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INVITATION TO COMMENT

**ACCOUNTING FOR SOCIAL POLICIES
OF GOVERNMENTS**

WORKING DRAFT - FOR PSC REVIEW

WORKING DRAFT FOR PSC REVIEW APRIL 2003

Commenting on this Invitation to Comment

This Invitation to Comment of the International Federation of Accountants (IFAC) was prepared by the Steering Committee on Social Policy Obligations (SCSPO) on behalf of the Public Sector Committee (PSC).

The aim of this ITC is to canvas a broad range of views on the most appropriate accounting treatment for social policy obligations in the public sector. These views will then be used as a source of information to inform the Committee's deliberations in the preparation of an Exposure Draft of an International Public Sector Accounting Standard.

Comments are invited on any aspect of this Invitation to Comment (ITC). In particular, respondents are asked to provide a clear view on whether they agree or disagree with the preliminary views in this paper, and the reasons why. Comments should be submitted in writing so as to be received by [XX Month Year]. E-mail responses are preferred. Unless respondents specifically request confidentiality, their comments are a matter of public record once the Public Sector Committee has considered them. Comments should be addressed to:

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Fax: +1 (212) 286-9570
E-mail Address: EDComments@ifac.org

Specific Matters for Comment

[Insert specific matters for comment]:

- is the scope of the ITC an appropriate basis for a future ED IPSAS?
- is there any evidence to support the existence of an obligating event between workforce age and retirement age for old age pensions?
- [other specific matters for comment to be inserted in due course]

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Steering Committee

Kevin Simpkins, Deputy Controller and Auditor-General of New Zealand (Chair, member of the PSC).

Brian Donaghue, Consultant to the International Monetary Fund.

Kristina Lundqvist, Head of the Accounting Development Unit, National Financial Management Authority, Sweden.

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Members of the Steering Committee are appointed in their personal capacity rather than as representatives of their nominating body.

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Executive Summary

The Steering Committee on Social Policy Obligations (SCSPO) of the Public Sector Committee (PSC) has prepared this Invitation to Comment (ITC) to elicit views on how social policy obligations of public sector entities should be recognized and measured in the general purpose financial statements of those entities.

[Insert executive summary once final draft approved]

Summary of Preliminary Views

[Insert preliminary views once final draft approved]

Chapter 1 Introduction

Introduction

- 1.1 Governments provide a wide range of social benefits to individuals and organizations, including the provision of goods and services and the re-distribution of income via cash transfers. In providing social benefits governments frequently make assertions regarding the nature or amount of future benefits or commit themselves to future actions.
- 1.2 Accrual based financial reporting in the public sector is still evolving and there is currently no internationally agreed method of accounting for and reporting on liabilities arising from the provision of social benefits by governments.
- 1.3 The publication of this ITC is intended to promote consideration and debate of this issue. It is the first step in a process that will lead to the development of guidance on accounting for obligations arising from social benefits. The ITC includes a number of preliminary views on the appropriate financial reporting of obligations arising from the provision of social benefits by governments and seeks comments on these preliminary views.
- 1.4 This Invitation to Comment applies the definitions and principles in International Public Sector Accounting Standards (IPSASs), particularly International Public Sector Accounting Standard IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*¹, to a range of social benefits in order to determine the point at which:

¹ IPSAS 19 paragraph 1(a) excludes “provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits”. The PSC excluded such provisions and contingent liabilities from the scope of IPSAS 19 because it decided that both the determination of what constitutes the “obligating event” and the measurement of the liability required further consideration. This ITC represents a first step in addressing these issues.

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- a government has a present obligation as the result of a past (obligating) event that results in the government having no realistic alternative but to settle that obligation; and
- the settlement of the obligation is expected to result in an outflow of resources embodying economic benefits or service potential.

1.5 Where the provision of social benefits by governments gives rise to obligations that meet these criteria and the expected outflows are both probable and may be reliably measured, the obligations would be recognized as liabilities (including provisions) in the government's general purpose financial statements and the disclosure requirements relating to liabilities (including provisions) would apply. Where the provision of social benefits by governments does not give rise to such obligations, the possible existence of contingent liabilities is considered.

1.6 Application of definitions and principles within IPSASs will lead to recognition and disclosure in general purpose financial statements of only a subset of a government's obligations to provide social benefits. The issue of supplemental disclosures is therefore considered.

Public Sector Environment

1.7 Characteristics of a public sector environment which are of particular relevance to social policy obligations include the following:

- many government transactions are non-exchange transactions. Examples include the collection of revenue from taxes, the use of such revenue to provide goods and services free of charge to the community and the redistribution of income. Accounting for such non-exchange transactions is not well developed;
- the financial impact of a government's social policies can extend for many years into the future and have a significant impact on the future financial condition of a jurisdiction;
- the right to tax provides governments with some certainty as to the existence of future revenue flows; and
- aspects of a government's social policies may be incorporated in legislation. However, some governments have the sovereign right to create or change legislation.

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- 1.8 These characteristics of the public sector environment need to be taken into consideration when considering the application of existing accounting definitions and principles to a government's social policy obligations.

Current Financial Reporting Practices

- 1.9 At the present time, a number of governments that have adopted accrual accounting for the preparation of general purpose financial reports recognize:
- social benefits paid, or due to be the paid, during the period as an expense; and
 - social benefits due and payable at the end of the reporting period as a liability.
- 1.10 The application of this approach to accounting for obligations to provide universal old age pension benefits is sometimes referred to as a “pay-as-you-go” basis.
- 1.11 Some would argue that this approach leads to inadequate recognition of social policy obligations in a government's financial statements. For example, some believe that in order to demonstrate the sustainability of certain welfare programs, a government should recognize its full exposure for the future impact of its current social policies.
- 1.12 However, even those who acknowledge the limitations of current reporting practices find it difficult to agree on the point at which a government should recognize liabilities in relation to its future social policy obligations and how those liabilities should be measured. For example, if it is argued that liabilities for social policy obligations should be recognized when individuals have met eligibility criteria, it is still necessary to identify the point(s) at which the eligibility criteria have been satisfied and the government has no alternative but to settle the associated liability.

General Purpose Financial Statements

- 1.13 General purpose financial statements are those intended to meet the needs of users who are not in a position to demand reports tailored to meet their specific information needs. Users of general purpose financial statements include taxpayers and ratepayers, members of the legislature, creditors, suppliers, the

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media and employees. General purpose financial statements include those that are presented separately or within another public document such as an annual report.

1.14 General purpose financial statements as identified in International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements*, are:

- the statement of financial position;
- the statement of financial performance;
- the statement of changes in net assets/equity;
- the cash flow statement; and
- accounting policies and the notes to the financial statements.

1.15 A government's social policy obligations may give rise to:

- liabilities which are recognized in the financial statements. For a social policy obligation to be recognized in the financial statements it must meet the definition of a liability and the recognition criteria for liabilities. Liabilities recognized in the financial statements include liabilities which are uncertain as to timing or amount (provisions) and those for which no such uncertainty exists, for example, amounts due and payable; or
- contingent liabilities which are disclosed in the notes to the financial statements.

