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IFAC
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Committee

Issued [Month Year]

Draft Invitation to Comment

DRAFT ONLY
FOR REVIEW BY PSC

Accounting for
Social Policies
of Governments

Issued for
comment by
the International
Federation of
Accountants



DRAFT ITC ONLY – FOR PSC REVIEW**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]

Item 8.3 SC - Draft Invitation to Comment *Accounting for Social Policies of Governments*
PSC Vancouver July 2003

DRAFT ITC ONLY – FOR PSC REVIEW**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.

Elizabeth Moran, Executive Manager, Finance & Business Strategy, City of Tea Tree Gully, Australia.

Thomas Müller-Marqués Berger, Senior Manager, Ernst & Young AG Wirtschaftsprüfungsgesellschaft, Germany.

Masud Muzaffar, Financial Advisor, Capital Development Authority of Pakistan, Pakistan.

Ron Salole, Director of Accounting Standards, Canadian Institute of Chartered Accountants, Canada.

Song Qichao, Deputy Division Director, Department of Social Security, Ministry of Finance, People's Republic of China.

David Watkins, Accounting Policies Manager, Whole of Government Accounts Programme, Her Majesty's Treasury, United Kingdom.

Members of the Steering Committee are appointed in their personal capacity rather than as representatives of their nominating body. The views expressed in this ITC are those of the members, and not those of their employers or nominating organization.

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INVITATION TO COMMENT
ACCOUNTING FOR SOCIAL POLICIES
OF GOVERNMENTS

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DRAFT ITC ONLY – FOR PSC REVIEW**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.

Most jurisdictions currently recognize as liabilities only that portion of such obligations that are due and payable. The PSC was concerned that this accounting treatment may have been adopted for pragmatic rather than conceptual reasons and there was no generally agreed approach as to how to account for long term social policy obligations.

The PSC's tentative views are that

[Insert body of executive summary once final draft approved]

Although the PSC has carefully considered these issues, the views it has formed are tentative only, and the PSC welcomes the views of its constituents on the issues raised in this ITC.

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Summary of Preliminary Views

[Insert preliminary views once final draft approved]

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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. Governments frequently make public announcements regarding the nature or amount of social benefits that may be provided in the future and/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. International Public Sector Accounting Standard IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* 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”. These are excluded from the scope of IPSAS 19 to allow for further consideration of the “obligating event” and the measurement of such liabilities.
- 1.3 The publication of this ITC is intended to promote consideration and debate of this issue. It is intended to contribute 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. These are the views of the Steering Committee. They are not necessarily the views of the PSC.
- 1.4 This ITC applies the definitions and principles in International Public Sector Accounting Standards (IPSASs), particularly IPSAS 19, to a range of social benefits in order to determine the point at which these social benefits give rise to present o

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- 1.5 Obligations that meet the definition of a liability and the recognition criteria for liabilities. Relevant definitions and recognition criteria are discussed in Chapter 3.
- 1.6 Application of IPSAS 19 means that a present obligation for the provision of social benefits by a government that meets the definition of a liability and satisfies the relevant recognition criteria will be recognized as a liability in the government's general purpose financial statements, and the disclosure requirements relating to liabilities (and possibly provisions) will apply. Where the provision of social benefits by a government does not give rise to a liability, it may give rise to a contingent liability. This ITC considers whether contingent liabilities as defined by IPSAS 19 may arise in respect of a government's obligation to provide social benefits at some time in the future.
- 1.7 Not all obligations of a government to provide social benefits will give rise to liabilities that are recognized or contingent liabilities that are disclosed in a government's general purpose financial statements. This ITC also considers the usefulness of supplemental disclosures about a government's obligations to provide social benefits in the future and the ways in which they may be funded.

Public Sector Environment

- 1.8 In applying existing accounting definitions and principles to a government's social policy obligations it is necessary to acknowledge that accounting for non-exchange transactions is not well developed, particularly non-exchange transactions in the public sector (for example, there is no generally accepted method of accounting for the use of taxation revenue to provide goods and services free of charge to the community and the use of cash transfers to redistribute income). It is also necessary to consider the characteristics of the public sector environment – for example:
 - 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; and

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- aspects of a government's social policies may be incorporated in legislation. However, some governments have the sovereign right to create or change legislation.

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 It may be argued that use of the due and payable approach leads to inadequate recognition of social policy obligations in a government's financial statements. Some are of the view that in order for financial statements to fully reflect the government's liabilities, and enable the government to discharge its obligation to be accountable for the full impact of its decisions, a liability should be recognized for the obligation to provide social benefits well before those benefits become due and payable.
- 1.11 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 social policy obligations, and how those liabilities should be measured.

General Purpose Financial Statements

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

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- 1.13 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.
- 1.14 A government's social policy obligations may give rise to
- present obligations. Present obligations that meet the definition of a liability and the recognition criteria for liabilities, are recognized in the financial statements and included in the totals on the face of the financial statements. Such liabilities include provisions (liabilities which are uncertain as to timing or amount) and amounts due and payable; and/or
 - contingent liabilities. Contingent liabilities are not recognized on the face of the financial statements but are disclosed in the notes to the financial statements.
- 1.15 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, resources and financial obligations. A government may also publish supplemental disclosures in general purpose financial statements or in a separate report, which may or may not include general purpose financial statements. This ITC deals with recognition and disclosure of liabilities and contingent liabilities in general purpose financial statements but it refers to the possibility of disclosure in other reports as appropriate.

Structure of the ITC

- 1.16 The ITC comprises nine Chapters. Chapters 2 to 4 provide additional background to the topic, outline the approach adopted

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by the Steering Committee and establish the principles that are to be applied to a range of social benefits as follows:

- Chapter 2 explains the scope of the ITC and outlines 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 (GFSM 2001);
- Chapter 3 describes the general approach that is used in determining whether a government’s intention to provide social benefits in current and future periods gives rise to liabilities or contingent liabilities in the context of general purpose financial reporting. Chapter 3 also discusses measurement and disclosure issues.
- Chapter 4 discusses the issues that arise in applying the definitions and recognition criteria in IPSAS 19 to social policy obligations and the differing interpretations of the factors that are relevant in applying those definitions.

1.17 Chapters 5 to 7 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 range of social policy activities. The discussion of social benefits is structured as follows:

- Chapter 5 – Collective Services and Individual Services;
- Chapter 6 – Individual Benefits Provided by way of Cash Transfer;
- Chapter 7 – Other Benefits; and
- Chapter 8 – Old Age Pension Benefits.

1.18 Chapter 9 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 5, 6 and 7 to specific examples. Appendix 2 illustrates the disclosures proposed in the ITC.

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**Chapter 2 Scope****Introduction**

- 2.1 This ITC deals with accounting for those social benefits specifically excluded from the scope of IPSAS 19 paragraph 1(a). IPSAS 19 paragraph 1 is reproduced 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

- 2.2 This Chapter attempts to provide readers with a fuller understanding of the range of social benefits referred to in paragraph 1(a) of IPSAS 19. It does this by using the GFSM 2001 definition of social benefits as a starting point.

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

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- 2.3 The discussion and preliminary views in this ITC may also provide useful guidance on accounting for certain social policy obligations which, while not excluded from the scope of IPSAS 19, are not specifically addressed within IPSAS 19. This Chapter identifies these types of obligations and indicates which of these obligations are specifically addressed in the ITC.
- 2.4 The ITC does not address obligations associated with exchange transactions such as the provision of retirement benefits to government employees as compensation for services provided during their employment, or the purchase by individuals of health or education services from a government entity.

IPSAS 19 Social Benefit Exclusion

Social Benefits

- 2.5 IPSAS 19 does not define “social benefits”. However, it does provide an explanation of the types of social 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 encompasses 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).

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**Non-Exchange Transactions**

- 2.6 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.”
- 2.7 The companion document to this ITC, the ITC on Accounting for Non-exchange Revenue, proposes that the term non-exchange be defined as follows:
- A non-exchange transaction is a transaction that is not an exchange transaction. In a non-exchange transaction, a public sector entity either receives value from another party without directly giving approximately equal value in exchange or gives value to another party without directly receiving approximately equal value in exchange.***
- 2.8 The definition of non-exchange transactions used in this ITC is a transaction where a consideration of approximately equal value is not received directly in respect of a transfer of goods and services. Non-exchange transactions will therefore include those transactions where *some* consideration is received from the recipients of the benefits. In some cases it may be appropriate to view non-exchange transactions involving some consideration from recipients as having an exchange component and a non-exchange component.
- 2.9 The social benefits considered in this ITC are generally provided directly to a recipient by a government free of charge or for consideration which is considerably less than the full cost of the good or service.
- 2.10 The next section in this Chapter provides an overview of the relevant GFSM 2001 definitions and classifications and their relevance to this ITC.

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**GFSM 2001 Social Benefits**

- 2.11 GFS terms and definitions are well understood by a wide range of government officials. The notions of “social benefits” in GFSM 2001 and in IPSAS 19 are not equivalent. This Chapter uses the definition of social benefits” in the IMF’s GFSM 2001 framework as a starting point in identifying the types of social benefits referred to in IPSAS 19 paragraph 1(a) and identifies the relationship between social benefits as used in IPSAS 19 and the economic classifications adopted in GFSM 2001.
- 2.12 Social benefits are one category of economic classification of an expense within the IMF’s GFSM 2001 framework. A summary of the economic classifications used in GFSM 2001 is illustrated in Figure 2.2 (readers are referred to GFSM 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

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

Figure 2.3 GFSM 2001 Definitions of Social Benefit and Social Risk

<p>Social benefit [GFSM 2001]. 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 security pensions. See social risk.</p>

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

GFSM 2001 Companion Material – Glossary

- 2.14 Although GFSM 2001 provides a broad definition of social benefits it acknowledges that the definition is not exhaustive – there is no universally accepted list of items included within the scope of social benefits² and that the social risks in respect of which protection (social benefit) is provided may vary 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.
- 2.15 Social benefits provided by way of cash transfer include specific benefits (for example, unemployment benefits) and payments which are intended to enable households to purchase specific goods and services.
- 2.16 Examples of social benefits that GFSM 2001 would classify as “benefits provided in kind” are:
- 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

² 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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medicines, medical or dental treatments, hospital bills, and optometrists' bills.

- 2.17 The social benefits excluded from the scope of IPSAS 19 are those where the entity providing the benefit does not receive consideration that is *approximately equal* to the value of goods and services provided by the recipients of those benefits. The GFSM 2001 definition of a transfer transaction refers to the provision of goods or services without the simultaneous receipt of a good or service of *any* value in return. However, in many instances, the social benefits excluded from the scope of IPSAS 19 will also meet the GFSM 2001 definition of a transfer transaction.
- 2.18 The GFSM 2001 definition of social benefits also has a collective focus: the benefits are provided in relation to a collective group – not just one individual. However, individuals within that group may enjoy the benefits.³
- 2.19 GFSM 2001 describes a variety of social protection schemes under which benefits may be provided to the community. These include social assistance schemes (non-contributory) and social insurance schemes (contributory). Social insurance schemes include those social security schemes operated by government units, employers and others. Social protection schemes which fall within the scope of this ITC are social assistance schemes and social security schemes operated by government units where the level of contribution is low enough for it to be classified as non-exchange. As noted in the following paragraph, employer social security schemes are outside the scope of this ITC.
- 2.20 Employer social insurance schemes (social insurance schemes in which an employer provides social insurance benefits to its employees, former employees, or their beneficiaries under the scheme) are not social benefits in the context of IPSAS 19 paragraph 1(a). The benefits are provided as part of an exchange transaction between the employer and employee and are therefore not within the scope of this ITC. Employee benefits are excluded from the scope of IPSAS 19 by virtue of

³ The application of the collective arrangement requirement to social protection schemes is described in GFSM 2001 (Annex to Chapter 2, paragraph 5).

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paragraph 1(g) (guidance on accounting for employee benefits is found in International Accounting Standard IAS 19, *Employee Benefits*).

- 2.21 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.

GFSM 2001 paragraphs 6.69 to 6.71

IPSAS 19 Social Benefits

- 2.22 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 GFSM 2001. Many, but not all of these benefits

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would also meet the GFSM 2001 definition of a transfer transaction. Those where some consideration is received would not meet the GFSM 2001 definition of a transfer transaction. The GFSM 2001 definition of benefits in kind is limited to the redistribution of goods and services purchased by governments from third parties. However governments also take a range of other actions in order to meet their social objectives. Other actions which would be encompassed by the description of social benefits in IPSAS 19 paragraph 1(a) include:

- the direct production and distribution of goods and services by a government (for example, the provision of education services through government owned schools). Under GFS such actions would be classified as compensation of employees etc.; and
- the provision of subsidies and grants, including subsidies and grants to foreign governments and international organizations.

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

2.24 Within GFSM 2001, 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

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and services to households (GFSM 2001 social benefits in kind); and

- the production of health related goods and services by a general government unit.

- 2.25 Although the scope of IPSAS 19 encompasses 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. The discussion in this ITC may be useful. For example, the discussion in Chapter 7 on foreign aid could be usefully applied to similar grants, regardless of whether such grants are made in pursuit of the governments social policy objectives, economic policy objectives or for other purposes.
- 2.26 Social benefits as defined in GFS encompass employer social insurance schemes such as employee pension schemes. As noted above, financial reporting for employee benefits, including benefits provided by such pension schemes, are not considered in this ITC. Figure 2.5 below identifies a range of common transactions and events that may give rise to social benefits under GFSM 2001 and whether they are considered by this ITC, by IPSAS 19 or elsewhere.

Figure 2.5 Types of Transactions and Events

Transaction or Event	Location of Guidance
Provisions and contingent liabilities arising from exchange transactions apart from those specifically excluded by IPSAS 19 paragraph 1.	IPSAS 19.
Provisions relating to employee entitlements.	IAS 19 Employee Benefits.
Provisions and contingent liabilities arising from non-exchange transactions (other than social policy obligations).	IPSAS 19. Guidance in this ITC may also be useful in accounting for discretionary transfers to individuals or other entities where the objective of the transfer is for reasons other than social policy.
Provisions and contingent	This ITC.

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liabilities arising from non-exchange social policy transactions.	
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DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**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). Hereafter these benefits are referred to simply as social benefits.
- 3.2 This Chapter also includes a Decision Tree that provides guidance on accounting for provisions and contingent liabilities and explains the application of the Decision Tree to social benefits.
- 3.3 The discussion in this ITC proceeds on the assumption that the definitions and principles in existing IPSASs may be applied to the social benefits considered in this ITC.

Definitions and Principles in Existing IPSASs

- 3.4 The two IPSASs relevant when considering how to account for the social benefits are IPSAS 1 and IPSAS 19.
- 3.5 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.
- 3.6 IPSAS 19 defines provisions, contingent liabilities and contingent assets, identifies the circumstances in which provisions should be recognized, provides guidance on how provisions should be measured and sets out required disclosures in relation to provisions, contingent liabilities and contingent assets. Key definitions⁴ and recognition criteria⁵ for provisions are shown in Figure 3.1.

⁴ The Glossary to this ITC contains a list of all defined terms (from IPSASs) used throughout this ITC.

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**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

⁵ 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 Preparation and Presentation of Financial Statements. The IASB Framework (paragraph 91) contains the recognition criteria for liabilities.

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obligation.

IPSAS 19 paragraph 22

3.7 This Chapter draws on paragraphs 23 to 34 of IPSAS 19. These paragraphs discuss the criteria necessary for identification and recognition of a provision and provide guidance on factors to consider in determining whether a past event gives rise to a present obligation. The guidance deals with matters such as:

- whether a present obligation exists and identification of the past event which gives rise to the present obligation (the obligating event);
- determining 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

3.8 The Decision Tree in Figure 3.2 summarizes the main recognition requirements of IPSAS 19 and is relevant for transactions and events, which fall within the scope of IPSAS 19⁶. The Decision Tree is consistent with 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. Together with the text in the body of IPSAS 19 it provides guidance on accounting for:

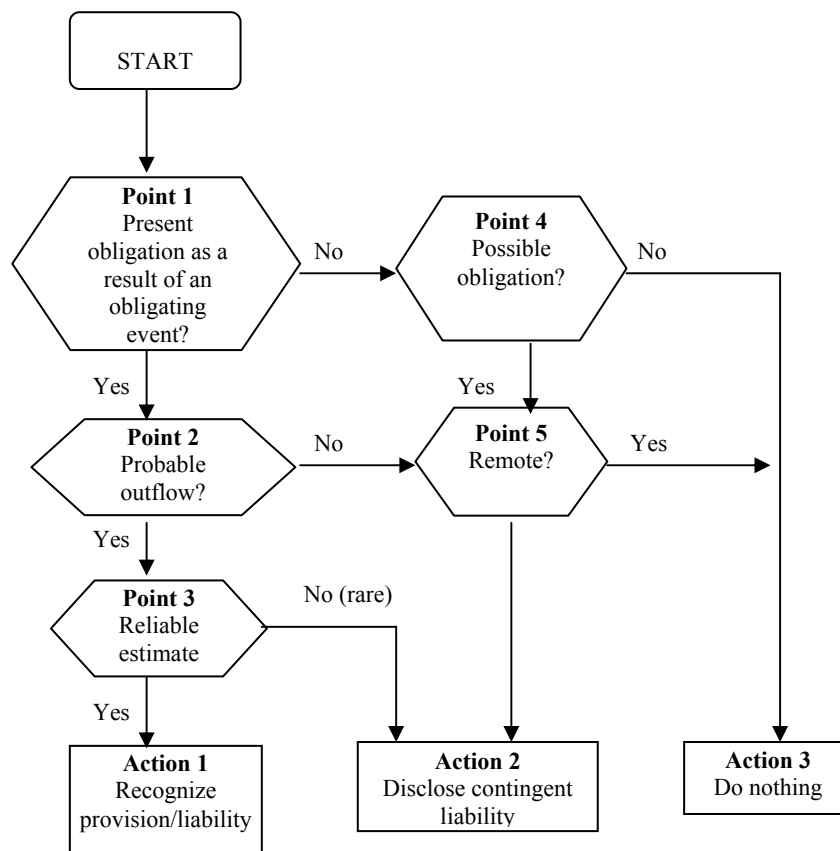
- liabilities that are uncertain as to timing or amount (provisions);
- liabilities that are not recognized because their existence will be confirmed only by one or more uncertain future events not wholly within the control of the entity (contingent liabilities); and

⁶ 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).⁷

⁷ 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).

