is another term for its wealth.

its assets) as its operating capability (or a similar notion). This is because a change in the price of the same resources does not change the operating capability they embody; and therefore it would be appropriate to exclude that recognised price change from surplus or deficit for the period, which represents the change in the entity's capital (excluding ownership contributions and ownership distributions) recognised for the period. However, the ED does not identify 'capital maintenance adjustments' as elements.

Regardless of which of the views in the two immediately preceding paragraphs is held, it seems revaluations excluded from surplus or deficit for the period are not catered for in the ED's proposed definitions of the elements of financial statements.

Did the IPSASB intend not to cater for revaluations excluded from surplus or deficit in the definitions of the elements of financial statements? If that apparent omission was not intended, the AASB suggests addressing this concern by either amending the definitions of revenues and expenses to refer to enhancements or diminutions of resources, or by identifying capital maintenance adjustments as elements of financial statements.[10] At this stage, the AASB does not have a preference for either solution.

However, the AASB considers that, if the IPSASB were to regard particular remeasurements of assets and liabilities excluded from surplus or deficit for the period as repricing the same service potential or obligations to sacrifice service potential, it would be logical for the Conceptual Framework to treat those remeasurements as capital maintenance adjustments.

[10] The only item recognised in financial statements that the AASB would not regard as an element is net assets. As noted in the comments above on Specific Matter for Comment 6(a), the AASB considers net assets not to be an element in its own right because it is the residual of the amounts of other elements, namely, assets and liabilities.