



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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**Agenda Item
2B**

Date: March 19, 2010
Memo to: Members of the IPSASB
From: Tim Beauchamp, Annette Davis and John Stanford
Subject: Conceptual Framework: Elements and Recognition

Objective of this Session

The objective of this session is to **consider** issues related to the “Definition and Recognition of Elements” phase (Elements phase) of the Conceptual Framework project and provide directions on key issues so that Staff can draft a Consultation Paper for consideration at the June 2010 meeting.

Action required

Members are asked to:

- **Consider** the issues raised in the attached Issues Papers and **provide** directions; and
- **Highlight** further issues that are not addressed in the Issues Papers and Appendix and **provide** directions.

Agenda Material

- 2B.1 Issue 1: Has IPSASB identified the right elements?
- 2B.2 Issue 2: How should assets be defined?
- 2B.3 Issue 3: How should liabilities be defined?
- 2B.4 Issue 4: How should revenue and expenses be defined?
- 2B.5 Issue 5: Net assets/equity
- 2B.6 Issue 6: What should the recognition criteria be?

Background

1. The Conceptual Framework Sub-committee met on March 6–7, 2010 and discussed the Elements and Measurement phases of the Conceptual Framework project. The Measurement phase is addressed in Agenda Item 2C. For Elements the Sub-committee discussed the six Issues Papers listed above and identified areas that should be addressed in a draft Consultation Paper.
2. Time constraints between the date of the Sub-committee meeting and the posting of agenda papers for the April IPSASB meeting have allowed only minor revisions to the Issues Papers. For the Sub-committee meeting the Issues Papers included comparative tables providing detailed guidance on the definitions of current elements for a number of private sector and public sector standard setters.

- On the direction of the Sub-committee these tables have been deleted. These tables are available from Staff on request. The Issues Papers on assets, liabilities and recognition criteria include summary information on the current approaches of certain standard setters.
3. Appendix A to this memo highlights the Key Points that arose from discussion of the individual Issues Papers by the Sub-committee. The Sub-committee considered that these points should be discussed at the Board meeting and addressed in the Consultation Paper. Appendix A provides cross-references, where appropriate, to the Issues Papers. While Members, Technical Advisors (TAs) and Observers may wish to read the Issues Papers in their entirety, Staff acknowledges that there is a large amount of material and the cross-references are intended to allow Members, TAs and Observers to focus their reading on areas specifically identified by the Sub-committee for discussion at the April 2010 meeting.
 4. Appendix B to this memo includes the Staff's draft bullet point notes of the Elements part of the March 6–7, 2010 meeting. These notes have been included to provide further background detail to the Key Points in Appendix A.

Points to Note

5. At the April 2010 meeting individual Members of the Sub-committee will lead discussion on the Key Points in Appendix A. The Members are:
 - Issue 1: Elements – Ian Carruthers.
 - Issue 2: Assets – Erna Swart.
 - Issue 3: Liabilities – David Bean.
 - Issue 4: Revenue and expenses – Ken Warren.
 - Issue 5: Net assets/equity – Tadashi Sekikawa.
 - Issue 6: Recognition – Ron Salole.

Borrowing costs

6. Issues Paper 2: “How should assets be defined?” includes an analysis of borrowing costs from a conceptual viewpoint in Appendix B. The Sub-committee considers that this material is worthwhile, but that using borrowing costs as an example is not helpful in illustrating application of the definition of an asset in the public sector as it includes a level of detail that is unnecessary at the conceptual level. Instead, Appendix B could form the basis of a separate future agenda item considering borrowing costs from a conceptual viewpoint.

Question:

Does the IPSASB agree that borrowing costs from a conceptual viewpoint should be considered as a separate item, distinct from the Conceptual Framework project?

Appendix A: Elements Key Points

Overall approach

Do you agree that the starting point should be an analysis of the economic substance of transactions and events not the existing elements as defined in IPSAS 1, “Presentation of Financial Statements”?

Issue 1: Has IPSASB identified the right elements?

Board Member assigned to this issue: Ian Carruthers.

Do you agree that the following should be discussed in the CP:

- The approach should be derived from an assessment of user needs. User needs dictate the objectives of GPFR; which then dictate the generic information categories (high-level structure); which then dictate which elements are required.
- User needs are broader than information provided just in GPFS. The Subcommittee acknowledges that additional information contained in GPFRs is needed. The Project Brief states that elements may need to be defined in the context of GPFRs. However, the Project Brief also stated that at this stage the CP should focus on GPFS.
- There are at least four key elements (assets, liabilities, revenue and expenses). Does the IPSASB agree?
- Are other elements required for GPFS? (AP2B.1, paragraphs 6–74)¹
- How should the qualitative characteristics inform whether items are recognized or disclosed in the GPFS or disclosed in the wider GPFRs, e.g., narrative reporting.

Issue 2: How should assets be defined?

Board Member assigned to this issue: Erna Swart.

Do you agree that the following should be discussed in the CP:

- Whether it is necessary to distinguish economic benefits and service potential and reflect both notions in the definition? Does the term “economic benefits” only encompass cash flows or does it include a broader notion of service potential? Does the non-exchange characteristic of some transactions require the separate identification of service potential? Include a table of “types of assets” (see page 2 of AP2B.4 for an example of a similar table). (AP2B.2, paragraphs 67–71)
- Can an item generate service potential if it does not attract future cash flows? An example is a public sector entity which builds a public monument and decides that it will not incur expenditure on maintaining that monument.

¹ Where a bullet point is specifically addressed in the Issues Papers, it has been cross-referenced. Bullet points which do not have cross-references are either general points or the issue is not currently addressed.

- The CP should consider whether the definition of an asset should include the right of access rather than the resource itself. (AP2B.2, paragraphs 18–20)
- Should the CP explore the notion of control, in particular, when does a public sector entity control a naturally occurring asset, e.g., water. What is being controlled – the future economic benefits/service potential or the resource? Consider a dam which prevents flooding; it provides benefits to citizens outside of the jurisdiction of the entity controlling the dam. (AP2B.2, paragraphs 21–53)
- The Sub-committee considers that the power to tax (AP2B.2, Appendix A) and the rights to issue licenses should be used for testing against developing definitions of assets.
- The Sub-committee has strong reservations about using borrowing costs as an example and considers that it is not helpful in illustrating application of the definition of an asset in the public sector. This example should be deleted. (AP2B.2, Appendix B)

Issue 3: How should liabilities be defined?

Board Member assigned to this issue: David Bean.

Do you agree that the following should be discussed in the CP:

- Whether liabilities should be limited to legally enforceable obligations? (AP2B.3, paragraphs 23–34 and A2) In this context the following should be considered:
 - Government’s ability to change legislation;
 - Legislation in place at the reporting date (AP2B.3, paragraphs 84–86);
 - Exchange versus non-exchange transactions;
 - The difference between constructive obligations (AP2B.3, paragraphs A3–A16) and enforceable obligations;
 - Legal enforceability of international treaties; and
 - Whether liabilities require specific time stipulations (AP2B.3, paragraph 71).
- The distinction between financial obligations and performance obligations.
- A discussion of stand-ready obligations and whether or not they are liabilities.
- Whether executory contracts give rise to liabilities and assets? For example a “take-or-pay” contract in which an entity enters into a contract to purchase 1000 liters of petrol, the entity will still have to pay for the fuel even if it does not need it in the future.
- Whether a liability arises from the right to forgo a revenue stream? For example, a “non-compete” agreement.
- How to distinguish business risks (AP2B.3, paragraphs 79–83) and performance obligations, including those identified in IPSAS 23, “Revenue from Non-exchange Transactions (Taxes and Transfers).”

- Whether there should be symmetry between liabilities and assets, e.g., should an entity only recognize a liability if another entity recognizes an asset?
- Can economic compulsion give rise to a liability? For example reputation risk arising as a result of entering into a contract with a morally-dubious third-party. (AP2B.3, paragraph 35)
- The CP should test arguments and evolving approaches in the context of:
 - Social benefit obligations (AP2B.3, paragraphs B5–B12);
 - Budget allocations and appropriations.

Issue 4: How should revenue and expenses be defined?

Board Member assigned to this issue: Ken Warren.

Do you agree that the following should be discussed in the CP:

- Whether there is a distinction between types of flows that have the common attribute of increasing or decreasing net assets. Do the following factors affect this distinction and, if so, in what way:
 - Transferor intent or stipulations;
 - Contributions from owners and distributions to owners (AP2B.5, paragraphs 21–37);
 - Exchange versus non-exchange character of transactions; and
 - Distinguishing between capital and operating revenue.

If there is such a distinction whether there is a need for additional elements (see Issue 1) or additional financial statements?

- What is financial performance? What should be included in it? How does this dictate what goes directly into net assets? The Sub-committee notes that there are multiple concepts of performance and that these could influence the high-level structure of information, e.g., the amount to be recognized in financial performance for the disposal of an asset at carrying value (i.e., net versus gross amounts). (AP2B.4, paragraphs 48–54)
- Whether revenue and expenses can be defined without depending on the definition of assets and liabilities (AP2B.4, paragraphs 24 and 47). Need to refer to the inter-period equity approach. (AP2B.4, paragraphs 25–28 and 55–58)
- A discussion of the relief of liabilities (note that a liability relief model is being explored by the IASB). A liability that can be settled for less than carrying amount can increase net assets but how does this relate to models of financial performance?

Issue 5: Net assets/equity

Board Member assigned to this issue: Tadashi Sekikawa.

Do you agree that the following should be discussed in the CP:

- Whether net assets/equity is an element or a residual amount? If an element, is it an ownership or equity interest? (AP2B.5, paragraphs 17–19)
- Types of flows are discussed in Issues Paper 4 (AP2B.4).

Issue 6: What should the recognition criteria be?

Board Member assigned to this issue: Ron Salole.

Do you agree that the following should be discussed in the CP:

- The linkage with the Qualitative Characteristics in CP 1.
- The tension between neutrality and prudence, noting that although prudence is an attribute that has commonly been applied in the public sector, it is not a proposed qualitative characteristic in CP 1.
- Existence uncertainty (AP2B.6, paragraphs 8–19) and measurement uncertainty. (AP2B.6, paragraphs 49–56)
- Relevance and materiality and whether materiality relates to recognition criteria rather than a qualitative characteristic.
- How disclosure can complement but not replace recognition (e.g., assumptions and risks in making judgments such as where an event has a very low probability of occurring but the associated financial amount may be high and what level of fair value hierarchy has been applied to determine a carrying amount). Also consider disclosure in the wider GPFRs, e.g., narrative reporting.
- Whether the definitions should include recognition criteria? (AP2B.6, paragraphs 60–61) The firm view of the Sub-committee is that recognition criteria should be excluded from the definitions, i.e., the “expected to flow” part of the definitions (see also Issue 2 (AP2B.2) and Issue 3 (AP2B.3)).

Appendix B: Draft Staff Notes of Conceptual Framework Sub-Committee Meeting on Elements, March 2010

Issue 1: Has IPSASB identified the right elements? (AP2B.1)

- The Issues Paper should be structured to begin with user needs, then the objectives of GPFR, then the high level structure of GPFRs, then which elements are required to fulfill user needs.
- What do users require? Information about stocks (assets and liabilities) and information about flows (revenue and expenses). So it looks like there are at least four elements – are any other elements needed to meet user needs?
- GPFS does not give the complete picture of a government's finances and so there needs to be additional information given to fully understand that government's financial performance and financial position, i.e., GPFR are required. GPFR includes long-term fiscal sustainability (LTFS) reporting, i.e., there are other things are needed to complete the picture of government finances. Possibly, the LTFS report could use the same elements as those used in GPFS but these items do not meet the recognition criteria for GPFS.
- Need to consider whether there are other elements related to GPFR later, as we are dealing with GPFS only at the moment.
- The breadth of elements – discuss the extent to which they are constrained by current practice or economic elements.
- Financial statement presentation approaches (pages 5–6): These approaches illustrate that financial information can be presented in different ways and highlight different user needs. Which approach better delivers on user needs? For example, the Inter-period Equity (IPE) and Net Cost of Services (NCS) approach distinguish between different types of transactions and separate operations from holding gains and losses.
- The income statement approach and balance sheet approach should be drawn out further.
- For each of the elements identified, does the exchange or non-exchange nature of the transaction make a difference to the elements?
- The history of GFS is that it started off with the income statement approach and has been moving towards the balance sheet approach. This point should be discussed together with the reasoning behind this change.
- GFS and accounts – are they different? Both approaches are looking at different aspects of the same information. Previously, the availability of information has been limited, but now, with information being collected for accounts purposes, the bottom-up approach can be used for GFS.
- Paragraph 25 arguments are not convincing – GFS and accounting is extremely well aligned conceptually as fiscal policy is required for accountability and

decision-making purposes. However, traditionally and in practice there are differences.

- The IPSASB currently has five elements identified in IPSAS 1, “Presentation of Financial Statements”. Has the Issues Paper identified enough that is different to make a change?
- More discussion is required on the concepts of capital. (Note that concepts of capital are addressed in Agenda Item 2C.)

Issue 2: How should assets be defined? (AP2B.2)

- Is the asset the resource or the right to access the resource? The argument for rights needs to be strengthened. Andrew Lennard will provide wording.
- Rights are different for governments, so it may be acceptable for the private sector to use rights to access a resource in a definition of an asset, but not suitable for the public sector.
- Use the right to tax as an example to test the definition of an asset and incorporate this example into the Issues Paper itself, rather than including it as an appendix.
- The view that the power or right to tax itself is not an asset was put forward on the grounds that the entity has to do something for such a power or right to become an asset.
- Linking back to Issue 1 above, the power to tax is an example of why there is a need for GPFR as GPFS do not encompass this power. However, the power to tax is relevant to users for accountability and decision-making purposes, so consideration in GPFR is required.
- Another example that needs to be included is the right to issue licenses.
- The discussion should test whether or not the IASB-FASB’s proposed amendments to its definition of an asset are relevant to the public sector.
- The phrase “future economic benefits” in 2010 is seen as referring to cash flows. However, when it was originally devised and included in the IASB’s Conceptual Framework, it was used to convey the idea of “wealth”. So the phrase was seen as encompassing service potential. “Service potential” has been added to the current IPSASB definition of an asset because of how the term “future economic benefits” evolved.
- Additionally, public sector entities generally do not receive the benefit from the service potential of a non-cash-generating asset, rather it is the recipients of the non-exchange transaction that receive the benefits. Does this result in a requirement to separately identify service potential in the definition of an asset?
- The appendix on borrowing costs should not be included in the Conceptual Framework project. Rather, the topic should be in a separate paper discussing borrowing costs in relation to concepts and not in the Conceptual Framework project itself.

- Discussion needs to be included regarding the phrase “rights or other privileged access”.
- Can an asset exist if it only has service potential, i.e., there are no future economic benefits (cash flows) associated with it? Assets with only service potential are usually used in non-exchange transactions, so this seems to support the notion that an item can meet the definition of an asset if it only has service potential.
- A discussion is required of what is meant by “control” in the public sector, including control versus ownership in the context of naturally-occurring assets, e.g., water.
- Include a table of “types of assets” similar to the table illustrating types of flows on page 1 of Issues Paper 4 on revenue and expenses (AP2B.4).

Issue 3: How should liabilities be defined? (AP2B.3)

- Paragraph 24: note that the IASB considers equitable obligations to be enforceable.
- Including the notion of enforceability at the reporting date in the definition might help remove the ambiguity in the application of the current definition of a liability, particularly in the context of social policy obligations. However, to include the notion of enforceability might change how employee benefits are recognized and therefore have significant implications for current reporting of liabilities.
- The discussion on enforceability should be positioned before constructive obligations. It also needs to be clear whether or not enforceability is a legal concept only or might extend to constructive exchange obligations or constructive non-exchange obligations.
- When considering the notion of enforceability, the timing of the enforceability needs to be considered, e.g., a term loan with a set repayment date is enforceable only once the repayment date is passed. Further, should the definition of a liability be limited to legally enforceable obligations?
- Paragraph 27 reads as if a constructive obligation equates to a moral obligation. This is unintentional and so this paragraph needs to be redrafted.
- Constructive obligations are defined in terms of exchange transactions, especially in law. How does the notion of constructive obligations apply to non-exchange transactions?
- Economic compulsion needs to be considered, e.g., the voluntary cleaning up of environmental damage when inaction might damage an entity’s reputation.
- Paragraph 36: note that budget appropriations are not obligations and so should not be considered to be liabilities.
- Where social benefit obligation examples are used, generic characteristics rather than jurisdiction-specific characteristics should be used.

- Other examples should be included using the requirements of IPSAS 23, “Revenue from Non-exchange Transactions (Taxes and Transfers)” relating to performance obligations.
- Can you have a liability where an entity enters into an agreement to forgo something, e.g., a non-compete agreement?
- The discussion should explore the difference between a performance obligation and a financial obligation. It should also include a comparison of business risks and performance obligations.
- Does a liability exist where there is no counter-party that recognizes an asset?
- A discussion needs to be included on the following items:
 - Executory contracts;
 - Take-or-pay contracts; and
 - Stand-ready obligations.
- The New Zealand definition of liabilities in its old Statement of Concepts (rather than its current Conceptual Framework based upon the IASB’s Framework) is not different from other liability definitions – the difference in wording is just semantics. References to the NZ Framework should be updated to refer to its current Framework.

Issue 4: How should revenue and expenses be defined? (AP2B.4)

- The first aspect this Issues Paper should address is what is going to be in the income statement as an inflow? With an increase in an asset – how do you tell whether or not it is an inflow which should be recognized in the income statement?
- The table on page 1 of the Issues Paper, which shows types of flows, should be extended to illustrate all types of flows.
- Looking further at the different flows to an economic entity:
 - Ordinary revenue is an exchange transaction;
 - Non-exchange revenue is generally received from outside of the economic entity;
 - Transfers within the economic entity – does the management intent of the transferor count?
- What is the best conceptual point to distinguish between flows?
- What information is given to users by separating flows into revenue or contributions from owners? Does this distinction relate to the concept of capital adopted? Or does it relate to the overall structure of the GPFS, i.e., the split of inflows between the income statement and the balance sheet?
- Is it possible to clearly distinguish between a contribution from an owner and revenue where it is a non-exchange transaction? Distinguishing between these

- two items is easier in the for-profit private sector as they are exchange transactions.
- Commonly, governments distinguish between contributions for operations (revenue) and contributions for the obtaining of an asset (capital). In this context, what are the user needs, as the economic substance of the transaction is similar. Accounting, at the moment, is focusing on where the money has come from and not what it is to be used for. Is this a fundamental difference between the public sector and the for-profit private sector? Is transferor intention an acceptable way of determining whether a transfer is a contribution from an owner or revenue?
 - Intent is seen to be a requirement to use the funds in a particular way. Intent is not ultimately observable in the transaction itself, rather it is secondary information. There needs to be a discussion of the difference between management intent and transferor intent.
 - Another aspect to a transfer from an owner is that, where they are to be used for the obtaining of assets, these assets are generally used for operations rather than increasing the size of the entity.
 - If different types of flows are put into separate classifications, does this mean that other statements are needed?
 - Another view is that unless there is an ownership interest, i.e., a form of equity has been issued, the contribution is revenue.
 - Revenue and expenses need to be linked to assets and liabilities regarding changes in condition and use of the asset.
 - There are situations where the entity uses terminology such as a “loan” to describe a contribution which is not to be paid back. In accounting terms, this item is not a loan and should not be described as such, i.e., the substance of the transaction needs to be determined. Relying on the terms used is not reliable.
 - The difficulty of determining what is a contribution from an owner or a transfer (revenue) is an application issue. Could consider whether the transaction is an injection of capital to enlarge the entity or for the maintenance of the operations of the entity.
 - The discussion needs to focus on what is needed to be reported on to meet users’ needs, e.g., report the net cost of operations and so appropriations are treated as contributions from owners.
 - Many local governments in Japan use the following format:

Income Statement

Cost of services	100
Less revenue received	(20)
Net cost of services	80

Statement of Changes in Net Assets

Opening net assets	(1000)
Net cost of services	80
Transfers from central government	(40)

- | | |
|--------------------|--------------|
| Taxes received | (20) |
| Revaluation of PPE | <u>(10)</u> |
| Closing net assets | <u>(990)</u> |
- The scenario where a government gives a contribution to a Health Board that has incurred an unbudgeted deficit was suggested by Ken Warren and considered. It was suggested that the purpose of the contribution is to maintain net assets and that it is not a transfer. The government providing the contribution thinks of it in a particular way. However, is this a difference in economic substance or is it just a policy decision from the perspective of the contributor?
 - The current definition of revenue refers to “gross inflows” and so it is not clear what should be recognized in the income statement when the sale of a fixed asset occurs, e.g., sale of an item of PPE at its carrying value of CU1000. Do you reflect revenue of 1000 and expense of 1000? For the disposal of fixed assets should the gross or net inflows be shown?
 - The discussion on defining revenue and expenses independently of assets should be retained and related to the Inter-period Equity (IPE) approach.
 - The IASB is currently exploring a “relief of a liability” approach. This should be included in the discussion.

Issue 5: Net Assets/Equity

- Should net assets/equity be an element? If it is not an element, what happens where there is an ownership interest?
- Ownership interest should be addressed at the conceptual level. An “entity” concept of equity could be adopted where there is no ownership interest. The legal idea of ownership does not fit easily in a public sector context.
- Does net assets/equity have information content? What does it mean? E.g., does it reflect operating capacity?
- The concept of capital is a separate notion from a residual interest notion.
- GFS uses “net worth” to describe the residual amount. This phrase has a particular meaning so we should call it a “residual”.
- Contributions from owners and distributions to owners are flows and so should be included in the discussion of revenue and expenses. These items can only be excluded from revenue and expenses if they are a different element, i.e., if the item is not a liability or a revenue item, then it is a contribution from owners or distribution to owners. Need to explain why a flow transaction can be classified differently from revenue. One of the differences is that it is a policy decision by the entity to undertake transactions with owners rather than revenue and expenses. This should help clearly define revenue and expenses. See also Health Board example in Issue 4.
- The examples to test definitions in this section should be transfers between different levels of government.

Issue 6: What should the recognition criteria be?

- The Sub-committee agreed that the recognition criteria should remain separate from the definitions. This means that the phrase “expected to flow” should be removed from the definitions of assets and liabilities.
- The relationship between the recognition criteria and the qualitative characteristics outlined in Consultation Paper (CP) 1 should be discussed. Note that Preliminary View 7 in CP 1 lists the qualitative characteristics of GPFR and includes faithful representation which includes the notion that items in the GPFR should be neutral (paragraphs 4.15–16 of CP 1 and is a part of) and does not include prudence in any of the qualitative characteristics.
- Existence uncertainty affects:
 - Whether the entity has a right?
 - Whether the amount is recognized?
- Where does existence uncertainty fit into the qualitative characteristics – perhaps in “verifiability” (CP 1, paragraphs 4.28–32). Where should existence uncertainty (and measurement uncertainty) be positioned – in element recognition or in phase 3 on measurement?
- There should be discussion of where the benefits are expected to flow, e.g., an entity provides a service to eligible recipients, the benefits flow to the recipients and not the entity.
- Materiality is seen as a constraint on the qualitative characteristics (CP 1, paragraphs 4.33–34) however, it seems to more closely relate to recognition criteria.
- Does disclosure satisfy user needs better than recognition for some events? For example, does an entity recognize a provision for an event which occurs in 1 in 100 years, but when it does happen the amount is large. How does recognition relate to disclosure, e.g., an item is recognized but there is no disclosure regarding the range of estimates and probabilities of those estimates occurring result in reliable information?

ISSUE 1: HAS IPSASB IDENTIFIED THE RIGHT ELEMENTS?

Purpose

1. The purpose of this paper is to decide whether the elements identified by the IPSASB are suitable for the general purpose financial statements (GPFS) of public sector entities.

What are the elements that IPSASB has defined?

2. IPSAS 1, “Presentation of Financial Statements” notes that:
“Accrual basis means a basis of accounting under which transactions and other events are recognized when they occur (and not only when cash or its equivalent is received or paid). Therefore, the transactions and events are recorded in the accounting records and recognized in the financial statements of the periods to which they relate.”
3. Within its definition of accrual accounting, IPSAS 1 notes that the elements recognized under accrual accounting are:
 - (a) Assets (including financial and physical);
 - (b) Liabilities;
 - (c) Net assets/equity;
 - (d) Revenue; and
 - (e) Expenses.
4. In Phase 1 of IPSASB’s Conceptual Framework project, it was noted that general purpose financial statements, and their notes and supporting commentary and schedules, can provide information about the economic resources of the entity and claims to those resources at the reporting date, and changes to them during the reporting period. For example, this information will enable users of GPFS to identify:
 - The economic resources, and their classes, that are available for providing services at the reporting date, and the increase or decrease in those resources during the reporting period;
 - The nature and sources of any increase in the economic resource base available for providing services in the future, and the extent to which any decline in that base arose because of consumption of service potential in the delivery of services, or for other reasons; and
 - The nature and amount of claims to the resources at the reporting date, the increase or decrease in those claims during the reporting period and their sources, and the amounts and timing of cash flows necessary to service and repay them.
5. Providing services to constituents, obtaining resources from them and a range of other events (such as changes in interest rates) will have consequences for the

economic resources of the entity and claims to them during the reporting period. These activities, transactions and other events will affect the entity's financial performance presented under the accrual basis of accounting. For example, (a) the provision of services during the reporting period will consume cash and other economic resources, (b) amounts received or receivable as taxes and user charges for the reporting period will increase cash and receivables, and (c) changes in interest rates will change the cost of servicing debt or the return from cash deposits and other investments.