1.16 In addition to general purpose financial statements, a government may prepare other reports such as statistical, economic and intergenerational reports which convey information about the government's activities and financial obligations. Jurisdictions which require supplemental disclosures may require them to be presented in general purpose financial statements, in a separate section of a report which includes general purpose financial statements or in an entirely separate report. This ITC focuses on reporting and disclosure within general purpose financial statements but it refers to the possibility of disclosure in other reports as appropriate.

WORKING DRAFT FOR PSC REVIEW APRIL 2003**Application of IPSASs**

- 1.17 This ITC applies the definitions and principles in IPSASs to obligations arising from social benefits. IPSASs establish the definitions and recognition criteria to be applied in determining whether certain obligations should be recognized as liabilities. Application of the definitions and recognition criteria relating to liabilities lead to the recognition of liabilities (including provisions) where these obligations are the result of past events and where the recognition criteria for liabilities (measurability and probability) are met. Relevant definitions and recognition criteria are discussed in Chapter 3.

Structure of the ITC

- 1.18 The ITC comprises eight Chapters. This Chapter contains an introduction to the issues addressed in the ITC. Chapters 2 and 3 outline general issues relevant to the scope and approach of the ITC:

- Chapter 2 explains the scope of the ITC and explains differences in the way the term “social benefit” is used in this ITC and in the International Monetary Fund’s (IMF) Government Finance Statistics Framework (GFS 2001)¹;
- Chapter 3 describes the general approach that is used in considering whether the provision of social benefits by a government gives rise to liabilities or contingent liabilities in the context of general purpose financial reporting. Chapter 3 uses the definitions in existing IPSASs to develop this general approach. In particular, Chapter 3 discusses the issues that arise in applying the principles, including definitions, in IPSAS 19 to social policy obligations. Chapter 3 also discusses measurement and disclosure issues.

- 1.19 Chapters 4 to 6 examine the identification, measurement and disclosure issues associated with specific types of obligations. The ITC does not attempt to examine the full range of social benefits or methods of providing social benefits that exist in jurisdictions. Instead the ITC attempts to develop general recognition and measurement principles that can be applied to a

¹ Where possible this ITC uses terminology in a manner consistent with GFS 2001 or explains the difference in use.

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range of social policy activities. The discussion of social benefits is structured as follows:

- Chapter 4 Collective Services and Individual Services;
 - Chapter 5 Individual Benefits Provided by way of Cash Transfer;
 - Chapter 6 Other Benefits; and
 - Chapter 7 Old Age Pension Benefits.
- 1.20 Chapter 8 considers the desirability of supplemental disclosures about major government activities and outlines the possible form and content of such disclosures. Appendix 1 illustrates application of the principles discussed in Chapters 4, 5 and 6 to specific examples. Appendix 2 illustrates the disclosures proposed in the ITC.

Chapter 2 Scope

Introduction

- 3.5 This ITC principally focuses on accounting for those social benefits specifically excluded from the scope of IPSAS 19 paragraph 1(a). IPSAS 19 paragraph 1 is shown in Figure 2.1 below.

Figure 2.1 IPSAS 19 Scope

An entity which prepares and presents financial statements under the accrual basis of accounting should apply this Standard in accounting for provisions, contingent liabilities and contingent assets, except:

- (a) those provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits;
- (b) those resulting from financial instruments that are carried at fair value;
- (c) those resulting from executory contracts, other than where the contract is onerous subject to other provisions of this paragraph;
- (d) those arising in insurance entities from contracts with policyholders;
- (e) those covered by another International Public Sector Accounting Standard;
- (f) those arising in relation to income taxes or income tax equivalents; and
- (g) those arising from employee benefits except employee termination benefits that arise as a result of a restructuring as dealt with in this Standard.

IPSAS 19 paragraph 1

- 3.5 This Chapter attempts to give readers a fuller understanding of the range of social benefits referred to in paragraph 1(a) of IPSAS 19. It does this by using the GFS 2001 definition of social benefits as a starting point.
- 3.5 Although the focus of this ITC is on social policy obligations specifically excluded from the scope of IPSAS 19, the discussion and preliminary views in the ITC may provide useful guidance on accounting for certain social policy obligations

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which fall within the scope of IPSAS 19. This Chapter identifies these types of obligations and indicates which of these obligations are specifically addressed in the ITC.

- 3.5 The ITC does not address obligations associated with exchange transactions such as the provision of retirement benefits to government employees as part of their compensation or the purchase by individuals of health or education services – even where such transactions are between an individual and a government entity.

IPSAS 19 Social Benefit Exclusion**Social Benefits**

- 3.5 IPSAS 19 does not include a specific definition of “social benefits”. However, it does provide some explanation of the types of benefits that would be excluded from the scope of the standard. Relevant extracts from IPSAS 19 are:

- for the purposes of this Standard “social benefits” refer to goods, services and other benefits provided in the pursuit of the social policy objectives of a government (paragraph 7);
- social benefits may include “the delivery of health, education, housing, transport and other social services to the community. In many cases there is no requirement for the beneficiaries of these services to pay an amount equivalent to the value of these services” (paragraph 7(a));
- social benefits may include “the payment of benefits to families, the aged, the disabled, the unemployed, veterans and others” (paragraph 7(b));
- social benefits “generally fall within the “social protection”, “education” and “health” classifications under the International Monetary Fund’s Government Finance Statistics framework” (paragraph 8); and
- the scope exclusion would “encompass those circumstances where a charge is levied in respect of the benefit but there is no direct relationship between the charge and the benefit received” (paragraph 9).

WORKING DRAFT FOR PSC REVIEW APRIL 2003**Non-Exchange Transactions**

- 3.5 The social benefits referred to in IPSAS 19 paragraph 1(a) are commonly referred to as non-exchange social benefits. IPSAS 19 does not define the term “non-exchange”. Instead IPSAS 19 paragraph 1(a) draws on the wording used in IPSAS 9 *Revenue from Exchange Transactions*. IPSAS 9 paragraph 5 states that “An exchange transaction is one in which the entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of goods, services or use of assets) to the other party in exchange.”
- 3.5 A non-exchange transaction is one where the transfer of goods and services is not of approximately equal value. Non-exchange transactions therefore include those where *some* consideration is received from the recipients of the benefits. In some cases it may be appropriate to view non-exchange transactions where some consideration is received from recipients as having an exchange component and a non-exchange component.
- 3.5 Essentially, an exchange relationship requires performance by both parties, which transfer economic benefits of approximately equal value to one another. Accordingly, the transaction and event must be on an arm’s length basis. Although there may be “discounts” or price reductions, the consideration provided by the recipient of the social benefit must bear a direct relationship with the value of the benefit provided. For example, in some jurisdictions individuals pay for private education for their children. When this occurs, the recipients of these services have entered into an exchange transaction with a private sector provider of educational services. Conversely, when individuals pay taxes and receive free education for their children in government schools, a non-exchange relationship exists. This is because taxes represent the general revenue base of governments and the amount of tax an individual pays is not directly related to the value of benefits the individual receives. A third alternative is also possible. Governments may subsidize the cost of educating children in private schools. In this case both the parents and the government have entered into an exchange transaction with the school, but the relationship between the parents and the government is a non-exchange relationship.