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**Figure 3.2 Decision Tree****Present Obligation and Obligating Event**

- 3.9 Point 1 in the Decision Tree identifies the existence of a “present obligation as a result of an obligating event” as the threshold condition. For an event to be an obligating event, it is necessary

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that the entity has no realistic alternative but to settle the obligation created by the event. A liability will exist when:

- a present obligation of the entity arises from a past (obligating) event; and
- settlement of the obligation is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Figure 3.3 IPSAS 19 Paragraph 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 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.

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IPSAS 19 paragraph 27

- 3.10 A government is expected to provide particular goods and services for the benefit of its constituents over the long term. A government may, as a result of previous public undertakings or commitments, be seen as having an obligation to provide particular goods and services for the benefit of its constituents in both current and future periods. However, an obligation to provide goods or services (or other benefits) to constituents in the future does not of itself give rise to a liability as defined for financial reporting purposes. Paragraph 27 of IPSAS 19 (refer Figure 3.3) makes it clear that only some of a government's obligations to provide social benefits in future periods may qualify for recognition in the financial statements as a provision. That is, the mere existence of an obligation to provide social benefits in future periods does not mean that a government has a present obligation that could be recognized as a provision. All aspects of the definitions of, and recognition criteria for, a liability must be satisfied including that the government has no realistic alternative but to settle the obligation. In addition, no provision is recognized for costs that need to be incurred to continue an entity's ongoing activities in the future.
- 3.11 IPSAS 19 explains that an obligating event may give rise to an obligation that the entity has no realistic alternative but to settle because:
- the obligation can be enforced by operation of law (legal obligation); or
 - other parties have a valid expectation that the government will discharge the obligation (constructive obligation).

The notions of legal and constructive obligations are further developed below.

Legal and Constructive Obligations

- 3.12 **Legal obligations:** Legal obligations include obligations deriving from:

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- contracts;⁸
 - legislation; or
 - other operation of law.
- 3.13 Legislation frequently imposes obligations on governments to provide social benefits. In many cases, these are obligations to provide social benefits on a collective basis to the community or sections thereof, rather than to identifiable individuals. 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. However, paragraph 28 also states that it is not necessary to know the existence of the other party. As such the inability to identify specific recipients of benefits does not preclude a present obligation from arising.
- 3.14 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 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. This issue is discussed further in Chapter 4.
- 3.15 **Constructive Obligations:** Constructive obligations may arise in respect of rights specified in legislation, but the existence of legislation is not necessary for such obligations to arise. The key issue is identifying what constitutes the obligating event.
- 3.16 It may be argued that the obligating event giving rise to a constructive obligation occurs when:
- the government has publicly committed to policies which specify the provision of social benefits in future periods to constituents;

⁸ 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.

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- a government has advised constituents of its intention to provide social benefits to particular individuals or groups and identified the amount of those benefits and the recipients; and
- constituents have a valid expectation that the government will provide them with those benefits.

3.17 However, some may also argue that the events identified in paragraph 3.16 above would not qualify as a past event which gives rise to a present obligation. They would argue that for a present obligation to exist a government must have clearly accepted the responsibility to sacrifice resources in the provision of benefits and communicated its acceptance of this responsibility to relevant parties. Such acceptance of responsibilities need to be supported by evidence such as:

- 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.

3.18 While rarely ever uncontestable, in a commercial environment judgments can be, and are made, about whether particular events and practices give rise to a constructive obligation such that the entity cannot realistically avoid the sacrifice of resources as a result. There is an ongoing and steady development of conventions, practices and guidance that can be used to assist analysis of circumstances that give rise to constructive obligations in a commercial environment. By contrast there is little precedent or practice to guide consideration of the circumstances in which non-exchange transactions in the public sector might give rise to a constructive obligation. In addition, it might be argued that the notion of a constructive obligation has little practical relevance in the public sector. Factors supporting this include:

- the fact that nature of the relationship between a government and its constituents is not a commercial or exchange relationship. Social benefits are frequently

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“promised” and provided on a global or collective basis as opposed to an individual basis;

- the authority of government to amend policies on its own authority with consequential financial, and financial reporting, effects; and
- the difficulty in determining on a consistent basis within the same, and across different jurisdictions, when past actions give rise to an obligation to discharge resources that the government can not realistically avoid.

- 3.19 Current reporting conventions support this view that there are few constructive obligations in the public sector. Chapter 4 considers alternative approaches that can be adopted in determining the circumstances and events that may give rise to a constructive obligation and factors that would need to be considered in determining whether a government had no realistic alternative but to settle an obligation.

Figure 3.4 IPSAS 19 Paragraph 28

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

Probable Outflow – Point 2

- 3.20 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;

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- 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.
- 3.21 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.

Reliable Estimate – Point 3

- 3.22 The other criterion that needs to be satisfied before a liability is recognized is that of reliable measurement (Point 3 in the Decision Tree). Provisions are liabilities of uncertain nature or amount. Therefore most provisions are likely to require estimation. For example, in order to reliably estimate the amount that might be paid 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.
- 3.23 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).

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- 3.24 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 flow 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).
- 3.25 In making the best estimate of the provision it is necessary to identify future cash flows associated with cash transfers or the delivery of goods and services. 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.
- 3.26 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.
- 3.27 There may be a considerable time difference between the establishment of a provision and the settlement of that provision.

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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.

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Recognition of Provisions – Action 1

- 3.28 If the criteria for recognition of a provision are met, the amount of the provision (or other liability⁹) is calculated or estimated (Point 3 in the Decision Tree) and included in the liability amounts shown on the face of the statement of financial position.

Disclosure of Recognized Provisions

- 3.29 Chapter 9 considers relevant disclosure requirements in IPSASs and additional supplemental disclosures that may be made about social policy obligations which are recognized as provisions, 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. Chapter 9 also considers disclosures that might be made about social benefits to be provided in the future that are not recognized as provisions.
- 3.30 However, separate disclosure of items, which are not material, is not required. 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.

Disclosure of Contingent Liabilities – Action 2

- 3.31 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).

⁹ 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.

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**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

- 3.32 The definition of contingent liabilities states that they may be possible obligations or present obligations. In both cases, the obligation must arise from a past event. However, in the case of possible obligations the existence of the obligating event may only be confirmed in the future.
- 3.33 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.”
- 3.34 The disclosure of uncertainties as to amount or timing of outflows could include disclosure of measurement estimates and the impact of changes in assumptions.

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Chapter 4 Application of Principles

Introduction

- 4.1 Figure 4.1 summarizes the requirements of relevant definitions and recognition criteria that must be satisfied before a social policy obligation giving rise to a *legal obligation* or *constructive obligation* would be recognized as a liability (including a provision) in the statement of financial position. *Each* aspect of these definitions and recognition criteria must be met before a liability (including a provision) is recognized in the financial statements. For example, a government may have an obligation to provide certain services in future periods, but that does not necessarily mean that the obligation meets the definition of a legal or constructive obligation, or that it is a present obligation.

Figure 4.1 Criteria for Recognition

Legal Obligation	Constructive Obligation
Past (obligating) event (<i>from definitions of a liability and an obligating event</i>).	Same as for legal obligations.
Legal obligation derived from a contract, legislation or other operation of law (<i>from definitions of an obligating event and a legal obligation</i>).	Constructive obligation when a government, by an established pattern of past practice, published policies or sufficiently specific current statement has indicated acceptance of responsibility and created a valid expectation that it will discharge those responsibilities (<i>from definitions of an obligating event and a constructive obligation</i>).
No realistic alternative to settling the obligation (<i>from definition of an obligating event</i>).	Same as for legal obligations.

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Present obligation (<i>from definition of a liability</i>).	Same as for legal obligations.
Settlement is expected to result in an outflow of resources embodying economic benefits or service potential (<i>from definition of a liability</i>).	Same as for legal obligations.
Expected outflow must be probable and measurable (<i>from recognition criteria</i>).	Same as for legal obligations.

- 4.2 This Chapter considers various types of social policy obligations that could be classified as legal obligations and constructive obligations and considers the types of factors that would need to be considered in deciding whether they met each of the requirements for recognition in the financial statements.

Legal Obligations and Social Policy Obligations

- 4.3 Legal obligations include obligations deriving from contracts, legislation, or other operation of law. A legal obligation exists when a party has a legal right to obtain judgement in a court of competent jurisdiction to enforce payment, performance or compensation. This may be the result of taking legal action and obtaining an enforceable judgment via the jurisdiction's legal system. A determination of whether a particular factual situation would give rise to a legal obligation must ultimately be made by a court. However, when it is clear from legislation or previous examples of legal action that if the issue were taken to court the issue would be decided in the applicant's favor, it is also possible to argue that a legal obligation exists.
- 4.4 Legal obligations as defined in IPSAS 19 can arise from a contract, legislation or other operation of law. Each of these categories is discussed further below.
- 4.5 A contract is an agreement with specific terms between two or more persons or entities in which one promises to provide goods

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or services or take certain actions in return for valuable benefits known as consideration. Where consideration is equivalent to the value of the benefit conferred by the contract the contract would be classified as an exchange contract and any associated liability would fall within the scope of IPSAS 19. Contracts may also arise where the consideration provided by one party is not of equivalent value to the benefits conferred by the other party. In some cases the consideration is nominal in relation to the benefits conferred (for example, a small monetary consideration may be provided merely to give the transaction the form of a contract). If there is no consideration the transaction is a gift. Gifts are not contracts. Gifts may, but do not always, give rise to legally enforceable obligations. Deeds are sometimes used to formally record details of gifts or other settlements that do not meet the criteria for contracts.

- 4.6 In some jurisdictions a government's delivery of social benefits to constituents may be referred to as a "social contract". 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.
- 4.7 Legislation and delegated legislation such as regulations can give rise to legal obligations. In some cases, a legal obligation exists from the time that the statute is created. In other cases legislation may set out the broad framework for certain social policy benefits and legal obligations may arise under that legislation as a consequence of subsequent events. Legislation could include details of eligibility criteria for a cash transfer, 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. For example, under certain health care programs, a government may have a legal obligation to provide medical assistance to eligible persons for health conditions associated with cigarette smoking, and those persons may have a legal entitlement to receive such medical assistance. However, a legal obligation would not arise until an individual who meets all the eligibility criteria has a right to take legal action against the government for payment or provision of the benefit.

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- 4.8 The definition of a legal obligation also refers to legal obligations arising from “other operation of law”. Such obligations can result in one party taking legal action against another party and obtaining a judgment from a court in relation to matters that are not covered by a contract or legislation (for example, actions in relation to negligence, defamation, trespass, and obligations in equity). In certain jurisdictions some of these matters are covered by what is referred to as the common law (law based on precedent rather than statutory law or legislation). Examples of social policy obligations that could fall within the “other operation of law” category include court orders in relation to deeds of settlement or assets that a government holds in trust.

Constructive Obligations and Social Policy Obligations

- 4.9 IPSAS 19 also introduces the notion of constructive obligations which is much broader than legal obligations. The definition of constructive obligations in IPSAS 19 (as discussed in Chapter 3) encompasses certain obligations that a government has a “moral” duty to honor because it has led individuals or entities to believe that it will settle such obligations. The definition of constructive obligations highlights that there must have been some action or statement by the entity that has led others to believe that it has accepted certain responsibilities and will discharge them.
- 4.10 Where entities predominantly engage in exchange transactions, constructive obligations that arise can often be linked with an underlying exchange contract. Where a link with an exchange contract is possible this can help in identifying the relevant past event. For example, where an entity has a practice of rectifying problems with products sold (even in the absence of a clearly specified warranty), it can be argued that the entity has a constructive obligation for claims likely to arise from products sold. The sale of the products can be treated as the past event that has given rise to the constructive obligation.
- 4.11 IPSAS 19 is based on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* which was developed for entities that are predominantly engaged in exchange transactions. In common with IAS 37, IPSAS 19 provides only limited guidance in relation to identifying the past event that gives rise to a present obligation particularly in circumstances where there are a range

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of possible past events that may “build” to the point where a present obligation exists. For example, IPSAS 19 does not contain specific guidance on selecting a past event when there is more than one possible past event.

- 4.12 In interpreting IPSAS 19 in the context of non-exchange transactions it is pertinent to note that IPSAS 19 refers to events that create a legal obligation or a constructive obligation and specifies that a constructive obligation may arise when the past event has occurred, the entity has indicated that it will accept certain responsibilities and as a result a valid expectation is created in potential recipients. However IPSAS 19 does not specify the relationship between timing of the past event and the creation of a valid expectation. For example, where legislation sets out a broad framework for the payment of benefits to eligible individuals it is usually possible to identify the point at which a legal liability arises. It is also possible that a government has indicated acceptance of its responsibility to provide the benefit and generated a constructive obligation prior to the existence of any legal obligation. However, it is not always clear what events would be required for a constructive obligation to exist.

- 4.13 As noted in Chapter 3 it might be argued that the notion of constructive obligations should not be used for non-exchange transactions in the public sector. The Steering Committee acknowledges that the concept of constructive obligations can be difficult to apply in the public sector, but considers that this concept is necessary to guide the approach to a range of potential public sector obligations.

- 4.14 Governments make pronouncements about the types of long term benefits they intend to provide in the future. Some of these pronouncements may be incorporated in legislation (for example, old age pension benefits, housing benefits, free or subsidized education). Others that are not necessarily incorporated in legislation include disaster relief, recurring non-legislative benefits and discretionary transfers (both recurring and non-recurring). Regardless of whether or not the details of benefits are set out in legislation, the principles to be applied in determining whether an obligation should be recognized in the financial statements should be the same.

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- 4.15 Constructive obligations may be long term obligations for a series of future payments or amounts that are due and payable. If a long term constructive obligation for benefits payable under legislation existed, as each payment date approached the amounts that were due and payable under the legislation could become legal obligations. In practice the boundary between legal and constructive obligations is not always clear. This does not necessarily cause a problem for financial reporting as the definition of a constructive obligation could also encompass some legal obligations where the right to enforce payment or action is uncertain.

Past Events Giving Rise to Legal Obligations

- 4.16 Where it is clear that a legal obligation exists the liability is recognized in the financial statements at the point that payment or performance is due. This is normally the point at which an individual could seek judgment in a court for payment or nonperformance. Where a matter is subject to court judgment and the outcome of the judgment is uncertain the obligation may give rise to a contingent liability.
- 4.17 In the context of a (cash) benefit where eligibility criteria are specified in legislation¹, a legal obligation arises at the point that an individual satisfies all eligibility criteria, including the right to receive payment. This would normally be at the point that the benefit is due and payable.
- 4.18 The calculation of the legal obligation for amounts due and payable depends on the way in which entitlement has been expressed. 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);

¹ Where benefits are not specified in legislation amounts due and payable in respect of such benefits may also be legal obligations if an individual would be able to take legal action to enforce payment of the benefit. An individual's right to take legal action will depend on the common law which has developed within a particular jurisdiction. For financial reporting purposes the classification of an amount due and payable as a legal obligation or a constructive obligation is immaterial. Both would normally meet the criteria for recognition in the financial statements.

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- 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. The identification of amounts due and payable is influenced by the specific options for commencement and cessation of benefits that have been adopted by policymakers for specific benefits.

4.19 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 an individual's notification that eligibility has ceased;
- the date on which the government processes an individual's notification that eligibility has ceased;
- 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.

4.20 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.

4.21 In the context of services provided by a government to individuals and where eligibility criteria for entitlement to services are specified in legislation, an individual would not normally have a right to the service or be able to take action against the government to enforce performance of the service until the service was due to be provided. The existence of a legal obligation would also depend on the likelihood of the individual receiving a favorable and enforceable judgment.

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Past Events Giving Rise to Constructive Obligations

- 4.22 The existence of individuals or entities entitled to benefits that are due and payable clearly demonstrates that a past event giving rise to a present obligation has occurred. For example, in the case of child benefits this would be the point at which the regular weekly or monthly payment is due to be paid to the child or family and the amount of the liability would be the amount due at that point in time. If the recipient had a defensible right to payment in law, this would be a legal obligation. However, it would be argued that a constructive obligation could arise before amounts are due and payable.
- 4.23 Although the creation of legislation establishes broad parameters within which benefits may be paid, few would argue that the creation of legislation, on its own, constitutes a past event which would give rise to a present obligation which the government has no realistic alternative but to settle. Some other event such as the existence of an individual meeting the criteria specified in the legislation is usually required to. In addition, it is often not possible to measure future expected payments under legislation at the time the legislation is enacted.
- 4.24 The range of possible past events that could give rise to a constructive obligation will depend on the type of benefit. In general, past events could be one of the following:
- time of birth;
 - the point at which an individual reaches economic independence – that is the point at which the individual takes responsibility for meeting their personal needs, (for example, food, clothing, education and housing);
 - the point at which it becomes likely that an individual will, in the future, satisfy the criteria required to receive a benefit;
 - the point at which an individual satisfies all the threshold (initial) criteria required to qualify for a benefit; and
 - the point at which benefits are payable or services are due to be provided.
- 4.25 In relation to constructive obligations, a government's past practice in accepting obligations at certain points can also influence the identification of an appropriate past event.

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- 4.26 The range of possible past events that may be relevant can vary depending on the nature of the benefit to be provided. For example, in the case of tertiary education possible past events include:
- birth;
 - satisfactory performance during secondary education;
 - the passing of entrance examinations for tertiary education; and
 - the actual provision of tertiary education services.
- 4.27 In the case of old age pensions possible past events include:
- birth;
 - reaching the age of economic independence;
 - commencing to pay income tax on earnings from regular employment;
 - satisfying the threshold age criteria required to receive an old age pension (for example, 65 years);
 - satisfying all criteria required to receive an old age pension (for example, age criteria and income tests);
 - becoming entitled to payment of an old age pension.
- 4.28 In the case of discretionary transfers, such as some forms of foreign aid and disaster relief, the past event could be:
- the occurrence of an underlying event (for example, a typhoon) together with the evidence that the government's past practice has demonstrated a commitment to provide relief funding in these circumstances;
 - an announcement by a government of its intention to make the transfer and identification of recipients;
 - the publication of a draft budget including amounts for the transfer;
 - the final approval of a budget including amounts for the transfer; or
 - the time that payment of the transfer is due.
- 4.29 There can be differing views about which of these points in time or combinations of points constitutes (perhaps collectively) a past event giving rise to a present obligation and the point at which individuals or entities can have a valid expectation that they will receive a benefit. The objective of this ITC is to

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identify the point in time or combination of factors where it is most likely that a constructive obligation meets all aspects of the relevant definitions and recognition criteria.