Which elements have others defined?

6. The particular elements that are defined by standard setters can be categorized into two broad types or kinds: those economic “things” that describe things that exist at a point in time (stocks) and those economic “things” that explain changes in the stocks over a period of time (flows). At a point in time elements include assets, liabilities and net assets/equity. Further they agree that the “change over time elements” should include revenue and expenses, or other such similar terms such as gains and losses to describe the related changes in the “at a point in time” elements. The number of specific elements of financial statements that are identified in the frameworks of other standard setters range from 5 to 10.
7. The IPSASB has defined only 5 specific elements of GPFS – 3 for financial position: assets, liabilities and net assets/equity; and 2 for financial performance: revenue and expenses and makes no mention of other elements. Generally, this is the approach followed by most others.

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

Does presentation affect which elements to define?

8. There are significant differences in the determination of what gets reported as financial performance. The standards in various jurisdictions and GFS present financial performance differently. For some, different elements have been defined to achieve that presentation. In other cases, the elements have been defined as those basic or fundamental things required for financial position and financial performance and have treated the presentation of these items separately from the elements and their definitions. For example, some have defined revenue and gains separately while others have defined revenue to include gains.
9. Without “peeking” ahead to the individual element definitions themselves, four approaches representing different depictions of financial position and performance are considered, and therefore the elements that comprise them. Transactions with owners can occur under each of the approaches and have been excluded for this purpose.
10. The purpose of this section is to provide a general overview of alternative financial statement presentation approaches so that their possible affect on the definition of individual elements can be assessed. The approaches discussed below are based on approaches currently being used by public sector entities in various jurisdictions.
11. The approaches represent different depictions of financial performance, and therefore the elements that comprise performance. The intention is not to limit discussion to these four approaches, but rather to illustrate the various elements that could be considered and how those elements might be defined. The approaches considered are:
 - (a) IPSAS 1;
 - (b) Government Finance Statistics (GFS);
 - (c) Inter-Period Equity;
 - (d) Net Cost of Services; and
 - (e) Change in Accumulated Surplus or Deficit.

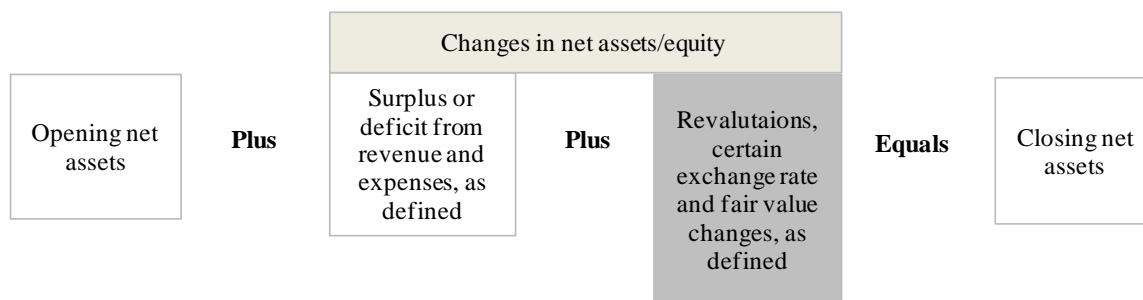
Current approach

12. IPSAS 1 provides the IPSASB’s current definitions of revenue and expenses:
 - Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.
 - Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or other incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distribution to owners.
13. IPSAS 1 requires all items of revenue and expense recognized in the period to be included in surplus or deficit unless another Standard requires otherwise. Several

standards require specific items to be recognized directly as changes in net assets/equity. These items are presented in a separate statement of changes in net assets/equity. Thus, the overall change in net assets/equity during a period represents the total revenue and expenses for the period, including those recognized directly in net assets/equity together with any contributions from, and distributions to owners, in their capacity as owners.

14. Examples of current IPSASs which require specific items to be recognized directly in net assets/equity are as follows. IPSAS 17, “Property, Plant and Equipment” requires revaluation increases or decreases related to property, plant and equipment to be recognized directly in net assets/equity. IPSAS 4, “The Effects of Changes in Foreign Exchange Rates” requires certain gains and losses related to particular foreign exchange differences to be recognized directly in net assets/equity. The IPSASB has also decided that certain gains and losses related to financial instruments be recognized directly in net assets/equity.

Diagram of current approach



Alternatives considered

15. The basic concepts in all four approaches are similar in terms of assets and liabilities and their respective definitions. However, there are differences in the determination of surplus or deficit under the alternative approaches. Each approach treats various items, such as revaluations of property, plant and equipment, financial instruments, foreign currency translation and price changes somewhat differently.
- The Government Finance Statistics approach focuses on the economic flows in an economy. It separately analyzes these flows into transactions and other economic flows. Under this approach, operating balance is determined by operating revenue and expense transactions. Other changes in net worth, that are not part of operating balance, are considered as other economic inflows and outflows, i.e., those arising from non-operating transactions and price changes related to, for example, financial instruments. These amounts are presented in a separate Statement of Other Economic Flows. Together, the Statement of Operations and the Statement of Other Economic Flows explain changes in net worth.
 - The Inter-Period Equity approach focuses on presenting information to assist users to determine whether or not the burden of the current year cost of services is borne by current, past or future year taxpayers and revenue providers. It defines net position as the residual difference between assets, liabilities and deferred inflows and outflows. Under this approach, surplus or deficit is determined from all changes in net position, thus requiring only one performance statement.
 - The Net Cost of Services approach focuses on separately presenting performance between the surplus or deficit arising from the delivery of services or operations from the surplus or deficit arising from the responsibility for and management of assets and liabilities. For example, interest on outstanding debt, revaluations, exchange rate and fair value changes would be shown as part of the responsibility for and management of assets surplus or deficit. All changes in net assets, i.e., net surplus or deficit from the delivery of services or operations plus net surplus or deficit from the responsibility for and management of assets is presented in one performance statement.
 - The Change in Accumulated Surplus or Deficit approach focuses on presenting all changes in net assets for a period in one performance statement. Thus, it does not distinguish between different types of performance. Under this approach, all transactions and other events, such as revaluation, exchange rate and fair value changes are included in surplus or deficit.
16. The following diagrams provide a basic overview of each of the approaches to illustrate how certain items are treated in the determination of surplus or deficit. The opening financial position, plus presentation of transactions and other events during the period within each approach, results in a closing position.

Diagram of Government Finance Statistics approach

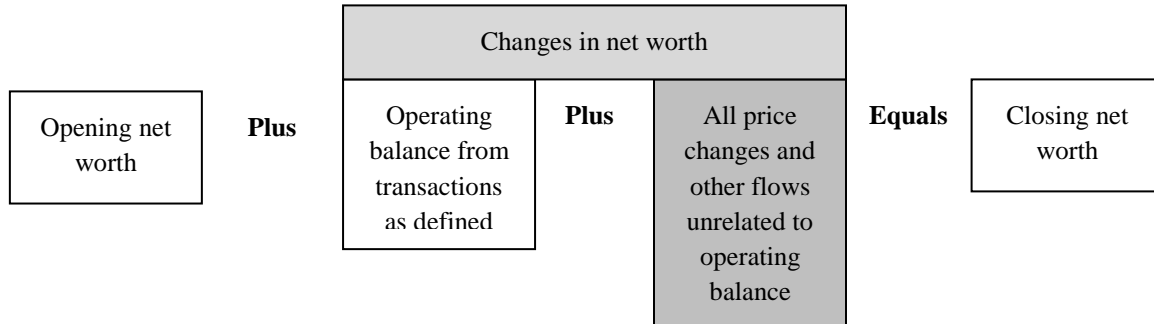


Diagram of Inter-Period Equity approach

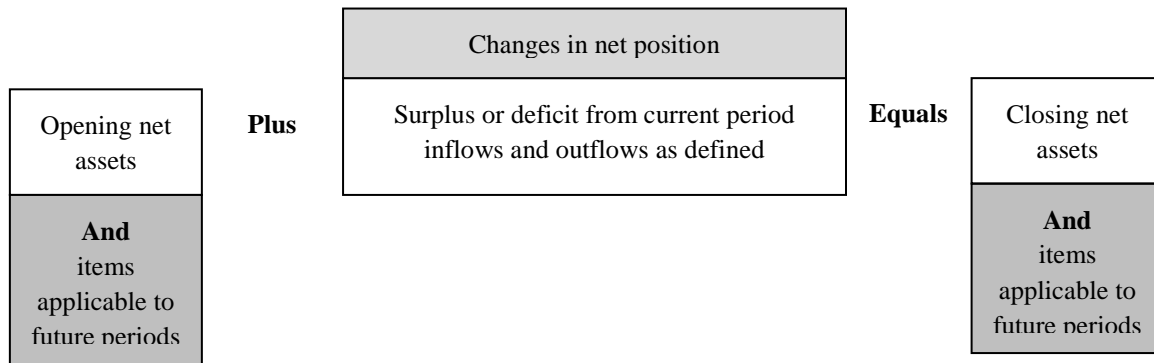


Diagram of Net Cost of Services approach

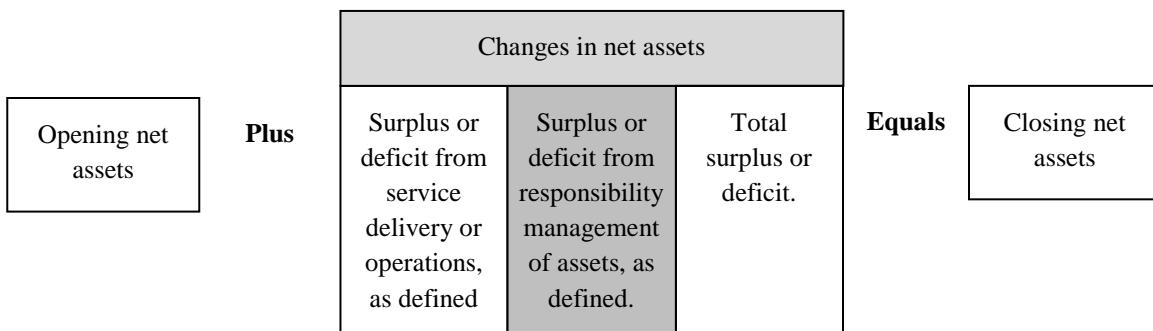
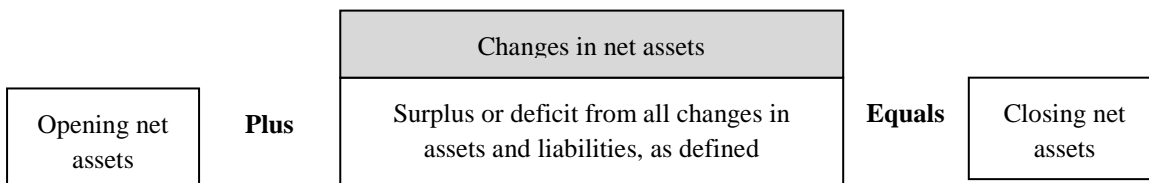


Diagram of Change in Accumulated Surplus or Deficit approach



Government Finance Statistics¹

17. The System of National Accounts² (SNA) is the internationally agreed standard set of recommendations on how to compile measures of economic activity designed for economic analysis, decision-taking and policy-making. The SNA collects data for the purposes of analyzing and evaluating the performance of an entire economy. Included in its scope are non-financial corporations, financial corporations, government units, non-profit institutions, households, and interactions with the rest of the world. It is used for monitoring the behavior of the economy, macroeconomic analysis and for making international comparisons.
18. The Government Finance Statistics (GFS) approach is based on the SNA, but limited in scope to public sector entities (called public units in the SNA) by providing public finance analysts with the ability to make assessments about such things as the size of the public sector, its contribution to aggregate demand, investment, and saving; the impact of fiscal policy on the economy, including resource use, monetary conditions and national indebtedness; the tax burden; tariff protection; and the social safety net. In addition, analysts have become increasingly interested in assessing the sustainability of fiscal policies, net debt, net wealth, and future claims, including social security pensions.

Rationale for the approach

19. The GFS approach provides an analytic framework for the consistent presentation of fiscal statistics which are suitable for analyzing and evaluating fiscal policy, especially the performance of public units in an economy.

Description of the approach

20. The GFS Balance Sheet presents assets, liabilities, and the reporting entity's net worth, as the difference or residual between the value of all assets and liabilities. In accounting terms, net worth is equivalent to accumulated surplus or deficit. GFS also provides a sub-category for another measure of net worth: net financial worth, which is the difference between financial assets and all liabilities.
 - Assets (both financial and non-financial assets) are generally described as those items where the reporting entity enforces ownership rights over the asset from which economic benefits may be derived by holding or using those assets.
 - Liabilities are described as obligations to provide economic benefits to others that hold a corresponding financial claim. Shares and other equity items are treated as financial claims even though the holders of those claims do not have a fixed or predetermined monetary claim on the entity.

¹ The description of GFS is based upon the IMF's Government Finance Statistics Manual (GFSM), Second Edition, 2001. In some parts of the world, e.g., Europe, the standard presentation of GFS may differ, although the underlying principles are the same.

² SNA 2008 is an updated version of the SNA 1993. The 2008 SNA is published under the auspices of Commission of European Communities, International Monetary Fund, Organization for Economic Co-operation and Development, United Nations and the World Bank.

21. The Statement of Operations presents the flows or changes in the stocks of assets and liabilities that result from all transactions during the accounting period which affect a change in net worth.
- Revenue is defined as those increases in net worth that result from transactions.
 - Expenses are defined as those decreases in net worth resulting from a transaction. Note that changes in the liability for retirement schemes resulting from changes in the benefit structure are not included in expenses (see paragraph 24 below).
22. The Statement of Other Economic Flows presents those changes in net worth that result from price changes (holding gains and losses) and a variety of other economic flows that affect the value of recognized assets and liabilities as a result of holding of assets and liabilities.
- A holding gain or loss results from a change in price including gains and losses resulting from changes in exchange rates.
 - Other economic flows representing changes in the volume of assets and liabilities include:
 - Recognition or derecognition caused from changes in relative prices, technology or some other event.
 - Changes in the quality or quantity of assets and liabilities such as damage to assets caused by an earthquake or volcanic eruption; reduction in the volume of mineral deposits due to the availability of more accurate information; amortization of certain intangible assets; and changes in the liability for retirement schemes resulting from changes in the benefit structure.

Benefits of the approach

23. The GFS approach is useful because it provides a common basis of reporting that supports international comparisons among different governments and promotes comparability within a government itself.
24. The GFS approach separates transactions that undertaken as part of the entity's activities from those that arise outside of the normal operations of the entity such as price changes, asset impairments, gains on sale of non-financial assets, and catastrophic events (other economic flows). This type of classification is easier to apply when determining whether or not an item is a transaction (and therefore a part of operating balance) or it is another economic flow and therefore less judgment is required resulting in greater comparability between entities. It provides a basis for fiscal analysis in determining and separately displaying the different types of inflows and outflows as macroeconomic analysis focuses on transactions.

Disadvantages of the approach

25. From the viewpoint of the use of GFS, there is an imperfect alignment between “transactions” and “operations” and that creates difficulties in interpreting the reported results. The decision to write down a loan to its fair value may be regarded as the recognition of an “other economic flow”. The decision to forgive a loan, or to provide a loan with concessionary terms, may be regarded as an operational transaction. Such distinctions may be difficult to implement in practice and difficult to interpret by users.
26. From a conceptual viewpoint, the objectives of GFS are different from the objectives of GPFs and so the GFS approach will not, except by coincidence, meet the needs of the users of GPFs. One way of looking at it, is that the GFS approach produces special purpose financial statements.

Effect on element definitions

27. Assets are described as those items where the reporting entity enforces ownership rights from which economic benefits may be derived by holding or using those assets. GFS may result in differences arising from applying an “enforcement of ownership rights” approach.
28. Liabilities are obligations to provide economic benefits to units or individuals holding the corresponding “financial claim.” This may have implications for things such as environmental obligations or asset retirement obligations where no other party presently has a corresponding financial claim on resources.
29. Existing definitions of revenue and expense would need to reflect the transaction based approach.

Inter-Period Equity

30. As previously noted, the Inter-Period Equity (IPE) approach provides information to determine whether current-year revenues were sufficient to pay for current year services. The information assists users of GPFs in determining whether the burden of the current year cost of services is borne by current, past or future year taxpayers and revenue providers.

Rationale for the approach

31. The IPE approach is built on an objective of providing accountability; that a public sector entity must answer to its citizenry to explain the raising of public resources and the purposes to which those resources have been used.
32. The IPE approach attributes costs of the services to the period in which those services were provided and attributes revenues provided by taxpayers and other revenue providers to the appropriate period for the purpose of assessing whether those revenues were sufficient to finance the costs of providing services during that period. IPE is a relevant concept for assessing accountability and decision usefulness as it demonstrates whether revenues were sufficient to meet the costs of the services provided in the period. For users of financial statements, the

concept of IPE may be useful because it demonstrates the effects of fiscal decisions made today that have implications for the future.

Description

33. The Balance Sheet presents net position as the residual difference between assets, deferred outflows, liabilities and deferred inflows. This approach introduces two additional elements:
- Deferred outflows are generally described as a consumption of assets and increases in liabilities by the entity that is applicable to a future period. Typical types of deferred outflows include bond issuance costs.
 - Deferred inflows are generally described as an increase in assets and decrease in liabilities of the entity applicable to future periods. Typical types of deferred inflows would include sales of future revenues, e.g., amounts expected to be collected from future tax collections.
34. The Statement of Inflows and Outflows records the changes that affect a change in net position. It does not include those inflows and outflows that are applicable to future period but does include those inflows and outflows that are applicable to the current period.
- Inflows are generally defined as those increases in net assets that are applicable to the current period.
 - Outflows are generally defined as those decreases in net assets that are applicable to the current period.

Benefits of the approach

35. The IPE approach presents the costs of services applicable to the current period and the amount and extent of the cost recovery applicable to the current period. Overall, the Statement of Inflows and Outflows demonstrates whether or not IPE has been achieved by showing whether the revenues (as defined) were sufficient to meet costs (as defined). A surplus for the period would mean that the current year taxpayers have paid more than they needed to cover that period's costs and a deficit for the period would mean that the current year taxpayers have transferred some of the costs of the current year to future year taxpayers.

Disadvantages of the approach

36. Under the IPE approach, the Statement of Financial Position is not measured as the difference between assets and liabilities. Instead, it reflects assets, liabilities, deferred inflows and deferred outflows. Unless specific recognition concepts can be developed, the determination of whether or not a deferred inflow or deferred outflow should be applied to the current period requires the use of judgment. This may mean that, at the standards level, detailed guidance would be required to determine when a particular item is applicable to the current period or a future period or periods.

Effect on element definitions

37. The IPE approach does not affect the definitions of assets and liabilities. However, additional elements are required to address the items included in deferred inflows and outflows. The definitions of revenue and expense would also need to reflect that they include only those items of revenue or expense that apply to the current period.

Net Cost of Services

38. The Net Cost of Services (NCS) approach presents two types of performance, transactions and other events that are related to the delivery of services or operations are reported separately from transactions and other events related to the responsibility for, and management of, assets and liabilities.
39. Under the NCS approach, a public sector entity measures a period's financial performance by determining which revenues and expenses are related to the delivery of services or operations, i.e., outputs. Revenues and expenses that are not related to the delivery of services or operations are presumed to be related to the responsibility for, and management of, assets and liabilities and are presented separately from the net surplus or deficit from the delivery of services or operations. The total of surplus or deficit relating to service delivery in addition to the total related to the responsibility for, and management of, assets and liabilities explains all changes in net assets.

Rationale for the approach

40. Citizens and others as recipients of services are likely to require information on the quantity, quality and cost of services delivered. To enhance understandability for these users, financial performance relating to the cost of the services provided and the revenue received to perform those services is presented separately.
41. Citizens and others as providers of the resources of public sector entities wish to ensure that assets are used efficiently, that the entity maintains its capacity to provide services efficiently in future years, in accordance with their expectations. The financial effect of decisions that an entity makes in respect of its assets and liabilities needs to be separated from the delivery of services so that a separate assessment can be made as to the entity's management of those assets and liabilities. An example of responsibility for and management of assets is an increase or decrease in the value of housing stock owned due to changes in demand as economic conditions change.

Description of the approach

42. The Statement of Financial Position includes assets and liabilities, and net assets, which is the residual difference between assets and liabilities.
- Assets are generally described as resources controlled by a public sector entity.
 - Liabilities are generally described as present obligations to sacrifice resources.

43. The Statement of Financial Performance records all of the changes in assets and liabilities that effect a change in net assets. However, this approach provides a separate presentation between those revenue and expense items that relate to the delivery of services and those that relate to its other responsibilities.
- Revenue from service delivery or operations would be generally defined as those increases in assets or decreases in liabilities arising from operations.
 - Revenue from responsibility for and management of assets and liabilities would be generally defined as those increases in assets or decreases in liabilities not arising from service delivery or operations.
 - Expenses from service delivery or operations would be generally defined as decreases in assets or increases in liabilities arising from service delivery or operations.
 - Expenses from ownership and management of assets and liabilities would be generally defined as those decreases in assets or increases in liabilities not arising from service delivery or operations.

Benefits of the approach

44. The benefit of the NCS approach is that an entity's performance relating to its delivery of services is reported separately, making it easier for users to assess that component or aspect of an entity's performance. Separately displaying those revenue and expenses that arise from the responsibility for and management of assets and liabilities assists users in understanding the entity's decisions.
45. The Statement of Financial Performance provides a summary of all transactions and events that effect net assets. It can demonstrate a type of inter-period equity from the perspective of illustrating the costs of services provided and the revenue generated in the period to finance those costs. However, it should be noted that revenues or expenses that relate to future periods but do not meet the definition of an asset or a liability will not be recognized in the Statement of Financial Position as a deferred outflow or deferred inflow. In this respect the NCS approach is different from the IPE approach described above.

Disadvantages of the approach

46. A challenge with the NCS approach is the determination of whether a transaction or other event is related to the delivery of services or from the responsibility and management of assets and liabilities. For example, a decision to discontinue a significant group of activities is likely to result in restructuring costs that it would be more appropriate to report as an asset management cost than as a cost of service. Costs involved however, in improving or realigning a group of activities, might be more properly considered part of the ongoing cost of services. Judgment is likely to be required, and this may be an area where standards would need to be developed to ensure useful information is prepared consistently to meet the needs of users of GPFs.

Effect on element definitions

47. The NCS approach separates revenue and expenses into two classifications, transactions that relate to the delivery of services or operations and the responsibility for and management of assets and liabilities. These classifications do not affect the definitions of elements because the classification is made after the transaction or other event is identified as revenue or expense.
48. Similarly, the NCS approach does not affect the definitions of assets and liabilities because it focuses on separating the performance of the entity between the delivery of services or operations and the responsibility for and management of assets.

Changes in Accumulated Surplus or Deficit

49. The Changes in Accumulated Surplus or Deficit (CASD) approach is similar to the NCS approach. However, it does not separate service delivery or operations performance from ownership of assets performance. It defines surplus or deficit simply as changes in net assets, other than transactions with owners.

Rationale for the approach

50. Net assets can be increased or decreased only by transactions with owners or from the operations of a public sector entity. This approach explains that all changes in net assets, other than transactions with owners, are part of the operations of the entity or its surplus or deficit. All transactions and events that meet the definitions of revenue and expenses are presented as part of surplus or deficit therefore eliminating the judgment required in determining whether or not an item is included in operating surplus, other economic flows or ownership.

Description of the approach

51. The Statement of Financial Position includes assets and liabilities, and net assets, which is the difference between assets and liabilities.
 - Assets are generally described as resources controlled by a public sector entity.
 - Liabilities are generally described as present obligations to sacrifice resources.
52. The Statement of Financial Performance records all of the changes in assets and liabilities that affect a change in net assets without requiring a separate presentation of the types of revenue or expense.
 - Revenue would be defined as increases in assets or decreases in liabilities.
 - Expenses would be defined as decreases in assets or increases in liabilities.