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- 3.5 The social benefits considered in this ITC are generally provided by a government free of charge or for considerably less than the full cost of the good or service.
- 3.5 The next section in this Chapter provides an overview of the relevant GFS 2001 definitions and classifications and their relevance to this ITC.

GFS 2001 Social Benefits

- 3.5 As noted above, IPSAS 19 does not define the term “social benefits”. This Chapter uses the definition of “social benefits” within the International Monetary Fund’s (IMF) Government Finance Statistics framework (GFS 2001) as a starting point in identifying the types of social benefits referred to in IPSAS 19 paragraph 1(a). The GFS definition of “social benefits” is a useful starting point because GFS terms and definitions are well understood by a wide range of government officials.
- 3.5 Social benefits are one category of economic classification within the IMF’s GFS 2001 framework. A summary of the economic classifications used in GFS 2001 is shown in Figure 2.2 (readers are referred to GFS 2001, Table 6.1 for a more detailed list of economic classifications).

Figure 2.2 Economic Classification of Expense

| |
|------------------------------|
| Compensation of employees |
| Use of goods and services |
| Consumption of fixed capital |
| Interest |
| Subsidies |
| Grants |
| Social benefits |
| Other expense |

- 3.5 Relevant GFS definitions are provided in Figure 2.3 below.

Figure 2.3 GFS Definitions

| |
|--|
| <p>Social benefit [GFS]. A payment, in cash or in kind, to protect the entire population, or specific segments of it, against certain social risks Examples of social benefits are the provision of medical services, unemployment compensation, and social</p> |
|--|

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security pensions. See social risk.

Social risk. An event or circumstance that may adversely affect the welfare of households either by imposing additional demands on their resources or by reducing their incomes.

Transfer transaction. A transaction in which one unit provides a good, service, asset, or labor to a second unit without receiving simultaneously a good, service, asset, or labor of any value in return.

GFS Manual 2001 Companion Material – Glossary

- 3.5 Social benefits provide for needs arising from events such as sickness, unemployment, retirement, housing or family circumstances.
- 3.5 Cash transfers include payments relating to specific benefits (for example, unemployment benefits) and payments which are intended to enable households to purchase specific goods and services.
- 3.5 Benefits in kind are provided when a government purchases goods and services from a third party and distributes them. Examples of benefits that would be classified as “benefits provided in kind” by GFS include:
- transfers of goods held in inventory;
 - the purchase and simultaneous transfer of goods and services from non-government suppliers; and
 - the reimbursement of expenditures by households on specified goods or services, such as expenditures on medicines, medical or dental treatments, hospital bills, and optometrists’ bills.
- 3.5 Although GFS 2001 provides a broad definition of social benefits it acknowledges that there is no universally accepted

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list of items included within the scope of social benefits¹ and that the social risks covered are liable to vary from scheme to scheme and from government to government. The following (adapted from paragraph 8.56 of 1993 SNA) is a list of typical social benefits:

- provision of healthcare usually in kind or by reimbursing households or individuals;
 - support of spouses, children, elderly relatives, invalids and other dependents usually through cash benefits;
 - compensation for a reduction in income as a result of not being able to work;
 - compensation for a reduction in income because of the death of the main income earner;
 - provision of housing either in kind or in the form of a cash benefit; and
 - allowances to cover education expenses or provision of educational services in kind.
- 3.5 The GFS definition of a transfer transaction refers to the provision of goods or services without the simultaneous receipt of a good or service of approximately equal value in return.
- 3.5 The collective arrangement aspect of social benefits means that the benefits are provided in relation to a collective group – not just for one individual. However, individuals within that group may enjoy the benefits. The detailed application of the collective arrangement requirement to social protection schemes is described in GFS 2001 (Annex to Chapter 2, paragraph 5).
- 3.5 GFS describes a variety of social protection schemes under which social benefits may be provided. These are:
- social security schemes: A social insurance scheme that is imposed, controlled, and financed by a government unit and covers the entire community or large sections of it;
 - social assistance schemes: non-contributory schemes; and

¹ In the GFS context a social benefit is always a transfer payment and is always provided in a collective arrangement. (GFS 2001, Annex to Chapter 2, paragraph 4).

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- employer social insurance schemes: a social insurance scheme in which an employer provides social insurance benefits to its employees, former employees, or their beneficiaries. These schemes may be funded or unfunded.

3.5 The first two schemes identified above are consistent with the types of social benefits referred to in IPSAS 19 paragraph 1(a). Social insurance benefits provided to employees in respect of their service to the employer are not social benefits in the context of IPSAS 19 paragraph 1(a). Instead, they are employee benefits which are excluded from the scope of IPSAS 19 by virtue of paragraph 1(g) (guidance on accounting for employee benefits is found in International Accounting Standard IAS 19, *Employee Benefits*).

3.5 A description of the types of benefits provided by governments under social security schemes and social assistance schemes is shown in Figure 2.4.

Figure 2.4

6.69 *Social security benefits* (271) are social benefits payable in cash or in kind to households by social security schemes. Typical social security benefits in cash include sickness and invalidity benefits, maternity allowances, children's or family allowances, unemployment benefits, retirement and survivors' pensions, and death benefits.

6.70 Social security benefits in kind consist of goods and services purchased from a market producer on behalf of households and reimbursements of benefits purchased by households in accordance with the rules of the scheme. These benefits are likely to consist of medical or dental treatments, surgery, hospital accommodation, spectacles or contact lenses, pharmaceutical products, home care, and similar goods or services.

6.71 *Social assistance benefits* (272) are transfers payable to households to meet the same needs as social insurance benefits but which are not made under a social insurance scheme. Social assistance benefits may be payable when no social insurance scheme exists to cover the circumstances in question, certain households do not participate in existing social insurance schemes, or social insurance benefits are deemed inadequate to meet particular needs. Social assistance benefits do not include transfers made in response to events or circumstances that are not normally covered by social insurance schemes, such as natural disasters. Such transfers are recorded under *miscellaneous other expense* (282). Social assistance benefits in kind consist of transfers to households similar in nature to social security benefits in kind and provided under the same circumstances as social assistance benefits.

GFS 2001 paragraphs 6.69 to 6.71

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WORKING DRAFT FOR PSC REVIEW APRIL 2003**The Scope of this ITC**

3.5 The types of social benefits referred to in IPSAS 19 paragraph 1(a) include social benefits provided in cash or in kind as defined in GFS 2001. In addition, the social benefits referred in IPSAS 19 paragraph 1(a) cover other actions taken by governments in order to meet their social objectives including:

- the direct production and distribution of goods and services (for example, the provision of education services through government owned schools);
- the provision of subsidies; and
- the provision of grants, including grants to foreign governments and international organizations.