- 4.30 In the case of legal obligations it is reasonable to argue that a government has no realistic alternative but to settle the obligation. Although some governments may have occasionally used their sovereign powers to enact or change legislation with the specific intention of avoiding legal obligations, this does not justify the widespread non-recognition of liabilities for legal obligations.
- 4.31 For financial reporting purposes it is usual 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). This convention has been adopted in this ITC when determining the existence and measurement of present legal obligations.

Constructive Obligations – Factors to Consider

- 4.32 In determining what would constitute a past event that creates a present obligation for constructive obligations one needs to consider the influence of key factors discussed below. These factors may assist in determining whether all aspects of the relevant definitions have been met.

Acceptance of Responsibilities

- 4.33 The definition of a constructive obligation requires that an entity indicate acceptance of certain responsibilities to others. IPSAS 19 refers to past practice, published policies and specific current statements as examples of such actions. In the public sector environment published policies and specific statements could refer to policies incorporated in legislation or other pronouncements such as manifestos, policies announced at the time a draft budget is released, inclusion of items in published budgets or the approval of budgets by legislative or governing bodies.

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**Creation of a Valid Expectation**

- 4.34 The definition of a constructive obligation also requires that such actions have created a valid expectation on the part of those other parties. For example, if a government has a history of declaring that it will give foreign aid, and subsequently providing the promised amounts, it is possible to argue that the valid reliance by the other entity gives rise to a constructive obligation. A constructive obligation would not exist merely because an individual claimed to have relied on the delivery of benefits pursuant to a government pronouncement. The existence of legislation and/or public pronouncements could be used as justification for valid reliance, but given the ability of many governments to change legislation or policies this would not necessarily be sufficient evidence.
- 4.35 For example, some would argue that if the right to education is set out in legislation and there is a past practice of providing education, individuals can have a valid expectation that they will receive free or subsidized education services prior to the point of actually satisfying all the eligibility criteria. However it is difficult to identify an exact point at which a valid expectation could occur. In the case of tertiary education some might argue that a government has a present obligation to provide future tertiary education from the time that an individual is born. Others might say that the government's present obligation for future tertiary education arises when an individual enters secondary school as by then it is easier to identify children who are likely to meet entrance requirements for tertiary education.

No Realistic Alternative But to Settle

- 4.36 The definition of an obligating event states that an entity must have no realistic alternative to settling the obligation. Factors to consider in trying to decide if there is no realistic alternative but to settle include:
- the extent to which constituents are dependent on a benefit provided by the government. If people are heavily dependent on a benefit it is unlikely that the government could easily cancel or decrease the benefit. This suggests that there is no realistic alternative but to settle the obligation. The size of the obligation on relation to a government's other obligations may also be relevant. A

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government's past practice may assume greater significance when the obligation is large. It may be harder for a government to change its policies in relation to large obligations;

- the government's past practice in removing or reducing particular benefits, changing the method of providing benefits or changing eligibility criteria. The ability to remove or reduce benefits may differ depending on the type of benefit and the groups of beneficiaries;
- 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;
- likely political consequences of changing benefits; and
- if there is a budget allocation for the item, particularly in the case of multi-year appropriations, this may provide more evidence of the government's intention to make payments. The existence of a budget allocation does not of itself guarantee that there is a present obligation. However, the absence of a budget allocation for an item that is due and payable would imply that the government has options other than to settle the obligation.

Summary of Factors to Consider

- 4.37 These factors do not operate in isolation. Some of them provide evidence in relation to more than one aspect of the definitions. They need to be considered in conjunction with each other and in the context of cultural and institutional arrangements and traditions in different jurisdictions. Ultimately judgment will be necessary in determining when a constructive obligation arises. The Steering Committee's views on the principles that should be adopted in exercising that judgment are set out below.
- 4.38 It is important to remember that the requirement that a government have no realistic alternative to settling an obligation (from the definition of an obligating event) needs to be applied to all constructive obligations that are being considered for recognition in the financial statements. If a constructive obligation exists, but the government has a realistic alternative to settling the obligation, no liability is recognized.

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- 4.39 The range of social benefits provided by government is wide and there are many different circumstances that may give rise to a present obligation. The Steering Committee is of the view that the identification of the following potential circumstances in which a present obligation may arise presents the best opportunity for an orderly discussion of these complex issues.
- 4.40 The approaches set out below reflect differing views about the past event which creates a valid expectation in individuals that the government will provide them with benefits (and that the government has no realistic alternative but to provide such benefits). In some cases all three approaches may be relevant. In other cases only one or two approaches may be relevant.
- 4.41 These three sets of factors, referred to as options were:
- amounts due and payable (when applicable);
 - individual meets threshold criteria; and
 - some point prior to meeting threshold criteria (where applicable).
- 4.42 In Chapters 5 to 8 the Steering Committee considers the relevance of various past events and other factors in determining the existence of legal and constructive obligations arising from social policy obligations. In Chapters 5, 6, and 7 (dealing with services for collective and individual consumption, cash transfers to individuals and selected other benefits) the Steering Committee concludes that a present obligation that meets the recognition criteria exists when amounts are due and payable or services are due to be provided. Because of the difficulties in identifying appropriate recognition points for all types of benefits and the risks of inconsistent recognition of liabilities between jurisdictions, the Steering Committee has generally chosen a conservative approach to the recognition of constructive obligations.
- 4.43 In Chapter 8 which deals with old age pension benefits the Steering Committee does not come to a unanimous view. The majority view in respect of old age pension benefits is that a constructive obligation for future benefits exists at the time that an individual reaches age of economic independence.
- 4.44 Some Steering Committee members acknowledge that they have come to different conclusions about when pensions and other

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benefits with similar characteristics will give rise to a present obligation. They acknowledge that in respect of child benefits and free/subsidized education and health services it is also possible to argue that a constructive obligation arises prior to an individual meeting all eligibility criteria. They have not accepted that these types of benefits give rise to constructive obligations that a government has no realistic alternative but to settle. However, they do accept this argument in respect of old age pensions. These Steering Committee members argue that the difference in their approach to old age pension benefits and other benefits is justified because the magnitude of old age pensions limits the ability of a government to change them and avoid settling the obligation.

- 4.45 The following options set out the Steering Committee's views on the different points at which obligations for future benefits (both cash transfers or free or subsidized goods and services) could be recognized.

Preliminary Views – Legal Obligations

1. *A government has a legal obligation when an individual² can seek judgment in relation to nonpayment or nonperformance. Such legal obligations will generally be present obligations when cash transfers are due and payable or goods or services are due to be delivered. In the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, the present obligation (legal) will be limited to the individual's current entitlement.*
- 4.46 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.

² Governments may have obligations to individuals, groups of individuals or entities. For ease of writing this ITC frequently refers to individuals only.

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Preliminary Views – Constructive Obligations – Option 1

2. *In the absence of a legal obligation, a government will have a present obligation (constructive) when individuals satisfy all eligibility criteria for benefits and cash transfers are due and payable or goods or services are due to be delivered. In the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, the present obligation (constructive) will be limited to the individual's current entitlement. The government has no realistic alternative but to settle such obligations.*
- 4.47 Individuals can reasonably rely on the expectation the expectation they will receive cash transfers, goods or services only from the point of initially satisfying the eligibility criteria until they are again required to satisfy all eligibility criteria. There are therefore a series of obligating events.
- 4.48 The Steering Committee has used this approach in explaining the point at which a government has a present obligation in relation to most benefits, apart from old age pension benefits.

Preliminary Views – Constructive Obligations – Option 2

3. *In the absence of a legal obligation, a government will have a present obligation (constructive) when individuals satisfy all eligibility criteria for benefits (including the right to payment or to services) and the government has no realistic alternative but to settle the obligation. The present obligation is for:*
- *current entitlements (cash transfers due and payable or goods and services due to be delivered); and*
 - *in the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, estimated future entitlements, assuming that individuals continue to meet all eligibility criteria in future periods.*
- 4.49 The likelihood of an individual continuing to meet eligibility criteria (including being alive if relevant) in future periods is a measurement issue. The obligation is measured as the best estimate (present value of future cash flows) of the amount expected to be transferred to the individual.

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- 4.50 Although the Steering Committee has identified this as a possible approach to identifying the point at which a present obligation exists, it has not used this approach in relation to any of the benefits considered in this ITC.

Preliminary Views – Constructive Obligations – Option 3

4. *In the absence of a legal obligation, a government will have a present obligation (constructive) when key participatory events have occurred that lead an individual to have a reasonable expectation of satisfying eligibility criteria and the government has no realistic alternative but to settle the obligation. This may be prior to the point at which individuals satisfy all eligibility criteria and therefore be prior to the point at which cash transfers are due and payable or goods or services are due to be delivered. The present obligation is for:*

- *any current entitlements to individuals that have already met the eligibility criteria (cash transfers due and payable or goods and services due to be delivered); and*
- *in the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, estimated future entitlements, assuming that individuals meet all eligibility criteria in future periods.*

- 4.51 The likelihood of an individual meeting eligibility criteria (including being alive if relevant), both initially and on an ongoing basis is a measurement issue. There are a number of possible approaches to measuring such obligations.

- 4.52 Measurement Option A: the obligation is measured as the present value of estimated future cash flows associated with the accrued benefit rights. Benefit rights are considered to accrue over a period of time (in the same way that an individual's rights to employment related pensions accrue over time). They would build from an initial value of zero to the total present value of all expected future benefits. Measurement of accrued rights would commence at some point prior to an individual satisfying eligibility criteria. The present obligation would be at its largest value at the point that an individual satisfied all eligibility criteria. It would then gradually decline as the government provided the benefits represented by the obligation.

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The likelihood of an individual meeting and continuing to meet eligibility criteria (including being alive where relevant) in future periods is treated as a measurement issue.

- 4.53 Measurement Option B: the obligation is measured as the present value of total estimated future cash flows. At some point the government is considered to have a present obligation for the full amount of future benefits to be provided to an individual. The likelihood of an individual meeting and continuing to satisfy eligibility criteria (including being alive where relevant) in future periods is treated as a measurement issue. Constructive Obligation Option 3 does not identify the exact point at which the present obligation arises. This point vary between benefits and in some cases the exact point at which the obligation arises will not be clear. In other cases there may be measurement difficulties and reliable measurement may not be possible until some later point. Where the point at which a present obligation arises is not obvious, it may be preferable to delay recognition until the existence of the present obligation under Constructive Obligation Option 3 is clearly evident (for example, when an individual satisfies all initial eligibility criteria). To illustrate, under Constructive Obligation Option 3, a government's obligation to pay old age pension benefits (where 60 years is the age at which entitlement commences) could be measured to take account of the present obligation to individuals aged 20 years and over, 30 years and over, 40 years and over, etc.,.
- 4.54 Measurement of the old age pension obligation for those aged 40 years and over would take into account:
- the number of individuals who are expected to live until age 60;
 - the number of years that individuals are expected to live to receive the old age pension benefit; and
 - the proportion of individuals that are expected to satisfy any other eligibility criteria such as income tests.
- 4.55 Measurement of the obligation for those aged 60 years and over would take into account
- the number of years that individuals are expected to live to receive the old age pension benefit; and

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- the proportion of individuals that are expected to satisfy any other eligibility criteria such as income tests.

Analysis of Constructive Obligation Options

- 4.56 The advantages of using Constructive Obligation Option 1 in the identification of obligating events are that:
- it leads to the calculation of certain amounts (similar to the amounts calculated for legal obligations) and is readily implemented;
 - it has widespread support in terms of current practice;
 - it is likely to give comparable information across jurisdictions;
 - liabilities identified under Constructive Obligation Option 1 also form part of the obligations under Constructive Obligation Options 2 and 3;
 - in the case of ongoing benefits, there is no need to make judgments about the likelihood of satisfying eligibility criteria in future periods; and
 - it would lead to consistent measurement of benefits regardless of the method used by governments to deliver those benefits.
- 4.57 The limitations of using Constructive Obligation Option 1 in the identification of obligating events are that:
- in the case of long term benefits, where individuals have relied on the expectation of a government providing future benefits it does not provide a complete picture of the extent of the government's future payments;
 - it understates the costs of operations/services; and
 - it does not provide information on the sustainability of current government policies.
- 4.58 The advantages and limitations of Constructive Obligation Option 2 are similar to Constructive Obligation Option 1. However, in addition to recognizing the short-term legal obligation that exists, Constructive Obligation 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.

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- 4.59 Constructive Obligation 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. However, in other cases such as when "means testing" was introduced in Australia in 1983-84, a significant number of individuals were excluded from access to old age pension benefits without recompense.
- 4.60 The difficulty with Constructive Obligation Option 3 is that the point at which the obligating event occurs is not as definitive as under Constructive Obligation 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.
- 4.61 If Constructive Obligation Option 3 were adopted, it could result in a number of governments recognizing previous unrecognized and significant liabilities for future benefit payments. However, this would not be accompanied by any increase in recognized assets. Principles for the recognition of tax revenue are still being developed³. The future tax revenues out of which such obligations are generally financed do not currently meet the recognition criteria for assets.
- 4.62 Such an increase in the amount of recognized liabilities could raise concerns about the sustainability of the government's

³ Another IFAC Steering Committee has been charged with developing an Invitation to Comment on accounting for non-exchange revenue.

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operations and the ability of a government to meet such obligations out of future taxes. If Constructive Obligation Option 3 were adopted, one would need to support the information presented in the financial statements with appropriate disclosures. The possible form and content of supplemental disclosures is discussed in Chapter 9.

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

Moving Forward

- 4.64 This Chapter has highlighted the difficulties that arise in applying the definitions and principles in existing IPSASs to social policy obligations. Ideally the application of such decisions and principles would lead to the development of accounting approaches that are intuitively reasonable and can be readily implemented. However, there is a tension between these two objectives. The conclusions in this document reflect the Steering Committee's attempt to strike a reasonable balance between principles and practical solutions.
- 4.65 Accounting for social policy obligations is a major unresolved issue in public sector financial reporting. Many jurisdictions have adopted a conservative approach to accounting for social policy obligations and have recognized only the portion of such obligations that is due and payable. Despite the general reluctance of most jurisdictions to recognize long term social policy obligations as liabilities, there is a concern that a larger portion of such obligations should be recognized. There is also a desire to have a rational and logical justification for recognizing or not recognizing certain components of such obligations.
- 4.66 For some the proposals in this ITC will go too far. For others, the proposals in this ITC will not go far enough. Nevertheless the proposals represent an important step forward as they will encourage public debate and focus that debate on the interpretation of accounting principles in the public sector environment.
- 4.67 The Steering Committee has attempted to develop a principles based approach to the identification of an obligating event.

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However, the Steering Committee is mindful 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. If a principles based approach would not lead to consistent reporting of transactions a criteria based approach may be required.

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Appendix 1 Amounts Due and Payable under Benefits

Chapter 5 Collective and Individual Services

Introduction

- 5.1 This Chapter applies principles and definitions in existing IPSASs, particularly IPSAS 19, to determine whether a government's obligations to provide collective and individual services¹ result in the creation of obligations that meet the definitions and recognition criteria for liabilities and provisions. Chapter 4 identified the criteria that must be met before a social policy obligation (either a legal or constructive obligation) would be recognized as a liability (including a provision) in the financial statements.

Goods and Services Provided for Collective Consumption

- 5.2 The GFS Classification of Functions of Government² distinguishes between goods and services provided for collective consumption (provided to the community as a whole) and those provided for individual consumption.
- 5.3 Collective services encompass:
- national defense;
 - relations with other countries;
 - public order and safety (including police services, fire protection services, law courts and prisons); and
 - the efficient operation of the social and economic system of a country.
- 5.4 Some services which are classified as collective services under GFS also provide benefits to individuals. For example legal aid³ (a component of law courts), the witness protection service (a component of police services) and the rehabilitation of prisoners (a component of prisons) provide benefits to both the community as a whole and to individuals. However, in these cases the primary benefit is to the community as a whole and

¹ Where appropriate the term service should be read as encompassing goods.

²For a complete list of GFS Classification of Functions of Government (COFOG) and the designation of functions as being for collective or individual consumption readers are referred to the Annex to Chapter 6 in GFS 2001.

³ A more detailed consideration of whether governments can have a present obligation in relation to legal aid is found in Chapter 7.

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the benefits to individuals are generally regarded as incidental benefits.

- 5.5 Although education and health services are generally consumed on an individual basis, the following components are collective services:
- formulation and administration of government policy;
 - setting and enforcement of standards, regulation and licensing of personnel and institutions; and
 - applied research and experimental development.

Current Practice

- 5.6 Governments generally recognize expenses associated with collective services as they engage in exchange transactions in order to provide the collective services. Salaries of government employees and other employee benefits are recognized as employees earn them. Amounts owing to suppliers are generally recognized when an invoice is received – in some cases there will be an end of period accrual of amounts owed to suppliers prior to the receipt of an invoice. If the government owns the buildings and other assets used to deliver these services it will account for any maintenance, depreciation or impairment of the assets. For example, in the case of a government owned and operated prison, the relevant costs of operating the prison (salaries of staff, food, maintenance of building, depreciation of building, lighting, heating, and medical fees) would be recognized as expenses in accordance with generally accepted accounting practice for those types of costs. Recognition of these expenses would also lead to recognition of amounts due and payable and some short term accruals.
- 5.7 In order to ensure that it can continue to meet the forecast need for prison services, a government may also enter into supply contracts and capital commitments for the construction of new prison facilities. Contracts for the supply of goods and services in future periods are executory contracts. The contracts are equally unperformed by both parties (the supplier will supply in future periods and the government will pay for goods supplied in accordance with the contract). Therefore, the government does not recognize a liability for future goods and services. Agreements relating to the construction of buildings are exchange transactions and are accounted for in accordance with

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existing IPSASs (for example IPSAS 11 *Construction Contracts*) or other authoritative accounting standards.