Benefits of the approach

53. The CASD approach is similar to the NCS approach as it does not distinguish between types of transactions and other events that effect overall surplus or deficit. However, it would include items such as interest costs and foreign

currency translation as part of the surplus or deficit, not distinguishing between the ongoing operations of an entity rather than as another economic flow or ownership and management of assets item.

Disadvantages of the approach

54. By including all changes in net assets in the surplus or deficit without a requirement for a separate presentation of different categories of items can make comparisons between actual and budget amounts difficult. It can also make the assessment of the normal operations of a public sector entity more difficult as the results from operations may be obscured by other unusual transactions and events.

Effect on element definitions

55. The CASD approach is consistent with the current definitions of revenue, expense, assets and liabilities.

Summary

56. The IPE, NCS and CASD approaches are similar in that their objective is directly related to the users of GPFs, whereas the GFS approach provides statistical information to enable policymakers and analysts to assess the public sector.
57. Without getting into specifics about the individual definitions of each of the elements, there seems to be agreement that the basic or fundamental building blocks of financial statements are assets, liabilities, net assets/equity, revenue and expenses.

Should deferred outflows and inflows be defined as elements?

58. Introducing elements for deferred items means that net position in the statement of financial position is measured by the difference between (a) assets and deferred outflows of resources and (b) liabilities and deferred inflows of resources.
59. A deferred outflow of resources can be defined as “a consumption of net assets that is applicable to a future reporting period.” A deferred inflow can be defined as “an acquisition of net assets that is applicable to a future reporting period.”
60. The period to which an outflow (or inflow) of resources is applicable is determined using the concept of inter-period equity. Inter-period equity is the state in which current period inflows of resources equal current period costs of services. For example, the burden of the cost of services is borne by present-year taxpayers and revenue providers. This burden is not shifted to future-year taxpayers or revenue providers through an increase in the level of borrowing, for example, and accumulated net resources are not used to provide current-period services. Inter-period equity is a relevant metric to assess accountability, rather than a goal that is expected to be met for any particular period of time.
61. One example of the use of and need for these elements is because certain transactions and events, such as those related to the recognition and measurement of financial instruments, are not realized until some future date, and, as a result, are excluded from the net asset position. The changes in fair value of derivative

- financial instruments that are classified as hedging derivative instruments are typically reported in the statement of financial position as deferrals. These changes are excluded from net assets/equity by introducing the notions of deferrals as elements into the calculation of net assets/equity.
62. In other circumstances, for example a sale of future revenues, the public sector entity might need to report the proceeds from the sale as a deferred inflow. In this case, revenue would be recognized over the duration of the sale agreement. This approach takes the view that the proceeds from the future revenue sale transaction is not a substitute for a revenue recognition event and, as a result, the proceeds from the sale would be considered a deferred inflow and recognized in revenue in the applicable time period.
 63. For example, a local government sells the rights to the estimated sales taxes collections for the next year to a third party in the current period. If those sales taxes will be collected by a national government and remitted directly to the third party instead of the local government, the amount received by the local government from the third party in the current period will not meet the definition of a liability. To meet the concept of inter-period equity, the amount received would be reported as a deferred inflow (the alternative would be to report two years of sales taxes as revenue in a single period).
 64. Inter-period equity is usually explained in the context of laws, such as those requiring balanced budgets and those placing limitations on debt issuance, with the intent of preventing the current generation of citizens from shifting the burden of paying for current-year services to future-year taxpayers. The concept of inter-period equity applies to accounting and financial reporting in accrual-based financial statements.
 65. Both the concept of inter-period equity and the traditional matching concept associate accounting events with periods; however, the criteria for associating events with periods and the objectives of the related financial reporting are different. The matching concept attributes costs to the revenues recognized during a period for the purpose of measuring earnings. In contrast, inter-period equity attributes costs of the services to the period in which those services were provided and attributes revenues provided by taxpayers and other revenue providers to the appropriate period for the purpose of assessing whether those revenues were sufficient to finance the costs of providing services during that period.
 66. Some argue that this approach eliminates the need to “recycle” other comprehensive income into revenues or expenses when certain criteria are met. The need for comprehensive income which can result in recycling is eliminated when deferrals are introduced. Another advantage is that the statement of financial performance equals the changes in net assets/equity unlike an OCI approach that permits similar items to be presented outside of “operations.” Another primary advantage is that net assets are not over or understated based on transactions that relate to future periods. Of course, others could consider this to be a disadvantage.

67. Others believe that the primary disadvantage is that net asset assets should only be affected by changes in assets and liabilities. It should be noted that most standard setters today have adopted a view that only the difference between assets and liabilities should be considered for the purposes of determining net assets/equity.

Do IPSASB's existing definitions of the elements depend on each other?

68. IPSASB's current definitions of the elements are:

“Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

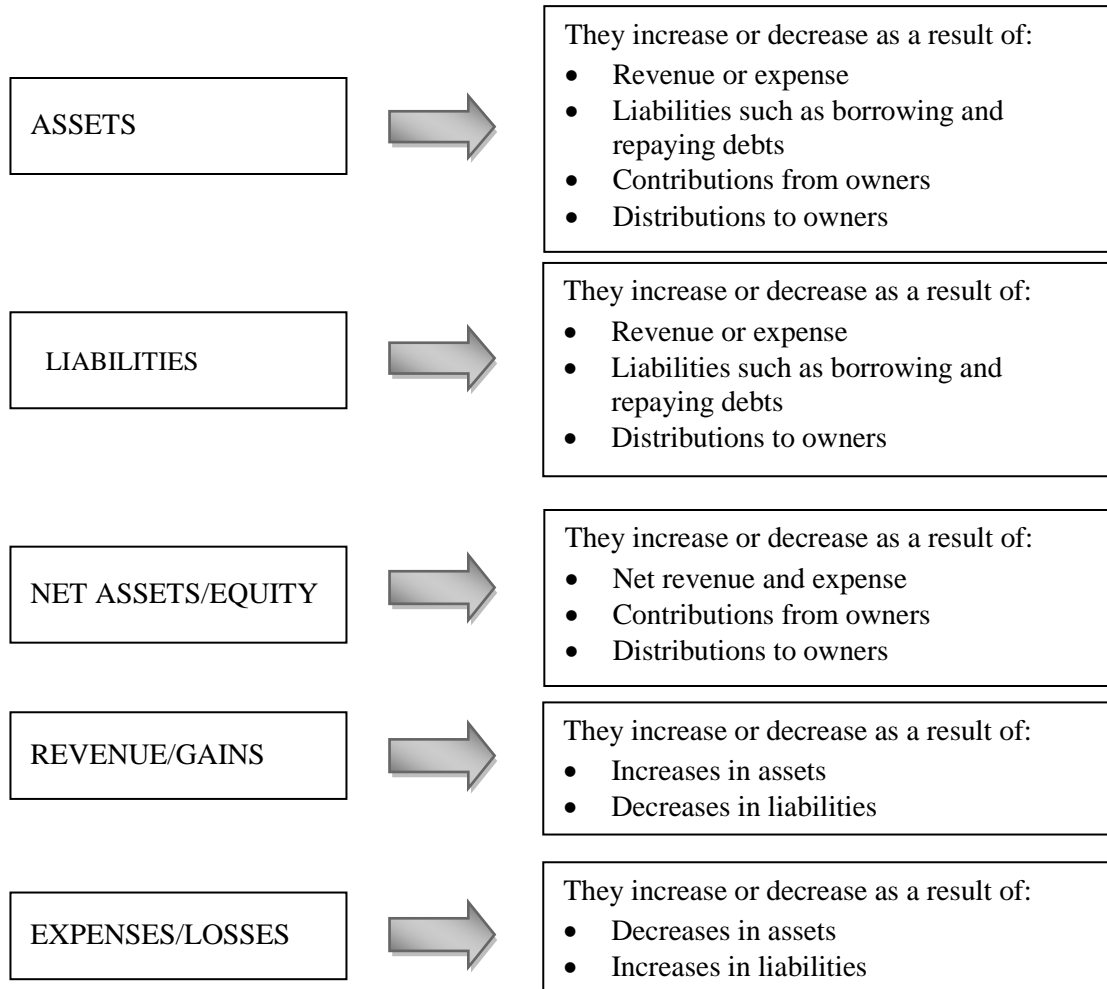
Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Net assets/equity is the residual interest in the assets of the entity after deducting all its liabilities.

Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.”

69. Without presuming what the individual definitions will be, the following diagram provides a basic illustration of the inter-relationship that exists among the elements. For example, assets could be defined to include deferred outflows and liabilities could be defined to include deferred inflows. Likewise, revenue and expense could be defined as inflows and outflows.



70. The existing definitions are inter-related as the liability definition speaks to the “outflow of resources embodying economic benefits or service potential” which is an essential characteristic of the asset definition. Revenue is linked to both the asset and liability definitions as it refers to “increases net assets/equity.” Expenses is also linked to the asset and liability definition (albeit using different wording) “outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity”. Both the revenue and expense definitions address the issue of contribution from and distribution to owners limiting their affect on one component of net assets/equity.
71. Assets are the primary starting point for determining all of the other elements. Liabilities are defined with reference to being claims on existing or future assets. This approach then uses the definitions of assets and liabilities to determine revenue and expenses.
72. Proponents of this approach note:
- Assets are fundamental to the entity and should affect all other elements in the financial statements;

- Revenue and expense can only be rigorously defined in terms of changes in assets and liabilities, as to permit certain changes in assets and liabilities to be excluded from financial performance is a distortion of financial performance;³
 - Defining revenue and expense by relating them to changes in assets and liabilities makes the determination of financial performance more precise and reliable;
 - Attempts to define revenue and expense independently and as a function of the intent to use an asset, for example, in a future period as the primary foundation of the financial statements, makes assets and liabilities essentially the fallout of the process of recognizing revenues and expenses; and
 - It is more reflective of the nature of organizations as organizations need resources, either from owners or from operations, to serve as inputs into the provision of goods and services or outputs which can lead to incurrence of liabilities.
73. Every conceptual structure builds on a fundamental idea that has primacy. That is simply another way of saying something must be given meaning before meaning can be attached to other things.⁴
- “I contend that assets have that primacy. I have not been able to define income without using a term like asset, resources, source of benefits, and so on. In short, meaning can be given to assets without first defining income, but the reverse is not true. That is what I mean by conceptual primacy of assets. No one has ever been successful in giving meaning to income without first giving meaning to assets.”⁵*
74. The FASB asked respondents to its Discussion Memorandum to submit precise definitions of revenues and expenses that were wholly or partially independent of assets and liabilities. That no one was able to do that without having to resort to subjective guides, such as proper matching and non-distortion of income, was a significant factor in the ultimate adoption of defining revenues and expenses based on the asset and liability definitions.⁶ It was noted that the definitions of revenue and expenses were primarily conventional, not conceptual, and made periodic measurement of financial performance largely a matter of individual judgment and personal opinion. The choice of using the asset and liability definitions as the anchor imposed limits or restraints not only on what can be

³ FASB Discussion Memorandum, Conceptual Framework for Financial Accounting, December 2, 1976, paragraph 56.

⁴ Oscar S. Gellein, “Primacy: Assets or income?” in *Research in Accounting Regulation*, vol. 6, edited by Gary John Previtis (Greenwich, Connecticut, JAI Press, 1992), page 198.

⁵ Oscar S. Gellein, “Primacy: Assets or income?” in *Research in Accounting Regulation*, vol. 6, edited by Gary John Previtis (Greenwich, Connecticut, JAI Press, 1992), page 198.

⁶ Ibid, page 79.

included in assets and liabilities but also what could be included in financial performance.⁷

Should capital maintenance adjustments be defined as elements?

75. Capital maintenance adjustments can be defined as those adjustments made under certain accounting models (financial capital and physical capital) to the entity's net assets/equity to take into account the effects measurement changes affecting assets and liabilities. Capital maintenance adjustments result from revaluations or restatements of assets and liabilities.⁸
76. The AASB notes:
- “The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves.”*
77. From this perspective, capital maintenance adjustments and the presentation of them is a matter of presentation rather than something that is an element.
78. IPSAS 1 acknowledges that some Standards require items such as revaluation increases and decreases to be recognized directly in net assets/equity. IPSAS 1 requires a statement of changes in net assets/equity that highlights an entity's total revenue and expenses, including those recognized directly in net assets/equity.

Should comprehensive income be defined as an element?

79. The FASB notes that comprehensive income “is a broad measure of the effects of transactions and other events on the entity, comprising all recognized changes in equity (net assets) of an entity during a period from transactions and other events and circumstances except those arising from investments by owners and distributions to owners.”
80. The FASB indicates that “earnings” are different than comprehensive income because certain gains and losses are included in comprehensive income but are excluded from earnings. Those items that are excluded from earnings include the cumulative effect of a change in accounting policy and other changes in net assets (principally certain holding gains and losses) that are recognized in the period but excluded from earnings such as some changes in market values of investments in marketable equity securities, some changes in market values of investments in industries having specialized accounting practices for marketable securities and foreign currency translation adjustments.⁹

⁷ Reed K. Storey, Ph.D., CPA and Sylvia Story, MBA, “The Framework of Financial Concepts and Standards”, Financial Accounting Series No. 181-C, Financial Accounting Standards Board, January 1998, page 80.

⁸ IASB Framework, paragraph 81.

⁹ FASB CON 5.

81. IAS 1 takes a similar approach as some IFRSs specify circumstances when an entity recognizes particular items outside of profit or loss in the current period. IAS 8 specifies two such circumstances: the correction of errors and the effects of changes in accounting policies. Other IFRSs require or permit components of other comprehensive income that meet the Framework's definition of income or expense to be excluded from profit or loss. For example, comprehensive income includes items such as revaluation surpluses (IAS 16), actuarial gains and losses on defined benefit plans (IAS 19), gains and losses on foreign operations (IAS 21) and gains and losses on certain financial instruments (IAS 39) to be recognized outside of profit or loss.
82. IPSASs take a somewhat similar approach. IPSAS 4 permits certain gains and losses on foreign currency items as direct entries to net assets/equity, IPSAS 17 permits changes in revaluation surpluses to be entered directly into net assets/equity, IPSAS 25 allows permits actuarial gains and losses to be recognized directly in net assets/equity and IPSAS 29 permits certain items relating to financial instruments to be included directly in net assets/equity.
83. The paragraphs above highlight that items included in comprehensive income are certain specified components of other elements. Due to the nature of certain gains and losses, they have been excluded from the financial performance statement and reflected directly in equity.

ISSUE 2: HOW SHOULD ASSETS BE DEFINED?

Purpose

1. The purpose of this paper is to determine what the IPSASB's definition of assets should be.
2. The IPSASB defines assets as:
"Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity."

Are there any issues with the current definition that need to be addressed?

3. IPSASB's current definition of an asset was developed from the IASB definition with some minor wording changes to address the public sector specific issue of service potential. The IASB definition and its meaning of future economic benefits is focused on the generation of net cash inflows.
4. The accountability of a public sector entity does not rest on generating net cash flows. The providers of resources and the recipients of public goods and services (users) expect that the public sector entity manages all of their assets efficiently and effectively in the provision of public goods and services. A public sector entity has a stewardship responsibility to acquire, hold, manage and invest public resources. A public sector entity accumulates both financial and physical resources in the provision of public goods and services and is accountable in relation to both of these aspects.
5. Public sector entities manage many types of resources. These resources may have been inherited by them through conquest, war, or changes in political boundaries. Managing national oil, gas and mineral reserves; fish stocks, forests, and lakes, for example, are a responsibility of public sector entities and users expect them to be accountable for the retention, use or sale of those naturally occurring resources. Users need to understand the effects these decisions (retention, use or sale) have on current and future resources available to provide public goods and services.
6. Public sector entities also have access to other rights that many private sector entities do not have. In these cases, public sector entities can create assets by exercising their sovereign powers. The power to tax and issue such things as licenses and other rights, its access and right to regulate access to intangible resources like the electromagnetic spectrum, are rights that others do not have. Users also expect public sector entities to be accountable for their retention, use and sale of such rights.
7. In addition, many public sector assets do not result in a flow of economic benefits or service potential "to the entity." Many public sector assets, such as public highways, provide benefits to those who use the highway, not the public sector entity itself. However, the public sector entity may have the responsibility or capacity to regulate access to these types of public assets.

8. Given the nature of government and its powers, rights and responsibilities, it is sometimes difficult to determine if and when a public sector entity has an asset.

How have assets been defined by others?

Public Sector Accounting Standard Setters	
IPSASB	Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.
Canada PSAB	Assets are economic resources controlled by a government as a result of past transactions or events and from which future economic benefits are expected to be obtained.
South Africa ASB	An asset is a resource controlled by the entity as a result of past events and from which future economic benefits or service potential is expected to flow to the entity.
US FASAB	An asset is a resource that embodies economic benefits or services that the federal government can control.
US GASB	Assets are resources with present service capacity that the government presently controls.
Private Sector Accounting Standard Setters	
IASB	An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
Canada AcSB	Assets are economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained.
UK ASB	Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.
UK ASB – PBE	Assets are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events.
US FASB	Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.
Accounting Standard Setters for Both Private and Public Sectors	
Australia ASB	An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
NZ FRSB	An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
Other	
Government Finance Statistics	Assets are assets over which general government units enforce ownership rights and from which they may derive economic benefits beholding or using them over a period of time.

What are the characteristics of an asset that have been identified?

9. Standard setters have established definitions of assets, setting out a number of characteristics in those definitions. In the following table, an “X” means the characteristic is part of the definition and a “G” means that it is provided in additional guidance supporting the definition.

Source	Resource	Rights or other access	Controlled by the entity	Past transaction or event	Expected inflow of economic benefit or service potential
IPSASB	X		X	X	X
PSAB	X		X	X	X
SA ASB	X		X	X	X
FASAB	X		X	G	X
GASB	X		X	G	X
IASB	X		X	X	X
Can AcSB	X		X	X	X
UK ASB		X		X	X
UK ASB PBE		X		X	X
US FASB			X	X	X
AASB	X		X	X	X
NZ FRSB	X		X	X	X
GFS	X			X	X

What is the asset?

10. The existing IPSASB definition of an asset focuses on the resource from which economic benefits or service potential are expected to flow to the entity. It notes that it is the resource that generates the flow of benefits to the entity. This view is shared by all of the public sector specific standard setters.
11. A review of some private sector definitions indicates that some do not agree that the asset is the “resource.” There are some who believe that the asset is the future economic benefits to be received and others who believe that the asset is the right or other access to the benefits.

Is the asset the resource?

12. The FASB’s definition focuses on probable future economic benefits as the asset. Focusing on the benefits puts the onus on realization of those benefits. Most standard setters have included the idea of “future” economic benefits or service potential. This suggests that the asset is something that is expected to happen in the future. It could lead to the wrong conclusion because the future economic benefit or service potential is based on a future event rather than a current one.
13. While there are other issues about resource existence, the resource must exist first before benefits can realized. Consider a water distribution system for example. Without the resource, i.e., the distribution system itself, there can be no economic

- benefits flowing to the entity. Likewise, a fire truck must exist before it can provide public services and have service potential.
14. Further, the FASB notes that the economic benefits or service potential is the thing that is controlled by the entity. In the previous example of the water distribution system, an entity can control the resource but not the future economic benefits or service potential expected to be obtained. In the case of a fire truck, an entity does not control its future service potential because there may never be any fires. The flow of the future economic benefits or service potential is something that will happen in the future. Generally, once it does flow, that is when the entity controls those benefits. It is the resource that is controlled not the economic benefits or service potential.
 15. The FASAB provides further support by noting that the federal government needs financial, economic, human and other resources to help it achieve its mission. In this context, the FASAB focuses on the resource. The GASB notes that the asset is the existing service capacity of a “resource”. In this case, the resource must exist before it can provide service capacity. The AASB notes that “an entity employs its assets to produce goods or services capable of satisfying the wants and needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay cash for them and hence contribute to the cash flow of the entity.” Here, too, the focus on the resource before the benefit. The South African ASB provides another point of view that focuses on the resources – “in many cases, assets are used to provide goods or services to beneficiaries or customers that are free or subsidized.”
 16. The IASB/FASB Conceptual Framework project indicates that the working definition of an asset also places the emphasis on the resource and not the future economic benefits associated with the asset.
 17. Most other standard setters agree that the benefits are derived from having the “resource” in the first instance and the economic benefit or service potential is expected to flow from the asset – “from which economic benefits or service potential are expected to flow to the entity.”

Is the asset the right or other access to the benefit?

18. The UK ASB’s definition of an asset focuses of the “right or other access” to future economic benefits. This appears to place the emphasis of the asset definition on the right to something as opposed to the resource itself:

“An asset is not the item of property itself, but rather the rights or other access to some of the future economic benefits derived from the item of property.”
19. It is important to note that the UK ASB makes it clear that not all rights result in assets – only those things that are rights to economic benefits that are derived from a resource, e.g., an item of property. For example, in cases such as leasing arrangements, joint venture arrangements and service concession arrangements or public/private partnerships, there is a resource but two or more parties may have rights to the benefits to be received. From this perspective, it may be useful to

- consider the rights of the individual parties as the asset rather than the item of property.
20. As noted in the IASB/FASB Conceptual Framework project, this alternative may focus on the wrong thing as being the asset. In the case of a lottery ticket, purchasing a lottery ticket provides a right to a chance of winning the lottery and not the winnings or future economic benefits themselves. So this approach could lead some to the wrong conclusion about what a right represents¹. Similarly, it can lead some to think that a loan guarantee is not an asset of its holder because the holder does not presently have the right to demand payment from the writer of the guarantee because the holder has not gone into default and there is no expectation of future economic benefits.

How do you know when the asset belongs to the entity?

An asset is a resource

21. If this approach is taken it defines assets generally but does not answer the question of which assets belong on the entity's financial statements. This could lead to identifying all possible assets then applying some supporting guidance to determine when it is that entity's asset. The problem with this approach is that there can be many assets that an entity knows of or may cause confusion due to knowing of an asset but it is not of the entity. For example, a government may have provided a grant to a private hospital for the purchase of some medical equipment but that equipment is not owned by the government but rather, is owned and controlled by the private hospital. Providing a link in the definition may be more efficient and easier to understand as it would not force the reader to seek out other guidance to determine when that resource should be reported in that entity's GPFS.
22. Another way is to introduce the phrase "of an entity." This would indicate that, at a minimum, the resource needs to belong to the entity.

An asset is a resource of an entity

23. While this links the asset to the entity, it still forces the reader into further research to better understand what is meant by "of an entity." In other words, when reading just the definition, it answers the question of what is an asset but it fails to respond to how or why it is an asset "of an entity."
24. The supporting text could describe how the asset is of the entity. The advantage is that this approach avoids having the reader to struggle with various terms, such as control, in the definition itself. The major disadvantage of this approach is that readers could apply their own meaning of "of an entity" and not refer to the additional guidance. This view was not supported by the IASB/FASB board members as they felt the definition to be too brief.

¹ IASB Agenda item 16C, October 16, 2007, paragraph 86.

25. Another approach is to focus on the legal title or ownership of the asset. An asset would have to be owned in order appear on an entity's GPFS. This alternative provides a legal basis for deciding when the asset belongs to the entity.

An asset is a resource owned by an entity

26. Because a leased asset under a finance lease is not owned by the lessee, it would be excluded from the definition of an asset. Alternatively, because it is owned by the lessor, it would still be considered as that entity's asset. Basing the determination of whether the asset is of the entity on legal form appears too narrow and may not result in a faithful representation of the resources of the entity.
27. The IPSASB's definition of an asset includes the phrase "controlled by an entity." Control is the mechanism that is used for identifying which assets belong to the entity – it is only those assets that are controlled that are included in the GPFS. The IASB, PSAB, Canadian AcSB, FASAB, GASB, UK ASB, AASB, NZ FRSB and SA ASB asset definitions include the phrase "controlled by the entity". GFS uses the phrase "enforce ownership rights" to describe how to determine if the asset belongs to the entity or not.
28. A government's ability to benefit from or use an asset is usually acquired through ownership or contract, which may be evidenced by title deeds, possession, or other devices, or legislation which gives a government the legal rights to the benefit. Legal enforceability of a right has not been considered by standard setters as an essential characteristic of assets if an entity has the ability to obtain and control the benefit in some other way.²
29. For example, a public sector entity may grant another entity, acting as an agent, physical possession of goods for sale and retain the right to receive the proceeds of sale. The goods are assets of the public sector entity because it controls access to the economic benefits embodied in the goods. The agent has physical possession of the goods, but they are not the agent's assets because it does not control access to the economic benefits. Also, through a lease arrangement a public sector entity may control access to the economic benefits or services embodied in a resource that it does not own.
30. Another approach is to focus on control of the asset.