3.5 IPSAS 19 identified Social Protection, Education and Health as areas of government activity in which a government could provide social benefits that gave rise to obligations. These functional areas are indicative only. Social benefits provided under other categories of government activity (for example, Defense, Public Order and Safety, and Housing and Community Amenities) could also give rise to present obligations. Some social benefits provided by governments (for example the provision of social benefits in relation to natural disasters) may fall within a number of these categories. For a complete list of GFS Classification of Functions of Government (COFOG) readers are referred to the Annex to Chapter 6 in GFS 2001.

3.5 Within GFS, all outlays for a particular function are collected in one category of the COFOG, regardless of how the outlays are implemented. Therefore a category such as Health could include:

- cash transfer payments designed to be used for particular health services;
- the purchase of health related goods and services from a market producer and the subsequent transfer of those goods and services to households (GFS social benefits in kind); and
- the production of health related goods and services by a general government unit.

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- 3.5 As mentioned in the Introduction to this Chapter, the focus of this ITC is on those social policy obligations specifically excluded from the scope of IPSAS 19. However, it is sometimes difficult to determine whether a government engages in a particular activity in order to meet its social policy objectives or for other reasons, such as to meet its economic objectives. This distinction is not critical in the context of this ITC. Although IPSAS 19 technically provides guidance on accounting for provisions and contingent liabilities arising from non-exchange transactions other than those arising from social benefits, there is limited guidance in IPSAS 19 on accounting for such transactions and the discussion in this ITC may be useful. For example, the discussion in Chapter 6 on foreign aid could be usefully applied to similar grants, regardless of the government's objective in providing those grants.

Chapter 3 General Approach**Introduction**

- 3.1 This Chapter identifies definitions and principles in existing IPSASs, particularly IPSAS 19, that are relevant in considering how to account for the social benefits referred to in IPSAS 19 paragraph 1(a). This Chapter considers general issues that arise as a result of applying these definitions and principles to these social benefits.
- 3.2 This ITC is based on the assumption that the definitions and principles in existing IPSASs are applicable to the social benefits considered in this ITC.

Definitions and Principles in Existing IPSASs

- 3.3 The two IPSASs relevant when considering how to account for the social benefits referred to in IPSAS 19 paragraph 1(a) are IPSAS 1 and IPSAS 19.
- 3.4 IPSAS 1 sets out overall considerations for the presentation of financial statements, guidance for their structure, and minimum requirements for the content of financial statements prepared under the accrual basis of accounting.
- 3.5 IPSAS 19 defines provisions, contingent liabilities and contingent assets, identifies the circumstances in which provisions should be recognized, states how provisions should be measured and sets out required disclosures in relation to provisions, contingent liabilities and contingent assets. Key definitions¹ and recognition criteria² for provisions are shown in Figure 3.1.

¹ The Glossary to this ITC contains a list of all defined terms (from IPSASs) used throughout this ITC.

² IPSASs are based upon equivalent International Accounting Standards (IASs) or International Financial Reporting Standards (IFRSs) to the extent that these standards are applicable to the public sector. In turn these standards are built upon the IASC (now IASB) Framework for the

Figure 3.1 Provisions – Relevant Definitions and Recognition Criteria

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

A provision is a liability of uncertain timing or amount.

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

A legal obligation is an obligation that derives from:

- (a) a contract (through its explicit or implicit terms);
- (b) legislation; or
- (c) other operation of law.

A constructive obligation is an obligation that derives from an entity's actions where:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

IPSAS 19 paragraph 18

Recognition Criteria – Provisions

A provision is recognized when:

- (a) an entity has a present obligation (legal or constructive) as a result of a past event;
- (b) it is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and
- (c) a reliable estimate can be made of the amount of the obligation.

IPSAS 19 paragraph 22

Preparation and Presentation of Financial Statements. This Framework contains the recognition criteria for liabilities (paragraph 91).

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3.6 This Chapter focuses on paragraphs 23 to 34 of IPSAS 19. These paragraphs discuss the criteria necessary for recognition of a provision and provides guidance on factors to consider in determining whether there is a present obligation. The guidance deals with matters such as:

- how to deal with uncertainty regarding whether or not there is a present obligation and the identification of the past event leading to the present obligation (the obligating event);
- how to determine whether an outflow of resources embodying economic resources or service potential is probable; and
- the use of estimates in making a reliable estimate of an obligation.

Decision Tree

3.7 The Decision Tree in Figure 3.2 is similar to the Decision Tree in Appendix B of IPSAS 19. It has been amended to highlight points where a decision is required and the actions required as a result of those decisions. The Decision Tree summarizes the main recognition requirements of IPSAS 19 and is relevant for transactions and events which fall within the scope of IPSAS 19¹. Together with the guidance in IPSAS 19 it assists entities in accounting for:

- liabilities that are uncertain as to timing or amount (provisions);
- liabilities that are not recognized because their existence will be confirmed only by one or more uncertain future events not wholly within the control of the entity (contingent liabilities); and

¹ The Decision Tree in IPSAS 19 was not intended to apply to obligations arising from employee entitlements as these are outside the scope of IPSAS 19.

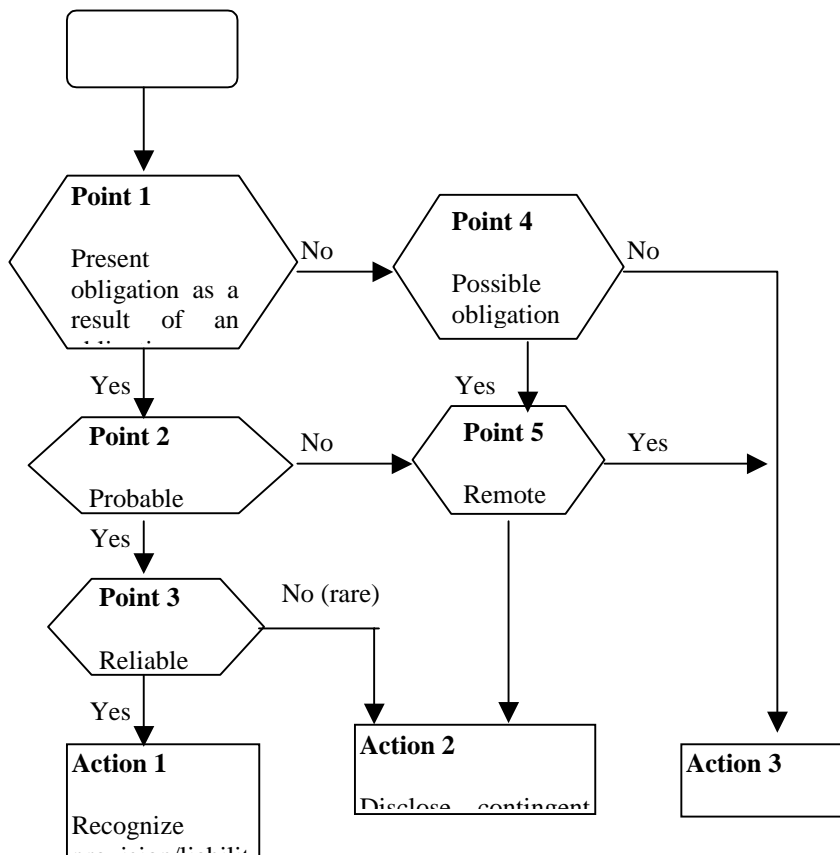
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- liabilities that are not recognized because they do not meet the recognition criteria for liabilities (contingent liabilities).¹

3.8 This Chapter extends the application of the Decision Tree by considering its relevance, in general terms, to the social benefits referred to in IPSAS 19 paragraph 1(a). Subsequent Chapters of this ITC apply the framework set out in the Decision Tree to specific social benefits in respect of which a government has obligations to provide social benefits in the future.