Application of IPSAS 19

- 5.8 Current practice does not recognize a liability for a government's obligations to deliver collective services (in relation to its social policy objectives) as a liability prior to the delivery of the service. The following section considers whether the application of IPSAS 19 would lead one to a different conclusion.
- 5.9 In the case of collective services it is difficult to identify past events that could reasonably be construed as obligating events. Possible past events that might be considered include government pronouncements regarding levels of collective services to be provided in future periods, the birth of individuals who will be entitled to receive/benefit from collective services in the future and the approval of current and future (multi-year) budgets which confirm a governments intention to incur costs and commit resources in providing such services in the future. However, the Steering Committee does not consider that these, or other past events, give rise to a present obligation for the provision of collective services at some time in the future for the following reasons:
- A government pronouncement regarding the level or quality of future collective services it intends to provide may result in a government being obligated to provide such services in future periods. In addition, there may be strong public opposition if the government subsequently decided not to provide such services. However, although such pronouncements may give rise to an obligations to provide services in the future, they do not give rise to present obligations which the government has no realistic alternative but to settle. As such they will not satisfy the definition of a liability which requires that the obligation be a present obligation.
 - There is unlikely to be a legal obligation to provide such services in the future. If a government has entered into a legally binding contract with a private supplier in relation to the provision of such services in the future, it would be required to honor the contract (or pay compensation). However, whether or not such contracts give rise to a

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present obligation at reporting date will depend on the terms of the contract and the extent to which whether performance under the terms of the contract has occurred.

- It may be argued that as a result of past actions and public announcements a government has created a valid expectation amongst its constituents that it will provide such services, and therefore a constructive obligation has arisen when government policy confirms, or does not change, past practice. However, in most if not all jurisdictions, an entitlement to future services does not arise with a policy announcement or as a consequence of past practice. There are no eligibility criteria for collective services under which an individual can claim entitlement. Governments can, and do, change the level of such services. The volume of collective services provided by a government is usually subject to annual review and is influenced by the government's current and projected fiscal position at that time.
- The definition of an obligating event requires that a government has no realistic alternative to settling the obligation. Governments have a number of realistic alternatives to providing future collective services. They can reduce the level of such services, cease to provide them or introduce other programs that alter the level of demand for such services. A government can therefore avoid the future expenditure.
- The birth of individuals who will receive future collective services helps a government forecast the level of demand for future collective services – it does not create a present obligation.
- The inclusion of amounts in budgets is a useful indicator of a government's intentions but it is not sufficient evidence to support the recognition of a liability.
- Collective services can be regarded as an ongoing activity of government. No provision is recognized for costs that need to be incurred to continue an entity's ongoing activities in the future (IPSAS 19, paragraph 26).

- 5.10 The Steering Committee considers that a government does not have a present obligation to provide services for the benefit of the community until the service is provided. Prior to this there may be an obligation and an expectation of service, but it is not a present obligation that results in the government having no realistic alternative but to settle. Consequently, the definition of

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a liability is not satisfied and a government will not recognize a liability for the provision of collective services, other than those liabilities that arise as a consequence of exchange transactions as discussed above.

Preliminary Views – Services for Collective Consumption

5. *Where a government meets its social policy objectives by delivering services for the benefit of the community as a whole, the act of providing a collective service is the obligating event that creates a present obligation. Input costs associated with exchange transactions that a government enters into to deliver collective services are accounted for in accordance with generally accepted accounting practice for those input costs.*

5.11 A government accounting for collective services in this way would:

- recognize liabilities for amounts due and payable and accruals (liabilities to pay for goods and services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees); and
- disclose any capital commitments or contingent liabilities associated with agreements with suppliers in the notes to the financial statements.

Goods and Services Provided for Individual Consumption**Introduction**

5.12 This section examines the nature of a government's obligations to provide services to individuals and whether such obligations meet the definitions and recognition criteria for liabilities and provisions. Social benefits commonly provided in relation to health and education are used as illustrative examples.

5.13 Governments provide free or subsidized health and education services to individuals in a number of ways including:

- the direct provision of free or subsidized goods and services. Governments may pay for all or part of the cost

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of consultations with a general medical practitioner or for the cost of certain medicinal drugs and patent medicines. The government's contribution or subsidy is generally restricted to service providers or products that are approved by a government agency. Governments also provide health and education services through government owned and operated hospitals and schools;

- paying another organization to deliver goods and services to individuals. For example, a government may pay a private hospital a set fee per service, such as for performing an operation on an individual meeting government specified criteria. Governments may also pay private education providers a subsidy for each student. Frequently upper limits are set on the amount that the government will pay under such arrangements;
- the reimbursement of households and individuals for certain types of expenditure. Rather than providing a subsidy at point of purchase or consumption, a government may require individuals to apply for reimbursement. For example, a government may reimburse individuals who require regular treatment at a hospital for the cost of transport to the hospital or it may reimburse individuals with disabilities for the cost of certain home services; and
- providing individuals with vouchers that they can redeem for goods and services. For example, some jurisdictions provide individuals with vouchers that entitle them to free education at one of a selected number of schools.

- 5.14 Under each of these options individual recipients benefit from the goods or services received, but they do not have any control over the resources used to provide the goods or services, nor do they have any option to receive alternative goods or services.
- 5.15 All of the methods of service delivery listed above ultimately result in a transfer of resources from a government to an individual. In the first two methods the provisions of goods or services saves the individual from purchasing the goods or services themselves. In the third case the individual purchases the goods and services, but is then recompensed by the government. When a government provides vouchers an individual is effectively purchasing the good or service but the government is paying for it.

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- 5.16 The above methods of provision of services differ from cash transfers. After satisfying any qualifying criteria, individuals and households frequently have discretion in how to spend cash transfers. The provision of social benefits by the use of cash transfers is discussed in Chapter 6. Scholarships, loans, grants and allowances fall within the scope of Chapter 6.

Current Accounting Treatment

- 5.17 Governments generally account for the delivery of goods and services to individuals in the same way that they account for the costs associated with collective services. That is, they account for the individual exchange transactions associated with the delivery of the service according to generally accepted accounting practice. In the case of vouchers and reimbursements they generally recognize a liability for amounts due and payable or accruals for services provided.
- 5.18 The main differences between collective and individual services are:
- the services are intended to benefit individuals rather than the community as a whole; and
 - some individual services are subject to eligibility criteria.
- 5.19 These differences strengthen arguments that a constructive obligation and a liability arise when, for example, governments announce the availability of such benefits because:
- such announcements and past practice create valid expectations that the government has accepted and will discharge these responsibilities; and
 - the government has no realistic alternative but to provide these services in the future.

Eligibility

- 5.20 Primary and secondary education services are often provided free of charge. Children are not generally required to meet any eligibility criteria apart from being residents or citizens of the jurisdiction. By contrast, access to free or subsidized tertiary education may be limited to those meeting certain academic standards and/or income related tests.
- 5.21 Eligibility for ongoing access to tertiary education may include:

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- continuing to satisfy any income related criteria; and
 - meeting course attendance and course work requirements including achieving minimum grades (such validation requirements may need to be satisfied on a regular basis).
- 5.22 Some jurisdictions provide free medical care (for example, general practitioner visits, hospital services and drugs) to all residents. To limit the cost of providing such services, some jurisdictions limit the availability of selected health services to subsets of the population such as young children, those on low incomes or those who have special medical needs. Some governments reduce the risk of higher than expected spending on these services by setting limits on the total amount to be spent or the total level of services to be provided. These types of restrictions may mean that individuals who are entitled to free or subsidized services will wait a period of time, possibly a number of years, until they receive the service.
- 5.23 The following sections set out the Steering Committee's conclusions that:
- a government's present obligation to provide health and education services to individuals arises as the services are provided; and
 - a government does not have a present obligation for health and education services to be provided to individuals in future periods.

Preliminary Views –Services for Individual Consumption

6. *Where a government meets its social policy objectives by delivering services to individuals, the act of providing the service is the obligating event that creates a present obligation. This act may be the direct provision of the service by the government or a third party, or the purchase by an individual of a good or service which will subsequently be reimbursed or paid for by the government.*
7. *The manner in which a social benefit is provided (e.g. services or cash) is not relevant to the existence of a present obligation.*
- 5.24 This section explains the Steering Committee's views on the nature of the obligating event in relation to different methods of service delivery.

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- 5.25 If a service is provided directly by government entities to individuals the government's present obligation to individuals would arise and be discharged as the service is provided and received by the individual. Because the liability arises and is discharged simultaneously a government would not recognize a liability for services provided directly to individuals. In order to provide such services the government may have entered into exchange contracts with employees and suppliers which give rise to present obligations. Present obligations arising from exchange contracts are an entirely separate issue.
- 5.26 If a service is funded by a government but provided via non-government entities or other government entities outside the reporting entity in question, the government's obligation to those other entities arises as an individual satisfying eligibility criteria receives the services. For example, the present obligation would arise when an individual visited a general practitioner, received outpatient services, was admitted to hospital or received an approved pharmaceutical product. The present obligation would be for the government's portion of the cost of the consultation, hospital admission or product (whether provided to the service provider or to the individual by way of reimbursement). This obligation is discharged when the government pays those other entities for services provided. At the end of a reporting period a government could therefore have a present obligation in respect of services delivered by other entities but not yet paid for. The government could therefore have a liability for services to individuals prior to the payment of cash for those services. The liability arises as the service is provided because at that point the government has no realistic alternative but to settle the obligation.
- 5.27 Sometimes governments provide funding for health or education to other levels of government. Such transfers may ultimately result in the provision of education or health services but the announcement of an intention to make such intergovernmental transfers does not itself represent a present obligation for education or health services. The recognition of liabilities in relation to certain intergovernmental transfers is discussed in Chapter 7.
- 5.28 Where individuals are entitled to seek reimbursement expenditure on for specified services, the present obligation arises when services are provided to individuals meeting

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eligibility criteria. At the end of a reporting period the government will have a present obligation for:

- amounts claimed and approved but not yet paid; and
- transactions meeting criteria for reimbursement which have been claimed but not yet approved; and
- transactions which have taken place and meet criteria for reimbursement but for which no claim has yet been made.

- 5.29 Where a service is provided by way of vouchers the government's present obligation would arise as the individuals received services pursuant to those vouchers. The government's agreement with the entities that provide the services is in the nature of a contract for services and would be accounted for as an exchange transaction. These entities would invoice the government for services provided in relation to the vouchers. However, in addition to any amounts invoiced, a government could have an obligation for services provided but not yet invoiced.
- 5.30 The identification of the obligating event for services provided to individuals is consistent with the due and payables approach discussed in Chapter 4. It would lead to the recognition of amounts due and payable and accruals for services provided. It would not generally lead to the recognition of provisions or the disclosure of contingent liabilities.
- 5.31 This analysis indicates that the manner in which a social benefit is provided (e.g. direct provision, provision in kind through a third party, reimbursement or vouchers) is not relevant to the existence of a present obligation. The existence of an obligation is not influenced by the manner of service delivery. However, the manner of service delivery may have an impact on the measurement of an obligation.

No Present Obligation Prior to Delivery of Service

- 5.32 The Steering Committee also considered whether a present obligation meeting all the relevant definitions and recognition criteria could exist prior to the delivery of services. There are a range of other events that some may argue are the obligating events giving rise to a present obligation. These include:
- the creation of legislation which sets out a government's policy in relation to such services and describes the criteria

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which must be satisfied in order for individuals to receive free or subsidized services;

- the birth of individuals who may qualify for free or subsidized services in future periods;
- some change in the age or status of individuals that makes it likely that they will satisfy all eligibility criteria for free or subsidized services in future periods; and
- meeting all eligibility criteria (initially and subsequently on an ongoing basis).

5.33 The Steering Committee does not accept that any of these events actually gives rise to a present obligation. Its reasons for rejecting these possible events follow.

5.34 A government is unlikely to have a legal obligation to provide services to individuals until the point at which the services are due to be provided. As discussed in Chapter 4, the mere existence of legislation setting out entitlements to benefits or the birth of individuals likely to receive the benefits described in legislation does not lead to the existence of a liability for financial reporting purposes. In order to be recognized as a liability in the financial statements such obligations would have to:

- satisfy the definition of a constructive obligation. That is, it would have to give rise to a valid expectation that the government will discharge certain responsibilities; and
- constitute an obligating event. That is, it would have to give rise to a present obligation that the government has no realistic alternative but to settle.

5.35 The birth of individuals who may be eligible to receive future individual services helps a government forecast the level of demand for future collective services – it does not create a present obligation.

5.36 Individuals may expect that they will receive free or subsidized goods or services from the government and may rely on such expectations. For example, individuals may rely on the expectation that the government will continue to provide free medical care for the aged and may choose not to privately insure or save for their future medical needs.

5.37 While past practice and current policies of government may confirm that a government accepts its responsibilities to provide

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services in the future and expectations about the provision of such services are validly made, they will not constitute a present obligation for financial reporting purposes because governments frequently change:

- the manner in which they provide education and health services;
- the types of services provided free of charge or the level of subsidy on services; and
- the eligibility criteria for entitlement to free or subsidized services.

5.38 For example, a government has considerable discretion in changing its approach to the provision and funding of education. Although a government is unlikely to totally withdraw its support for the provision of tertiary education services governments have made significant changes to the nature and amount of support from one reporting period to the next. A government which has traditionally provided free tertiary education plus a study grant to students may:

- require students to contribute part of the cost their education;
- restrict the number of years for which students can receive free tertiary education;
- restrict access to free or subsidized education to those whose parent's satisfy asset or income tests;
- replace entitlements to free or subsidized education with entitlements to student loans;
- charge for all tertiary education services but provide study grants to students from low income families; or
- introduce more restrictive academic criteria for students to qualify for free or subsidized education.

5.39 Many governments have made such changes. Some changes have been implemented over very short time periods – occasionally with no prior warning.

5.40 Even if a constructive obligation existed, in order to meet the definition of an obligating event the government would have to have no reasonable alternative to settling the obligation. This is not the case with services provided for individual consumption. Governments can withdraw or reduce the level of certain benefits or choose to meet their social objectives in different

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ways – for example, by redistributing income through the taxation system.

- 5.41 Chapter 9 examines alternative forms of disclosure, including the disclosure of future cash flows in order to assess the sustainability of government policies.

Chapter 6 Individual Benefits

Introduction

- 6.1 This Chapter examines the nature of a government's obligations to provide cash transfers¹ to individuals and whether such obligations meet the definitions and recognition criteria for liabilities and provisions. Cash transfers commonly provided in relation to the following are used as illustrative examples:
- child benefits;
 - invalid and sickness benefits;
 - unemployment benefits; and
 - housing benefits.
- 6.2 This chapter does not deal with obligations to make payments under universal old age pension schemes. These are dealt with in Chapter 8. Payments by governments to third parties for the delivery of services to individuals or payments to individuals to reimburse them for goods or services are discussed in Chapter 5.

Child Benefits

- 6.3 Universal child benefits and income tested child benefits are two common forms of child benefit.
- 6.4 Universal child benefits are paid to all children of a certain age regardless of the income or wealth of their family. They may be paid at a flat or variable amount for each child and are typically paid at regular intervals from the time of birth until the child reaches a set age (for example, 16 years of age or 18 years if the child is studying at an approved education institute). Apart from the requirement that a child of the eligible age exists there are generally few eligibility criteria. There may be a requirement that the child lives with a parent and that the parent is a resident or pays income tax within the jurisdiction. The fewer eligibility criteria that exist, the more likely it is that a child will satisfy the eligibility criteria for the entire period that the child benefit is available.

¹ Accounting for the provision of various goods and services in kind (education and health) is discussed in Chapter 5.

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- 6.5 Income tested child benefits are provided only to those children whose families meet certain criteria. The amount of the child benefit typically varies depending upon the number and age of the children and the joint parental income. Entitlement to the benefit is generally assessed on a regular basis and payment of the benefit ceases if the family ceases to meet all eligibility criteria.
- 6.6 Subject to the existence of income or asset tests, child benefits are provided from birth until a child reaches a set age. For income tested child benefits the age of entitlement is typically the time of birth or the point at which a child's family income satisfies the income eligibility criterion. Depending on the eligibility criteria, eligibility could also occur by immigration or the return of expatriate citizens.
- 6.7 A government's policy on child benefits is usually incorporated in legislation. Such legislation records the details of eligibility criteria and the amount of benefit to be paid in various circumstances.

Invalid and Sickness Benefits

- 6.8 Invalid or disability benefits provide assistance to individuals whose ability to work is impaired on a long-term basis due to non-occupational injury or disease. Some jurisdictions also provide sickness benefits for short-term illnesses or impairment (these are frequently set at the same level as unemployment benefits). The benefit may be provided on a permanent basis or eligibility may be subject to regular review. There may be supplements for dependents, daily assistance, and rehabilitation or training. In some jurisdictions partial disability benefits may be available.
- 6.9 The basic benefit may be a set amount or it may be income related – often it is calculated as a percentage of an individual's previous earnings or a percentage of a universal old age pension. The amount of the benefit may be adjusted annually for changes in a consumer price index or other index. Entitlement may be subject to asset or income tests and the amount of the benefit may be adjusted to reflect asset and income levels of the beneficiary.
- 6.10 Invalid or sickness benefits are provided from the time that an individual satisfies all eligibility criteria until the time that

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eligibility ceases. Individuals may be required to have their level of disability or their inability to work due to an illness certified by medical practitioners. Possible causes of disability that lead to an individual being unable to work full time include:

- short term illnesses;
- medical conditions known from the time of birth;
- medical conditions known from some point after birth but prior to the specified level of disability occurring (for example a progressive medical condition);
- medical conditions that are pre-existing but unknown until the time that the specified level of disability occurs; or
- medical conditions or accidents that occur at a given point in time.

6.11 Individuals are generally entitled to a disability benefit at the point that the disability becomes known or occurs. Some jurisdictions commence payment of the disability benefit some time (for example, one year) after the occurrence of the disability. There may also be a minimum age from which a disability benefit is payable (for example, 18 years of age).