An asset is a resource controlled by an entity

31. Control of an asset is the ability of the government to utilize the resource's present service capacity to meet its objectives and to determine the nature and manner of use of the present service capacity embodied in the resource. Generally, the entity controlling the asset has the ability to determine whether to (a) directly use the present service capacity to provide services to citizens; (b) exchange the present service capacity for another asset, such as cash; or (c)

² FASB CON 6, paragraph 187; GASB CON 4, paragraph 13 and FASB CON 5, paragraph 30.

- employ the asset in any of the other ways it may provide benefits. For an asset that is provided for use by the citizenry and general public, control is held by the entity that possesses the ability to control access to the present service capacity embodied in the asset.
32. Control generally refers to the ability to direct, manage, or have power over something so as to obtain or access benefits, or to increase, maintain or protect those benefits.
33. A government's ability to exercise control over an asset does not need to be actively exercised to meet the definition of an asset.³ Depending on how an asset is obtained, an asset may be subject to legal or other external constraints, however, such restriction on the use of the asset should not affect a government's control over the asset.⁴
34. The GFS definition employs a slightly different emphasis in that it focuses on the economic ownership of an item, i.e., the entity which has ownership rights has the majority of the risks and rewards of that asset. When goods are acquired under a financial lease, ownership is deemed to take place when the risks and rewards of ownership have been transferred. This approach is also used in securities repurchase agreements and securities lending arrangements.
35. Generally, control typically relates to the resource itself and ownership risks and rewards are connected to the expected flow of economic benefits or service potential. Both concepts are inter-related. Control over a resource is seen as encompassing an entity's access to the majority of the risks and rewards of that asset of the benefit.
36. Sometimes an entity cannot control the economic benefits or services that it obtains from a resource because it cannot deny or regulate the access of other entities. In those circumstances, the resource does not meet the definition of an asset. Public highways provide economic benefits to the entities that use them. But these are not assets of the entities that receive the benefit from them. They are assets only of the entity that controls their use or can regulate other entities' access to them by, for example, the use of tolls or other restrictions.
37. The IASB/FASB Conceptual Framework project noted that the use of control can be confusing because the definition of a reporting entity is based on the premise of control which refers to the power to obtain benefits or be exposed to the risks. However, in CP 1, the IPSASB did not use the word "control" in its description of what constitutes a reporting entity. For example, it notes that terms such as control, accountability, or oversight and substantial influence basis are used in a number of jurisdictions, but instead CP 1 uses the "power" criterion and the "benefit or financial burden/loss" criterion to determine the entities which comprise a whole of government group reporting entity⁵.

³ FASAB CON 5, paragraph 29.

⁴ GASB CON 4, paragraph 12.

⁵ CP 1, paragraphs 5.17–5.19.

38. If the IPSASB agrees that the use of control is troublesome for the purposes of linking an asset to the entity, the following alternatives are considered:
 - (a) To which an entity has a right;
 - (b) To which an entity has access;
 - (d) To which an entity has a right or other privileged access;
 - (e) To which an entity has an enforceable right.
39. The UK ASB's definition of an asset provides a useful approach to replacing the word "control." Their definition referred to the asset as being "the rights or other access to future economic benefits."
40. As a starting point, rights appear to express the association of the entity to the economic resource better than control. For example, an entity has rights to the shares representing its investment in a government business enterprise. The entity's access to the economic resource is by way of its rights to the shares representing its investment. The entity does not have direct rights or other privileged access to the underlying assets of that government business enterprise.
41. Similarly, an entity might enter into a contract whereby it agrees to purchase a building at a future date. In this example, the purchaser has the rights to any price appreciation on the building, but does not have rights to the building itself, or to the management of the building, until the date of ownership change – the entity does not control the building, but it does have rights to any price appreciation.
42. An entity might also have rights to something, aspects of which are outside its control. For example, a public/private partnership may not be controlled by a government nevertheless it has rights to or other privileged access to the economic resource.
43. The benefit of this approach is that it seems to link the asset to the entity in terms of the entity's ability or right to the economic resource.

An asset is a resource to which an entity has a right

44. However, focusing on "rights" alone could limit or restrict assets to those that are legally enforceable. The capacity of an entity to have a right to the asset normally stems from legal rights and may be evidenced by ownership through title or other mechanisms. For example, a central government agency may hold title to educational equipment. However, it is used by a local school board. From this perspective, the equipment should be that of the school board.
45. Similarly, when considering a leased asset, the owner of the asset has the title or right to it. However, the asset is enjoyed by the lessee (depending on the terms of the agreement) and would be an asset of lessee. Focusing solely on rights appears too restrictive.
46. Another approach is to link the asset to the entity in terms of "access."

An asset is a resource to which an entity has access

47. This addresses the concern with leased capital assets but it could result in a definition of an asset that is too broad. For example, an entity has access to fiber optic cable but that cable is not an asset of the entity. Further, the general public has access to many public sector assets, such as museums, but those assets do not belong to them.
48. While the word “rights” appears to suit many public sector situations, it is incomplete. Yet including simply “access” to address those situations such as capital leases is too broad. The IASB/FASB Conceptual Framework project agreed that the word access needed to be further qualified.
49. Acknowledging this issue, the IASB/FASB Conceptual Framework project introduced the phrase “or other privileged” to narrow its meaning. Including this into the definition indicates that linking the asset to an entity can be legally enforceable but also to include those assets where the entity has privileged access to an asset, such as a leased capital asset. Including “or other privileged access” also excludes those items that are generally accessible from the definition of an asset. For example, while the general public may have access to a road, their access is no different from the access enjoyed by others. However, a government has privileged access because it can choose to close the road for purposes of repair and maintenance, alter the direction of the road or completely remove the road from service.

**An asset is a resource to which an entity has a right or other
privileged access**

50. The difficulties with this alternative include whether “rights or other privileged access” is a clearer term than “control.” The IASB/FASB Conceptual Framework project noted that privileged access is an unfamiliar term that does not translate well into languages other than English. To alleviate the concern the word privileged could be deleted and dealt with in the supporting text. Also, to ensure that this is not just a common right or access such as a public highway the phrase “that others do not have” can be inserted.

**An asset is resource to which an entity has a right or other
access that others do not have**

51. The IASB/FASB Conceptual Framework project has tentatively agreed that “a right or other access that others do not have” which enables an entity to use the economic resources and to preclude/limit its use by others should be enforceable by legal or equivalent means.
52. However, the UK ASB notes the definition of an asset requires that the rights or other access to future economic benefits are controlled by the reporting entity. An entity will control the rights or other access if it has the ability both to obtain for itself any economic benefits that will arise and to prevent or limit the access of others to those benefits.
53. The requirement that the rights or other access should be controlled by an entity and treating them as assets means that a particular right or other access to future

economic benefits will appear in only one set of financial statements, because such rights or access can be directly controlled by only one entity. As indirect control is important in the determining of the boundaries of reporting entities, a right that is directly controlled by one entity and indirectly controlled by a second – through its control of the first entity – will be an asset of both the first entity and of the reporting entity that comprises both entities, i.e., the economic entity or group. This does not preclude an asset being jointly “controlled”.

What is the essential characteristic of a public sector asset?

54. The definition of an asset amongst standard setters is derived from its essential characteristic. An essential characteristic is something that all assets share and without them, the item would not be an asset⁶.
55. While many assets have a physical form this is not an essential characteristic. For example, patents, copyrights, mineral rights and trademarks can be assets of a public sector entity but lack physical form. If future economic benefits or service potential is expected to flow to the entity from them and the entity can control the resource, then the resource is an asset of the entity even though it lacks physical form.
56. Most resources result from a public sector entity incurring expenditure. However, the incurrence of expenditure is not an essential characteristic of a resource. In some cases, an incurred expenditure will not result in a resource because there is no future economic benefit or service potential associated with the expenditure, for example the payment of interest on debt. In other cases, a public sector entity can acquire a resource without incurring expenditure. Transfers between various levels of government, for example, can result in resources to the recipient government without incurring expenditure. Similarly, a resource may be created from financing activities such as the issuance of debt.
57. Many public sector assets can be exchanged or sold. Financial assets, such as accounts receivable and non-financial assets such as a fire truck can be sold. Some think that exchangeability is an essential characteristic of a resource that has future economic benefit or service potential. Exchangeability is generally meant to mean that a resource is separable from the entity and has a value in, and of, itself. Resources of a public sector entity do not have to be exchangeable to meet the test of a being a resource. A thruway overpass is not separable from the road leading up to and away from the overpass. Even if the overpass was separable, it cannot be exchanged directly for other resources. The entity acquiring the overpass would also want the ability to charge tolls or fees before it assumed responsibility for the overpass. Exchange is only one way to obtain economic benefits from a resource. Exchangeability gives a public sector entity a choice whether or not to sell the resource, but this is not a fundamental characteristic as there are resources that are not separable and therefore, not exchangeable.
58. IPSAS 1 explains that:

⁶ Adapted from FASAB Concepts Statements 5, paragraph 20.

“Assets that are used to deliver goods and services in accordance with an entity’s objectives but which do not directly generate net cash inflows are often described as embodying service potential. Assets that are used to generate net cash inflows are often described as embodying future economic benefits. To encompass all the purposes to which assets may be put, the Standard uses the term “future economic benefit or service potential” to describe the essential characteristic of assets.”

59. As an essential characteristic of an asset in the private sector, the IASB defines the future economic benefit as the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The FASB defines future economic benefit as a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows. The UK ASB notes that future economic benefits eventually result in net cash flows and the AASB has a similar focus as it notes the future economic benefit is the potential to contribute to the flow of cash and cash equivalents.
60. Some public sector resources only embody service potential. For example, resources such as public roadways, parks, and museums, are often used to provide public services at no direct charge as they are “tax supported.” On the other hand, some public sector resources do generate cash flows because they have user fees associated with them. But the distinctions between taxes and users fees are not clear. The only clear distinction is that the group paying the user fees may include a subset of all taxpayers and also might even include individuals who do not normally pay taxes. In addition, the user fee may or may not cover the full cost of the goods or services being provided. Whether an asset is cash-generating or not at any point in time rests with the choice the public sector entity makes because it determines what services are tax-supported and which services will be paid for through user fees.
61. The service potential aspect of the future benefits is a key difference between the definitions of assets in the private and public sectors. Most of the private sector standard setters focus solely on economic benefits as cash flows. The definition of service potential is the capacity to provide goods and services in accordance with the entity’s objectives, whether those objectives are the generation of net cash inflows or the provision of goods and services of a particular volume and quantity to the beneficiaries.⁷
62. Other public sector standard setters have referred to both economic benefit and service potential in their definitions. The FASAB refers to “economic benefits or services” and the South African ASB refers to “economic benefits or service potential”.
63. As an alternative, in the United States, the GASB refers to those resources that have “service capacity.” In the supporting text, service capacity is defined to include resources that generate cash or cash equivalents.

⁷ International Valuation Standards Committee, International Valuation Standards, 2001, United Kingdom.

“Cash is an asset with present service capacity that is used by the government to procure services for the citizenry. The present service capacity of investments, land held for sale, or income-producing assets can be used in a similar manner because they can be sold to produce cash or to generate cash. This form of present service capacity is sometimes referred to as economic benefit.”

64. As another alternative, in Canada, the PSAB has used the term “economic benefit.” In the supporting text, economic benefit is defined to include the provision of goods and services.

“They [economic benefits] embody a future benefit that involves a capacity, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services.”

65. From a public sector perspective, all three approaches are focusing on the same thing – assets have both future economic benefits and service potential.
66. The IPSASB’s current definition of an asset includes this essential characteristic of those resources that are to be included in GPFS.

**An asset is a resource controlled by an entity that embodies
future economic benefits or service potential**

Is it enough just to have future economic benefits or service potential?

67. The future economic benefits or service potential embodied in an asset may be:
- (a) Used singly or in combination with other assets in the production of goods or services to be sold by the entity;
 - (b) Exchanged for other assets;
 - (c) Used to settle a liability; or
 - (d) Distributed to the owners of the entity.
68. An entity usually employs its assets to provide goods or services capable of satisfying the needs of beneficiaries. Furthermore, in many cases, assets are used to provide goods or services to beneficiaries or customers that are free or subsidized. An item can meet the definition of an asset if it is used either directly or indirectly to provide goods and/or services that are used in furtherance of an entity’s objectives.⁸
69. If the economic benefit or service potential embodied in the asset is not expected to flow to the entity, the resource has no utility for the ongoing provision of public goods and services. IPSASs provide guidance for situations where there is no utility or a loss in utility requiring the asset to be written down to its recoverable amount or recoverable service amount.
70. For example, an entity may have a purpose-built military storage facility that it no longer uses. In addition, because of the specialized nature of the facility the entity

⁸ South Africa ASB Concepts, paragraph 72.

is unable to generate cash flows from leasing or disposing of the asset. The asset is regarded as impaired as it is no longer able to provide the entity with service potential or economic benefits, i.e., it has little, or no, utility in contributing to the achievement of the entity's objectives.

71. From this point of view, there must be an expectation that the economic benefits or service potential can actually be used. Most standard setters have defined this aspect of asset as "economic benefits or service potential that is expected to flow to the entity."

**An asset is a resource controlled by an entity from which
future economic benefits or service potential are expected to
flow to the entity**

How should future events be separated from past events?

72. The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets. Examples include property received by an entity from government as part of a program to encourage economic growth in an area, and the discovery of mineral deposits. Transactions or events expected to occur in the future do not, in themselves, give rise to assets. Hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset. Most standard setters have included past transactions or events in their definitions. Others have included in it supporting text.
73. There is a close association between incurring expenditure and generating assets but as previously noted the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits or service potential were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the statement of financial position. For example, items that have been donated to the entity may satisfy the definition of an asset.⁹
74. Implicit in the definition and essential characteristics of assets is that the event giving rise to the public sector entity's ability to control access to the economic benefits or services embodied in a resource must have occurred. For the resource to qualify as an asset, the public sector entity already must have acquired the resource or otherwise obtained access to the economic benefits or services it embodies to the exclusion of other entities.¹⁰ A reporting entity that has access to future economic benefits or service potential but did not, until after the reporting date, have the ability to restrict the access of others to those benefits, does not have an asset at the reporting date.¹¹

⁹ South Africa ASB, Concepts, paragraph 78.

¹⁰ FASAB, Concepts 5, paragraph 34.

¹¹ UK ASB Statement of Principles, paragraph 4.22.

75. The FASAB and the GASB have not referred to a “past transaction or event” in their asset definitions. However, the supporting guidance includes the requirement that there must have been past transaction or event.

An asset is a resource controlled by an entity as a result of past events from which future economic benefits or service potential are expected to flow to the entity

76. The IPSASB’s definition of an asset appears to contain all of the essential characteristics of an asset.

Is “past transaction or event” needed in the definition?

77. Some have placed undue emphasis on identifying the past event that gave rise to an asset or liability. Although its identification might be helpful, it can be a distraction and lead to debates about which event is the triggering event instead of focusing on whether the asset or liability presently exists at the reporting date.
78. While an observed transaction or other event might provide a signal that an asset exists, it is not a fundamental characteristic of an asset and the failure to observe a past event does not negate that an asset exists. The main purpose of including this aspect into the definition was to exclude future assets from meeting the definitions.
79. The difficulty with keeping the phrase “as a result of past events” is that:
- (a) This does not reflect that there may have been past transactions or events that resulted in assets which no longer exist.
 - (b) It has resulted in unwarranted debates about what the past event was (how the asset arose should not be at question).
 - (c) The inability to identify a past event may lead to non-recognition of an asset.
80. To improve the definitions, we considered inserting the word “existing” in front of resource. However, this may exclude items such as prepaid rent because prepaid rent gives the entity the right to a future, not a present, use of the item rented.
81. Using the term “future” resource is not appropriate as it could introduce the possibility of accruing future assets such as tax revenues. While a public sector entity may have the power to tax, until it exercises its authority to do so, it cannot have an asset. Assets are things that have arisen as result of past events, which, for all intents and purposes was intended to mean that it presently exists.
82. Inserting the word “present” before resource in the asset definition would require that the resource must be available as at the reporting date emphasizing that it cannot be a resource that will arise until the future or one that existed in the past but is no longer available at the reporting date. Taking this approach, the phrase “past event” in the definition becomes redundant as it would refer to a “present” resource.

**Assets are present resources controlled by an entity as a result
of past events and from which future economic benefits or
service potential are expected to flow to the entity**

83. This does not preclude including additional guidance relating to what is meant by “present.”

Is the phrase “expected to flow to the entity” best dealt with in the recognition criteria?

84. The concept of expected to flow is included in many asset definitions, albeit using different phraseology, to alleviate concerns that the definition would require that the inflow of future economic benefits or service potential be certain in order to qualify as an asset. “Probable” is included in the existing FASB definition in response to constituents’ concerns on earlier proposals that the definition would require that an item be certain in order to qualify as an asset or liability. Since few things in life are certain, the FASB observed that few items that are commonly thought to be assets or liabilities would qualify in accordance with the definition. Similar concerns have resulted in the inclusion of “expected to flow” in the IASB definition.
85. According to the IASB/FASB Conceptual Framework project, the phrase “expected to flow” has been misinterpreted as implying that there must be a high expectation of future economic benefits for the definition of an asset to be met. Some think that unless there is a high likelihood of economic benefits flowing in or out of the entity, the asset or liability definition is not met. To avoid this continued misinterpretation, the IASB/FASB Conceptual Framework project proposes the working definition of an asset and a liability exclude reference to the expected inflow or outflow of benefits from the definitions. They argue that it is preferable that this “expectation” be built into the recognition criteria rather than being built directly into the definitions themselves.¹²
86. This was the most favored improvement by the IASB/FASB Conceptual Framework project in the proposed working definitions when they consulted on the definition from December 2006 to March 2007.

**Assets are present resources controlled by an entity as a result
of past events and from which future economic benefits or
service potential are expected to flow to the entity**

87. While removing “expected to flow” from the definitions is a useful change as it appears to refer more to the recognition of rather than the definition of assets, it does create an additional problem – it could reintroduce the notion of certainty – which is what the previous definitions were trying to avoid.

¹² IASB/FASB Conceptual Framework, Elements & Recognition – Asset & Liability Definitions, August 20, 2008, pre-ballot draft.

88. Further, the phrases “from which future economic benefits or service potential are expected to flow to the entity” has another effect on the definition of assets. Including these phrases into the definition is designed to put limits on the type of assets that would be recognized in the financial statements. In other words, it would only be those assets where there is an expectation of an inflow that would be recognized. So, a tax receivable where cash is not expected to flow would not be an asset in the first place.
89. The view of the IASB/FASB Conceptual Framework project was that keeping the phrase in the definition made it less clear what an asset is and questioned whether the inclusion of the phrase was addressing issues of recognition and narrowing the definition of assets. As well, it was viewed that the phrases tended to overburden and confuse the definition of an asset. There is an argument that suggests that the definition of assets should stand on its own.

Should the definition include the recognition criteria?

90. Another approach is to address the recognition criteria in the definition of an asset. The phrase “expected to flow” was inserted to address uncertainty and the recognition criteria then attempts to clarify when that expectation should be considered i.e., when it is probable that the economic benefit or service potential will flow”. The asset definition could include this notion in the definition itself, making it easier for readers to identify the asset in one place. For example, and using the existing definition and the phrase more likely than not:

An asset is a resource controlled by an entity as a result of past events and from which future economic benefits or service potential are ~~expected~~ **more likely than not** to flow to the entity

91. In addition, the recognition criteria set out by all of the standards setters include the notion of the reliability of the measurement. This idea can be brought into the definition as well:

An asset is a resource controlled by an entity as a result of past events and from which future economic benefits or service potential are more likely than not to flow to the entity **and can be measured reliably**

92. This definition provides for “one stop shopping” as all of the key aspects of the element definition and the recognition criteria are contained in a single definition. The disadvantage to this approach is that the definition becomes very complex.

Appendix A: Is the power to tax or license an asset?

- A1. A government's power to tax and license is a distinguishing feature of governments and an important consideration for creditors, lenders or investors in assessing a government's revenue generating potential. However, these powers are not a present economic resource of a government because they are not capable of producing inflows of cash, cash equivalents, goods or providing services.
- A2. A government's power to tax or license cannot be sold, exchanged, assigned, or used to settle/discharge a government's liabilities at the reporting date. It also cannot be used to purchase or acquire goods or services for the government or give a government the right to receive goods or services, or the right to use others' assets on the reporting date.

When does power to tax or license provide control over economic resources?

- A3. The question is at what point will a government's power to tax become an economic resource that brings inflows of cash, cash equivalents, goods or services to the government; or that it will be able to provide services to meet a government's mission. Several critical events/steps normally happen in that translation process, including:
- A government's tax, fiscal and other policies or decisions to impose a tax or levy a fee;
 - Tabling of a new or amended tax or other enabling legislation;
 - Passage of enabling legislation;
 - Effective date of the enabling legislation;
 - Occurrence of the event subject to tax or license specified in the enabling legislation.
- A4. A government's power to tax or license represents its ability to obtain assets by imposing taxes and fees and is not, of itself, an asset. However, this is a necessary but not a sufficient condition for the creation of tax or fee related assets. Passage of enabling legislation provides a government with an enforceable legal claim against the economic resources related to the tax or fee revenue when certain events arise or if certain circumstances exist as specified in the enabling legislation. An economic resource that produces inflows of cash, cash equivalents, good or services to a government, or gives a government the right to receive goods/services or to use others' assets does not exist until the occurrence of the event subject to tax or license as specified in the enabling legislation.
- A5. The FASAB notes that the mere existence of a government's power to tax is not an asset because, until the government has exercised its power by imposing the tax and has access to the benefits by completing the taxable event (the levy or the event that otherwise gives rise to the benefit, such as sales tax), no event has occurred to generate resources that the government can control. The GASB supports this view and notes that the power to tax produces an asset only when that power is exercised and an enforceable tax levy or taxable transaction has

- taken place. Similarly, other powers inherent in governments, such as regulatory or eminent domain powers are not assets, but they may result in assets when the government exercises those powers.
- A6. This conclusion is consistent with the guidance provided in other public sector standards that address non-exchange transactions. IPSAS 23, “Revenue from Non-exchange Transactions (Taxes and Transfers)” recognizes that “in many instances, the entity will need to establish enforceability of its control of resources before it can recognize an asset. If an entity does not have an enforceable claim to resources, it cannot exclude or regulate the transferor’s access to those resources”.¹³
- A7. This application and interpretation of the definition of an asset to a government’s power to tax or license is consistent with the guidance provided in other public sector standards that address tax revenues or non-exchange transactions. The PSAB indicates that only when there has been a claim against a taxpayer does the power to tax give rise to an asset.¹⁴ IPSAS 23 identifies that a taxable event gives rise to control of an asset.¹⁵
- A8. The GASB requires that governments recognize assets from derived tax revenue¹⁶ transactions in the period when the exchange transaction on which the tax is imposed occurs or when the resources are received, whichever occurs first.¹⁷ Governments should recognize assets from imposed non-exchange revenue¹⁸ transactions in the period when an enforceable legal claim to the assets arises or when the resources are received, whichever occurs first.¹⁹ The GASB concluded that the conceptually appropriate recognition point for assets in non-exchange transactions is when an enforceable legal claim to resources arises, based on the specifications of enabling legislation or contractual requirements. In the normal course of events, a government’s claim over derived tax and imposed non-exchange revenues is legal and realizable because the government’s claim is supported by law or regulation and the government can enforce its claim to the taxpayer’s or the citizen’s resources.²⁰
- A9. Once it is established that an asset arising from a government’s exercise of its power to tax or license exists (that is, meets the definition of an asset), there are

¹³ IPSAS 23, paragraph 33.

¹⁴ PSAB, PS 3510.15.

¹⁵ IPSAS 23, paragraph 34.

¹⁶ Derived tax revenues result from assessments imposed by governments on exchange transactions. Examples include taxes on personal income, corporate income, and retail sales of goods and services GASB 33, paragraph 7(a).

¹⁷ GASB 33, paragraph 16.

¹⁸ Imposed non-exchange revenues result from assessments by governments or non-governmental entities, including individuals, other than assessments on exchange transactions. Examples include property taxes; fines and penalties; and property forfeitures, such as seizures and escheats GASB 33, paragraph 7(b).

¹⁹ GASB 33, paragraph 17.

²⁰ GASB 33, paragraph 64.

specific recognition criteria in standards that address tax revenue or non-exchange transactions and/or, if no such standard exists, the general recognition criteria in the conceptual framework must be met before an asset is recognized in a government's financial statements.