¹ If a present obligation clearly exists and the amount and timing of that present obligation is known, it is not necessary to apply the Decision Tree because the appropriate method of reporting the liability is clear (refer to IPSAS 19 paragraphs 11 and 19).

Figure 3.2 Decision Tree



3.9 Application of the Decision Tree to obligations arising from the social benefits provided by governments can be difficult. Some of the distinctive features of social benefits include:

- benefits may be provided to individuals, broad groups of the community or the community as a whole;
- agreements to provide such benefits are unlikely to be underpinned by a contract; and
- even where there is evidence that a present obligation exists, it can be difficult to identify the point at which the obligating event occurred.

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WORKING DRAFT FOR PSC REVIEW APRIL 2003**Present Obligation and Obligating Event**

- 3.10 In determining whether a provision should be recognized in respect of particular obligations the key issue for preparers of financial statements is deciding whether a present obligation has occurred. This can be a complex issue, particularly in the case of governments.
- 3.11 Point 1 in the Decision Tree queries whether there is a “present obligation as a result of an obligating event?”. If this question were restated to incorporate the full wording of definitions of a liability and an obligating event, it would have the following three components:
- present obligation of the entity arising from a past (obligating) event;
 - the settlement of the obligation is expected to result in an outflow from the entity of resources embodying economic benefits or service potential; and
 - an entity has no realistic alternative but to settle the obligation.

All three components must be satisfied before an entity has a liability.

- 3.12 Paragraphs 26 and 27 of IPSAS 19 provide further explanation of an “obligating event” (refer Figure 3.3).

Figure 3.3 IPSAS 19 Paragraphs 26 and 27

Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible future position in the future. Therefore, no provision is recognized for costs that need to be incurred to continue an entity’s ongoing activities in the future. The only liabilities recognized in an entity’s statement of financial position are those that exist at the reporting date.

IPSAS 19 paragraph 26

It is only those obligations arising from past events existing independently of an entity’s future actions (that is, the future conduct of its activities) that are recognized as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage imposed by legislation on a public sector entity. Both of these obligations would lead to an outflow of resources embodying economic benefits or service potential in settlement regardless of the future actions of that public sector entity. Similarly, a public sector entity would

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recognize a provision for the decommissioning costs of a defense installation or a government-owned nuclear power station to the extent that the public sector entity is obliged to rectify damage already caused (International Public Sector Accounting Standard IPSAS 17 *Property, Plant and Equipment*, deals with items, including dismantling and site restoring costs, that are included in the cost of an asset). In contrast, because of legal requirements, pressure from constituents, or a desire to demonstrate community leadership, an entity may intend or need to carry out expenditure to operate in a particular way in the future. An example would be where a public sector entity decides to fit emission controls on certain of its vehicles or a government laboratory decides to install extraction units to protect employees from the fumes of certain chemicals. Because the entities can avoid the future expenditure by their future actions - for example, by changing their method of operation, they have no present obligation for that future expenditure and no provision is recognized.

IPSAS 19 paragraph 27

- 3.13 Paragraph 27 of IPSAS 19 makes it clear that only some of an entity's obligations would be recognized as provisions. In the context of social benefits, only some of a government's obligations to provide social benefits in future periods would be recognized as provisions. The mere existence of an obligation to provide social benefits in future periods does not mean that a government has a present obligation. All aspects of the definitions of a liability and an obligating event must be satisfied, including the requirements for:

- an outflow of resources which is independent of the future actions of the government; and
- the government to have no realistic alternative but to settle the obligation because the obligation can be enforced by operation of law (legal obligation) or because other parties have a valid expectation that the government will discharge the obligation (constructive obligation).

Legal and Constructive Obligations

- 3.14 Chapters 4 to 7 examine various types of social benefits and try to identify the earliest point at which it is possible to determine that there has been an obligating event creating a legal or

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constructive obligation. In some cases both a legal and a constructive obligation may exist.

3.15 **Legal obligations:** The definition of legal obligations (refer Figure 3.1) includes to obligations deriving from:

- contracts;¹
- legislation; or
- other operation of law.

3.16 Legislation frequently imposes obligations on governments to provide social benefits. For example, legislation could include details of a government's policy in relation to certain social benefits including eligibility criteria, requirements for ongoing validation of eligibility criteria, the length of the validation period, the time period over which the benefit is available, and whether there is any monetary limit on the value of benefits to be provided. Such legislation may be enacted by a government itself (in which case the legislation represents a formal statement of that government's current policy regarding benefit levels and eligibility criteria) or it may be enacted by a higher level of government.

3.17 Where individuals or groups are able to take action against the government to enforce their right to receive their current entitlement to benefits specified in legislation the government

¹ Chapters 4 to 6 do not deal with present obligations arising from exchange contracts. A contract is an agreement with specific terms between two or more persons or entities in which there is a promise to do something in return for valuable benefits known as consideration. Contracts which involve the government providing goods and services in exchange for consideration of approximately equal value are exchange transactions and are therefore outside the scope of this ITC. Some people may refer to a government's provision of social benefits to constituents as a "social contract". In addition, some of the social risks covered by governments are similar, if not identical, to the risks that can be covered under an insurance contract (for example, poor health or loss of income). However, a government's implicit or explicit agreement to provide social benefits in future periods does not constitute a legal contract – although it may give rise to a constructive obligation. In the case of a legal contract an individual has a legally enforceable claim to the promised benefits.

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has a legal obligation in respect of those benefits. However, individuals and groups do not generally have a current entitlement to benefits that are to be provided in future periods. Rights to benefits to be provided in future periods may, but do not necessarily, give rise to constructive obligations.

3.18 The identification of legal obligations is not generally difficult. However, determining whether there has been an obligating event that turns those legal obligations into a present obligation may require judgement. The mere existence of legislation containing details of a government's policy in relation to a particular social benefit is not on its own sufficient for a present obligation to exist. There must also have been an obligating event. For example in order to demonstrate that an obligating event has occurred it is necessary to identify third parties who meet the eligibility criteria and are entitled to receive benefits from the government. In other cases the obligating event may have occurred prior to the enactment of legislation – the enactment of legislation may represent the government's formal acceptance of responsibility for a specific obligation.

3.19 **Constructive Obligations:** A government's social policies may give rise to constructive obligations. This could occur when:

- the government has advised constituents of its intention to provide social benefits to particular individuals or groups. Examples of ways in which such advice may have been provided to constituents include past practice, specific announcements and the inclusion of eligibility criteria for benefits in legislation;
- the government's policies involve the provision of social benefits in future periods to constituents; and
- constituents have a valid expectation that the government will provide them with those benefits.