6.12 Depending upon the eligibility criteria, a present obligation for future invalid or sickness benefits ceases when an individual:

- recovers from a short term illness;
- becomes employed;
- earns more than a set amount or accumulates assets worth more than a set amount and thereby fails to satisfy income or asset tests;
- is rehabilitated or trained and is assessed to be capable of full time employment; or
- dies (whether the obligation ceases at this point depends on whether there is a survivor's benefit).

Unemployment Benefits

6.13 Unemployment benefits are available in some jurisdictions for individuals of working age who are unable to find employment. The benefits generally commence once the individual has been unemployed for a specified period of time. Individuals may be required to be actively seeking work and attend job interviews arranged by government agencies. The benefits may be asset or income tested. In some jurisdictions the amount of the benefit reduces if the individual earns income from part time

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employment. The amount of the benefit is frequently linked to the amount of old age pensions. Eligibility generally ceases when an individual obtains employment.

Housing Benefits

- 6.14 Housing benefits are often provided by way of rent subsidy. Entitlement to, and the amount of, a rent subsidy may be influenced by a number of factors including:
- the income of the family or the proportion of family income spent on rent;
 - the amount of rent (of the specific property or of rents in the geographical area);
 - the size of the family and the age of family members; and
 - the size or age of the dwelling.

Past Event Giving Rise to a Present Obligation

- 6.15 Where eligibility criteria and the amounts of benefits are clearly specified in legislation, individuals (and families) satisfying eligibility criteria at each payment date will often have a legal right to enforce payment for the amounts they are entitled to as at that date. The amount due and payable and any amount accrued in respect of legal obligations would meet the criteria for recognition as liabilities in the financial statements. As noted in Chapter 4, the ways in which government policies express entitlements to cash transfers may have an impact on the calculation of the amount due and payable. Liabilities for amounts due and payable would generally be certain as to amount and timing – they would not generally be provisions. If there was a dispute (as to entitlement or the amount of the entitlement) which needed to be settled via the legal system then a government could have a contingent liability in respect of its legal obligations for cash transfers.
- 6.16 The amount of cash transfers due and payable or any contingent liability should be disclosed in accordance with the requirements of the relevant IPSAS (for example, IPSAS 1 and IPSAS 19).
- 6.17 Although individuals (and families) satisfying eligibility criteria for benefits specified in legislation may have a legal right to enforce payment for the amounts they are entitled to as at a

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given date, they will not generally have a legal right to enforce payment of:

- benefits not specified in legislation; or
- amounts that they will be entitled to if they satisfy eligibility criteria in future periods.

- 6.18 The existence of a legal obligation is a question of fact that will be determined by the legal system within a jurisdiction. What constitutes a legal obligation will vary dependant on the nature of the entitlement. In most jurisdictions there would be no legal entitlement to future child benefits until the child (and family if appropriate) satisfied all eligibility criteria in those future periods. However, if legislation in a jurisdiction specified that a benefit would be provided on the birth of a child or at some other point such that eligibility need be satisfied only once, a legal obligation for current and future child benefits could exist from that point, notwithstanding that payment of the benefit would be made over some future period. The nature of legal obligations may also differ between jurisdictions because of differences in interpretation of legislation and different application of common law principles by legal systems.
- 6.19 If a government has a legal obligation for benefit payments in future periods the obligation would be measured in accordance with IPSAS 19 by discounting the expected future cash flows to present values. Expected future cash flows would be determined by estimating the number of individuals expected to receive the benefit in future periods and the amounts that they would be entitled to.
- 6.20 In some cases benefits may be provided from the date of application rather than the date of approval. For example, unemployment benefits or income supplements for economic hardship may be provided on application, with verification of unemployment or hardship being made over future periods. In these cases, some estimation may be required of the number of applications received but not yet processed. If benefits are provided from the date of entitlement (for example, date of birth, date of becoming ill or unemployed), some estimation may be required of the number of individuals who are entitled to benefits but have not yet applied for them.
- 6.21 IPSAS 19 (paragraph 58) requires that future events that may affect the amount required to settle the obligation be reflected in

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the amount of the provision where there is sufficient objective evidence that those future events will occur. The effective functioning of the economy and the machinery of government in most, if not all jurisdictions, is predicated on the expectation that the government will honor its legal obligations and protect property and social rights. As such, rarely if ever, will the amount of the liability be amended to reflect that the government will not honor its legal obligations in the future. Governments may enact legislation which has retrospective effect on an individual's entitlement to benefits. In accordance with IPSAS 19, the amount of the provision recognized in respect of those benefits will be adjusted where there is sufficient objective evidence of a government's intention to enact legislative changes with such retrospective effects. It is anticipated that this will rarely occur.

- 6.22 In the absence of a present legal obligation, some may argue that a government has a constructive obligation to provide cash transfers in future periods to individuals who are currently eligible or likely to be eligible for cash transfers in those future periods. This is because in the absence of a government statement to the contrary, past practice and current policy have created a valid expectation that those benefits will be received in the future and individuals may have relied on those benefits in making economic decisions such as how much to save.
- 6.23 Amongst those who hold that a government's obligations for future benefits may give rise to present obligations there are differing views about what would constitute the past event and the point at which individuals or entities could have a valid expectation that they would receive future benefits. Possible past events giving rise to a constructive obligation are as follows.:

For child benefits:

- time of birth;
- once the child or family has satisfied the threshold eligibility criteria ; or
- when each benefit payment is due and payable.

For disability benefits:

- the time that the disability or illness is first known (the obligation would need to be adjusted to take account of the

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number of individuals that would potentially qualify for the benefit but do not claim the full benefit);

- the first time that all eligibility criteria are met; or
- eligibility criteria are satisfied for a number of consecutive periods.

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For unemployment benefits:

- on meeting the eligibility criteria for the first time (the obligation would be for the expected length of time that an individual is unemployed); or
- on meeting eligibility criteria for a number of consecutive periods.

For discretionary cash transfers to individuals:

- at the time of a government announcement;
- the publication of a draft budget;
- the enactment of an approved budget; or
- at the time of payment of the discretionary transfer.

- 6.24 As noted in Chapter 4, constructive obligations would be recognized for financial reporting purposes only when a government also had no realistic alternative but to settle those obligations. Valid reliance is not, in itself, sufficient to give rise to a present obligation.

Preliminary Views – Cash Transfers

8. *A present obligation for the payment of future cash transfers does not arise until the point at which cash transfers are due and payable. At this point, the government's obligation to pay certain cash transfers will be legal, rather than constructive.*

- 6.25 Factors that support the Steering Committee's view that a present obligation exists at the time that cash transfers are due and payable are as follows:

- a government would have no realistic alternative but to settle its obligations for amounts due and payable. In theory a government could refuse to make cash transfers that were not specified in legislation or subject to a court order, but in practice a government would suspend such payments only in extreme circumstances. Governments can change eligibility criteria and the types of cash transfers available to constituents at short notice but not at the stage that a cash transfer is due and payable; and
- benefits may be provided in a variety of forms including the provision of free or subsidized goods and services or cash transfers. In Chapter 5 the Steering Committee concluded that the form of provision of a benefit should

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not influence the point of recognition. Chapter 5 also argued that the point of recognition of a present obligation for goods and services is at the point that the good or service is delivered. The recognition of obligations to make cash transfers in respect of the benefits considered in this Chapter (child benefits, sickness and invalid benefits, unemployment benefits, and housing benefits) at the time the cash transfers are due and payable is consistent with the conclusions in Chapter 5. The same rationale would apply to cash transfers associated with health and education objectives.

- 6.26 In addition, an obligating event only occurs, and a present obligation only arises, when the entity, in this case the government, has no realistic alternative to settling the obligation. However, governments could make, and in many cases have made, changes to the amount of child or other individual benefits or amend the eligibility criteria. For example, some and perhaps all of the following changes to child benefits have been made in a number of jurisdictions over the long term:
- the replacement of universal benefits with income tested benefits;
 - the replacement of variable rates of child benefit (where the rate is determined by the age of children) with a flat rate;
 - changes in the rate of abatement (abatement refers to the rate of reduction of the benefit in relation to the amount of income earned);
 - the replacement of a number of existing child benefits with a new universal infant care allowance; and
 - the reduction of certain child benefits in order to provide more funding for early childhood education.
- 6.27 These types of changes mean that there is no certainty that:
- individuals who currently satisfy eligibility criteria will continue to do so in the future, or
 - individuals who anticipate satisfying eligibility criteria in future periods, will in fact do so.
- 6.28 In the case of unemployment and similar benefits, such benefits are only available for the period during which the eligibility criteria are satisfied. Individuals cannot have a valid

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expectation that they will receive an unemployment benefit in future periods as they may move in and out of employment. A government has realistic alternatives to settling obligations to make future cash transfers for the types of benefits discussed in this chapter. Each of the possible changes to child benefits discussed above could change the amount of, or eliminate, a government's obligation for future child benefits. Governments frequently alter level of support provided to constituents through cash transfers by altering the mix of cash transfers and free or subsidized goods and services.

- 6.29 The ability of a government to reduce or remove a particular cash benefit (and therefore one's assessment of whether or not the government has a realistic alternative to settling the obligation) may influenced by the relative level of dependence by individuals on the cash transfer and the anticipated reaction of the community to government initiatives the remove or vary the level of benefits. Although in some instances cash transfers represent a significant proportion of an individual's income, in many cases the level of a cash transfer is not significant to an individual's survival or decisions. For example, cash transfers to tertiary students may have a significant impact on the student's level of discretionary income, but the withdrawal of such cash transfers may not have a significant impact on the number of students choosing to complete tertiary qualifications.
- 6.30 Governments may have an obligation of some form to provide future cash transfers – in some cases the obligations may even meet the definition of a constructive obligation – but such obligations are not present obligations.
- 6.31 The types of additional information that could usefully be disclosed in respect of cash transfers to be provided in future periods (regardless of whether such future transfers are recognized as liabilities is discussed in Chapter 9).

Chapter 7 Other Benefits and Discretionary Transfers

Introduction

7.1 This Chapter considers when a government's obligations in relation to the following items meet the relevant definitions and criteria for recognition in the financial statements:

- disaster relief;
- foreign aid; and
- legal aid.

Disaster Relief

Disaster Relief – Introduction

7.2 Governments frequently take responsibility for rectifying damage or compensating individuals for damage caused by natural disasters such as earthquakes, volcanic eruptions and extreme weather events such as floods, hurricanes and droughts. Disaster relief may take the form of cash transfers or free or subsidized goods or services. For example, disaster relief provided by a government following a major flood may include:

- cash compensation to families whose homes were flooded;
- subsidized loans to allow people to rebuild their homes or businesses;
- the rebuilding of private dwellings for low income families or business premises for businesses meeting certain criteria;
- the rebuilding of infrastructure¹; and
- free emergency services such as rescue services, temporary shelter, food and water supplies and clean up services.

¹ A government's promises to provide disaster relief to individuals, businesses or other levels of government are promises to identifiable external parties. By contrast, a government's promises to rebuild government owned assets are not promises to external parties because such assets form part of the government reporting entity. Only obligations to parties external to the reporting entity are recognized in general purpose financial statements.

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- 7.3 Some types of disaster relief are services provided to the community as a whole (for example, clean water and food) or goods and services to individuals (for example, the rebuilding of homes) as discussed in Chapter 5.
- 7.4 The sequence of events that leads to the payment of cash transfers or delivery of goods and services will be influenced by factors such as whether the government has a policy in place in relation to those types of disasters and the steps required to obtain authorization for the disaster relief. If a government has:
- a policy setting out details of the type and amount of disaster relief it will provide and any eligibility criteria; and
 - funding available under an existing budgetary authority;
- individuals or entities entitled to benefits could submit claims immediately following the occurrence of a disaster and the government could approve such claims without seeking any further authority.
- 7.5 However, in the absence of a policy on disaster relief and approved funding a government would need to assess damage, develop a policy, advise constituents of the policy and seek the appropriate form of budget authorization to disburse or commit funds.
- 7.6 At any stage of the process following a disaster, governments may announce their intention to provide disaster relief. Such announcements may:
- indicate the government's intention to develop a policy;
 - provide information on the detailed aspects of the government's proposed policy; or
 - specify the disaster relief available and the circumstances in which they it be accessed.
- 7.7 Individuals or entities seeking assistance from the government are normally required to apply for disaster relief. Approval of claims for assistance is normally delayed until the government has obtained or is confident of obtaining appropriate budget authorization. In some jurisdictions, existing legislation authorizes a government to spend specified amounts on disaster

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relief without obtaining prior approval through the normal authorization process.

Disaster Relief – Past Event Giving Rise to a Present Obligation

- 7.8 The point at which a present obligation arises depends on the combination of the following factors:
- the existence of a policy on disaster relief and whether this policy is set out in legislation;
 - the nature and timing of government announcements regarding its intention to provide disaster relief;
 - the process required to obtain budgetary authorization for disaster relief and when such authorization is received; and
 - whether claims must be submitted to the government for approval.
- 7.9 This Chapter considers when a present obligation arises if there is a detailed policy set out in legislation, a detailed policy (not set out in legislation), and no policy.

Policy exists in legislation

- 7.10 If legislation provides individuals or entities with the right to take legal action against the government to obtain payment of cash transfers or delivery of goods and services, a present obligation (legal) exists at the point that:
- a disaster meeting the criteria in the legislation has occurred; and
 - individuals or entities satisfying the criteria to receive disaster relief exist.
- 7.11 Depending upon the point in time that the legislation requires the disaster relief to be provided, the present obligation could have both short-term and long-term components. For example, the legislation may require the government to pay compensation to eligible individuals within one year of the date of approving claims. A present obligation for disaster relief could therefore exist prior to the point that cash transfers are due and payable or goods and services are to be delivered.
- 7.12 The information that would be required to reliably measure a provision for disaster relief would include:

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- the expected number of eligible individuals;
 - the benefits (both cash and goods and services to be provided in kind) that eligible individuals would be entitled to;
 - the expected take up of the benefit – that is the proportion of eligible individuals that are expected to apply for the disaster relief;
 - the expected timing of future outflows; and
 - the amount of any limit (monetary or otherwise) on the amount of disaster relief to be provided.
- 7.13 Obtaining this information and developing a reliable estimate of the amount of disaster relief required by the legislation may take some time. Therefore recognition of the present obligation (legal) in the statement of financial position may not occur immediately following the disaster.
- 7.14 Although such provisions would be legal obligations, the guidance in IPSAS 19 paragraph 93 on measuring constructive obligations arising from restructuring would be applicable. Paragraph 93 states that a restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:
- necessarily entailed by the restructuring; and
 - not associated with the ongoing activities of the entity.
- 7.15 The present obligation (legal) exists independently of whether or not the government has sufficient budgetary authority to meet its obligation to provide disaster relief. However, if a government is unlikely to be able to obtain sufficient resources to meet its obligation, this may influence the measurement of amounts due and payable and any provision (because it would affect the estimation of the timing and amount of future cash flows). Where the amount of a provision cannot be reliably estimated a government would disclose the existence of a contingent liability.
- 7.16 Announcements by a government regarding its intention to provide disaster relief would not alter the point of recognition of a present obligation (legal).
- 7.17 In Chapters 5 and 6 the Steering Committee proposed that:

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- Where a government meets its social policy objectives by delivering services (such as health and education benefits) to individuals, the act of providing the service is the obligating event that creates a present obligation.
 - The manner in which a social benefit is provided (for example, services or cash) is not relevant to the existence of a present obligation.
 - A present obligation for the payment of future cash transfers to individuals (for benefits such as child benefits, unemployment benefits) does not arise until the point at which cash transfers are due and payable.
- 7.18 At first glance the Steering Committee's views on recognition of liabilities for disaster relief may appear to be inconsistent with the views expressed in Chapters 5 and 6. The views are consistent – it is the facts of the situations that differ. For example, in the case of education benefits the Steering Committee considers that up until benefits are due to be paid or provided, a government has realistic alternatives to settling the obligation. The government's present obligation is therefore only for the amount that is due and payable each time.
- 7.19 By contrast, at the point that a disaster has occurred and there are individuals meeting the eligibility criteria, the government has no realistic alternative but to provide the types and amount of disaster relief specified in legislation. In the case of disaster relief the obligating event is the occurrence of the disaster and the existence of qualifying individuals. In the case of education benefits the obligating event is the existence of qualifying individuals at each point that entitlement is assessed. There are therefore a series of obligating events for most ongoing benefits. In Chapter 6 the Steering Committee also acknowledged that if an individual's eligibility for a benefit was assessed only once there could be a single obligating event.

Preliminary View – Legal obligation for disaster relief

9. *Where individuals or entities have the right to take legal action against the government to obtain payment of cash transfers or delivery of goods and services for disaster relief, a present obligation (legal) exists at the point that:*
- *a disaster meeting the criteria in the legislation has occurred; and*

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- *individuals or entities satisfying the criteria to receive disaster relief exist.*

Policy exists – not in legislation

7.20 Where a government has an established policy (not in legislation) for specific types of disasters, containing clear details of eligibility criteria and the type and amount of disaster relief to be provided in certain circumstances, individuals or entities meeting the criteria could argue that the government has a constructive obligation to provide disaster relief to them in accordance with that policy. In this case the Steering Committee considers that:

- a past event giving rise to a present obligation (constructive) occurs at the point that a disaster covered by the disaster relief policy occurs and individuals exist who satisfy the eligibility criteria to receive disaster relief (a more detailed discussion of this point is provided below);
- if the government's communication of its acceptance of a claim gives an individual or entity a right to take legal action against the government, the constructive obligation would become a legal obligation;
- the present obligation to provide cash or goods and services would be recognized as a liability when it met the recognition criteria of measurability and probability. The liability would be measured at the best estimate of the benefit to be provided; and
- the liability would be recorded either as a provision or an amount due and payable. The liability would be due and payable at the point that the cash is due to be paid or the goods and services are due to be delivered.

7.21 IPSAS 19 provides guidance on the application of the recognition and measurement rules for provisions in certain circumstances, including restructuring². IPSAS 19 paragraph 83 provides guidance on the circumstances in which a constructive

² Restructuring includes termination or disposal of an activity or service, the closure of a branch office or termination of activities of a government agency in a specific location or region or the relocation of activities from one region to another; changes in management structure and fundamental reorganizations that have a material effect on the nature and focus of an entity's operations.