Appendix B: Borrowing Costs [For reference only – see covering memo]

- B1. IPSAS 5, “Borrowing Costs” currently permits two treatments for accounting for borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. They can be immediately recognized as an expense or, alternatively, capitalized. A qualifying asset is “an asset that necessarily takes a substantial period of time to get ready for its intended use or sale”.
- B2. For clarity, the issue regarding whether or not borrowing costs directly attributable to obtaining an asset should be included in the cost of that asset, is concerned only with the determination of the cost of the asset. That is, assets measured at fair value on initial recognition are not relevant to this issue.
- B3. In 2007, the IPSASB initiated a continuous improvements project to update its existing standards to converge with the related IFRSs to the extent appropriate for the public sector. As part of that project, the IPSASB reviewed the IASB’s amendments to IAS 23, “Borrowing Costs” issued in March 2007, which requires capitalization borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.
- B4. As a result of the review of IAS 23, the IPSASB issued Exposure Draft (ED) 35, “Borrowing Costs (Revised 200X)” in September 2008. ED 35 proposed that borrowing costs should be expensed however, where entities borrow funds specifically to acquire, construct or produce a qualifying asset, the entity has the option to capitalize those costs as part of the cost of that asset.
- B5. The responses to ED 35 did not indicate a preference to finalize ED 35 and also did not give a clear indication as to the direction the IPSASB should take. At its February 2009 meeting, the IPSASB agreed that its project to converge IPSAS 5 should be deferred so that this issue could be considered from a conceptual viewpoint.
- B6. This Appendix is in four parts:
- Conceptual views of borrowing costs;
 - Other standard setters’ requirements for borrowing costs;
 - GFS requirements; and
 - A comparison of accounting requirements with GFS requirements.

Conceptual views

- B7. This section sets out the conceptual considerations as to whether or not borrowing costs that are directly attributable to obtaining a qualifying asset should be capitalized.

Which items should be included in the cost of an asset?

- B8. IPSAS 1 contains the current definition of an asset:

“Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow.”

- B9. The application of the definition of an asset to a qualifying asset such as property, plant and equipment, or an intangible asset, requires that the cost of an item shall be recognized as an asset if, and only if, it is probable that future economic benefits or service potential associated with the item will flow to the entity and the cost or fair value of the item can be measured reliably. It is implicit in these requirements that the item is a resource because the entity considers that it is probable that future economic benefits or service potential are expected to flow to the entity.
- B10. The amount to be recognized is the item’s “cost”. The definition of cost is “the amount of cash or cash equivalents paid and the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction”.
- B11. IPSAS 17, “Property, Plant and Equipment” sets out the items of expenditure that comprise the cost of an asset, as follows:

“The cost of an item of property, plant and equipment comprises:

- (a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.*
- (b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.*
- (c) The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.”*

- B12. Thus, any costs directly attributable to obtaining a qualifying asset are included in the cost of an asset. Another way of explaining this is to say that those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made are directly attributable costs.
- B13. The IASB, when it removed the option to expense directly attributable borrowing costs, justified the mandatory capitalization of borrowing costs that are directly attributable to a qualifying asset on the grounds that this treatment:
- (a) Improves faithful representation of the cost of the qualifying asset because borrowing costs that are directly attributable to the asset are a cost of the asset; and
 - (b) Enhances comparability, in that capitalizing borrowing costs improves comparability between internally developed assets and those acquired from third parties. The IASB acknowledged that capitalizing borrowing costs achieves comparability amongst non-equity financed assets but it

does not achieve comparability between assets that are financed with borrowings and those that are financed with equity.

Are borrowing costs financing costs?

- B14. One of the qualitative characteristics of financial reporting is that it is comparable, i.e., information in financial statements is comparable when users are able to identify similarities and differences between that information and information in other reports. Comparability applies to the comparison of financial statements of different entities and the comparison of the financial statements of the same entity over periods of time.
- B15. From the viewpoint of comparability between different entities, capitalizing only borrowing costs to the extent of debt financing does not appear to meet the characteristic of comparability. Instead, to be comparable between entities, all financing costs directly attributable to the acquisition, construction or production of a qualifying asset should be included in its recognized cost regardless of the form that finance takes, i.e., include the cost of finance from debt financing and from the notional costs of equity financing.
- B16. The result of capitalizing only borrowing costs arising from debt financing means that the financing structure of an entity could affect the acquisition cost of an asset as well as its carrying amount. An asset should not have different acquisition costs (and therefore carrying amount) based on the financing adopted by the entity or simply based on difficulties associated with the apportionment of pooled funds. Where an entity is debt-free, it could have a qualifying asset with a lower carrying amount compared to a debt-financed entity. Therefore, it seems conceptually inconsistent that an entity should trace the source of funding to determine the amount to be capitalized to a particular qualifying asset.
- B17. Furthermore, equity financing in the context of public sector entities will almost always mean funding from a surplus, or previous years' surpluses since most public sector entities do not issue equity instruments. So identifying the "notional costs of equity" will bring further challenges.

Are borrowing costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management?

- B18. The cost of an asset comprises any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Borrowing costs do not appear to be a part of the costs "directly attributable to bringing the asset to the location and condition necessary" for its intended use. That is, the issuance of debt (and incurring a borrowing cost) is not "necessary" to place an asset in use from a conceptual viewpoint. Other costs incurred to bring the asset to the location and condition necessary for its intended use such as costs of site preparation, installation and assembly costs are a necessity; the asset will not be capable of operating if these costs are not incurred. Rather, the issuance of debt to fund an asset is a policy decision.

- B19. An entity could choose to use existing resources, raise additional resources by increasing taxes or user fees, divert resources from other activities, or issue debt to fund the acquisition or construction of an asset. Thus, borrowing costs represent an element of the cost of financing the entity's collective activities for a period and represent the cost of the return due to the lender for the funds held by the entity for a certain period. Therefore, borrowing costs should be treated the same as other financing costs and be expensed in the period in which they are incurred.
- B20. The policy decision as to whether or not to finance an asset differs from the policy decision to acquire the asset. The decision relating to the acquisition, construction or production of an asset relates to the objective of the entity. For public sector entities the decision to obtain a qualifying asset usually relates to what services are provided and to what level. In contrast, the decision relating to the funding of an entity relates to the entity's activities as a whole, i.e., it is a financing decision.

Other standard setters' requirements for borrowing costs

- B21. Other standard setters' requirements for borrowing costs are set out in Table 1 below.

Should borrowing costs be expensed?

- B22. The GASB requires borrowing costs to be expensed by not including this item in the list of ancillary charges that are necessary to place the asset into its intended location and condition for use. The FASB includes a list of assets for which interest is not capitalized. This includes "assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants." Staff is unsure as to whether this requirement will apply to all not-for-profit entities or to only some of these entities.

Should IPSASB permit capitalization?

- B23. Standard setters which permit the capitalization of borrowing costs as an accounting policy decision of the entity are the IPSASB, PSAB, the UK ASB and the Canadian ASB.

Should IPSASB require capitalization?

- B24. Two private sector entity standard setters, the FASB and the IASB require the capitalization of borrowing costs.

Should IPSASB require capitalization, except where inappropriate?

- B25. The South African ASB requires capitalization of borrowing costs except where it is inappropriate to do so and gives guidance on when it is inappropriate, i.e., "when, and only when, there is clear evidence that it is difficult to link the borrowing requirement of an entity directly to the nature of the expenditure to be funded i.e., capital or current".

Should IPSASB require capitalization, except for public sector entities?

- B26. Standard setters that set standards for both public and private sectors, such as the AASB and the New Zealand FRSB, have given temporary relief from the requirement to capitalize borrowing costs directly attributable to obtaining a qualifying asset for public sector entities. The AASB has a project on this topic and the New Zealand FRSB is awaiting the outcome of international developments.

Table 1: Treatment of borrowing costs

Public Sector Accounting Standard Setters	
IPSASB	<p>Borrowing costs should be recognized as an expense in the period in which they are incurred, except to the extent that they are capitalized in accordance with paragraph 18.</p> <p>Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard (IPSAS 5, paragraphs 17 and 18)</p>
Canada PSAB	<p>The cost of a tangible capital asset that is acquired, constructed or developed over time includes carrying costs directly attributable to the acquisition, construction or development activity, such as interest costs when the government's policy is to capitalize interest costs. (PS 3150.15)</p>
South Africa ASB	<p>An entity shall recognize borrowing costs that are directly attributable to the acquisition, construction or production of an asset, in accordance with paragraph .08, except when it is inappropriate to do so. It is inappropriate to capitalize borrowing costs when, and only when, there is clear evidence that it is difficult to link the borrowing requirement of an entity directly to the nature of the expenditure to be funded i.e. capital or current. In such cases, an entity shall expense those borrowing costs related to a qualifying asset directly to the statement of financial performance. (GRAP 5.10)</p>
UK ASB – Public Benefit Entities: No different requirements than for for-profit entities.	<p>Where an entity adopts a policy of capitalizing finance costs, finance costs that are directly attributable to the construction of tangible fixed assets should be capitalized as part of the cost of those assets. The total amount of finance costs capitalized during a period should not exceed the total amount of finance costs incurred during that period. (FRS 15.19)</p>
US FASAB	<p>All general PP&E shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use. For example, the cost of acquiring property, plant, and equipment may include:</p> <ul style="list-style-type: none"> • amounts paid to vendors; • transportation charges to the point of initial use;

	<ul style="list-style-type: none"> • handling and storage costs; • labor and other direct or indirect production costs (for assets produced or constructed); • engineering, architectural, and other outside services for designs, plans, specifications, and surveys; • acquisition and preparation costs of buildings and other facilities; • an appropriate share of the cost of the equipment and facilities used in construction work; • fixed equipment and related installation costs required for activities in a building or facility; • direct costs of inspection, supervision, and administration of construction contracts and construction work; • legal and recording fees and damage claims; • fair value of facilities and equipment donated to the government; and • material amounts of interest costs paid.²¹ (SFFAS 6.26)
US FASB – Not-for-Profit organizations	<p>The following subparagraph is added to paragraph 10 of Statement 34, which specifies the types of assets for which interest is not capitalized:</p> <p>(f) Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose. (SFAS 62.5)</p>
US GASB	<p>Capital assets should be reported as historical cost. The cost of a capital asset should include ancillary charges necessary to place the asset into its intended location and condition for use. Ancillary charges include costs that are directly attributable to asset acquisition—such as freight and transportation charges, site preparation costs, and professional fees. Donated capital assets should be reported at their estimated fair value at the time of acquisition plus ancillary charges, if any. (Statement 34.18 as amended by Statement 37.6, which deleted the requirement for borrowing costs to be included in the historical cost of an asset)</p>
Private Sector Accounting Standard Setters	
IASB	<p>An entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognize other borrowing costs as an expense in the period in which it incurs them. (IAS 23.8)</p>
Canada AcSB	<p>The cost of an item of property, plant and equipment that is acquired, constructed or developed over time includes carrying costs directly attributable to the acquisition, construction or development activity such as interest costs when the enterprise’s accounting policy is to capitalize interest costs. For an item of rate-regulated property, plant and</p>

²¹ “Interest costs” refers to any interest paid by the reporting entity directly to providers of goods or services related to the acquisition or construction of PP&E.

	equipment, the cost includes the directly attributable allowance for funds used during construction allowed by the regulator. (3061.23)
UK ASB	Where an entity adopts a policy of capitalizing finance costs, finance costs that are directly attributable to the construction of tangible fixed assets should be capitalized as part of the cost of those assets. The total amount of finance costs capitalized during a period should not exceed the total amount of finance costs incurred during that period. (FRS 15.19)
US FASB	The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset. (SFAS 34.6)
Accounting Standard Setters for Private and Public Sectors	
Australia AASB	An entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognize other borrowing costs as an expense in the period in which it incurs them. A not-for-profit public sector entity may elect to recognize borrowing costs as an expense in the period in which they are incurred regardless of how the borrowings are applied. (AASB 123, paragraphs 8 and Aus8.1) ²²
NZ FRSB	An entity shall capitalize borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognize other borrowing costs as an expense in the period in which it incurs them. (NZ IAS 23.8) Public Benefit Entities Notwithstanding paragraph 29 of this Standard [effective date paragraph], public benefit entities are permitted, but not required, to apply this Standard for annual periods beginning on or after 1 January 2009†. Earlier application is permitted in accordance with paragraph 29 of this Standard. A public benefit entity that elects to defer the application of NZ IAS 23 (revised 2008) shall expense borrowing costs in accordance with NZ IAS 23 (2004), shall disclose that fact and shall apply the related consequential amendments to NZ IAS 16 <i>Property, Plant and Equipment</i> and NZ IAS 11 <i>Construction Contracts</i> . (NZ IAS 23.29.1)

²² In April 2009, the AASB agreed to reintroduce the expense option for not-for-profit public sector entities. The AASB currently has a project on the application of AASB 123 to not-for-profit public sector entities.

GFS requirements for borrowing costs

- B27. GFS defines an asset as an item over which ownership rights are enforced and from which economic benefits may be derived by their owners by holding or using them²³. Assets are held at current market value²⁴ which is defined as the amount that would have to be paid to acquire the asset on the valuation date. The current market value for fixed assets on acquisition is the amount for which they could be exchanged. This value includes all transport and installation charges and all costs of ownership transfer. Costs of ownership transfer include fees paid to surveyors, engineers, architects, lawyers, and estate agents and taxes payable on the transfer²⁵.
- B28. GFS explicitly states that interest and other financing charges incurred in connection with a transaction are not a cost of ownership transfer²⁶. This is reflected in the definition of interest which reflects its economic nature of being a payment from the borrower to the lender for the use of the lender's funds, i.e., interest is the cost of borrowing or financing which provides the lender with some interest income. This creates consistency in the whole of the economic system, as the interest payments and the interest received by all economic units is equal, i.e., GFS is a part of the SNA which records the entire economy of a jurisdiction. If interest was capitalized, the cost of financing would be undercounted.
- B29. The use of current market value to value assets means that the same assets should be valued at the same prices. For example, a government unit is constructing two identical buildings, with one being financed by a loan and the other being financed from existing surplus cash reserves. If interest is included in the acquisition cost of the building being externally financed, it would lead the government unit to record two identical buildings at different values given that the one that is being financed from cash reserves will have a lesser value than the building constructed using the loan financing. However, the economic value of the two identical buildings should be equal. Hence, GFS does not capitalize the interest costs.

Comparison of accounting requirements with GFS requirements

- B30. The accounting requirements, where an asset is held at cost, vary. Entities can be required or permitted to capitalize borrowing costs directly attributable to obtaining a qualifying asset or be prohibited from doing so.
- B31. The GFS requirements for interest are based on its economic nature, i.e., it is the return a lender receives for lending funds. Consistency across all entities in a jurisdiction means that interest is recognized either as an expense or as income. The economic nature of the acquisition of an asset means that the cost comprises transport and installation charges and all costs of ownership transfer. Interest

²³ GFSM 2001, paragraph 7.4.

²⁴ GFSM 2001, paragraph 7.5.

²⁵ GFSM 2001, paragraph 7.22.

²⁶ GFSM 2001, paragraph 8.6.

costs are not a cost of ownership transfer and therefore do not comprise part of the cost of an asset.

ISSUE 3: HOW SHOULD LIABILITIES BE DEFINED?

Purpose

1. The purpose of this paper is to determine what the IPSASB's definition of liabilities should be.
2. The IPSASB defines liabilities as:
"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."

Are there any issues with the current definition that need to be addressed?

3. The IPSASB's current definition is based on the existing IASB definition with a change made to include service potential for the purposes of public sector entities.
4. Governments exist to provide a wide range of public services and are responsible for the ongoing provision of public services such as health, welfare and education. In addition, they offer a number of social programs such as public pensions and insurance schemes to the general public.
5. A public sector entity's budget usually specifies the purpose of the spending and set limits either in amounts or by way of other conditions. The budget is usually developed, approved and issued as a public policy statement and users look to the government to demonstrate whether public resources were administered accordingly. Because the budget is usually a public policy statement, it sets out specific programs and conditions and is approved by the governing body, it may establish an "obligation."
6. Public sector entities also react to a number of issues such as catastrophic events, natural disasters and epidemics for the purposes of assisting those in need. They can establish a pattern of past practice making it difficult to determine whether a government has an ongoing "obligation" when such an event occurs or even in the expectation that these events could occur.
7. Given the nature of public sector entity's responsibilities, it is sometimes difficult to determine when it has a liability.
8. How have liabilities been defined by others?

Public Sector Accounting Standard Setters	
IPSASB	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.
Canada PSAB	Liabilities are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits.

South Africa ASB	A liability is a present obligation 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.
US FASAB	A liability is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand
US GASB	Liabilities are present obligations to sacrifice resources that the government has little or no discretion to avoid.
Private Sector Accounting Standard Setters	
IASB	A liability is a present obligation 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.
Canada AcSB	Liabilities are obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future.
UK ASB	Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events.
UK ASB – PBE	Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events.
US FASB	Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.
Accounting Standard Setters for Private and Public Sectors	
Australia ASB	A liability is a present obligation 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.
NZ FRSB	A liability is a present obligation 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.
Other	
GFS	Liabilities are obligations to provide economic benefits to the units holding the corresponding claims.

What are the characteristics of a liability that have been identified?

9. In the following table, an “X” means the characteristic is part of the definition and a “G” means that it is provided in additional guidance supporting the definition.

Source	Present obligation	Expected outflow or transfer of economic benefit or service potential	Past event	No realistic alternative	Little or no discretion to avoid	To others or from the entity	Specified or determinable date, on occurrence of a specified event, or on demand
IPSASB	X	X	X	G		X	
PSAB	X	X	X	G	G	X	G
SA ASB	X	X	X			X	
FASAB	X	X	G			X	X
GASB	X	X	G		X	G	
IASB	X	X	X			X	
Can AcSB	X	X	X	G	G	G	G
UK ASB	X	X	X	G		G	
UK ASB PBE	X	X	X	G		G	
US FASB	X	X	X		G	X	G
AASB	X	X	X			X	
NZ FRSB	X	X	X			X	
GFS	X	X	G			G	

What is the liability?

10. The existing IPSASB definition of a liability focuses on the obligation, the settlement of which is expected to result in an outflow of economic benefits or service potential. It notes that it is the obligation that generates the expected outflow from the entity. This view is shared by all of the public sector specific standard setters.
11. A review of other standard setters definitions indicates that some do not agree that the liability is the “obligation.” There are some who believe that the liability is the future sacrifice of economic benefit or service potential.

The liability as the outflow of resources

12. The FASB focuses its definition on the sacrifice of economic benefits. Focusing on the probable future or future sacrifices of economic benefits or service potential puts the onus on the outflow of those benefits. The FASB has included the idea of “future” economic benefits or service potential. This suggests that a liability is something that is expected to happen in the future. It could lead to the

- wrong conclusion because the future sacrifice of economic benefits or service potential is a future event rather than a current one.
13. Focusing on the future sacrifice of economic benefits or service potential seems to place the emphasis on the wrong thing. Generally, the definition of a liability is focused on the “obligation.” From this perspective, the addition of “sacrifice of economic benefit” in the definition of a liability seems to qualify the types of obligations that are included in financial statements.
 14. The IASB/FASB Conceptual Framework project¹ provides some thoughts on focusing on the “outflow” rather than the obligation. It is noted that certain FASB Board members’ suggestions to a 1977 FASB exposure draft resulted in de-emphasizing the obligation and placing greater emphasis on the outflow of resources. This change was made based on a view that discharging a business need has the same effect on an organization’s assets as discharging an enforceable claim. From that perspective it was not the obligation but the need to reflect resources flowing out of the entity which takes precedence.
 15. While the FASB’s language, when taken as a whole, would not permit liabilities that are not obligations, the focus of the liability definition remains. The IASB/FASB Conceptual Framework project places the emphasis on the obligation as the liability and not on the outflow of resources.
 16. The IPSASB takes the view that the liability is the obligation which results in an expected outflow of resources. In other words, there must be an obligation first.
 17. Using IPSASB’s current definition:

A liability is a present obligation

How do you know when the obligation is the responsibility of the entity?

18. One way to identify the liability with the entity is to introduce the phrase “of an entity.” This would indicate that at a minimum, the resource needs to belong to the entity.
19. As with the asset definition, this approach defines liabilities generally but does not answer the question of which liabilities belong on the entity’s financial statements. Without providing a link to the entity, as was illustrated in the asset definition, the entity would first need to determine all obligations then applying some supporting guidance to determine when it is the entity’s liabilities. Linking the obligation to the entity within the definition, similar to the asset definition, is useful as there can be many obligations that the entity is not aware of and providing the link makes the definition more efficient and easier to understand.
20. The benefit of linking the liability to the entity in the definition itself is that it requires both aspects i.e., the obligation and the link to the entity to be present to determine which liabilities belong to the entity. For an entity to report a liability there must be a present obligation and it must be that entity’s obligation. For

¹ IASB/FASB Conceptual Framework – Elements 2: Liability Definition, March 2006 paper,

example, an account payable is a present promise to pay cash and it is that entity's obligation.

21. The IPSASB, IASB, PSAB, Canadian AcSB, FASAB, GASB, UK ASB, AASB, NZ FRSB and South African ASB definitions include the phrase “of the entity”, “of a government”, “of the federal government”, and of “a particular entity”. All of these phrases are attempts at limiting the liability to a particular entity.

A liability is a present obligation of the entity

22. While an improvement over a definition that defines liabilities generally as an obligation, it still forces the reader into the supporting guidance to determine what is meant by “of the entity.”
23. One approach is to link liabilities to the entity by using legal requirements or, in other words, those obligations that are legally enforceable against the entity. Many obligations arise from contractual obligations resulting from deliberate actions of the entity, such as exchange transactions with other parties to acquire the funds, goods, and services needed for the entity to operate. For example, borrowing cash requires an entity to repay the amount borrowed; acquiring assets on credit obligates an entity to pay for them; using employees' knowledge, skills, time, and efforts obligates an entity to pay for their use, often including non-payroll benefits. Guaranteeing debt of others would require a government to stand ready to pay cash to the borrower or repay the debt directly. They are obligations based on written or oral agreements which outline an entity's requirement to pay cash or to provide goods or services to specified or determinable other parties.
24. Legally enforceable obligations include those that are established by contract or otherwise imposed, as they can be enforced by a court of law. In some cases, constructive obligations – those that are created, inferred, or construed from the facts in a particular situation – may also be enforceable by the operation of various legal doctrines. Such doctrines can be considered part of law and thus, are also legally enforceable. In some cases, equitable obligations—those that stem from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right – might also be enforceable when they are supported by courts of equity.
25. The IASB notes that obligations may be legally enforceable as a consequence of a binding contract or legislation. This is normally the case, for example, with amounts payable for goods and services received. The PSAB, FASAB, GASB, AASB and the South African ASB also refer to contracts and legislation as components of legal obligations. The FASB notes that many liabilities are legally enforceable. The FASB and UK ASB do not specify the components of legal obligations, but note that many liabilities are based on legal obligations. GFS does not identify legislation in their definitions but refer to contractual or legally binding arrangements.
26. Some legal obligations of the entity result from non-reciprocal transfers. There may be a social program in place where recipients have met the eligibility criteria to receive a benefit and, as a result, a public sector entity can have a legal

- obligation. Such obligations of the entity include those arising from deliberate actions of the entity such as unconditional transfers that have not yet been paid.
27. Legal obligations of an entity might also arise as a result of actions taken by others that are binding on the entity, such as legislative actions (statutes such as those requiring the payment of income and sales taxes), judicial actions (such as court awards for damages), or executive actions (for example, regulatory requirements or fines). Even if some discretion is provided to the entity as to how it acts in response to that action, as long as the entity is required to take some action it has an economic obligation. For example, an entity might have a choice of remedying a breach of legislation or paying a fine. So long as others can require the entity to take one or the other action, the entity is obligated.
28. Other legal obligations of the entity arise from constructive obligations. A constructive obligation might be created, inferred, or construed from the facts in a particular situation, rather than contracted by agreement with another entity or imposed by government. For example, an entity might have a history of paying employee pension benefits even though there is no specified contractual agreement to do so and the entity has not announced a policy to do so. Nonetheless, in a country that has this type of law, a court could construe that action to have created a legally enforceable obligation.

**A liability is a present obligation that is legally enforceable
against the entity**

29. There is another view that obligations may also be enforceable against the entity by someone or something outside of the entity, but not necessarily in a court of law. In other words, it would include obligations that another party could force the entity to fulfill, otherwise satisfy or settle.
30. For example, two or more parties might agree to accept the decision of an arbitrator. The arbitrator in a wage settlement situation can impose and enforce requirements upon both the employees and the entity itself. Even though the consequences of enforcement might differ somewhat, they are regarded as the equivalent of legally enforceable obligations. Other mechanisms might make it very difficult for the parties to avoid abiding by the arbitrator's decision.
31. From this perspective, enforceable would mean that a:
- (a) *Separate party* is involved. In the case of the arbitrator, it is an individual appointed by the parties in dispute.
 - (b) *Mechanism* exists that is capable of forcing an entity to take a specified course of action or consequence. If that specified course of action is not taken by the entity, then the claimant or intended recipient of the action can seek assistance from the separate party to enforce the consequences.
32. Obligations that could not be enforced by a separate party or mechanism would not qualify for recognition. For example, an entity would not have an enforceable obligation to demand additional compensation merely because its employees are

on strike, because there is no mechanism or separate party by which to enforce any action.