3.20 Constructive obligations can arise from the specification of legislation but the existence of legislation is not necessary. Constructive obligations may also arise from a government's policies to provide grants and subsidies. A key issue in determining whether there has been an obligating event giving rise to a present (constructive) obligation is whether the government's acceptance of responsibility or promise of benefits has been clearly communicated to third parties. Other relevant factors include:

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- the extent to which the policy has been clearly articulated – this will have an impact on whether it is possible to identify the parties to whom the obligation is owed and the amount of the obligation;
- the formal adoption of a budget incorporating the financial impact of policies or other specific decisions;
- the enactment of legislation which authorizes a government to spend funds included in its budget; and
- the formal establishment of a program to implement a government's policy.

However, none of these factors, on their own, is likely to be sufficient to create a present obligation.

- 3.21 The determination of when a constructive obligation gives rise to a present obligation is complex. Judgment is required in determining the point at which an obligating event giving rise to a constructive obligation occurs, particularly obligations flowing from the specification of benefits in legislation. One argument is that if benefits are specified in legislation third parties may rely on the expectation of receiving those benefits in the future. However, it is also necessary to determine if such reliance is reasonable or is based on a "valid expectation". Governments can, and do, enact changes to legislation to reflect changes in policies on the provision of social benefits. Chapters 4 to 7 consider the extent to which third parties have a valid expectation of receiving benefits in future periods.

Identification of Other Parties and Present Obligations

- 3.22 IPSAS 19 paragraph 28 (refer Figure 3.4) highlights that in order for a liability to exist, there must be another party to whom the obligation is owed. This requirement is also highlighted in the definition of a constructive obligation. Paragraph 28 states that it is not necessary to know the existence of the other party. However, even though it is not necessary to know the identity of the other party, that other party must exist. This means that a government could not have a present obligation in respect of unborn children. As with other factors giving rise to present obligations, the existence of the other party, on its own, is not sufficient to create a present obligation – there must also be an obligating event.

Figure 3.4 IPSAS 19 Paragraph 28

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An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed — indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a decision by an entity's management, governing body or controlling entity does not give rise to a constructive obligation at the reporting date unless the decision has been communicated before the reporting date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

IPSAS 19 paragraph 28

- 3.23 The ITC considers whether individuals or groups have to meet all eligibility criteria before a present obligation exists, the point at which individuals or groups can be said to have met eligibility criteria for particular types of benefits and the impact of requirements to periodically revalidate entitlement to benefits. The ITC identifies differing interpretations of when an individual or group can be regarded as having satisfied eligibility criteria.

No Realistic Alternative to Settling an Obligation

- 3.24 To satisfy the definition of an obligating event in IPSAS 19 (reflected by Point 2 in the Decision Tree), an entity must have no realistic alternative but to settle an obligation.
- 3.25 It is necessary to determine whether a government has no realistic alternative but to settle an obligation regardless of whether that obligation is a legal obligation or a constructive obligation. In the case of legal obligations, although some governments may have occasionally used their sovereign powers to avoid obligations, this does not justify the widespread non-recognition of liabilities. Where a government has stated its intention to change legislation in order to avoid a legal obligation the wording in paragraph 60 of IPSAS 19 (refer Figure 3.5) is helpful.

Figure 3.5 IPSAS 19 Paragraph 60

The effect of possible new legislation which may affect the amount of an existing obligation of a government or an individual public sector entity is taken into consideration in measuring that obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in

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practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases, sufficient objective evidence will not exist until the new legislation is enacted.

IPSAS 19 paragraph 60

- 3.26 Similarly, new legal obligations, to be created by the enactment or amendment of legislation, would not be recognized until the conditions in IPSAS 19 paragraph 60 are met.
- 3.27 In the case of constructive obligations (including constructive obligations which arise from the specification of social benefits in legislation) an assessment of the extent to which a government has no realistic alternative but to settle that obligation would take account of a number of factors including:
- the government's past practice in removing or reducing particular benefits or changing eligibility criteria;
 - the extent to which a government has used transitional provisions to soften the impact of changes in benefit entitlements or eligibility criteria by delaying the implementation of the new criteria in order to protect the rights of existing beneficiaries or those who are close to meeting eligibility criteria;
 - the government's past practice in changing the method of providing benefits; and
- likely political consequences of changing benefits.
- 3.28 One approach would be to assume that a government will honor commitments under existing legislation unless amendments to the legislation have been substantively enacted (irrespective of whether the legislation is self-imposed or externally imposed). Another approach would be to assume that a government will honor its legislative commitments until it has publicly announced its intention to change legislation. The ability to remove or reduce benefits may differ depending on the type of benefit and the groups of beneficiaries. This issue is considered in more detail in Chapters 4 to 7.

Probable Outflow

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3.29 Determining whether there is a probable outflow is Point 2 in the Decision Tree. IPSAS 19 (paragraphs 31 and 32) explains that:

- for a liability to qualify for recognition there must be both a present obligation and the probability of an outflow of resources embodying economic benefits or service potential to settle that obligation;
- an outflow is probable if an event is more likely than not to occur; and
- where there are a number of similar obligations it may be necessary to consider the outflow of resources required to settle a class of obligations as a whole.

3.30 In the context of a government providing social benefits to constituents, an outflow of resources can occur when:

- a government provides cash benefits to constituents;
- when services are provided to constituents in accordance with a contractual arrangement between a government and another entity;
- a government reimburses households for specified expenditures; and
- a government provides goods and services directly to constituents.

3.31 Chapters 4 to 7 of this ITC consider whether a probable outflow of resources is likely to occur in relation to specific types of social benefits.

Reliable Estimate

3.32 The other criterion that needs to be satisfied before a liability is recognizes is that of reliable measurement (Point 3 in the Decision Tree). By virtue of their definition (liabilities of uncertain nature or amount) most provisions are likely to require estimation. For example, in order to create a provision for disaster relief the following factors might need to be estimated:

- the extent of damage;
- the cost of restoration;
- when amounts will need to be paid; and
- the number of individuals that may take advantage of a government program.

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- 3.33 However, as noted in IPSAS 19, the use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. In cases where a reliable estimate of a present obligation cannot be made, IPSAS 19 requires disclosure of a contingent liability (Action 2 in the Decision Tree).
- 3.34 The key requirements of IPSAS 19 in relation to the measurement of a provision are:
- The amount recognized as a provision should be the best estimate of the expenditure required to settle the present obligation at the reporting date (paragraph 44). A range of possible outcomes may need to be used in making an estimate of the amount of a provision (paragraph 33).
 - Risks and uncertainties surrounding the events and circumstances should be taken into account (paragraph 50).
 - Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation (paragraph 53).
 - The discount rate (or rates) should be a pre-tax rate (or rates) that reflects(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) should not reflect risks for which future cash flows estimates have been adjusted (paragraph 56).
 - Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision when there is sufficient objective evidence that they will occur (paragraph 58).
 - Gains from the expected disposal of assets should not be taken into account in measuring a provision (paragraph 61).
- 3.35 In making the best estimate of the provision it is necessary to identify future cash flows. Matters which will need to be considered include: the number of people entitled to a benefit in each period, the rate(s) of benefit to which they will be entitled in each period, the period over which the provision is being measured and changes in benefit entitlements.
- 3.36 Where the time horizon for the settlement of an obligation extends over many years, or there is a range of possible outcomes, it may be necessary to obtain actuarial valuations to form the basis of the estimate.