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obligation for restructuring exists (refer Figure 7.1)³. This guidance establishes principles that are useful in determining whether a government has a constructive obligation for disaster relief.

Figure 7.1
Restructuring Provisions

A constructive obligation to restructure arises only when an entity:

- (a) has a detailed formal plan for the restructuring identifying at least:
 - (i) the activity/operating unit or part of an activity/operating unit concerned;
 - (ii) the principal locations affected;
 - (iii) the location, function, and approximate number of employees who will be compensated for terminating their services;
 - (iv) the expenditures that will be undertaken; and
 - (v) when the plan will be implemented; and
- (b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

IPSAS 19 paragraph 83

7.22 Paragraph 83 of IPSAS 19 sets out the general recognition criteria or conditions under which a restructuring provision meets the definition of a constructive obligation. These additional criteria focus on the need for evidence that the entity with the obligation is likely to act on its intention to provide resources to another entity such that a valid expectation is created and the entity cannot avoid settlement. The criteria are intended to provide more detailed guidance and thereby improve the consistency and comparability of reported information. However, the recognition of such constructive obligations is still governed by the definition of an obligating event which requires that an entity have no realistic alternative to settling the obligation.

7.23 The Steering Committee proposes that comparable criteria be developed in for application in determining whether a provision

³ At time of writing (June 2003) the IASB is reviewing the application guidance on restructuring provisions in IAS 37. It is considering amending the guidance so that when a contract becomes onerous as a result of the entity's own actions, such as a decision to restructure, the resulting provision is not recognized until that action has occurred.

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for constructive obligations for disaster relief has arisen. The Steering Committee has applied the principles reflected in the guidance on restructuring in IPSAS 19 to identify the conditions that would need to exist and events that would need to have occurred for a present obligation for disaster relief to arise.

Preliminary View – Constructive obligation for disaster relief

- 10. *A constructive obligation for disaster relief arises only when:***
- (a) *a government has a detailed formal policy for the disaster relief identifying at least:***
 - (i) *the types of disasters and principal locations covered by the policy;***
 - (ii) *a description of the eligibility criteria required for individuals or groups to qualify for disaster relief, including any limit on the number of individuals covered by the policy;***
 - (iii) *the nature and amount of disaster relief that will be provided to individuals and groups, including any total monetary limit;***
 - (iv) *the process for approving claims; and***
 - (v) *when and how the disaster relief will be provided;***
 - (b) *a disaster of the type covered by the policy has occurred;***
 - (c) *individuals satisfying the criteria in the policy exist; and***
 - (d) *a government has raised a valid expectation in those affected that it will provide the disaster relief. This valid expectation could be initiated by a government announcing the main features of the plan to those affected by the disaster, or by beginning to formally approve applications for the disaster relief.***

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11. *Any provision recognized for disaster relief is to include only the direct expenditures associated with that disaster relief, which are those that are both:*

- (a) *necessarily entailed in order to make payments or provide goods and services associated with disaster relief; and***
- (b) *not associated with the ongoing activities of the government.***

7.24 The limitation on the amount which should be recognized in a provision is based on the guidance in IPSAS 19 paragraph 93. This means disaster relief that is provided as part of the ongoing activities of entities forming part of the governmental reporting entity (for example, ongoing activities of the army or fire service forming part of the consolidated reporting entity) would not be included in the provision.

12. *The manner in which disaster relief is provided (for example, services or cash) is not relevant to the existence of a present obligation.*

Discretionary disaster relief

7.25 In the absence of an existing policy on disaster relief, the Steering Committee considers that a government's present obligation to provide disaster relief arises at the earlier of the following points:

- the time that the disaster relief is due to be paid or provided; or
- the time that the government's formal acceptance of a claim for disaster relief gives an individual or entity the right to take legal action against the government to enforce payment or performance.

Disaster Relief – Contingent Liabilities

7.26 A government should disclose a contingent liability for disaster relief:

- if a present obligation for disaster relief exists, but the amount of the obligation cannot be reliably measured; or

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- if the existence of the past event or present obligation is uncertain (for example, there is a dispute as to whether a claim for disaster relief meets the criteria in the disaster relief policy).

Disaster Relief – Disclosure

- 7.27 A government recognizing a provision for disaster relief should comply with the requirements of IPSAS 19 paragraphs 97 and 98 if the disclosures are material. Disclosure issues are discussed more fully in Chapter 9.

Foreign Aid**Foreign Aid – Introduction**

- 7.28 Governments provide both military and development aid to other jurisdictions. The aid may take the form of cash, loans or goods and services in kind. Foreign aid may be provided for social policy reasons or in order to meet other objectives of a government such as development of trade relationships. Therefore, the guidance in IPSAS 19 is applicable to some types of foreign aid (only social policy obligations are excluded from the scope of IPSAS 19). However, the guidance in this ITC may be useful for foreign aid and other forms of aid regardless of a government's objectives in making such aid.
- 7.29 The provision of foreign aid is similar in a number of respects to the provision of disaster relief. Such aid may be determined on a case by case basis, in accordance with an established policy or as a result of a government's obligations under international agreements. The factors that were considered in relation to disaster relief including existence of legislation, existence of policy and the existence of funds with appropriate budgetary authority, are also relevant for foreign aid. The main difference between the two is that foreign aid, like disaster relief, may be provided in relation to a specific event, such as a natural disaster in the other jurisdiction, or it may consist of general ongoing support which is unrelated to specific events (for example, aid which aims to develop infrastructure or develop skills within a jurisdiction).
- 7.30 Where foreign aid is provided in relation to specific events such as natural disasters, the principles established in respect of

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disaster relief are relevant. Where foreign aid takes the form of ongoing support for a jurisdiction, the principles established in relation to services and cash transfers provided to individuals (Chapters 5 and 6) are relevant.

Foreign Aid – Past Event Giving Rise to a Present Obligation

- 7.31 The existence of a present obligation for (legislated) ongoing aid is influenced by the nature of the aid and the eligibility validation process. Some jurisdictions have legislated policies for the provision of foreign aid (either in their own legislation or in international agreements). Where the legislated policy sets out the nature and type of aid to be provided in relation to specific events such as natural disasters, the occurrence of a disaster satisfying the criteria in the policy would give rise to a present obligation (legal) to provide aid to the jurisdiction concerned.
- 7.32 Where long-term benefits are to be provided as a consequence satisfying eligibility criteria and the criteria need to be satisfied only once, a legal obligation for both current and future benefits would exist from the point that the eligibility criteria are satisfied. Where eligibility criteria must be satisfied on a regular basis, there would be a series of obligating events as the eligibility criteria were satisfied at each assessment.
- 7.33 A government may therefore have a legal obligation for foreign aid:
- where foreign aid is provided for in legislation or in an international agreement which is enforceable by an international body; or
 - where formal notification by the government to a recipient of its intention to provide aid is made under the terms of an arrangement or agreement which gives the recipient a right to take legal action against the government to enforce payment or delivery of the aid. Such situations are likely to be rare.

Preliminary View – Legal obligation for foreign aid

- 13. *A government has a present obligation (legal) for foreign aid when individuals or entities have the right to take legal action against the government to obtain payment of cash transfers or***

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delivery of goods and services. In the case of foreign aid related to specific events, the present obligation will exist at the time that the relevant event has occurred and entities/jurisdictions satisfying the criteria to receive foreign aid exist. In the case of ongoing foreign aid benefits, a present obligation will arise each time individuals or entities satisfy the eligibility criteria.

Constructive obligation for foreign aid

7.34 It could also be argued that a government has a constructive obligation for foreign aid if:

- the government has a detailed policy on foreign aid (but that policy is not contained in legislation or an enforceable international agreement);
- the specific events that give rise to aid occur; and
- jurisdictions exist that meet the criteria in the policy.

7.35 The Steering Committee considers that its preliminary views on when to recognize a constructive obligation for disaster relief (adapted as necessary) could also apply to the recognition of constructive obligations for foreign aid, where that aid is triggered by an event such as a natural disaster. However, where there is no specific external event that gives rise to aid, and the aid is in the nature of ongoing assistance, the Steering Committee considers that a present obligation arises only at the point that the aid is due to be provided. Prior to this point, a government has realistic alternatives to settling the obligation. The Steering Committee applied similar reasoning in determining when a government has a present obligation for ongoing benefits to individuals (Chapters 5 and 6).

Preliminary View – Constructive obligation for foreign aid

14. *A constructive obligation for foreign aid as a result of a disaster or other specific event arises only when:*

- (a) *a government has a detailed formal policy for the foreign aid identifying at least:*
 - (i) *the types of disasters or events and principal locations covered by the policy;*

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- (ii) *a description of the eligibility criteria required for a jurisdiction to qualify for the aid;*
- (iii) *the nature and amount of aid that will be provided to jurisdictions, including any total monetary limit;*
- (iv) *the process for approving requests or making decisions to provide unsolicited aid; and*
- (v) *when and how the aid will be provided;*
- (b) *a disaster or event of the type covered by the policy has occurred;*
- (c) *jurisdictions satisfying the criteria in the policy exist; and*
- (d) *a government has raised a valid expectation in those jurisdictions affected that it will provide the aid. This valid expectation could be initiated by a government announcing the main features of the plan to those affected by the disaster or event, or by formally approving requests for aid.*

7.36 In considering whether a government has raised a valid expectation in a jurisdiction that it will receive aid, the existence of an amount for foreign aid in an approved budget is not sufficient evidence on which to base a valid expectation. The amount of aid ultimately provided to a jurisdiction may be less than that initially announced or budgeted.

15. *Any provision recognized for foreign aid is to include only the direct expenditures associated with that foreign aid, which are those that are both:*

- (a) *necessarily entailed in order to make payments or provide goods and services associated with the foreign aid; and*
- (b) *not associated with the ongoing activities of the government.*

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- 16. *The manner in which foreign aid is provided (for example, services or cash) is not relevant to the existence of a present obligation.*
- 17. *In the case of ongoing foreign aid, a government's present obligation to provide aid arises when the aid is due to be paid or delivered.*
- 7.37 The discussion of measurement and disclosure of obligations to provide disaster relief above is also relevant for foreign aid.

Legal Aid**Legal Aid – Introduction**

- 7.38 Legal aid is the provision by governments of legal representation and advice on behalf of others. The circumstances in which legal aid is made available varies across jurisdictions. It is generally available to low income individuals for a variety of legal problems such as family, civil and criminal matters. Legal aid may be for a limited period or amount or it may be provided on an unrestricted basis until a trial is completed or charges are withdrawn. Legal aid entitlements are often specified in legislation.
- 7.39 Legal aid is usually subject to both financial eligibility tests and “merit” tests. A merit test generally requires that there be a reasonable prospect of success when bringing or defending proceedings.⁴
- 7.40 Governments may provide legal aid services directly using government agencies and employees, they may pay private agencies or lawyers to deliver the services or they may reimburse individuals who have incurred legal costs.
- 7.41 Legal aid is a component of the GFS category of Law Courts. It is classified as being for collective consumption because it contributes to the efficient and equitable function of the legal system.

⁴ An example of a merit test is that the applicant has a case in law, the issues or amount at stake are sufficient to justify going to law and a privately paying client of adequate but abundant means would be likely to proceed in similar circumstances.

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- 7.42 Chapter 4 discussed a government's obligations to provide services for collective consumption and concluded that a government does not have a present obligation for the provision of services for collective consumption until the point at which the services are due to be provided. Legal aid is considered again within this Chapter because it has some similarities to disaster relief. The similarities between legal aid and disaster relief include:
- there has been an event (for example, the execution of a crime and the committal for trial of a person charged with the crime); and
 - the government is committed to provide aid to those meeting eligibility criteria for the duration of the trial or hearing.
- 7.43 The following section examines when a present obligation for legal aid arises and the nature of that obligation. In considering the appropriate point of recognition for legal aid obligations, this Chapter refers to the accounting treatment adopted by a private law firm providing pro bono legal aid.

Legal Aid – Past Event Giving Rise to a Present Obligation

- 7.44 Consistent with the discussion of disaster relief earlier in this chapter, it could be argued that where an individual satisfied the criteria for legal aid (as set out in legislation), the government would have a present obligation (legal) for the estimated cash transfers or services to which the individual would be entitled until his/her case was completed. However, if the legislation specified that entitlement is subject to approval by the government or a government nominated entity then the legal entitlement would arise at the point that the claim was approved.
- 7.45 A government's approval of legal aid claims under an established policy (not incorporated in legislation) would also give rise to a present obligation (legal) if such acceptance gave an individual the right to take legal action against the government to enforce the delivery of legal aid.
- 7.46 The nature and amount of the obligation will be influenced by the nature of the entitlement. Entitlements may vary depending on the type of case and the jurisdiction. For example, on initial qualification for aid, an individual could be entitled to:

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- unrestricted access to all legal services and all costs of gathering information required to defend the charge;
- 40 hours of free legal advice and a limited monetary amount for obtaining documents and other evidence. Approval of any further assistance is subject to further approval; or
- a subsidy of 40% of the total cost of all services used in defending the charge.

7.47 The obligation would be measured as the best estimate of the future cash flows required to settle the obligation. Measurement would take account of the number of hours of legal services estimated to be provided to the individual and the average cost of such legal services. Measurement could also be influenced by the way in which legal aid is provided. The liability recognized would be the direct expenditures arising from the obligation to provide legal aid and would exclude any expenditures that are associated with the ongoing activities of the entity (based on IPSAS 19, paragraph 93).

Preliminary View – Legal obligation for legal aid

18. *Where individuals or entities have the right to take legal action against the government to obtain payment of cash transfers or delivery of goods and services for legal aid (as set out in legislation), a present obligation (legal) exists at the point that:*

- *events meeting the criteria in the legislation have occurred; and*
- *individuals satisfying the criteria to receive legal aid exist.*

Constructive obligation for legal aid

7.48 It could also be argued that a constructive obligation may arise prior to the approval of a claim. For example, a constructive obligation may arise if the criteria for legal aid is specified in legislation or in an established policy and an individual meets the criteria (or the case is similar to other cases that have been granted legal aid). Criteria similar to those set out in IPSAS 19 paragraph 83 could be used to determine whether there is sufficient evidence of a constructive obligation. The Steering

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Committee's application of these criteria to legal aid are set out below.

Preliminary View – Constructive obligation for legal aid

- 19. *A constructive obligation for legal aid arises only when:***
- (a) *a government has a detailed formal policy on legal aid identifying at least:***
 - (i) *the types of cases covered by the policy;***
 - (ii) *the eligibility criteria required for an individual to qualify for the aid;***
 - (iii) *the nature and amount of aid that will be provided to individuals, including any monetary limit on components of that aid;***
 - (iv) *the process for approving requests for aid; and***
 - (v) *when and how the aid will be provided;***
 - (b) *an event of the type covered by the policy has occurred (for example, a individual has been charged with a criminal offence, a hearing will be held to determine the custody of children);***
 - (c) *individuals satisfying the criteria in the policy exist; and***
 - (d) *a government has raised a valid expectation in those individuals that it will provide the aid. This valid expectation would arise when a government formally approves requests for aid.***
- 7.49 These recognition criteria for legal aid are intended to ensure that a government has sufficient information to make a reliable estimate of its legal aid obligation.**
- 20. *Any provision recognized for legal aid is to include only the direct expenditures associated with that legal aid, which are those that are both:***

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- (a) *necessarily entailed in order to make payments or provide goods and services associated with the legal aid; and*
- (b) *not associated with the ongoing activities of the government.*

- 7.50 The conclusions reached above would not apply where an individual was required to satisfy ongoing eligibility criteria in order to receive legal aid. For example, if income tests for legal aid were applied on a regular basis and an individual began to earn more than the level of permitted income, entitlement would cease. If legal aid is subject to ongoing entitlement criteria this would limit the recognition of a liability to the amount expected to be paid from one assessment point until the next. This is consistent with the Steering Committee's conclusions on cash transfers to individuals in Chapter 6
- 7.51 The Steering Committee's views on legal aid differ from its conclusions in relation to other services provided for collective consumption. In Chapter 5 the Steering Committee concluded that a government has a present obligation for services provided for collective consumption only at the point that the services are due to be provided. The reason for this difference is that the occurrence of a past event (such as charging an individual with a crime) has committed the government to providing legal aid to an individual in the future. The government has no realistic alternative but to settle obligations for legal aid claims which have been approved. In the case of other collective services the government does have realistic alternatives, up until the point that the services are due to be delivered. Legal aid also differs from other collective services because in many jurisdictions individuals would be able to take some form of legal action to obtain the legal aid to which they were entitled.
- 7.52 A contrasting argument is that the obligating event is the provision of legal aid services. Application of this approach would be consistent with the way in which private professionals recognize obligations for pro bono services. Private professionals generally recognize the cost of providing pro bono services as those services are delivered. The Steering Committee considers that this difference in treatment is justified if:

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- an individual is unable to take legal action against a law firm that had offered to provide pro bono services; and
- the law firm will not incur any direct expenditures arising from providing the legal aid (as per IPSAS 19 paragraph 93).

7.53 A government recognizing a provision for legal aid should comply with the requirements of IPSAS 19 paragraphs 97 and 98 if the disclosures are material. Disclosure issues are discussed more fully in Chapter 9.

Chapter 8 Old Age Pension Benefits

Introduction

- 8.1 This Chapter addresses the recognition of liabilities arising from social security (also referred to as social security pensions) and other universal old age pension benefits provided by governments to citizens when they reach pensionable age. It provides preliminary views on the recognition of these pension obligations as liabilities, and the measurement, presentation and disclosure¹ of such liabilities.
- 8.2 This Chapter does not address the recognition of liabilities arising from:
- pension schemes for government employees which are funded by contributions from the government entities in their capacity as employers and by contributions from employees. These schemes provide benefits to employees as part of the compensation provided in exchange for their services they provide as employees, and are therefore the result of an exchange transaction; or
 - guarantees provided by governments in respect of pension rights of government employees or members of private pension schemes (both voluntary and mandatory). The guarantees may cover the insolvency of the schemes, minimum benefits or indexation of benefits to price or wage movements. These guarantees may give rise to provisions or contingent liabilities. However, the guarantees themselves are not pensions.
- 8.3 The universal old age pension benefits considered in this Chapter:
- are those funded by general tax revenue or earmarked taxes. They are not directly linked to the amount of tax paid by the ultimate beneficiaries or to contributions made by individuals;

2.1 _____

¹ Chapter 9 contains a discussion of the disclosure of projected cash flows associated with current government policies, including disclosures which may assist readers in making assessments of the sustainability of current government policies.