33. Alternatively, it might be clear that environmental damage has occurred. In some cases, however, there may be no legal or equivalent requirement to clean-up certain abandoned mines sites. An entity that simply chooses to introduce a cleanup program, would not qualify as a liability because no external party can force the entity to clean up those sites. The entity doing the clean up maintains discretion as to whether or not to do it, in this or a subsequent period. This would not be the case, if there was legal or equivalent requirement to act.

**A liability is a present economic obligation that is enforceable
by legal or equivalent means against the entity**

34. While statutes, regulations and situations may differ from country to country, this enforceability approach provides a solid basis upon which to build a definition of liabilities. Otherwise, liabilities are in the eyes of management who can decide whether or not to honor these types of compulsions. No other party could force the entity to settle or act upon them.
35. The IASB/FASB Conceptual Framework project² notes that when an entity feels morally or economically compelled to do something, these are things that are outside of legal compulsion. Moral compulsion refers what one ought to do to be fair, right or just. This differs from legal compulsion which emanates from forces external to the entity. Moral compulsion is an internal compulsion. Economic compulsion refers to an entity doing what is in its own best interests. This differs from legal compulsion as it too emanates from internal rather than external forces. The difficulty with these types of obligations is determining if the entity really “feels” morally or economically compelled. Management may feel compelled in good times while not so compelled in bad times.

What are the essential characteristics of a liability?

36. Governments³ often make commitments relating to such things as program delivery choices, the levels and quality of services to be provided, the levels and types of taxes, and the acquisition or construction of a new road or hospital. Generally, a commitment is different than an obligation because the government retains the ability to change its decision. Acts of budgeting, future program commitments and other such commitments require future actions by the government prior to them becoming a present obligation to others.
37. Including possible future obligations for expected purchases or budgeted items could lead to manipulation of the reported financial position and results as the government could choose not follow through with its intentions, and thus overstate liabilities and, for example, expenses in the current period and understate them in a following period when the entry is reversed.

² IASB/FASB, Elements 2 – Liability Definition, February 2006, paragraphs 57 – 60.

³ The word government is used in place of public sector entity.

38. Consider the issue of management intent. If management simply were to decide to discontinue particular operations, should that change in its intentions affect how those operations are to be accounted for? In what circumstance, if any, should accounting decisions depend on assumptions about the future that are based on management's stated intentions?
39. Management intent is a present assertion about management's plans for future courses of action. To the extent that those intentions about future courses of action are consistent with present courses of action, management intent may be thought of as a reasonable basis for accounting treatments. However, management intent can and sometimes does change, raising the question of whether the accounting treatment should change whenever stated intentions change. Because intentions are inherently unknowable by others, and because the actual course taken cannot be known until it ultimately unfolds, management intent is a particularly difficult notion to use.
40. While the general meaning of obligations is very broad, obligations for the purposes of accounting are not liabilities until they meet the two essential characteristics of liabilities – there must be a present obligation and the obligation is expected result in an outflow or transfer of economic benefits or service potential.
41. It is the occurrence of a past event on or before the reporting date that distinguishes a present obligation from a future obligation. This is sometimes referred to as the "obligating event". The word "present" preceding the word obligation is a useful addition to help users understand that liabilities are dealing with things that exist today.
42. When a government receives resources from others, and the amounts received have external conditions placed on the use of those resources, such as requiring the government to use the resources to build a water treatment plant, then the government does have a present obligation as those resources do not belong to the government until the government fulfills its obligation related to the condition.
43. Certain transfers, such as entitlements or shared cost agreements, that have not been authorized or where the recipients have not met the eligibility criteria are not present obligations of the government. While the government may have future obligations associated with these types of transfers, there are not present obligations. In these instances, the government is not obligated until recipient meets certain criteria. For many government transfers, recipients must continually meet those criteria to remain eligible for the amounts of the transfers.
44. Shared cost agreements require that the recipient of the funding incur expenditures and until the recipient incurs those expenditures, the government does not have a present obligation. It is only those items that are present obligations of the government at the end of the reporting period that are present obligations.
45. Based on the guidance in other standard setters' material, the following sets out the major characteristics of an obligation:

- (a) There is a valid expectation on behalf of a recipient and the entity cannot realistically withdraw from the obligation.

For special termination benefits and for those meeting eligibility criteria for assistance under various social programs or other government transfer payments, for example, once the government announces the terms of those plans and programs, and the intended recipient is aware of those terms or meets the eligibility criteria, the government has created a valid expectation among the recipients, a detrimental reliance by them on the government fulfilling its obligation and, as a result, the government cannot realistically withdraw from that obligation.

- (b) The government has little or no discretion to avoid the obligation.

Discretion is the ability to make individual choices, judgments or decisions. Decisions such as budgeting for the purchase of fire truck and commitments for future ongoing program expenditures are possible future obligations that the government could avoid through its own actions. In these circumstances the entity is not bound to a particular course of action, as the government has discretion to change or avoid the obligation through its own actions. The government has given up its freedom to make further choices related to the obligation.

When a government purchases a good, for example, the government has lost its discretion to avoid payment or other form of settlement with the provider of the good. If the government chooses not to pay, it is virtually certain that the vendor will take recourse against the government in a court of law, and, all else being equal, the court would decide in favor of the vendor.

- (c) There must be a duty or responsibility to others.

A liability always involves a third party external to the reporting entity to which the government is obliged. It is not necessary for the government to know the identity of the party(s) involved as the obligation may be to the public at large or to a group of recipient such as those obligations related to social assistance. A government cannot be both the entity that is obliged and the entity to which settlement is made – the obligation must be to other organizations or individuals.

Governments do not need the consent of others, for example, to alter budgeted items, or intentions to provide of future goods and services. The entity can choose to change or even cancel these programs without the consent of others, albeit perhaps at the cost of suffering adverse political consequences.

46. Most standard setters note that liabilities do not have to be legally enforceable provided that they otherwise meet the definition of liability. Governments can also have a present obligation that is as a result of its actions through past practices, published policies or making promises provided that it has created a valid expectation on the part of the parties involved that the government will

- discharge those responsibilities. The provision of voluntary retirement benefits is an example of where a government establishes a reasonable expectation on behalf of its employees that it will pay special termination benefits. In this instance, the present obligation is based on a number of facts or circumstances that have created a valid expectation that the government will implement the decision. In other words, the government cannot realistically withdraw from the plan.
47. Similarly, for other types of obligations, the fact the government has created a valid expectation that it will accept responsibility would indicate that the government has an obligation when there is an expectation that the government will proceed with its decision. Where a government contaminates land, for example, and no legislative requirements exist to clean up the contamination, a present obligation may exist because the government has a widely published policy that it will undertake to clean up land contamination. In this case, the government may have a present obligation because of the fact that the land is contaminated, that the government has an established policy for clean up and it has indicated to other parties that it will clean up the land.
48. That is not to say that all established patterns of past practice, for example, lead to an obligation. There are numerous examples of where a government in the past has enhanced pension and other similar benefits to employees, but more recently, those governments have in fact been reducing or eliminating those benefits. Patterns of past practices, published policies or even current statements must include an indication by the government to those parties that it will accept those responsibilities.
49. An obligation could exist when the government makes a promise such that the recipient of the promise has a reasonable expectation that the promise will be fulfilled. In other words, the government cannot realistically withdraw from its obligation.
50. A promise to oneself cannot be an obligation of the entity. For example, in the absence of external requirements, an entity is not obligated to repair the roof of its office building or maintain its water treatment facility. Although, completing any repair or maintenance may be economically worthwhile, the entity can choose defer repairs and maintenance.
51. An essential characteristic of liabilities is that the entity has a present obligation.

Is the sacrifice of economic benefits or service potential an essential characteristic?

52. Present obligations can encompass many things such as a promise of one party to walk across a bridge if the other party agrees to read a book. Once the first party walks across the bridge, the other has a present obligation to read the book. However, the objectives of financial statements do not include these types of obligations. To meet the objectives of financial statements, there needs to be a way to determine which obligations are included in financial statements and those which are outside of their scope.
53. It is only those obligations where the entity expects that the obligation will result in an outflow or transfer of economic benefits or service potential that are

- included in GPFS. Present obligations that do not result in an outflow or transfer of economic benefits or service potential are beyond the scope of financial statements.
54. For an obligation to meet the test of being a liability there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits or service potential to settle that obligation.
55. For the most part, the settlement of a liability will entail a sacrifice of economic benefits. That sacrifice is typically in the form of cash, but can also be in the form of another asset such as transferring an item of inventory or other property, plant and equipment or an investment. Not all liabilities are settled with the transfer of assets. Some are settled by using assets in a particular way such as, transfers received that have use conditions. In this situation, there is no outflow of resources in the same sense as a cash payment, but there is a sacrifice of economic benefits from the perspective that the assets cannot be used for any other purpose and the entity must perform in a certain way.
56. The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits or service potential in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:
- (a) Payment of cash;
 - (b) Transfer of other assets;
 - (c) Provision of services;
 - (d) Granting a right to use an asset;
 - (e) Replacement of that obligation with another obligation; or
 - (f) Conversion of the obligation to equity.
- An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.
57. Although many liabilities involve transfers of known amounts of cash, a liability could involve an obligation to transfer economic benefits other than cash, by providing services such as space to be used by renter who has prepaid their rent. Certainty that the obligation will result in a transfer of future economic benefits is not necessary. Obligations that may not result in a transfer of economic benefits, such as the guarantee of another entity's debt where that entity is expected to remain solvent, may be a liability.
58. The IPSASB's current definition that indicates liabilities are present obligations and that the obligation is expected to result in an outflow from the entity of resources captures the essential characteristics of liabilities.
59. The IPSASB's application of the current definition of a liability is in IPSAS 19, "Provisions, Contingent Liabilities and Contingent Assets". A present obligation is a duty or responsibility to act or perform in a particular way, i.e., the entity has no realistic alternative to settling the obligation. Settlement means that the entity

only has two options, to perform the obligation or to repay the amount. An obligating event is the past event which creates a constructive obligation or a legal obligation that results in an entity having no realistic alternative to settling that obligation, such as the purchase of an item on credit. A present obligation means that a public sector entity has little or no discretion to avoid the obligation to avoid settlement.

Is it enough just to have a future sacrifice of economic benefit or service potential?

60. While this notion of requiring settlement by sacrifice of economic benefit may be true in most circumstances, it is not always true. A government, for example, may have a loan payable however, at some future point that loan is forgiven by the lender. In this case, the liability does not result in an outflow or sacrifice of future economic benefits. Given the IPSASB's existing definition of revenue, a forgiven loan results in an increase in net assets/equity which has the same result as does an inflow of resources.
61. In other cases, the liability may be settled by replacing it with another liability. Governments do refinance outstanding debt when the situation indicates that it would be an advantage or when their cash requirements require them to refinance. In these cases, there is no outflow or sacrifice of economic benefits but merely the replacing one liability with another.
62. From this point of view, there must be an expectation that the economic benefits or service potential will actually flow out of the entity but there is a possibility that they may not. Most standard setters define this aspect as "economic benefits or service potential that is expected to flow from the entity."

How should future obligations be separated from present obligations?

63. The liabilities of an entity result from past transactions or other past events. Entities normally incur liabilities from purchasing goods and services, borrowing and non-reciprocal transactions, such as government transfers. Transactions or events expected to occur in the future do not, in themselves, give rise to present obligations. Hence, for example, an intention to purchase inventory does not, of itself, meet the definition of liability. Most other standard setters have included past transactions or events in their definitions. Others have included in it supporting text.
64. Implicit in the definition and essential characteristics of a liability is that the event giving rise to the government's obligation must have occurred. The government's intent or ability to acquire a resource in the future does not create liability. For the obligation to qualify as a liability, the government already must have lost its discretion to avoid the sacrifice of economic benefits or service potential. An entity that plans to incur a liability after the reporting date does not have a liability at the reporting date.
65. The FASAB and the GASB have not referred to a "past transaction or event" in their definitions. However, the supporting guidance includes the requirement that there must have been past transaction or event.

Is the characteristic that the obligation must be to others essential?

66. Obligations are usually documented, including that it is the entity which is required to bear the obligation. For example, in a construction contract to build a new water treatment facility, the contract will usually specify the names of the parties to the contract and other terms. However, the identity of the other party need not be known to obligate the entity before the time of settlement. For example, while a government may have an environmental liability, the identity of a contractor, who will be hired to carry out the work, may not be known.
67. Equity investors acting in their capacity as owners are not other parties. Claims to the residual interest in an entity which are capable of settlement with the entity, only as a result of actions by the entity, are not present economic obligations of the entity.
68. The existing definition does not directly suggest that the obligation must be to others, only that there is a present obligation that is expected to result in an outflow of resources from the entity.
69. However, the guidance in IPSAS 19 notes that 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.
70. The FASAB notes that in order for an obligation to qualify as a liability two separate entities must be involved because the same entity cannot be both the recipient of the settlement and the entity with the duty to settle. From this perspective, it may be useful to include the idea that the obligation should be to others.

Is a settlement date an essential characteristic?

71. Some note that the settlement of the obligation must have a specified or determinable date, occurs when a specified event happens or on demand. Including the notion of a time characteristic can provide useful guidance for identifying when an item is a liability or a contribution from an owner. While owners have claims on the residual interest of an entity, there is no time element involved. Further, there may be some instances where a public sector entity may have created a valid expectation but there is no time element. However, a liability that is not payable on demand, on a specified date, or on the occurrence of specified event may cast doubt as to whether the item meets the definition of a liability.

Is past transaction or event needed in the definition?

72. While an observed transaction or other event might provide a signal that a liability exists, it is not a fundamental characteristic of the element and the failure to observe a past event does not negate that a liability exists. The inclusion of the notion of a present obligation in the liability definition may nullify the need to include a reference to past events. Something must have happened to create an obligation. The main purpose of including this aspect into the definition is to exclude future liabilities from meeting the definition of a liability.
73. The difficulty with keeping the phrase “as a result of past events”:
 - (a) This does not reflect that there may have been past transactions or events that resulted in liabilities which no longer exist;
 - (b) It has resulted in unwarranted debates about what the past transaction or event was (and how the obligation arose should not be at question); and
 - (c) The inability to identify a past transaction or event may lead to non-recognition of a liability.
74. Using the term “future” obligation is not appropriate as it introduces the possibility of recognizing future liabilities such as ongoing program commitments. While a government may have a future commitment to provide education or purchase a new fire truck, until it provides that service or acquires that fire truck, it does not have a liability for them.
75. Removing the phrase “past event” from the definition of a liability does not preclude it being used as an indicator to provide evidence to support a present obligation. Users of financial statements are interested in liabilities that exist at that point in time. The definition of a liability requires that the obligation presently exists at the reporting date.
76. This means that a liability must have already arisen at the reporting date. Often an entity incurs liabilities when it receives purchased assets or services, but other transactions or events may give rise to liabilities. The means of incurring a liability does not affect whether something meets the definition of a liability, that is, the history of how the liability arose, or of how the entity incurred the liability, does not matter.

Is the phrase expected to flow from the entity best dealt with in the recognition criteria?

77. The definition of a liability includes a reference to the phrase “expected to result in an outflow.” For some, it is unclear what is meant by this phrase. Initially, this phrase was included to reflect a concern that without including it, many entities would not recognize a liability unless it was certain that there would be an outflow of economic resources.
78. Current practice in the application of the existing definition of a liability has led to some entities not recognizing a liability unless there is a high likelihood of economic resources flowing out of the entity. To avoid this misinterpretation, the

IASB/FASB Conceptual Framework project proposes that the working definition of a liability exclude reference to the expected outflow of economic resources from the definition. The IASB/FASB considers that it is preferable that this “expectation” be built into the recognition criteria rather than being built directly into the definition itself.

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow of economic benefits or service potential.

Are general business risks liabilities?

79. Governments face general risks, i.e., the possibility or chance of loss, in the same way as all other entities. General risks result from where, when and how an entity conducts its operations. Examples of these risks include variability in exchange rates or interest rates, or a change in economic conditions.
80. A public sector entity will also face general risks arising from its specific activities, i.e., where the demand for goods and services changes, there is an associated risk. For example, the prison population is expected to rise and therefore, more prisons, being non-cash-generating assets, are required.
81. Another example of a risk arising from specific activities could occur where an incoming government, in its election manifesto, promised to improve the ratio of teachers to children. This represents a risk that more resources will be required to fund education once the incoming government is in power. The public sector entity responsible for providing state education on behalf of the government currently has an alternative to settling the obligation and therefore does not have a present obligation. However, it could have a future obligation.
82. Other risks can occur where a public sector entity has a history of providing financial and other aid to individuals and organizations affected by a natural disaster, e.g., where a region is devastated by a typhoon. A government could pass legislation obligating itself to providing relief assistance to natural disaster victims, but until such a disaster occurs (the event), there has not been a past transaction or event creating a present obligation. Because a transaction or event has not occurred, the public sector entity does not have a present obligation.
83. Similarly, public sector entities may need to act to mitigate the effect of emergencies, such as a contamination to the water or blood supply. Because a past transaction or event has not occurred, the public sector entity does not have a present obligation. A present obligation arises after something has happened whereas a risk arising from a possible event is something that might happen in the future as a result of conditions that exist at the reporting date.

Is legislation a liability?

84. Governments have the power to pass new legislation and the enactment of that legislation may create an obligation. However, it does not necessarily follow that the enactment of legislation creates a present obligation. An obligating transaction

- or event, such as the meeting of eligibility criteria, must occur before a present obligation exists. To meet the definition of a liability, a present obligation must exist. Thus, the absence of a present obligation distinguishes a risk or future obligation from a liability.
85. The existence of another government's legislation on its own is not an obligating transaction or event. Environmental legislation, for example, may establish basic rules that, if not complied with, can result in a present obligation. However, normally it is the occurrence of environmental damage that is the obligating transaction or event. The existence of a government's own legislation containing details of the government's policy in relation to a particular program is not an obligating transaction or event:
- (a) For programs such as entitlements until recipients meet the eligibility criteria;
 - (b) Programs that provide relief assistance to natural disaster victims until such a disaster occurs.
86. Legislation having retroactive application cannot create a past obligating transaction or event. Any obligations related to such legislation would be accounted for in the current period, not in the period of the effective date of the legislation.

Appendix A: Types of obligations

- A1. The IPSASB's existing definition of liabilities is supported with text that provides guidance on the types of liabilities that included under the definition of a present obligation. IPSAS 1, paragraph 25 notes that:

“A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

- (a) where the settlement of the obligation can be enforced by law; or in the case of constructive obligations*
- (b) where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.”*

Legal obligations

- A2. The IPSASB's definition of liabilities includes legal obligations derived from:

- (a) Contracts (through its explicit or implicit terms)

Obligations can arise from contracts where only one party has fulfilled its obligation such as accounts payable, salaries payable or where both parties have partially fulfilled their obligations such as a partially completed shared cost agreement where one party has incurred eligible expenditures and the other has yet to pay.

- (b) Legislation

Some obligations can be imposed on a government by other governments. For example, a national government could place obligations on a state or local government or private sector entity by requiring them to operate within certain standards. Non-compliance with the legislation can place an obligation on the other entity. A government's own legislation may create obligation. For example, a government could introduce a transfer program such as welfare to individuals. Depending on the terms and conditions associated with that transfer, the legislation could obligate that entity.

- (c) Other operation of law

Some obligations can be imposed on a government through other operations of law. For example, a government could be involved in a lawsuit.

Constructive obligations

- A3. The IPSASB's definition of liabilities also includes constructive obligations that are derived 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 the other parties that it will discharge those responsibilities.
- A4. For these types of obligations, a government has little or no discretion to avoid the obligation when there is evidence that:
 - (a) The government acknowledges and indicates it will act upon its decision to accept responsibility for the obligation; and
 - (b) The government has sufficiently communicated its decision to the affected parties.
- A5. A constructive obligation is a broader notion than a legal obligation. The notion of a constructive obligation was introduced into accounting guidance on the issue of IAS 37, “Provisions, Contingent Liabilities and Contingent Assets” in September 1998. The development of IAS 37 was undertaken as a joint project with the UK ASB which issued its, almost identical standard, Financial Reporting Standard (FRS) 12, “Provisions, Contingent Liabilities and Contingent Assets” at the same time. At the time, only FRS 12 included an explanation, or basis for conclusions, on the development of the standard.
- A6. The background to the development of these standards was that, in the absence of guidance on when to recognize a provision, some for-profit entities were recognizing in one large provision: liabilities, expected liabilities of future years, and sometimes even expected expenditures related to ongoing operations. The standards contain the central principle that a provision shall be recognized only where, at the end of the reporting period, a liability exists that can be measured reliably.
- A7. Consequently, it can be seen that constructive obligations were created to limit the recognition of a provision to where it meets the definition of a liability. The essence of this obligation is that there is a commitment to a third party such as through the actions of an entity by past practice, which raises a valid expectation in the third party that the entity will fulfill its commitment. Thus, an intention to incur expenditure in the future, does not, of itself, meet the definition of a liability.
- A8. Intentions and individual items of evidence on their own may not be sufficient for determining whether a government has created a valid expectation. However, when announcements of decisions and sufficient communication are taken together, this may indicate that it has. Each circumstance needs to be judged individually given the available information.
- A9. Evidence that a government has acknowledged and will act upon its decision to accept responsibility for the obligation can include, but is not limited to, consideration of the following:
 - (a) Past practices;

- (b) Established policies;
 - (c) Cabinet minutes, orders-in-council, ministerial orders;
 - (d) Approved plans;
 - (e) Ministerial letters; and
 - (f) Approval of legislation at various stages, such as first, second or third reading.
- A10. If those affected are unaware of the government making its decision, no obligation can exist; the decision must be communicated to the parties affected. Communication to affected parties needs to be sufficient so that it creates a valid expectation among others resulting in a government not being able to withdraw from the obligation and having no realistic alternative but to settle the obligation.
- A11. Evidence that a government has sufficiently communicated its decision to affected parties could include, but is not limited to, the following:
- (a) An announcement of the amount the government is providing;
 - (b) Identification of the individuals, organizations or groups affected by the decision; and
 - (c) An announcement of the time frame for implementing the decision.
- A12. When taken together, a government's decision and communication of that decision can raise a valid expectation among others that it will accept certain responsibilities and, as a result, the government has little or no discretion to avoid the obligation and cannot realistically withdraw from it.
- A13. There may be situations where a government is contemplating a particular program and evidence of the program may be found in approved plans or other similar documents. However, without sufficient evidence that the government has accepted responsibility for and communicated its decision, a person may be acting on that information to his or her own detriment.
- A14. Not all established patterns of past practice or policy decisions lead to a loss of discretion. There are numerous examples where a government, in the past, has enhanced pension and other similar benefits to employees. However, more recently, governments have been reducing or eliminating those benefits, so in this case past practice is not sufficient to indicate that a government has little or no discretion to avoid the obligation.
- A15. A constructive obligation is one that implied rather than expressly written. Determining when a government has a constructive obligation can be a matter of professional judgment. For example, in a voluntary retirement situation, raising a valid expectation amongst employees could exist at many points during the development and negotiation of the plan, such as during the basic formulation of the retirement plan, when the plan is finalized, approval of the plan by someone with authority, when the plan is communicated to the effected employees or when the employee accepts the offer.

- (a) Similarly, non-contractually based obligations to an employee who has provided services to the government with the expectation that the government will fulfill its promise to provide, for example, health care benefits upon retirement can be constructive obligations.
 - (b) The government decides to clean up damage and in turn has communicated its decision publicly. These actions can create a valid expectation in others to incur clean up costs creating a situation where the government may no longer be able to avoid its settlement.
- A16. Constructive obligations are not possible obligations. Possible obligations are dependent on the future actions of another entity or other future transactions or events that are generally outside the control of a government. For example, while an entity may have an obligation under a loan guarantee, before it has a liability to pay that loan, the holder of the guarantee must be expected (with some degree of certainty) to default on the loan – a future event is expected to happen that is not wholly within the control of the entity. Confirmation that an obligation exists will only be confirmed by the occurrence or non-occurrence of a future event.

Appendix B: Comparison of state pensions and post-employment pensions

Introduction

- B1. At the December 2009 Sub-committee meeting, it was agreed that a comparison between a state pension and an employee pension should be illustrated in the Appendix to the Liabilities Issues Paper.
- B2. This Appendix is in three parts:
 - (a) A description of the characteristics of social benefit obligations and state pensions;
 - (b) A description of the characteristics of employee pensions; and
 - (c) A comparison of the two pensions.