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- 3.37 There may be a considerable time difference between the establishment of a provision and the settlement of that provision. At each reporting date prior to settlement of the obligation, the provision should be reviewed and adjusted to reflect the current best estimate. The calculation of the current best estimate should include a review of the discount rate and the assumptions underlying the variables used to calculate the estimated size and timing of cash flows. IPSAS 3 *Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies* sets out the general principles for dealing with changes in estimates.

Measurement of Amounts Due and Payable

- 3.38 Although IPSAS 19 focuses on the measurement of provisions, some of the guidance in IPSAS 19 is also relevant to the measurement of amounts due and payable. The measurement of amounts due and payable also needs to take into account the specific options for commencement and cessation of benefits that have been adopted by policymakers for specific benefits. These entitlement options can have an impact on measurement of benefit liabilities.
- 3.39 Entitlements for ongoing benefits may be expressed in a variety of ways. Possible dates on which entitlement begins include:
- the actual day on which the individual meets the eligibility criteria (regardless of when notification is provided to the government or when the benefit is approved);
 - the date on which the individual's application is received by the government;
 - the date on which the application is approved; or
 - the beginning of the first payment cycle following confirmation of eligibility. Benefit payment cycles are generally regular periods of time such as weekly, fortnightly, monthly, six monthly or annually.
- 3.40 Possible dates on which entitlement ceases include:
- the actual day on which the individual ceases to meet the eligibility criteria (regardless of when the government is notified that eligibility has ceased);
 - the date on which the government receives the individual's notification that eligibility has ceased;
 - the date on which the government processes the individual's notification that eligibility has ceased;

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- the end of the payment cycle during which eligibility ceases or during which the government is notified that eligibility has ceased; or
- the end of the formal review or validation period. Individuals may be required to confirm eligibility for certain benefits at set intervals such as once a month or every six months.

3.41 Depending on the nature of a benefit and the way in which a policy expresses entitlement, an individual may be entitled to a benefit on a day to day basis or for a set period. A set period could be from the date of initial entitlement until the end of a payment cycle or the end of a formal review period.

3.42 Chapters 4 to 7 of this ITC discuss measurement issues associated with specific types of social policy obligation.

Contingent Liabilities

3.43 IPSAS 19 defines contingent liabilities (refer Figure 3.6) and requires them to be disclosed in the notes to the financial statements (refer Points 4 and 5 and Action 2 of the Decision Tree).

Figure 3.6 Contingent Liabilities – Definition

A contingent liability is:

- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) a present obligation that arises from past events but is not recognized because:
 - (i) it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation;
 - (ii) or the amount of the obligation cannot be measured with sufficient reliability.

IPSAS 19 paragraph 18

3.44 The definition of contingent liabilities states that they may be possible obligations or present obligations. In both cases, the

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obligation must arise from a past event – in order to have a contingent liability the obligating event must have occurred. This is a key requirement in determining whether contingent liabilities exist in relation to the social benefits discussed in Chapters 4 to 7.

- 3.45 IPSAS 19 (paragraph 100) requires that “unless the possibility of any outflow in settlement is remote, an entity should disclose for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, where practicable:
- (a) an estimate of its financial effect;
 - (b) an indication of the uncertainties relating to the amount or timing of any outflow; and
 - (c) the possibility of any reimbursement.”
- 3.46 The disclosure of uncertainties as to amount or timing of outflows could include disclosure of measurement estimates and the impact of changes in assumptions.

Recognition and Disclosure of Provisions

- 3.47 If the criteria for recognition of a provision are met, a provision (or other liability¹) is measured (Point 3 in the Decision Tree) and included in the liability amounts shown on the face of the financial statements.
- 3.48 IPSAS 19 (paragraphs 97 to 99) contains disclosure requirements in relation to provisions. In summary, these are:
- for each class of provision, the opening and closing balances and various changes in those balances; and
 - for each class of provision, a brief description of the nature of the obligation and the expected timing of any outflows, including an indication of uncertainties regarding the amount or timing of outflows and the amount of any expected reimbursement.

¹ In some cases both a provision and an amount due and payable may be recognized. In other cases, the nature of entitlement and the validation period may mean that only an amount due and payable is recognized.

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- 3.49 IPSAS 19 (paragraph 98(b)) requires the disclosure of an indication of the uncertainties about the amount or timing of those outflows and states that, where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events which affect the measurement of the provision. This disclosure requirement may lead to the inclusion of sensitivity analysis information in the notes to the financial statements.
- 3.50 IPSAS 1 contains broad requirements concerning the disclosure of liabilities in the financial statements including:
- the classification of liabilities as current or non-current where such a classification basis is adopted (paragraphs 83 to 88);
 - the specification of information required to be presented on the face of the statement of financial position. It requires the separate disclosure of transfers payable, payables under exchange transactions and provisions (paragraph 89);
 - the general disclosure of provisions (paragraph 96); and
- the specification of information required to be disclosed in the notes to the financial statements (paragraphs 122 to 127).
- 3.51 IPSASs set out minimum disclosure requirements. They do not prevent preparers from presenting additional information to that required. Preparers may make additional disclosures in relation to liabilities which have been recognized on the face of the financial statements or contingent liabilities which have been disclosed in the notes. In addition, preparers may provide information about transactions or events which do not meet the definition and recognition criteria for liabilities or the definition of a contingent liability.
- 3.52 The two main issues in relation to the disclosure of supplementary information are the nature of the disclosures and where such information should be presented. IPSAS 1 states that disclosures may be made as:
- part of the general purpose financial statements; or
- as supplementary information which is not part of the financial statements.
- 3.53 IPSAS 1 requires that the two types of information be clearly distinguished. Disclosures made as part of the general purpose financial statements form part of those statements, and if the

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statements are audited, would also be subject to audit. In some jurisdictions, certain supplementary information is also audited.

- 3.54 Chapters 4 to 7 of this ITC consider whether particular social benefits give rise to provisions which should be recognized in the general purpose financial statements of governments. The ITC argues that the disclosure requirements in IPSAS 19 represent the minimum disclosure requirements in respect of such provisions. The disclosure requirements in IPSAS 19 do not prevent additional disclosures being provided. Chapter 8 considers the usefulness of supplemental disclosure relating to social policy obligations, particularly disclosure of forecast cash flow information. It considers the usefulness of such disclosures for a broad range of social policy obligations, including those that have not been recognized as provisions.