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- may be provided to all citizens or only to those citizens who have participated in the work force or paid taxes for a specified period;
 - generally take the form of a cash payment to be paid regularly until death;
 - may be subject to means tests (assets or income); and
 - may be subject to other eligibility criteria such as being made available to only those persons who are citizens and who have contributed taxes for a specified number of years.
- 8.4 These schemes are sometimes referred to as “social insurance” schemes. Such schemes are currently the dominant form of public pension².
- 8.5 The nature and amounts of benefits provided under pension schemes and any eligibility or other conditions that must be complied with to access the benefits are generally set out in legislation (sometimes referred to as social security law). The eligibility criteria for old age pension benefits generally include a pensionable age and may also include asset or income tests.

Present Obligation – Alternate Options

- 8.6 Chapter 4 discussed three different options or views of the circumstances that give rise to an obligating event in relation to constructive (social policy) obligations. The obligating event is the past event, or group of past events, which collectively or cumulatively give rise to a constructive obligation. Critical aspects of relevant definitions are discussed in Chapter 4. This Chapter considers the circumstances under which a legal obligation for old age pension benefits would arise and tests the application of the three options identified in Chapter 4 to the existence of constructive obligations.

2.1

² Countries such as France, Germany and Italy offer comprehensive public pension programs designed to provide retired citizens with a retirement income based on the income they earned during their working life. These pensions fall within the scope of this Chapter. Countries such as Australia, Canada, the United Kingdom and the United States rely more heavily on private pensions but also have some state pensions that would fall within the scope of this Chapter.

DRAFT ITC ONLY – FOR PSC REVIEW (July 2003)**Legal obligation**

- 8.7 Where the rights of individuals to benefits, and the related eligibility criteria, are specified in legislation, the government would have a legal obligation to individuals meeting the eligibility criteria. The present obligation (legal) would be for the amount that the individual is entitled to as at that point in time (amounts due and payable). Governments frequently recognize accrued benefits (amounts accrued since the last payment date) although such accruals are not technically legal obligations. A government does not have a legal obligation for old age pension benefits that will accrue as a result of the satisfaction of eligibility criteria in the future.
- 8.8 Legal obligations for old age pension benefits satisfy the recognition criteria for provisions in IPSAS 19 – that is, they are probable and can be reliably measured. In measuring the liability some estimation may be required. For example:
- where benefits are paid from date of receipt of application, some estimation may be required of the number of applications received but not yet processed; and
 - where benefits are paid from the date of age of entitlement, some estimation will be required of the number of individuals who have reached age of entitlement and who intend to claim their pension benefit but have not yet done so.
- 8.9 Amounts due and payable should be disclosed in accordance with the requirements in IPSAS 1. Because such amounts are normally certain as to amount and timing they would not be provisions.
- 8.10 Current practice in accounting for liabilities associated with old age pension benefits is to recognize the legal obligation and the accrual since the last payment date as outlined in this section. This method has widespread acceptance. However, some would argue that this legal obligation does not accurately reflect the true extent of a government's present obligation to provide old age pension benefits. Options 2 and 3 discussed in Chapter 4 explore the possibility of an obligating event (or series of events) leading to a constructive obligation to provide pension benefits occurring prior to the existence of a legal obligation to provide those benefits.

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- 8.11 Some would argue that satisfaction of initial/threshold eligibility criteria for old age pension benefits can give rise to a contingent liability for all future old age pension benefits likely to be paid to those individuals and that this contingent liability should be disclosed. Others argue that this obligation to make future payments does not satisfy the definition of contingent liability because there has been no obligating event.
- 8.12 The Steering Committee's preliminary views in relation to constructive obligations, as discussed in Chapter 4, are repeated in Figures 8.1 to 8.3 below.

Constructive Obligations – Option 1**Figure 8.1 Constructive Obligations – Option 1**

In the absence of a legal obligation, a government will have a present obligation (constructive) when individuals satisfy all eligibility criteria for benefits and cash transfers are due and payable or goods or services are due to be delivered. In the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, the present obligation (constructive) will be limited to the individual's current entitlement. The government has no realistic alternative but to settle such obligations.

- 8.13 Rights to old age pension benefits are generally specified in legislation. However, the absence of legislation would not preclude the existence of a constructive obligation for the payment of old age pension benefits. Application of Option 1 to old age pension benefits would lead to the conclusion that individuals have a valid expectation of receiving old age pension benefits when they satisfy all eligibility criteria because, at that time, a government has no realistic alternative but to provide those benefits. To do otherwise would risk undermining confidence in, and support for, the government and could threaten the ability of the government to continue to operate under normal conditions – as going concerns governments are unlikely to risk such consequences.
- 8.14 Under Option 1 the present obligation is limited to the pension benefits receivable from the point that eligibility criteria are satisfied until the next payment date (or date at which eligibility must be satisfaction again, if different). Individuals can cease to meet eligibility criteria at any point in time (due to death or

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failing to meet income or asset tests) so there is no constructive obligation for future pension benefits. Governments applying Option 1 would recognize and measure a liability for old age pension benefits (both amounts due and payable and accruals) as the amount currently due and payable or accrued in respect of persons who have satisfied eligibility criteria. They would not include amounts that will accrue in the future.

- 8.15 As with legal obligations, some would argue that satisfaction of initial/threshold eligibility criteria for old age pension benefits can give rise to a contingent liability for future old age pension benefits. Others would argue that this obligation to make future payments does not satisfy the definition of contingent liability because there has been no obligating event.

Constructive Obligations – Option 2**Figure 8.2 Constructive Obligations – Option 2**

In the absence of a legal obligation, a government will have a present obligation (constructive) when individuals satisfy all eligibility criteria for benefits (including the right to payment or to services) and the government has no realistic alternative but to settle the obligation. The present obligation is for:

- current entitlements (cash transfers due and payable or goods and services due to be delivered); and
- in the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, estimated future entitlements, assuming that individuals continue to meet all eligibility criteria in future periods.

- 8.16 Option 2 reflects the view that the obligating event for the constructive obligation occurs when individuals meet initial or threshold eligibility criteria. The constructive obligation in relation to future old age pension benefits under Option 2 arises prior to any legal obligation or constructive obligation under Option 1.
- 8.17 Those that hold this view note that, in the absence of advice to the contrary, persons who satisfy the eligibility criteria have a valid expectation that pension benefits will be made available during the period of their retirement, and will have arranged

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personal, family and business affairs on that basis. They argue that in these circumstances, and given individuals' dependence on the receipt of old age pensions to fund their retirement, a government has no realistic alternative but to provide, and continue to provide, pension benefits to all who satisfy the initial/threshold criteria. To do otherwise would undermine the ability of the government to continue to operate as a going concern. Those that hold this view also argue that, if a government is to prepare financial statements that are transparent and reflect the full amount of the present obligation to provide old age pension benefits to eligible individuals under current policy, this liability should be recognized in the general purpose financial statements.

- 8.18 Under Option 2 the likelihood that an individual will continue to meet eligibility criteria for old age pension benefits in future periods is reflected in the measurement of the amount of the present obligation that arises when the initial or threshold eligibility criteria are satisfied.
- 8.19 Application of Option 2 to old age pension benefits would lead to the following conclusions:
- a present obligation for future pension benefits to those who meet eligibility criteria exists at the age of entitlement, despite the fact that it is not known with certainty which individuals will continue to satisfy all eligibility criteria in each subsequent period. The likelihood of an individual continuing to satisfy eligibility criteria in future periods can be addressed as a measurement issue;
 - the amount of the present obligation is determined by reference to the amount that is expected to be paid in future periods to individuals who satisfy the threshold eligibility criteria old age pension benefits. The amount includes all expected cash flows to be provided to such individuals from the time of initial entitlement until they die or fail to meet ongoing asset or income requirements;
 - it is probable that an outflow of resources will be necessary to settle the present obligation (constructive) for future old age pension benefits. The amount of the outflow is able to be reliably measured and would be recognized as a provision; and

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- present obligations (legal) or present obligation (constructive) for amounts due and payable and arrears would be recognized as liabilities.
- 8.20 If there is uncertainty as to whether an individual is entitled to old age pension benefits (for example, because of a dispute as to residency or income) there may be a contingent liability for future old age pension benefits.
- 8.21 The amount of the present obligation to provide old age pension benefits in future periods would be measured as the present value of the best estimate of future cash flows. The estimated cash flows are based on current eligibility criteria and benefit amounts, with future cash flows being adjusted for any changes that have already been approved. For example, estimates of future cash flows would take account of any known changes to age of entitlement in specific future years.
- 8.22 Estimates of the length of time that individuals are expected to continue receiving benefits (for example, based on mortality rates and the probability of an individual satisfying residency or asset tests) and their expected entitlement over that period would be based on actuarial valuations. There may also need to be estimation of the liability to individuals who have reached the age of entitlement but have not yet claimed pension benefits.
- 8.23 In theory the best estimate of future cash flows would be made by identifying all possible outcomes for each assumption that affects cash flows and multiplying each outcome by its probability. In practice, actuaries may derive the best estimate of cash flows based on a single set of assumptions. The key point from the perspective this ITC is that estimates of future old age pension benefit obligations are possible and are already prepared by some jurisdictions.

Constructive Obligations – Option 3**Figure 8.3 Constructive Obligations – Option 3**

In the absence of a legal obligation, a government will have a present obligation (constructive) when key participatory events have occurred that lead an individual to have a reasonable expectation of satisfying eligibility criteria and the government has no realistic alternative but to settle the obligation. This may

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be prior to the point at which individuals satisfy all eligibility criteria and therefore be prior to the point at which cash transfers are due and payable or goods or services are due to be delivered. The present obligation is for:

- any current entitlements to individuals that have already met the eligibility criteria (cash transfers due and payable or goods and services due to be delivered); and
- in the case of ongoing benefits which are subject to regular satisfaction of eligibility criteria, estimated future entitlements, assuming that individuals meet all eligibility criteria in future periods.

8.24 Option 3 reflects the view that the obligating event which gives rise to a constructive obligation occurs when key participatory events have occurred and, based on those events, the individual has a reasonable expectation of satisfying eligibility criteria. The participatory events that cumulatively or in aggregate give rise to a present obligation are not specified under Option 3. They will involve the application of judgment and be determined in the context of the particular benefits to be provided. However, the obligating event may occur prior to the point at which individuals meet initial eligibility criteria. Under Option 3 governments may have a constructive obligation in relation to future old age pension benefits prior to the point that a legal obligation arises and earlier than is contemplated by Options 1 and 2 above.

8.25 Those that hold this view would stress the consequences of a government not honoring its present constructive obligations for pension obligation, the need for transparent financial reporting, and the government's responsibility to be accountable for its obligations to provide old age pension benefits in future periods. They consider that the past event(s) that gives rise to the present obligation to provide pension benefits (that the government cannot realistically avoid settling), occurs before the threshold eligibility criteria are satisfied. They argue that:

- in the absence of advice to the contrary, individuals will make spending and investing decisions based on current policies and past practices of governments and will rely on the expectation of satisfying eligibility criteria and receiving old age pension benefits in the future; and

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- individuals are likely to have arranged personal, family and business affairs on the expectation that such benefits will be available well and they are likely to have made these arrangements well in advance of reaching age of entitlement;
 - the cumulative effect of these arrangements and the dependence of individuals on those benefits is such that, in effect a government has no realistic alternative but to provide pension benefits to all who approach retirement age. As such, the satisfaction of the initial/threshold criteria is not the single obligating event.
- 8.26 Under Option 3 the likelihood of an individual or group meeting the threshold eligibility criteria for old age pension benefits in the future and subsequently continuing to meet those criteria during the period of retirement is reflected in the measurement of the amount of the present obligation at each reporting date.
- 8.27 Application of Option 3 to old age pension benefits would lead to the following conclusions:
- individuals can validly rely on the expectation of receiving future old age pension benefits prior to the point at which they meet initial eligibility criteria. Because eligibility criteria tend to be stable, particularly for those nearing retirement age, a government can have a constructive obligation to individuals who have not yet qualified for old age pension benefits but who have a reasonable expectation of meeting eligibility criteria. Governments have implicitly and explicitly acknowledged individual's reliance on the expectation of receiving old age pension benefits;
 - a present obligation for future pension benefits exists prior to the age of entitlement, despite the fact that it is not known with certainty which individuals will eventually satisfy both the initial/threshold eligibility criteria and ongoing eligibility criteria. The likelihood of an individual meeting eligibility criteria in future periods is a measurement issue;
 - it is probable that an outflow of resources will be necessary to settle the present obligation (constructive) for old age pension benefits to be provided in the future. The amount of the outflow is able to be reliably measured and would be recognized as a provision; and

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- present obligations (legal) or present obligation (constructive) for amounts due and payable and arrears would be recognized as liabilities.
- 8.28 Those that support this view note that it is difficult to determine exactly what the obligating event is, or events are, and when such obligating event(s) occur. The obligating event (and therefore recognition of the constructive obligation) could be a number of events such as entering the workforce and becoming economically independent, beginning to pay taxes, paying taxes for a number of years or the reliance on expectation of receiving future old age pension benefits in making economic decisions.
- 8.29 There is no general agreement on when obligating event(s) occur from those that support this option. In seeking to identify points at which an individual could validly rely on the expectation of future old age pension benefits, two events at either end of the possible range (workforce entry and reaching pensionable age) are used to illustrate how the obligation would be measured.
- 8.30 **Workforce entry:** Those that support this view argue that it is the point at which a member of the community makes economic decisions based on the expectation of receiving a pension. It creates a present obligation of the government which accumulates until retirement age is achieved.
- 8.31 If workforce entry (to be determined in each jurisdiction, for example, at age 20) is selected as the appropriate point of recognition of the constructive obligation, the obligation is measured as the best estimate of future cash flows (from pensionable age onwards) discounted back to the reporting date. An alternative approach which would yield the same measurement would be to identify the amount that an individual would be required to invest each reporting period in order to achieve a lump sum at retirement age (equal to the present value of post retirement cash flows) and to calculate the present value of these cash flows;
- 8.32 **Pensionable age:** Those that support this view argue that reaching pensionable age and satisfying eligibility criteria does not of itself create a present obligation that the government has no realistic alternative but to settle. They are of the view that the present obligation has occurred prior to that point and note that the consequences for a government of failing to honor

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obligations to those who are of pensionable age or are one day, one month or one year short of that age are likely to be similar. They also acknowledge arguments that the present obligation could arise much earlier. However, they believe that identification of reaching pensionable age and satisfying threshold age eligibility criteria as the obligating event will provide reliable and comparable information across jurisdictions. They do not consider that workforce entry or other alternative obligating events will necessarily provide reliable and comparable information across a range of jurisdictions.

- 8.33 If pensionable age is selected as the appropriate point for recognition of the constructive obligation, measurement is as per Option 2.
- 8.34 The reliability of measurement of such provisions depends on the reliability of the assumptions and the sensitivity of the result to changes in assumptions.
- 8.35 In addition to any contingent liability that exists due to disputes as to entitlement there is a theoretical contingent liability for any constructive obligations that exist, but which have not been recognized because it is not known whether or not the obligating event has occurred. For example, some would argue that a government has a contingent liability to pay pension benefits in the future and that this contingent liability arises at some point before individuals satisfy all eligibility criteria including the age of entitlement. However, in the case of pension benefits because it is not clear at what point the obligating event actually occurs no contingent liability would be disclosed.
- 8.36 The following discussion looks more closely at the argument that a government has no realistic alternative, prior to individuals reaching pensionable age, to pay old age pensions to individuals who have validly relied on the expectation of receiving pension benefits. The three main arguments considered are:
 - Reliance: individuals rely on the expectation of future benefits over a considerable time span;

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- Past Practice: past practice indicates that most governments do not alter pension benefits for people close to retirement age; and
- Compensation: there is evidence that governments will not withdraw pension benefits without offering some form of compensation to individuals.

Reliance

- 8.37 An individual's expectation of receiving old age pension benefits is based on a perception that they are "entitled" to the benefits. Many individuals consider that because they have paid taxes for a period of years, the government "owes" them a pension. This argument could be used to support payment of taxes as the obligating event giving rise to the constructive obligation. This expectation is reinforced in some jurisdictions by the requirement that to be eligible for an old age pension an individual must have been in the workforce for a certain period of time. In many jurisdictions old age pension benefits represent a significant part of an individual's post retirement income. Individuals' decisions on consumption and saving during their working life are influenced by their reliance on future expected pension benefits. Individuals' reliance on pension benefits becomes greater as they get closer to age of entitlement.

Past Practice

- 8.38 In theory governments have the ability to change the amount of pension benefits or the eligibility criteria for pensions. However, in practice governments find it extremely difficult to reduce or remove old age pension benefits. A government's ability to remove or reduce pension benefits (and therefore avoid an obligation) may vary between age groups. For example, a government may be able to reduce future old age pension benefits for people currently aged between 20 and 40 years of age but it may have considerable difficulty reducing future old age pension benefits for people aged over 40 years. This argument could be used to support the making of economic decisions, such as how much to save for retirement, as the obligating event.
- 8.39 Governments generally choose not to change benefit entitlements for those who have already reached retirement age

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and gradually phase in changes for other citizens. The circumstances in which citizens will accept pension reform that reduces benefits are limited. For example, citizens may accept pension reform when it is imperative that government spending be reduced and the alternative would be to reduce essential government services. In some countries industrial action by citizens has delayed or prevented the introduction of pension reform. In others, the courts have intervened to restrict pension changes.

Compensation

- 8.40 Supporters of Option 3 argue that if a government decided to withdraw old age pension benefits under an unfunded public scheme in order to create a new funded scheme it would have to compensate those who voluntarily switched to the new scheme. This occurred in Chile in May 1981.

Figure 8.4 Pension Reform in Chile

In May 1981 Chile replaced its government-run pay-as-you-go retirement system with a system of private pension accounts. Workers who were already in the labor force before January 1983 had the option of staying in the old, government-run system or moving to the new system. Workers who moved to the new scheme received recognition bonds from the government that acknowledged the contributions they had already made, via taxes, to the old system. The provision of recognition bonds showed that the government accepted that it had an obligation to citizens for accrued pension benefits. This obligation existed prior to those citizens reaching retirement age.