Background

- B3. The IPSASB currently has a project on social benefit obligations. The IPSASB agreed that this project should continue and be closely linked to Phase 2 of its Conceptual Framework project, and in particular in relation to the definition of a liability.
- B4. Earlier IPSASB work in this area includes the ITC, “Accounting for Social Policies of Governments” issued in January 2004 and the CP, “Social Benefits: Issues in Recognition and Measurement”.

What are the characteristics of a state pension?

Social benefits

- B5. The 2008 CP on social benefits defined social benefits as:
 - (a) Cash transfers; and
 - (b) Collective and individual goods and servicesthat are provided by an entity to individuals or households in non-exchange transactions to protect the entire population, or a particular segment of the population, against certain social risks.
- B6. A social risk is 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. Cash transfers include social security pensions, child benefits and unemployment benefits. Individual goods and services include healthcare and educational services provided directly to the recipient. Collective goods and services include national defense and most aspects of the criminal justice system.
- B7. Programs that are a social benefit obligation are those programs where the level of the participant’s contribution is low enough for it to be classified as non-

exchange.⁴ The programs are either non-contributory or include partial-contribution arrangements.

Applying social benefit obligations to the notion of a constructive obligation

- B8. Past analysis of non-exchange social benefit obligations has focused on determining what would constitute a past event that gives rise to a constructive obligation. Below is an extract from the 2004 ITC.

Acceptance of Responsibility to Others

- 4.25 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 actions that provide such an indication. In the public sector environment, published policies and specific statements could refer to policies incorporated in legislation, policies included in documents such as manifestos, policies announced at the time a draft budget is released, inclusion of funding for policies in published budgets or the approval of budgets by legislative or governing bodies.

Creation of a Valid Expectation

- 4.26 The definition of a constructive obligation requires that one entity has engaged in actions that have created a valid expectation that it will discharge those responsibilities on the part of other parties. However, a constructive obligation would not exist solely because an individual claimed to have relied on the delivery of benefits pursuant to a government pronouncement. There must also be a past event that provides the entity with no realistic alternative but to settle the obligation.
- 4.27 Some may argue that if the right to education is set out in legislation and there is a past practice of providing education, individuals have a valid expectation that they will receive free or subsidized education services prior to the point of actually satisfying all the eligibility criteria – in some cases, this valid expectation may arise from the time of birth of a child. However, others are of the view that the birth of a child is not the past event that gives rise to a valid expectation that the government will discharge its responsibilities where eligibility criteria need to be satisfied for primary, secondary or tertiary education. They argue that in respect of, for example, tertiary education, it is only when an individual enters secondary school and appears likely to meet entrance requirements for tertiary education that a valid expectation about the delivery of tertiary education could be formed. Still others argue that even if a valid expectation was created at birth that education benefits would be provided in the future, a liability for financial reporting purposes would arise only when the reporting entity was obligated to compensate employees or other service providers for their services, or suppliers for the acquisition of

⁴ 2004 ITC, paragraph 2.9.

goods.

No Realistic Alternative But to Settle

4.28 To satisfy the definition of an obligating event, an entity must have no realistic alternative to settling the obligation. The Steering Committee acknowledges that interpreting the meaning of this requirement in the context of constructive obligations is difficult. On the one hand it can be argued that a government's ability to change legislation means that it has a realistic alternative to settling constructive, and arguably legal, obligations. Those that support this argument point out that governments frequently change the nature and amount of benefits and rarely provide categorical assurances that current benefits will continue to be provided in future periods. They note that in many jurisdictions governments are frequently in power for limited periods and would be unable to give such assurances even if they wanted to. On the other hand, it may be argued that governments operate with the intention of meeting their outstanding obligations and financial statements should reflect this. In addition, governments frequently have significant difficulty in changing policies that "promise" benefits to constituents, particularly where past practice creates and supports the valid expectation that those benefits will be provided. In this context, the "no realistic alternative but to settle" criterion does not apply in the same way to the public sector as it does to the private sector and needs to be interpreted having regards to the circumstances and traditions in each jurisdiction.

- B9. This could be summarized by saying that, using the current definition of a liability and the application of the notion of a constructive obligation, generally, an existing program for a non-exchange social benefit, meets both the conditions required for a constructive obligation because there is a past practice of paying out under the program and this has raised a valid expectation in individuals that the entity will continue with this program.

State pensions

- B10. A state pension is one type of social benefit. The general characteristics of a state pension include the following:
- (a) Principally funded by general tax revenue or earmarked taxes and which are not provided in relation to an individual's services as an employee. They are not directly linked to the amount of tax paid by the ultimate beneficiaries or to contributions made by individuals;
 - (b) May be provided to all citizens who reach pensionable age or only to those citizens who have participated in the work force or paid taxes for a specified period;
 - (c) Generally take the form of a cash payment to be paid regularly until death;
 - (d) May be subject to asset tests or income tests; and

- (e) 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.⁵
- B11. A specific program obligation such as a state pension is usually set out in legislation. Unlike contractual or other binding arrangements, an entity does not explicitly agree to perform for another party. Legislation is usually created by governments and public sector entities are expected to fulfill any obligations arising.
- B12. A constructive obligation can be met where a government, by its past actions, indicates that the provision of a state pension will continue into the future and it raises a valid expectation in an individual that, once they become eligible, they will receive that pension. Is this “constructive obligation” a present obligation?

Why is a post-Employment pension a liability?

Employee benefits

- B13. IPSAS 25, “Employee Benefits” defines employee benefits as “all forms of consideration given by an entity in exchange for service rendered by employees”.
- B14. An entity is willing to pay for employee benefits as the service rendered by employees is integral to the process of fulfilling that entity’s objectives. Employee benefits include:
 - (a) Short-term benefits such as wages, salaries, holiday pay, bonuses payable and social security contributions payable in respect of employee benefits within twelve months of the reporting date.
 - (b) Post-employment benefits such as pensions and post-retirement medical insurance.
 - (c) Other long-term employee benefits which may include long-service leave, long-term disability benefits and, bonuses, etc., which are not payable within twelve months after the end of the reporting date.
 - (d) Termination benefits.⁶

Post-employment pensions

- B15. This Appendix is concerned only with post-employment benefits that are pensions as they are seen as similar to state pensions. IPSAS 25 defines post-employment benefits as “employee benefits (other than termination benefits) which are payable after the completion of employment”.
- B16. There are two types of post-employment pensions:

⁵ 2004 ITC, paragraph 8.3.

⁶ IPSAS 25.5.

- (a) Defined contribution plans—where the level of benefits depends on the value of contributions paid in respect of each member and the investment performance achieved on those contributions. The employer's liability is limited to the contributions it has agreed to pay. The employee takes both the actuarial risk (that the benefits will be less than expected) and the investment risk (if the investments have performed well the individual will obtain a higher pension than if the investments have performed badly). Contributions to the plan can be made by either or both the employer and employee.
 - (b) Defined benefit plans—where the rules of the plan specify the benefits to be paid and they are financed accordingly. The majority of these plans define benefits in relating to an employee's final salary. The employer takes both the actuarial risk and the investment risk. Contributions to the plan can be made by either or both the employer and employee.
- B17. Accounting for defined benefit plans is complex because actuarial assumptions and valuation methods are required to measure the defined benefit obligation in the statement of financial position and the expense in the statement of financial performance. The expense recognized is not necessarily the contributions made in the period. IPSAS 25 defines the present value of a defined benefit obligation "as the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods". It comprises legal obligations under the formal terms of the plan and constructive obligations arising from an employer's actions. Hence, the components of the defined benefit obligation reflect the characteristics of a present obligation.
- B18. Distinguishing between a defined contribution plan and a defined benefit plan depends upon the economic substance of the plan as derived from its principal terms and conditions. Where the employer is exposed to the actuarial risk and the investment risk, the plan is a defined benefit plan. This means that the amount of expense recognized in the statement of financial performance for services rendered by employees comprises of current amounts paid and amounts to be paid in the future. The amounts to be paid in the future are accrued because are for services rendered in the current period. This is even though the benefits have not vested because the employees are still employed.

Comparison of state pensions and post-employment pensions

- B19. Table 1 below sets out the distinguishing characteristics of a state pension and a post-employment pension.

Table 1: Comparison of state pension and post-employment pension

From the perspective of the reporting entity	State pension	Post-employment pension
Objective of benefit	To pay individuals to protect them from the adverse welfare affects of a low income in retirement.	To pay for services rendered by employees.
Objective of accounting treatment	?	To ensure that an entity recognizes a liability when an employee has provided service in exchange for employee benefits to be paid in the future and to recognize an expense when the entity consumes the economic benefits or service potential arising from service provided by an employee in exchange for employee benefits.
Type of arrangement	Usually set out in legislation.	Usually contractual.
Parties to arrangement	Individual meets eligibility criteria.	Employer contracts with employee for services rendered in the past.
Arises	As a result of meeting eligibility criteria.	As a result of past service and meeting eligibility criteria.
Eligibility criteria	Reaching retirement age.	Reaching retirement age.
Accounting treatment	?	Expense is accrued when the service is rendered.

B20. A state pension is one type of social benefit where individuals receive a benefit to offset the social risk of having little or no income in retirement. In contrast, a post-employment pension is directly linked to past services rendered by employees to their employer.

ISSUE 4: HOW SHOULD REVENUE AND EXPENSES BE DEFINED?

Purpose

1. The purpose of this paper is to determine what the IPSASB's definitions of revenue and expense should be.
2. The IPSASB defines revenue and expense as:

“Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.”

What are the types of revenue in the public sector?

Exchange transactions (IPSAS 9)	Non-exchange transactions (IPSAS 23)	Other events excluding price changes	Price changes
<ul style="list-style-type: none"> • The rendering of services; • The sale of goods; • The use by others of entity assets yielding interest, royalties and dividends. 	<ul style="list-style-type: none"> • Taxes, including income tax, value added tax, goods and services tax, customs duty, death duties, and property tax; • Transfers, including grants, debt forgiveness, fines bequests, gifts, donations, and goods and services in-kind. 	<ul style="list-style-type: none"> • Reversals of asset impairment reversals (IPSAS 17); • Changes in policy relating to items such as employee future benefits or social policy benefits (IPSAS 25); • Changes in accounting estimates (IPSAS 3). 	<ul style="list-style-type: none"> • Revaluations of financial assets such as investments; • Revaluations of liabilities such as foreign currency translation (IPSAS 4); • Revaluations of non-financial assets such as property, plant and equipment (IPSAS 17).

3. IPSAS 1 defines revenue as:

“Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.”

What are the general characteristics of revenue?

4. A review of the various definitions of revenue (including gains) provide some general characteristics:
 - (a) Revenue arises from increases in assets that change net assets/equity;

- (b) Revenue arises from decreases in liabilities that change net assets/equity;
 - (c) Revenue does not arise from increases in assets resulting from financing transactions such as borrowing as there is no increase in net assets/equity;
 - (d) Revenue does not arise from decreases in liabilities resulting from financing transactions such as repaying borrowing as there is no increase in net assets/equity; and
 - (e) Revenue does not arise from increases in assets resulting from contributions from owners whether it is share capital or contributed surplus.
5. The IPSASB's definition of revenue addresses those transactions and events that do not result in an increase to net assets/equity by making reference to "result in an increase in net assets/equity." It also addresses the issue of those transactions that can increase net assets/equity but are related to owner transactions by making reference to "other than increases relating to contributions from owners." These aspects of the definition are similar to the IASB's existing definitions of both income and revenue.

Are there reasons for changing IPSASB's existing definition of revenue?

6. The IASB's current definition of income is:
- "Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from equity participants."*
7. In the development of the IASB definition of revenue in IAS 18, "Revenue" a number of respondents to the Exposure Draft 41 (May 1982) indicated they were unclear about the interrelationship between income, revenue and gains. To that end, IAS 18 (re-issued in 1993) included the definition of income reiterating the fact that income includes both revenue and gains. IAS 18 defines revenue:
- "Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants."*
8. However, that definition is used specifically to address revenue generated from the rendering of services, the sale of goods and the use by others of an entity's assets yielding interest, royalties and dividends – it was limited to those particular circumstances and not meant to be all inclusive. The IASB's Framework definition of income is the overall definition as it is defined as the element, not revenue.
9. The IPSASB's definition of revenue more closely resembles the IASB's definition of revenue from exchange transactions than it does the IASB's definition of income.

10. Because the current definition is focused on the inflow of economic benefits or service potential, it may not specifically address those situations where decreases in liabilities can result in revenue. For example, situations can arise where a creditor such as lender forgives a loan payable – a reduction of liability by another entity. In this instance there is no gross inflow of resources but a reduction in an expected outflow. Lenders will sometimes waive their right to collect a debt owed by a public sector entity, effectively cancelling the debt. Entities recognize revenue in respect of debt forgiveness when the former debt no longer meets the definition of a liability or no longer satisfies the criteria for recognition as a liability, provided that the debt forgiveness does not satisfy the definition of a contribution from owners.
11. In other situations, revenue can arise upon settlement of a liability by the reporting entity. IPSAS 23 notes that conditions placed on transferred assets require that the entity either consume the future economic benefits or service potential of the asset specified or return the future economic benefits or service potential to the transferor in the event that the conditions are breached. The recipient incurs a present obligation to transfer future economic benefits or service potential to third parties when it initially gains control of an asset subject to a condition. As an entity satisfies a present obligation it shall reduce the carrying amount of the liability recognized and recognize an amount of revenue equal to that reduction.

Is the definition of revenue consistent with the definition of expenses?

12. The revenue definition focuses on the inflow of economic benefits or service potential whereas the expense definition is broader by referring to all decreases in assets and incurrences of liabilities that decrease net assets/equity other than distributions to owners.

“Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.”

13. The IASB’s definitions of income and expense focus on increases and decreases in economic benefits resulting from the inflow or enhancement of assets or decreases in liabilities and the outflow or depletions of assets or incurrences of liabilities, that result in changes in equity other than from transactions with owners.

Can the definition be improved?

14. The definition of revenue can be improved by including other changes in assets that do not arise directly as a result of inflows resulting from exchange or non-exchange transactions. IPSAS 28, “Financial Instruments: Presentation”, notes

that physical assets such as property, plant and equipment create an opportunity to generate an inflow of cash or other assets but it does not give rise to a present right to receive cash or other or other financial assets¹. Revaluation adjustments under IPSAS 17 do not give rise to a present right to receive cash or other financial assets but create an opportunity to generate an inflow.

Revenue is the gross ~~inflow of~~ **increase in** economic benefits or service potential during the reporting period **in the form of inflows or enhancements of assets** when those inflows **or enhancements** result in an increase in net assets/equity, other than increases relating to contributions from owners.

15. This revision to the definition reflects that there can be other increases in economic or service potential arising from things such as revaluations of property, plant and equipment, reversals of impairments foreign exchange rates and price changes related to financial instruments.

Revenue is the gross increases in economic benefits or service potential during the reporting period in the form of inflows or enhancements of assets **or reduced outflows or settlement of liabilities** when ~~they those inflows or enhancements~~ result in an increase in net assets/equity, other than increases relating to contributions from owners.

16. The revenue definition could parallel the expense definition given that both definitions are referring to opposite changes in net assets/equity:

Revenue is the gross increases in economic benefits or service potential during the reporting period in the form of inflows or enhancements of assets or ~~reduced outflows or settlement of~~ **decreases in liabilities** when they result in an increase in net assets/equity, other than increases relating to contributions from owners.

17. Further, gains and losses are not specifically defined elements in and of themselves. The IASB Framework, PSAB, FASAB, UK ASB, AASB, NZ FSRB and SA ASB all indicate that the definition of revenue includes gains. They point out that gains are considered to be a subset of revenue rather than a distinct element, just as tangible capital assets and financial assets are considered a subset of assets. Gains are no different in nature [increases in economic benefits] than revenue as they both result in increases in economic benefits or service potential. To clarify that the IPSASB's definition is similar to the IASB's, the notion of gains and losses can be built into the definitions of revenue:

¹ IPSAS 28, paragraph AG17.

Revenue, **including gains**, is the gross increases in economic benefits or service potential during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets/equity, other than those relating to contributions from owners.

18. Using the IASB's Framework definition of revenue, revenue could be defined as:

~~Income~~ **Revenue, including gains**, is increases in economic benefits **or service potential** during the ~~accounting~~ **reporting** period in the form of inflows or enhancements of assets or decreases in liabilities that result in increases in net assets/equity, other than those relating to contributions from ~~owners equity~~ **participants**.

19. This alternative has the advantage of paralleling the IASB's definition and making it clear that the use of the term "revenue" by the IPSASB is intended to include gains.
20. The current definition focuses on the flow of assets and the stock of liabilities.
21. Another alternative is to refer only to increases in assets or decreases in liabilities because attempting to explain how an asset increases may not capture all of the possibilities that exist.

Revenue, including gains, is increases in assets ~~in economic benefits or service potential during the accounting reporting period in the form of inflows or enhancements of assets or decreases in liabilities that result in increases in net assets/equity, other than those relating to contributions from owners equity participants~~.

22. Another alternative, and perhaps a more generic one, would be to not to refer to increases or decreases in assets or liabilities.

Revenue, including gains, result in increases to net assets/equity, other than those that relating to contributions from owners.

23. This approach would necessarily need to rely on the definition of net assets/equity. Additional guidance may be needed to assist readers of the definition to better understand which items are included in and how those increases in net assets/equity arise.

Can we define revenues independently?

24. Another alternative is to attempt to define revenue without making reference to assets, liabilities or net assets/equity. Most of the examples that are not derived from definitions of assets and liabilities are commonly defined by listing items

that are included in revenue. A number of examples have been provided for consideration:

Revenue results from the levying of taxes, the rendering of services, the sale of goods, transfers received or receivable, gains and revaluation adjustments, other than contributions from owners.

Revenue is the measure of a public sector entity's sources of cash and cash equivalents and other non-financial assets that are to be used for funding of, or in the provision of goods and services related to, the ongoing operations of an entity, other than contributions from owners.

Revenue is the monetary expression of the aggregate amount of income flowing to the entity, other than contributions from owners.

Should we define revenues as those applicable to the current period?

25. Another alternative is to attempt to define revenue as:

Revenue is the increases in net assets/equity applicable to the current period.

26. In many cases, the inflow or enhancements of assets and decreases in liabilities that result in a change in net assets/equity will occur in the reporting period to which those inflows are applicable. For example, the sale of goods will result in an increase in an asset and revenue in the same period. However, in some cases, an inflow or enhancement of assets or decreases in liabilities may be applicable to a future period or alternatively they may have occurred in prior periods but are applicable to the current period.
27. For those increases in assets or decreases in liabilities that occur in the current period but are applicable to a future period, a deferred inflow is recognized on the statement of financial position. The deferred inflow is recognized in revenue of a future period. For example, a transfer received under IPSAS 23 that has no repayment clause for the purposes of property, plant and equipment could then be deferred and amortized (matched) over the related asset's useful life. Similarly, under IPSAS 4 the effects of foreign currency exchange rate differences could be deferred and amortized over the remaining term of the outstanding debt.
28. IPSAS 13, "Leases", notes that if the sale price is above fair value, the excess over fair value shall be deferred and amortized over the period for which the asset is expected to be used.

How does IPSASB's definition compare to Government Finance Statistics definition?

29. The definition of revenue as set out in the Government Finance Statistics Manual (GFSM) 2001:

Revenue is an increase in net worth resulting from a transaction.

30. GFSM defines a transaction as an interaction between two units by mutual agreement or an action within a unit that is analytically useful to treat as a transaction². This definition includes increases in net worth resulting from taxes and other compulsory transfers imposed by government units, property income derived from the ownership of assets, sales of goods and services, and voluntary transfers received from other units.
31. However, this definition excludes what are referred to as “other economic flows.” Other economic flows relate to a change in the volume or value (holding gains) of an asset or liability that do not result from a transaction. Volume changes cover a wide variety of events. They involve the addition or deletion from the balance sheet of an existing asset or liability with no changes in its quantity or quality. They include those events that change the quantity or quality of assets. The final group is made up of changes in the classification of assets. Holding gains and losses result from changes in the level and structure of prices, assuming the asset or liability has not changed in quantitatively or qualitatively.

What are the types of expenses in the public sector?

Exchange transactions	Non-exchange transactions	Other events excluding price changes	Price changes
<ul style="list-style-type: none"> • The acquisition of services; • The purchase of goods; • Salaries, wages and benefits; • The use by the entity of others assets incurring interest, royalties and dividends. 	<ul style="list-style-type: none"> • Social policy obligations such as health welfare and education; • Military and other protection to persons and property; • Transfer payments, including grants, debt forgiveness, fines bequests, gifts, donations, and goods and services in-kind. 	<ul style="list-style-type: none"> • Asset impairment and write-downs (IPSAS 17); • Changes in policy relating to items such as employee future benefits of social policy benefits (IPSAS 25); • Changes in accounting estimates (IPSAS 3). 	<ul style="list-style-type: none"> • Revaluations of financial assets such as investments; • Revaluations of liabilities such as foreign currency translation (IPSAS 4); • Revaluations of non-financial assets such as property, plant and equipment (IPSAS 17).

32. IPSAS 1 defines expense as:

“Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in a decrease in net assets/equity, other than those relating to distributions to owners.”

What are the general characteristics of expense?

33. A review of the various definitions of expense (including losses) provide some general characteristics:

² GFSM 3.5.

- (a) Expense arises from increases in liabilities that change net assets/equity;
 - (b) Expense arises from decreases in assets that change net assets/equity;
 - (c) Expenses does not arise from decreases in assets resulting from financing transactions such as repaying borrowing as there is no decrease in net assets/equity;
 - (d) Expense does not arise from increase in liabilities resulting from financing transactions such as borrowing as there is no decrease in net assets/equity; and
 - (e) Expense does not arise from decreases in assets resulting from distributions to owners.
34. The IPSASB's definition of expense addresses those transactions and events that do not result in a decrease to net assets/equity by making reference to "result in a decrease in net assets/equity." It also addresses the issue of those transactions that can decrease net assets/equity but are related to owner transactions by making reference to "other than those relating to distributions owners." These aspects of the definition are similar to the IASB's existing definitions of both income and revenue.

Are there any reasons for changing IPSASB's existing definition of expense?

35. The IASB's current definition of expense is:
- "Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to equity participants."*
36. This differs from the IPSASB definition in using depletion rather than consumption. One definition of consumption refers to the utilization of economic goods in the satisfaction of wants, or in the process of production resulting chiefly in their destruction, deterioration or transformation.
37. Alternatively, one definition of depletion refers to the lessening in quantity, content, power or value. The definition goes on to indicate that depletion implies a reduction in number or quantity so as to endanger the ability to function.
38. From this perspective, using the word depletion rather than consumption appears to broader in application and may better address the issue of value changes in such things as financial instruments and property, plant and equipment as not all instances of reductions in these assets results from their use or deterioration or transformation.

Can the definition be improved?

39. The definition of expense could be improved by broadening expenses to include depletions of assets:

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or ~~consumption~~ **depletions** of assets or incurrences of liabilities that result in a decrease in net assets/equity, other than those relating to distributions to owners.

40. Further, losses are not specifically defined as elements in, and of, themselves. The IASB Framework, PSAB, FASAB, UK ASB, AASB, NZ FRSB and SA ASB all indicate that the definition of expenses includes losses. They point out that losses are considered to be a subset of expenses rather than a distinct element, just as tangible capital assets and financial assets are considered a subset of assets. Losses are no different in nature [decreases in economic benefits] than expenses as they both result in decreases in economic benefits or service potential. To clarify that the IPSASB's definition is similar to the IASB's, the notion of gains and losses can be built into the definitions of revenues:

Expenses, **including losses**, are decreases in economic benefits or service potential during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in a decrease in net assets/equity, other than those relating to distributions to owners.

41. Taking from the IASB's Framework, expenses could be defined as:

Expenses, **including losses**, are decreases in economic benefits **or service potential** during the ~~accounting~~ **reporting** period in the form of outflows or depletions of assets or increases in liabilities that result in decreases in net assets/equity, other than those relating to distributions to **owners** ~~equity participants~~.

42. This alternative has the advantage of paralleling the IASB's definition and making it clear that the use of the term "expenses" by the IPSASB is intended to include losses.
43. The current definition focuses on the flows of assets and the stock of liabilities.
44. Another alternative is to refer only to increases in liabilities and decreases in assets because attempting to explain how the asset decreased may not capture all of the possibilities that exist.

Expenses, including losses, are decreases in assets or increases in liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.

Can expenses be defined as decreases in net assets/equity?

45. Another alternative, and perhaps a more generic one, would be to not to refer to increases or decreases and assets of liabilities.

Expenses, including losses, result in decreases to net assets/equity, other than those relating to distributions to owners.

46. This approach would necessarily need to rely on the definition of net assets/equity. Additional guidance maybe needed to assist readers of the definition to better understand which items are included in and how those decreases in net assets/equity arise.

Can we define expenses independently?