Preliminary Views – Disclosure

- 3.55 *Where a provision is recognized in respect of a social policy obligation, the requirements in IPSAS 19 regarding the disclosure of provisions are applicable and represent the minimum level of disclosure required.*
- 3.56 *Where an amount due and payable is recognized in respect of a social policy obligation, the disclosure requirements of IPSAS 1 are relevant.*

Materiality

- 3.57 IPSASs do not apply to items that are immaterial. IPSAS 1 (paragraphs 50 to 53) explains that information is material if its omission or misstatement could influence the decisions or assessments of users made on the basis of the financial statements. Provisions that are immaterial due to nature or size still need to be identified and measured in a manner that is consistent with the entity's accounting policies but it may be possible to use approximations or samples to identify the amount of the provision. Separate disclosure of immaterial amounts is not required.

Preliminary Views – Obligor Event

- 3.58 This section sets out preliminary views on the identification of obligor events in relation to the provision of social benefits by governments. As noted earlier in this Chapter, in the case of

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exchange transactions there is generally a readily identifiable obligating event. In the case of non-exchange transactions the obligating event is often not clear. IPSAS 19 provides guidance on identifying the obligating event for exchange transactions and certain non-exchange transactions. This ITC proceeds on the basis that the guidance in IPSAS 19 is applicable to the types of social benefits referred to in IPSAS 19 paragraph 1(a). In considering whether an obligating event has occurred this ITC will consider both obligating events giving rise to legal obligations and to constructive obligations.

- 3.59 This section of the ITC sets out three possible approaches to determining when an obligating event arises. These approaches focus on the earliest point at which there is reasonable reliance by an individual or group on the expectation of social benefits. In some cases it will be obvious when reliance occurs. In other cases reliance can evolve over a long period of time and there may be different views on the point at which it occurs. For example, in the case of old age pensions, reliance may occur at some point between the age of economic independence and reaching pensionable age.
- 3.60 The ITC identifies three views on the earliest point at which there can be reasonable reliance by an individual or a group on the expectation of receiving social benefits. In some cases all three approaches may be relevant. In other cases only one or two approaches may be relevant.
- 3.61 The ITC has attempted to develop a principles based approach to the identification of an obligating event. However, it is appropriate to acknowledge that where application of principles does not lead to a clear identification of an obligating event, accounting standards have often developed criteria for particular types of transactions to ensure consistency in the identification of an obligating event.

Obligating Event – General Approach

- 3.62 The obligating event is the earliest point in time at which there is reliance by a third party on the expectation of satisfying all eligibility criteria in the future and receiving future benefits and the government has no realistic obligation but to settle the obligation.

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Obligating Event Option 1

- 3.63 *The earliest point that an individual or group can reasonably rely on future benefits is the point at which they satisfy all eligibility criteria.*
- 3.64 *In the case of ongoing benefits, individuals or groups can only reasonably rely on the expectation of receiving the benefit from the time of meeting all eligibility criteria until they are again required to satisfy all eligibility criteria. There are therefore a series of obligating events.*
- 3.65 The obligation is measured as the amount due and payable as at reporting date. The amount due and payable will depend on the nature of the benefit and the way in which entitlement is specified. In the case of regular periodic benefits it could be a portion of the regular payment. In the case of benefits paid in a single amount, or where no further validation of entitlement is required, the amount due and payable may be the whole amount of the benefit.

Obligating Event Option 2

- 3.66 *The earliest point that an individual or group can reasonably rely on future benefits is the point at which they initially satisfy all eligibility criteria.*
- 3.67 *In the case of ongoing benefits, individuals or groups can reasonably rely on the expectation of receiving the benefit from the time of initial eligibility until they cease to meet eligibility criteria. The likelihood of an individual or group continuing to meet eligibility criteria (including being alive where relevant) in future periods is treated as a measurement issue.*
- 3.68 The obligation is measured as the best estimate (present value of future cash flows) of the amount expected to be transferred to the individual or group.

Obligating Event Option 3

- 3.69 *The earliest point that an individual or group can reasonably rely on future benefits can occur when key participatory events have occurred and the individual has a reasonable expectation*

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of satisfying eligibility criteria – this may be prior to the point at which they satisfy all eligibility criteria.

- 3.70 There are three measurement Options:
- 3.71 Measurement Option 1: the obligation is measured as the present value of future cash flows associated with the accrued benefit rights. Benefit rights accrue over a period of time. The likelihood of an individual or group meeting and continuing to meet eligibility criteria (including being alive where relevant) in future periods is treated as a measurement issue.
- 3.72 Measurement Option 2A: the obligation is measured as the present value of all future expected cash flows at the point at which an individual or group satisfies all eligibility criteria. The likelihood of an individual or group continuing to meet eligibility criteria (including being alive where relevant) in future periods is treated as a measurement issue.
- 3.73 Measurement Option 2B: the obligation is measured as the present value of all future cash flows at some point before the individual or group satisfies all eligibility criteria. The likelihood of an individual or group meeting and continuing to satisfy eligibility criteria (including being alive where relevant) in future periods is treated as a measurement issue.

Analysis of Options

- 3.74 The advantages of using Option 1 in the identification of obligating events are that:
- it leads to the calculation of certain amounts based on legal obligations and is readily implemented;
 - it has widespread support in terms of current practice;
 - it is relevant to all Options;
 - in the case of ongoing benefits, there is no need to make judgements about the likelihood of satisfying eligibility criteria on future periods; and
 - it would lead to consistent measurement of benefits regardless of the method used by governments to deliver those benefits.
- 3.75 The limitations of using Option 1 in the identification of obligating events are that:

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- in the case of long term benefits, where individuals have relied on the expectation of future benefits it does not reflect the substance of the government's obligation;
- it therefore understates the costs of operations/services; and
- it does not provide any useful information on the sustainability of current government policies.

3.76 The advantages and limitations of Option 2 are similar to Option 1. However, in addition to recognizing the short-term legal obligation that exists, Option 2 also recognizes a long term constructive obligation. In the case of ongoing benefits, it therefore better reflects the substance of the transaction – that is, the government's implied acceptance of responsibility to provide future benefits.

3.77 Option 3 acknowledges that the existence of legislation and established past practice can lead to the creation of a valid expectation by individuals that they will receive future benefits, and that this expectation can arise prior to individuals satisfying all eligibility criteria. There is some evidence that in certain cases governments do accept that individuals have a valid expectation to receive future benefits. In one case a government has actually compensated individuals for removing their expectation to future benefits. In May 1981 Chile replaced its government-run pay-as-you-go retirement system with a system of private pension accounts. It provided workers with recognition bonds which could be used as deposits in the new private schemes. A separate government old age pension remained for those who had not worked for the requisite number of years to obtain the worker's old age pension.

3.78 The difficulty with Option 3 is that the point at which the obligating event occurs is not as definitive as under Options 1 and 2. Although it is possible to assert that individuals have relied on the expectation of receiving future benefits, and there may be evidence that such reliance has occurred, it is difficult to identify the exact point at which valid expectations have occurred. In some cases, there may have been a series of points at which valid expectations arose, leading to an increasing expectation over time.

3.79 Subsequent Chapters apply these three approaches to broad categories of social benefits to determine when an obligating event arises in respect of those benefits.

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