The value of the recognition bonds was computed by multiplying a percentage of the worker's average salary (indexed for inflation) in the 12 months before mid-1979 by the number of years the worker had contributed to the system (up to a maximum of 35 years) and multiplying that result by an annuity factor. Different annuity factors were used for men and women.³

³ Rodríguez, L. Jacobo, July 30 1999, Social Security Privatization No. 17, *Chile's Private Pension System at 18: Its Current State and Future Challenges*

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- 8.41 Although this example supports the existence of an obligating event prior to age of entitlement, it does not assist in determining when the obligating event occurred. Participation in the workforce, the payment of contributions and the payment of taxes are all possible obligating events leading to the creation of this constructive obligation.
- 8.42 However, others would disagree that the experience in Chile reflects what would happen or has happened in other jurisdictions. In certain other jurisdictions individuals approaching retirement age have had their access to old age pension benefits restricted without compensation (for example, by the introduction of a means test when pension benefits were previously available regardless of an individual's income or assets).

Comparison of Options with GFS

- 8.43 No liability is recognized in the GFS system for retirement pensions and other benefits in the future to be provided social security schemes, regardless of the level of assets in a social security fund or other segregated accounts. All payments of benefits are treated as transfers (expense). Under GFS the present value of social security benefits that have been earned (according to the existing laws and regulations) but are payable in the future are calculated in a manner similar to the liabilities of an employer retirement scheme and are shown as a memorandum item (these items are presented as supplementary information – they are not recognized as liabilities). Liabilities for the payment of benefits that were due to be paid but have not yet been paid are classified as other accounts payable (GFS 2001, paragraphs 7.126 and 7.145)⁴.
- 8.44 The recognition of pension liabilities under GFS is therefore similar to Option 1.

Obligating Event

- 8.45 The Steering Committee does not have an unanimous view on the circumstances in which a present obligation for aged pension benefits arises and therefore the amount that should be recognized as a liability in the financial statements.

⁴ At the time of writing (March 2003) the GFS treatment of government pensions is under review.

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- 8.46 Some Steering Committee members note that their views on the circumstances which give rise to a present obligation which should be recognized in the financial statements for aged pensions differ from their views on other individual benefits. They consider that this difference is justified because of the significance of old aged pensions to the economic well being of individual members of the community. In their view, the circumstances giving rise to a present obligation that a government has no realistic alternative but to settle in respect of old age pensions differ from the circumstances associated with other benefits such as child benefits, university education and health care. They argue that, up until the point that eligibility criteria are satisfied and benefits are due to be provided, a government does have a realistic alternative to settling these other obligations. However, in the case of old age pensions, a government has no realistic alternative but to settle the obligation as the individual approaches pensionable age, or indeed, well before that time.
- 8.47 The Steering Committee acknowledges that in applying the definitions of a constructive obligation and an obligating event to individual services it has rejected arguments that it considers may be persuasive in supporting the recognition of a provision for old age pension benefits. Factors that have influenced the Steering Committee in accepting that there may be an obligation for future old age pensions include:
- the observed use of transitional provisions to delay the implementation of old age pension benefit changes so that individuals nearing or over pensionable age are protected from the changes. Governments may, but do not generally use transitional provisions when introducing changes to health and education benefits; and
 - the extent of an individual's reliance on the pension benefits and the length of time over which this reliance occurs. Individuals may also rely on health and education benefits but the monetary value of these benefits to the individual is generally much less than old age pension benefits.

Preliminary Views – Old age pensions

21. *The views of the Steering Committee regarding the identification of present obligations for old age pension benefits to be provided in future periods are outlined below:*

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- *Option 3 is the approach preferred by the majority of Steering Committee members. Of the two alternative recognition points, workforce age is the preferred recognition point, although there is also support for retirement age as the recognition point;*
- *Option 1 is supported by a minority of Steering Committee members; and*
- *Option 2 is not supported by Steering Committee members.*

Contributions by Beneficiaries

- 8.48 In some cases individuals contribute directly to the financing of their social security pensions, albeit that they are not exchange transactions. In most cases these contributions by beneficiaries are treated as general revenues of the government concerned. However, in some cases contributions may be separately identified and linked to particular benefits. Where the pension comprises both an exchange and a non-exchange component it would be necessary to account for them separately. This ITC deals only with the non-exchange aspect of such transactions.

Disclosure

- 8.49 Application of the relevant disclosure requirements in IPSASs to obligations for old age pension benefits is discussed in Chapter 9.

Chapter 9 Disclosure

Introduction

9.1 This Chapter:

- considers the application of the disclosure requirements in IPSASs to social policy obligations;
- considers the appropriate scope, nature and method of presentation of supplemental disclosures;
- briefly describes the purpose and contents of generational accounts; and
- notes the potential application of the disclosures in this ITC to the cash basis of accounting.

IPSAS 1

9.2 IPSAS 1 contains broad requirements concerning the classification and disclosure of liabilities in the financial statements.

9.3 For example, application of the disclosure requirements in IPSAS 1 to pension obligations would lead to the following disclosures:

- the accounting policy used to determine the amount of the expense and the associated liability (whether for an amount due and payable or a provision) including a description of accrued rights and the point at which these accrued rights are first recognized for an individual;
- the amount due and payable, either as a line item on the statement of financial position or in the notes to the financial statements;
- the amount of any provision where appropriate either as a line item on the statement of financial position or in the notes to the financial statements; and
- the pension expense for the period, either as a line item on the face of the statement of financial performance or in the notes to the financial statements.

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IPSAS 19

- 9.4 IPSAS 19 requires certain disclosures in relation to provisions – IPSAS 19 paragraphs 97 and 99 are shown in Figure 9.1.

Figure 9.1 IPSAS 19 paragraphs 97 and 98

97.	For each class of provision, an entity should disclose:
(a)	the carrying amount at the beginning and end of the period;
(b)	additional provisions made in the period, including increases to existing provisions;
(c)	amounts used (that is, incurred and charged against the provision) during the period;
(d)	unused amounts reversed during the period; and
(e)	the increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.
	Comparative information is not required.
98.	An entity should disclose the following for each class of provision:
(a)	a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits or service potential;
(b)	an indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity should disclose the major assumptions made concerning future events, as addressed in paragraph 58; and
(c)	the amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

IPSAS 19 paragraphs 97 and 98

- 9.5 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

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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.

- 9.6 The Steering Committee considers that the IPSAS 19 disclosure requirements are relevant to any provisions recognized in respect of social policy obligations. However, it also considers that additional information on the reasons for changes in the amount of a provision (such as the extent to which the change is due to changes in benefits or estimates of number of eligible individuals) would be useful to readers. Understanding the reason for changes may assist readers in forming a judgment on the sustainability of such benefits in future periods.
- 9.7 IPSAS 19 also requires certain disclosures in relation to contingent liabilities.

Figure 9.2 IPSAS 19 Paragraph 100

100.	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, measured under paragraphs 44 to 62;
(b)	an indication of the uncertainties relating to the amount or timing of any outflow;
(c)	the possibility of any reimbursement.
IPSAS 19 paragraph 100	

Preliminary Views – Disclosure

22. *Where a liability for amounts due and payable or arrears is recognized in respect of a social policy obligation, the disclosure requirements of IPSAS 1 are applicable.*
23. *Where a provision is recognized in respect of a social policy obligation, the requirements in IPSAS 19 regarding the disclosure of provisions should apply.*

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24. *Entities should disclose the extent to which changes to provisions for benefits to individuals or entities are due to:*
- *changes in the numbers of eligible individuals or entities; and*
 - *changes in actuarial assumptions.*
25. *Where a contingent liability exists, the requirements in IPSAS 19 regarding the disclosure of contingent liabilities should apply.*

Other IPSASs

- 9.8 Other IPSASs also contain disclosure requirements that may be applicable to social policy obligations. For example:
- IPSAS 2 (paragraph 63(c)) recommends the separate disclosure of restrictions on cash balances; and
 - IPSAS 17 Property, Plant and Equipment (paragraph 74) also requires that the financial statements disclose the existence and amounts of restrictions on title for property, plant and equipment pledged as securities for liabilities.
- 9.9 These requirements mean that where a government has specifically identified certain assets as having been set aside to fund certain social policy obligations, the existence of the assets and the extent to which they are available to fund certain provisions should be disclosed. Such disclosure could include a narrative description of any restrictions on the use of such funds or assets.

Supplemental Disclosures

- 9.10 IPSASs do not prevent preparers from presenting additional information to that required. IPSAS 1 also notes that additional disclosures may be made as:
- part of the general purpose financial statements; or
 - as supplementary information which is not part of the financial statements.
- 9.11 IPSAS 1 requires that the two types of information be clearly distinguished. Disclosures made in the notes to general purpose

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financial statements form part of those statements, and if the statements are audited, would also be subject to audit. In some jurisdictions, certain supplementary information is also audited.

- 9.12 IPSAS 1 also encourages other disclosures:
- IPSAS 1 paragraph 23 encourages entities to disclose additional information to assist users in assessing the performance of the entity, and its stewardship of assets, as well as making and evaluating decisions about the allocation of resources;
 - IPSAS 1 paragraph 24 encourages entities to disclose information about compliance with legislative, regulatory or other externally-imposed regulations; and
 - IPSAS 1 paragraph 122(c) requires that the notes to the financial statements of an entity should provide additional information which is not presented on the face of the financial statements but that is necessary for a fair presentation.
- 9.13 In many cases projected future spending in relation to significant government programs does not meet the definitions of liabilities, provisions or contingent liabilities and would not be subject to the proposed disclosure requirements. It is therefore appropriate to consider whether users of general purpose financial statements require additional information, other than that required to be disclosed by existing IPSASs. For example, where a social policy obligation does not result in the recognition of a provision, the disclosure of amounts due and payable provides limited information on the future cash flows associated with the obligation.
- 9.14 Key issues in relation to the disclosure of supplementary information are the activities to which the disclosures apply, the nature of the disclosures and where such information should be presented.

Scope of Supplementary Disclosures

- 9.15 The supplementary disclosures discussed in this Chapter could be provided in relation to all activities included within the scope of this ITC. This would lead to the disclosure of a large volume of information both at a whole of government level and at the level of individual reporting entities within a government.

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There is a risk that requiring too much disclosure would reduce the ability of users to access and use the information. It could also place unreasonable burdens on preparers and lead to the unnecessary duplication of information already presented in a government's annual budget documents (or other documents containing forecast cash flows or forecast financial statements).

- 9.16 An alternative approach is to limit the supplemental disclosures to broad categories of disclosure for major government programs at the whole of government level. The discussion in this Chapter is based on this approach.

Nature of Disclosures

- 9.17 The purpose of the supplemental disclosures discussed in this section include:
- where provisions for certain items have been recognized in the financial statements, to assist users of the financial statements in forming an opinion on the reliability of any present value information presented in the financial statements;
 - where no provision for items has been recognized in the financial statements, to provide users with additional information which allows them to make their own assessment of the present value of such future cash flows associated with obligations to certain individuals or groups of individuals;
 - to allow users to form an opinion on the sustainability of a government's current policies. Users of general purpose financial statements are likely to be interested in the extent to which the current level of goods and services provided by a government are sustainable. Disclosure of projected future cash flows and the assumptions on which such cash flows are based is a critical aspect of communicating information on the sustainability of government activities and whether a government will be able to meet obligations as they fall due; and
 - to provide information which allows users to assess the impact of projected spending on the government's financial condition.

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Preliminary Views – Supplemental disclosure

26. *The following disclosures would assist users at a whole of government level:*

DESCRIPTION OF BENEFITS

- *a clear and concise definition of broad classes of benefits;*
- *a description of how a benefit is financed including a description of any funds that have been established or assets that have been dedicated to financing benefits and the nature of any restrictions on the cash balances (refer IPSAS 2 Cash Flow Statements, paragraph 63(c)) or assets;*

FORECAST INFORMATION

- *a description of major assumptions used in preparing forecasts;*
- *forecast long range cash inflows and outflows (real or nominal) for major classes of social benefits for each year for a specified number of years. Cash inflows would be the expected contributions from individuals or earmarked taxes. Cash outflows would be the amounts forecast to be spent on transfers, the provision of goods and services in kind or the provision of goods and services through government agencies and employees. Cash flows may be limited to those who currently qualify for benefits or may be in respect of those who are likely to qualify for benefits in the future;*
- *long range cash flow projections expressed as a percentage of relevant economic indicators such as Gross Domestic Product;*
- *the present value of future benefits to be provided to those currently meeting eligibility criteria (from the present time until they are expected to cease receiving the benefits or for a specified time period);*
- *the present value of future benefits to be provided to those not currently meeting eligibility criteria but expected to meet eligibility criteria at some future point (using cash flows over a specified period of time);*

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- *the present value of any cash inflows expected (possible cash inflows include dedicated taxes, income tax payable on cash transfers and part charges);*
- *sensitivity analysis showing the effect of changes in the most significant assumptions (for example, birth and death rates); and*
- *where social benefits are provided by way of specific social security schemes, long-range projections of the ratio of contributors to beneficiaries.*

- 9.18 At a minimum, separate disclosures would be made for each GFS functional classification under which social benefits are provided. Where jurisdictions have specific social security schemes, separate disclosure of projected cash flows for each major scheme would be appropriate.

Presentation and Status of Supplemental Disclosures

- 9.19 This section considers alternative locations for the presentation of supplemental disclosures, the status of those disclosures and whether they should be mandatory.
- 9.20 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. Supplemental disclosures which are not presented as part of the financial statements would generally be presented as a separate component of the relevant report containing the financial statements. These are the two options considered in this Chapter. Forecast cash flow information can also be disclosed in:
- other reports published at the same time as general purpose financial statements;
 - budget documents; and
 - separate reports, including generational accounts.
- 9.21 Those who support the inclusion of forecast cash flow information in general purpose financial statements or accompanying reports would argue that it is artificial to draw a distinction between ex post and ex ante reporting in the public sector. They argue that forecast cash flow information may usefully be displayed in the financial statements because users

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of financial statements are likely to be interested in both ex ante and ex post information.

- 9.22 Others argue that it is not appropriate to disclose forecast cash flow information in general purpose financial statements because a government has some discretion to change or avoid these future cash flows. They consider that it is more appropriate to present such information in budget documents alongside a government's descriptions of its future intentions across a broad range of policy areas or in separate reports such as generational accounts. There are no IPSASs specifying the appropriate form and content of budget reports. However, where the financial statements and the budget are on the same basis of accounting, IPSAS 1 paragraph 22 encourages the inclusion in the financial statements of a comparison with the budgeted amounts for the reporting period.
- 9.23 The location of supplemental disclosures has implications for whether they are audited or unaudited. General purpose financial statements encompass the notes to the financial statements. If a government's general purpose financial statements are required to be audited, any disclosures in the notes to the financial statements would also be required to be audited.
- 9.24 If preparers choose to disclose information as a separate component of a report containing the general purpose financial statements, the supplemental disclosures may or may not be subject to audit depending upon the requirements in that jurisdiction. In some jurisdictions, all financial and non-financial information in annual reports is audited.

Preliminary View – Location of Supplemental Disclosures

27. *Supplementary disclosures may be made either in the notes to the financial statements or elsewhere in the general report that includes the financial statements, with any audit requirement determined consistent with the national requirements in relation to that information.*

Generational Accounting

- 9.25 Generational accounting is a method of long-term fiscal planning and analysis that is useful in assessing the financial

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sustainability of a government's current policies. Generational accounts have a different purpose to financial statements. They:

- show the sustainability of fiscal policies without significant increases in the tax burden on current and future generations and without cutbacks in government expenditure. They can be used to quantify the increase in taxation revenue necessary for government policy sustainability. Sustainable policy occurs when a government is able to meet its commitments in a planned and timely manner. Generational accounts do not necessarily focus on solvency, but may include information which is relevant to assessments of ongoing solvency; and
- show the size of the projected fiscal burden on future generations based on continuing current policies. That is they show the amount of taxes less transfers the average person of each age at a given date (each generation or specified age group) can expect to pay over the remainder of his or her lifetime. For each generation, the generational account is computed as the present value of net taxes to be paid over their remaining lifetimes. A generational account is thus a set of numbers, one for each existing generation, indicating the average remaining lifetime burden imposed by the government on members of the generation; and
- help in identifying any alternative policies needed to achieve generational balance and the effect of those alternative policies on the current generation.

9.26 Generational accounts are constructed using:

- projections of the population by age;
- projections of the average net payments (taxes less transfers) to government for each generation for each year in which at least one member of the generation is still alive;
- a discount rate (interest rate);
- a productivity growth rate;
- the value of government debt and financial assets; and
- projections of future government expenditure on goods and services.

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- 9.27 Generational accounts are generally prepared as documents separate from financial statements. They may be published in conjunction with ex ante budget reports or ex post financial statements. Some of the proposed supplemental disclosures discussed in this Chapter are likely to be included in generational accounts. The preparation of generational accounts in some jurisdictions demonstrates the belief of those jurisdictions that, despite difficulties in obtaining reliable measures of some items, the information in the accounts is sufficiently reliable to be useful to readers.

Cash Basis

- 9.28 The Cash Basis IPSAS encourages entities to provide additional disclosures of items not recognized in the financial statements. Part 2 of the Cash Basis IPSAS is not mandatory. It identifies additional accounting policies and disclosures that an entity is encouraged to adopt to enhance its financial accountability and the transparency of its financial statements. It includes explanations of alternative methods of presenting certain information. The PSC envisages proposing additions to the Cash Basis IPSAS over time as additional accrual based IPSASs are approved.
- 9.29 Depending upon the reliability of forecast information prepared by an entity, the supplemental disclosures presented in this Chapter could be presented by entities preparing a financial statement under the cash basis. Entities preparing such disclosures as supplemental information to the cash basis would need to consider the cost of producing such information in relation to the benefits to users. Given the relative significance of old age pension obligations for most jurisdictions and the those obligations on a government's projected financial condition, forecast pension obligations may be one item for which supplemental disclosures would be appropriate.