47. Another alternative is to attempt to define expenses without making reference to assets, liabilities or net assets/equity. Most of the examples that are not derived from definitions of assets and liabilities are commonly defined by listing items that are included in expenses. A number of examples have been provided for consideration:

Expense results from the payment of taxes, the use of services, the purchase of goods, transfers paid or payable, losses and revaluation adjustments, other than distributions to owners.

Expense is the measure of a public sector entity's uses of cash and cash equivalents and other non-financial assets that are used for the provision of goods and services related to, the ongoing operations of an entity, other than distributions to owners.

Expense is the monetary expression of the aggregate amount of past or present revenue flowing out of the entity, other than distributions to owners.

Should IPSASB include gains/losses with revenue/expense in the element definitions?

48. The IPSASB does not now distinguish between revenue and gains and expenses and losses. Most of the other standard setters do not separate revenues from gains or expenses from losses in their element definitions.
49. The UK ASB does not define revenue and expenses as elements rather they choose to use the phraseology gains and losses. The terms "gains" and "losses" include items that are often referred to as "revenue" and "expense", as well as gains and losses arising from, for example, the disposal of fixed assets and the remeasurement of assets and liabilities. For the purposes of element identification, it would seem that the UK approach is similar to other standard setters as others define revenue to include gains whereas the UK defines gains to include revenue.
50. The IASB's Framework notes that income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example:

"It is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and

those that do not. Distinguishing between items of income and expense and combining them in different ways also permits several measures of entity performance to be displayed. ... For example, the income statement could display gross margin and profit and loss.”

51. As previously discussed, elements are intended to reflect the fundamental components or building blocks of GPFSS. Using element definitions to make distinctions of presentation, which are without specific limits, goes beyond the “fundamental component” notion as intended in both the IASB’s Framework, as well as beyond the notions of “basic” or “fundamental” in general dictionary definitions.
52. It is important to point out that the items identified as elements do not have an effect on how that information is reported. For example, just because the definition of revenues may be defined to include gains, this does not prevent them from being displayed differently.
53. The FASB’s Concepts Statement No. 6 acknowledges that revenues, expenses, gains, and losses were defined largely for reasons of display:

“Distinctions between revenues and gains and expenses and losses in a particular entity depend to a significant extent on the nature of the entity, its operations, and its other activities. Items that are revenues for one kind of entity may be gains for another, and items that are losses for one kind of entity may be expenses for another.”
54. This seems appropriate for public sector entities as well. For example, expenditures incurred resulting from a hurricane or a forest fire may be treated as a loss in one country and an expense in another that is susceptible to hurricanes or fires. Since a primary purpose of distinguishing gains and losses from revenue and expenses is to make displays that convey information about performance, these distinctions are principally matters of presentation and hence do not seem to merit being defined as elements.

Can we define expenses as those applicable to the current period?

55. Another alternative is to attempt to define expense as:

Expense is the decrease in net assets/equity applicable to the current period.

56. In many cases, the outflow or depletions of assets and increases in liabilities that result in a change in net assets/equity will occur in the reporting period to which those outflows are applicable. For example, the purchase of goods will result in a decrease in an asset and expense in the same period. However, in some cases, an outflow or depletion of assets or increases in liabilities may be applicable to a future period or alternatively they may have occurred in prior periods but are applicable to the current period.
57. For those decreases in assets or increases in liabilities that occur in the current period but are applicable to a future period, a deferred outflow is recognized on

- the statement of financial position. The deferred inflow is recognized in expense of a future period. For example, a transfer paid that has no repayment clause for the purposes of another acquiring property, plant and equipment could then be deferred and amortized (matched) over the related assets useful life. Similarly, under IPSAS 4 the effects of foreign currency exchange rate differences could be deferred and amortized over the remaining term of the outstanding debt.
58. IPSAS 13 notes that if the sale price is below fair value, if the loss is compensated by future lease payments at below market price, it shall be deferred and amortized in proportion to the lease payments over the period for which the asset is expected to be used.

How does IPSASB's definition compare to Government Finance Statistics definition?

59. The definition of expense as set out in the Government Finance Statistics Manual (GFSM) 2001:

Expense is a decrease in net worth resulting from a transaction.

60. GFSM defines a transaction as an interaction between two units by mutual agreement or an action within a unit that is analytically useful to treat as a transaction. This definition includes decreases in net worth resulting from the provision of selected goods and services to the community on a non-market basis and to redistribute income and wealth by means of transfer payments³.
61. However, this definition excludes what are referred to as “other economic flows.” Other economic flows relate to a change in the volume or value (holding gains) of an asset or liability that do not result from a transaction. Volume changes cover a wide variety of events. They involve the addition or deletion from the balance sheet of an existing asset or liability with no changes in its quantity or quality. They include those events that change the quantity or quality of assets. The final group is made up of changes in the classification of assets. Holding gains and losses result from changes in the level and structure of prices, assuming the asset or liability has not changed in quantitatively or qualitatively.
62. When considering the definition of expense and other economic flows together as one, they are similar in nature to that of the IPSASB's proposed definition.

³ GFSM 6.1.

ISSUE 5: NET ASSETS/EQUITY

Purpose

1. The purpose of this paper is to determine the essential characteristics of net assets/equity. This is the current term that the IPSASB uses.

Existing definition of “net assets/equity”

2. The term “net assets/equity” has been defined in IPSAS 1, as follows:

“Net assets/equity is the residual interest in the assets of the entity after deducting all its liabilities.”

Other standard setters’ definitions of net assets/equity

3. The first characteristic that all the definitions have in common is that net assets/equity is a calculation: the result of subtracting total assets from total liabilities, i.e., it is a residual amount¹. It is described using slightly different terms, such as residual interest, arithmetic difference, residual or residual amount. The remainder of this section uses the term “residual amount” to describe this credit entry in the statement of financial position.
4. The second characteristic that all the definitions have in common is that the residual amount is directly linked to an entity².
5. Where the difference in definition appears is whether or not the standard setter has referred to the residual amount being an ownership interest.
6. The goals of government are to provide public goods and services and to redistribute wealth for a variety of social and economic purposes. Revenue is primarily obtained by the levying of taxes in a non-exchange and non-voluntary transaction with the people and entities of a jurisdiction. Expenses relate to a government’s responsibility to provide public goods and services. Governments and other public sector entities are generally formed by a Constitution or by legislation. Thus, most public sector entities, by their very nature, do not have owners or an ownership interest.
7. Because the residual amount does not represent an ownership interest, public sector entity or private sector not-for-profit entity standard setters use terms such as net assets, net position and residual interest to describe the residual amount. The exception is the SA ASB which describes net assets as “the residual interest of the owners...”. Staff is not aware of the reason for this.
8. In contrast, the residual amount for private sector for-profit entities is an ownership interest. Private sector for-profit entity standard setters use the term

¹ Note that the GASB defines it as the residual of all elements in the statement of financial position because, in addition to assets and liabilities, it defines deferred outflows and deferred inflows as elements.

² The GASB uses different terminology to refer to the entity: “presented in a statement of financial position”. Staff considers this to be an indirect method to refer to the entity.

- “equity” to describe this ownership interest. The UK ASB uses the term “ownership interest”. This term is broader than “equity” as it encompasses the concept of ownership without the use of an equity instrument, e.g., an ownership interest arising from a deed or statute.
9. Other standard setters, such as the AASB and the New Zealand FRSB, set standards for both private and public sector entities and also use the word equity. Both standard setters, at the standards level, explicitly state that the descriptions used in the standards may need to be amended for particular line items in the financial statements and for the financial statements themselves. The IASB has an equivalent statement. Additionally, the IPSASB permits use of terms other than “net assets/equity” provided that their meaning is clear. Examples of other terms used to describe the residual amount are taxpayers’ funds, accumulated funds or net worth.

The GFS approach

10. GFS includes any “ownership interest” as a liability so there is no definition or element reflecting the residual amount. It is simply the difference between assets and liabilities.

What does “equity” mean?

11. The Oxford English Dictionary’s definition of “equity” is “the shareholders’ interest in a company”. The use of the word shareholder highlights that equity is an ownership interest in an entity. The use of the word company generally means a commercial business, i.e., an entity engaged in an activity or activities in order to make a profit.
12. The word equity for financial reporting purposes is consistent with the dictionary definition. Equity generally means the owners interest in an entity as it is an “equity instrument” that a shareholder buys to invest in an entity and in return the shareholder receives an ownership interest in that entity. The rights that ownership confers is an entitlement to receive resources, such as dividends, at the discretion of the entity’s management and where an entity is wound up, an entitlement to a share of the amount remaining after all liabilities have been extinguished, i.e., a right to the residual amount of net assets.

Distinguishing between the residual amount and liabilities where the residual amount includes ownership interests

13. The distinguishing characteristic between liabilities and ownership interests is that with ownership interests there is no obligation on the entity to transfer resources to owners or to use net assets/equity in a particular manner. In contrast, liabilities are present obligations that are expected to result in an outflow from the entity of resources. That is, creditors have the ability to insist that a transfer of economic benefits or service potential is made to them regardless of the circumstances, whereas owners cannot. Owners are only entitled to the remaining assets, if there

are any left, once all the liabilities of the entity have been extinguished, i.e., the residual amount³.

What are the essential characteristics of the residual amount?

14. From the above, the essential characteristics of net assets/equity are:
 - That it is a residual amount; and
 - The residual amount is directly linked to the entity.
15. Certain standard setters have directly linked the residual interest to owners. These standard-setters have made this link only where they are setting a framework for for-profit entities, which, almost always, have identifiable owners. Public sector entities, on the other hand, almost always, do not have identifiable owners. This is a distinguishing characteristic of the residual amount between public sector entities and for-profit private sector entities, but not a distinguishing feature between different elements.

What does the residual amount mean?

16. The residual amount is the difference between assets and liabilities and has resulted solely from the accumulated revenues and expenses of the past. It represents the net economic resources available for providing future goods or services, or alternatively, the future economic resources necessary to address past net expenses.

Do public sector entities have ownership interests?

17. In some jurisdictions, the residual amount may include ownership interests. This situation can occur for example, at the whole-of-government level, where a GBE included in the economic entity has been partially privatized which means that there are third-parties who have a financial interest in the residual amount of that GBE, i.e., an ownership interest. This ownership interest represents the portion of the surplus or deficit and residual amount of a controlled entity attributable to a third-party.
18. Whilst ownership interests occur only rarely in public sector entities, it is important to understand the type of transactions that could occur because transactions with owners acting in their capacity as owners need to be distinguished from transactions with owners acting in other capacities, e.g., as suppliers or customers.
19. Types of transactions which can arise between an entity and its owners are “contributions from owners” and “distributions to owners”. These transactions are analyzed below.

³ Note that where the residual amount includes ownership interests, the distinction between equity instruments and instruments that are liabilities is very important. This topic is currently a joint project between the IASB and the FASB.

Contributions from owners

20. The term “contributions from owners” has been defined in IPSAS 1, as follows:

“Contributions from owners means future economic benefits or service potential that has been contributed to the entity by parties external to the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets/equity of the entity, which:

- (a) Conveys entitlement both to distributions of future economic benefits or service potential by the entity during its life, such distributions being at the discretion of the owners or their representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or*
- (b) Can be sold, exchanged, transferred or redeemed.”*

Other standard setters' definitions of contributions from owners

21. Some other standard setters have defined contributions from owners and these are included in Appendix B to this paper.
22. The South African ASB and the New Zealand FRSB have almost identical definitions to the current definition. Characteristics of these definitions are:
- That the contribution is from a party external to the entity; and
 - That the contribution establishes a financial interest in the net assets of the entity; and
 - That the contribution conveys entitlement to distributions of future economic benefits or service potential and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or
 - The interest can be sold, exchanged, transferred or redeemed.
23. The UK ASB's definition for PBEs includes the first two characteristics by reference to “...increases in residual interest resulting from transfers from parties that establish a financial interest in that residual interest”. The text relating to this definition explains that the term “financial interest in the residual interest” is an interest that conveys a right to participate in the residual interest, either on an ongoing basis or in a winding-up. So the third characteristic is implicit in the UK ASB's definition for PBEs. The UK ASB's definition of contributions from owners for for-profit entities includes the same characteristics however the terminology differs to take into account the differences between for-profit entities and PBEs.
24. The difference between the UK ASB's definition and the others is that the other definitions explicitly include a fourth characteristic that “the interest can be sold, exchanged, transferred or redeemed”.
25. The fourth characteristic differs from establishing a financial interest in the net assets of the entity and that the contribution conveys entitlement to distributions of future economic benefits or service potential characteristics as these two

- characteristics are unique to the definition of a contribution from owners. The fourth characteristic is common to other definitions, such as liabilities and therefore is not a unique characteristic. This suggests that the fourth characteristic is not an essential characteristic to the definition of contributions from owners.
26. The FASB defines “investments by owners” as an element of the statement of financial position for business enterprises only. For business enterprises, owners invest with the expectation of obtaining a return on their investment as a result of the enterprise’s providing goods or services to customers at a profit. Owners benefit if the enterprise is profitable but bear the risk that it may be unprofitable. The definition includes the first two components of a contribution from owners, although the wording differs: “...transfers to it from other entities of something valuable to obtain or increase ownership interests (or equity) in it”. The explanatory text refers to owners of a business enterprise having ownership interests that can be sold, transferred, or redeemed, or that convey entitlement to a share of a residual distribution of resources in the event of the entity being wound up.
27. The FASB considers that NFP entities do not have an ownership interest in the same sense as business enterprises because they have neither owners nor a profit purpose. A NFP’s net assets are a result of receipts of assets from resource providers who do not expect to receive either repayment or economic benefits proportionate to the assets provided and expenditures in providing goods or services.
28. Several standard setters have not defined contributions from owners. The PSAB, US FASAB and the US GASB set standards for public sector entities and ownership interests are rare so it is understandable that they do not have a definition. There are also private sector standard setters which do not have a definition of contributions from owners however, they do have definitions for equity instrument and equity interests.

Should “contributions from owners” be an element?

29. In Issues Paper 1.1 elements are described as a basic constituent part of the financial statements. Are contributions from owners a basic constituent part of the financial statements?
30. Only the UK ASB and the FASB consider that contributions from owners as an element of the financial statements. For public sector entities, contributions from owners are rare and thus are unlikely to be a basic constituent part of the financial statements.

Distributions to owners

31. The term “distributions to owners” has been defined in IPSAS 1, as follows:
- “Distributions to owners means future economic benefits or service potential distributed by the entity to all or some of its owners, either as a return on investment or as a return of investment.”*

Other standard setters' definitions of distributions to owners

32. Some other standard setters have defined distributions to owners and these are included in Appendix C to this paper.
33. When compared with the definitions of contributions from owners, the definition of distributions to owners has more variation in wording however, the meaning appears to be similar.
34. Common to all the definitions is that it is a transfer to owners or to parties holding a financial interest in the residual interest, a distribution by the entity to owners.
35. The description of what is distributed varies. The FASB, SA ASB and the UK ASB describe a distribution to owners from the viewpoint of the entity, i.e., as being a decrease in residual interest or equity. Other standard setters such as the IPSASB and the NZ FRSB describe what is distributed: future economic benefits or service potential, either as a return on investment or as a return of investment. The FASB includes explanatory text describing a distribution to owners resulting from transferring assets, rendering services, or incurring liabilities by the enterprise to owners.
36. Consistent with its definition of “investments by owners”, the FASB defines distributions to owners as an element of the statement of financial position for business enterprises only. Similarly, the standard setters who have not defined contributions from owners also do not define distributions to owners.

Should “distributions to owners” be an element?

37. For the reasons stated above relating to contributions to owners, it is unlikely that distributions to owners are an element of public sector entity financial statements.

Presentation of an ownership interest in public sector entity financial statements

38. A detailed analysis of how to present a minority interest is not within the scope of Phase 2 of the Conceptual Framework project, however, an understanding is required of how it may be presented.
39. Where a public sector entity has ownership interests, the question arises as to how to appropriately reflect this ownership interest. One method is to include it as a component of the residual amount and term it “minority” or “non-controlling” interest. This means that in the consolidated financial statements of the economic entity, all assets and liabilities, revenues and expenses of the partially privatized controlled entity is consolidated on a line-by-line basis. The portion of surplus or deficit and net assets of the controlled entity representing the ownership interest attributable to the third-party is presented separately in the residual amount. The advantage of this method is that all of the assets and liabilities that are under the control of the economic entity are included in the financial statements. The disadvantage with this method is that an ownership interest needs to be reflected in the residual amount.
40. Another method to present a partially privatized controlled entity in the consolidated financial statements of the economic entity is to equity account or

proportionately consolidate the portion of surplus or deficit and net assets of the controlled entity that the economic entity “owns”. The advantage with this method is that it eliminates any ownership interest and therefore removes the difficulty of reflecting an ownership interest in the residual amount. From this viewpoint, the residual amount represents accumulated surpluses or deficits. The disadvantage with this method is that it excludes assets and liabilities that are under the control of the economic entity.

Should the residual amount be defined independently of the definitions of assets and liabilities?

41. All of the standard setters noted above have defined the residual amount as representing a residual or residual interest in the net assets of an entity. One of the reasons that standard setters have done this is that trying to define both liabilities and equity separately can lead to mezzanine items being presented in the statement of financial position that are neither liabilities or equity items. Thus, standard setters have focused on defining a liability and defined the residual amount as a calculation dependent upon the result of the difference between assets and liabilities.

The concept of capital maintenance

42. IPSAS 1 notes that while many public sector entities do not have share capital, there are many instances where an entity will be controlled exclusively by another public sector entity. The nature of the controlling entity’s financial interest in the net assets/equity of the controlled entity is likely to be a combination of contributed surplus and the aggregate of accumulated surpluses or deficits. In addition, there may be a minority interest in the net assets/equity of a controlled government business enterprise. Accordingly, there may be private shareholders who have a financial interest in the net assets/equity of a public sector entity. The IPSASB and other standard setters, because they have concluded that ownership interest should be presented, and, as a result, net assets/equity has other characteristics than just accumulated surplus/deficit or “retained earnings.”
43. In the private sector, a concept of capital maintenance or cost recovery is needed to make distinctions between whether the entity has improved, maintained or deteriorated its “ownership” interests. From this perspective, only those inflows in excess of the amounts needed to maintain the previous ownership position are considered a return on equity or, in private sector words, income. This determination is made by separating revenues, gains, expenses and losses from those financing transactions associated with investors and transactions with owners.
44. Although the residual amount of a public sector entity does not have an ownership interest or a profit objective in the same sense as a for-profit entity does, there still remains a need to determine whether financial performance has maintained, added to or drawn upon the entity’s net economic resources in the period.
45. IPSAS 1 addresses the private sector situation of maintaining owners’ capital by providing definitions of contributions from owners and distributions to owners but

do not define them as elements. Alternatively, the FASB and the UK ASB provide similar definitions but do define them as elements.

46. Please see Agenda Paper 2C for a further discussion on the issue of capital maintenance.

ISSUE 6: WHAT SHOULD THE RECOGNITION CRITERIA BE?

Purpose

1. The IPSASB does not now have general recognition guidance. Criteria for recognizing certain transactions and events have been identified within the specific Standards. IPSAS 19, “Provisions, Contingent Liabilities and Contingent Assets” however, does set out general criteria for liabilities.

Why are recognition criteria important?

2. The effect that transactions and other events have on public sector entity’s financial position and financial performance is determined by applying the definitions of the various elements. Element definitions are designed as the first screening for whether the transaction or other event resulted in, for example, an asset or an expense. The definitions of the elements provide the starting point for determining *what* is considered to be part of the measurement of financial position and what is considered to be part of the measurement of financial performance.
3. Recognition is the process of deciding *when* a transaction or event should be included in the GPFS. Recognition means inclusion of an item within one or more individual statements and does not mean disclosure in the notes to the financial statements. Notes to the financial statements either provide further details about items recognized in the financial statements, or they provide information about items that do not meet the criteria for recognition and thus are not recognized in the financial statements. The failure to recognize such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.
4. The SA ASB indicates that recognition not only involves recording an item at the time of acquisition or otherwise, it also includes subsequent changes in the amount and those changes that occur that will result in the derecognition of the item from the GPFS.
5. The difficulty is that entities operate in an uncertain environment. For example, it is never absolutely certain that taxes levied will be collected. The only way to be certain is when the taxes are actually paid. If uncertainty exists, reliable information will become available only when the uncertainty has resolved itself. Waiting until the uncertainty has resolved itself will often reduce the relevance of the financial statements. Accrual accounting attempts to recognize transactions and events when those transactions and events happen. Moving along the spectrum from cash-based accounting to accrual accounting, means the information becomes more relevant but it may, to some degree, reduce in reliability due to the effects of uncertainty. From this perspective, there is a balance that needs to be struck between reliability and relevance.
6. Recognizing an item too early can result in overstating assets and liabilities. Recognizing an item too late can result in understating assets and liabilities. Further, it may be only in the future that an entity is able to determine that an item recognized as an expense should have been recognized as an asset or an item recognized as a liability should have been recognized as a revenue, as, for

example, the creditor chose to forgive the obligation. Similarly, reporting an item at particular cost or estimate of cost may unfold in the future somewhat differently than the original amounts. Employee retirement benefits are an example of uncertainty related to the measurement of items in reported in the GPFS of a public sector entity.

How do others address the recognition criteria?

Public Sector Accounting Standard Setters	
Canada PSAB	<p>The recognition criteria are as follows:</p> <ul style="list-style-type: none"> (a) the item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved; and (b) for an item that involves obtaining or giving up future economic benefits, it is expected that such benefits will be obtained or given up.
South Africa ASB	<p>The recognition criteria are as follows:</p> <ul style="list-style-type: none"> (a) the item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved; and (b) for an item that involves obtaining or giving up future economic benefits, it is expected that such benefits will be obtained or given up.
US FASAB	<p>The basic recognition criteria established in this Statement are (a) the item meets the definition of an element of financial statements and (b) the item is measurable. As used in this Statement, the term <i>measurable</i> means that a monetary amount can be determined with reasonable certainty or is reasonably estimable.</p>
Private Sector Accounting Standard Setters	
IASB	<p>An item that meets the definition of an element should be recognized if:</p> <ul style="list-style-type: none"> (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and (b) the item has a cost or value that can be measured with reliability.
Canada AcSB	<p>The recognition criteria are as follows:</p> <ul style="list-style-type: none"> (a) the item has an appropriate basis of measurement and a reasonable estimate can be made of the amount involved; and (b) for items involving obtaining or giving up future economic benefits, it is probable that such benefits will be obtained or given up.
UK ASB: No different requirements for PBEs	<p>If a transaction or other event has created a new asset or liability or added to an existing asset or liability, that effect will be recognized if:</p> <ul style="list-style-type: none"> (a) sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and (b) the new asset or liability or the addition to the existing asset or liability can be measured at a monetary amount with sufficient reliability.
US FASB	<p>An item and information about it should meet four fundamental recognition criteria to be recognized and should be recognized when the criteria are met,</p>

	<p>subject to a cost-benefit constraint and a materiality threshold. Those criteria are:</p> <p><i>Definitions</i>—The item meets the definition of an element of financial statements.</p> <p><i>Measurability</i>—It has a relevant attribute measurable with sufficient reliability.</p> <p><i>Relevance</i>—The information about it is capable of making a difference in user decisions.</p> <p><i>Reliability</i>—The information is representationally faithful, verifiable, and neutral.</p>
Accounting Standard Setters for Private and Public Sectors	
Australia AASB	<p>An item that meets the definition of an element should be recognized if:</p> <p>(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and</p> <p>(b) the item has a cost or value that can be measured with reliability.</p>
NZ FRSB	<p>An asset shall be recognised in the statement of financial position when and only when:</p> <p>(a) it is probable that the service potential or future economic benefits embodied in the asset will eventuate; and</p> <p>(b) the asset possesses a cost or other value that can be measured with reliability.</p> <p>A liability shall be recognised in the statement of financial position when and only when:</p> <p>(a) it is probable that the future sacrifice of service potential or future economic benefits will be required; and</p> <p>(b) the amount of the liability can be measured with reliability.</p> <p>Revenues shall be recognised in the determination of the result for the reporting period, when and only when:</p> <p>(a) it is probable that the inflow or other enhancement or saving in outflows of service potential or future economic benefits has occurred; and</p> <p>(b) the inflow or other enhancement or saving in outflows of service potential or future economic benefits can be measured with reliability.</p> <p>Expenses shall be recognised in the determination of the result for the reporting period, when and only when:</p> <p>(a) it is probable that the consumption or loss of service potential or future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred; and</p> <p>(b) the consumption or loss of service potential or future economic benefits can be measured with reliability.</p>

7. There are three areas of uncertainty that need to be addressed:

- Uncertainty about whether assets, liabilities, revenue, expense actually exist;

- Uncertainty as to whether there will be inflow or outflow of resources; and
- Uncertainty about the reliability of the amount to be reported in the GPFS, for example, employee future benefits are measured using various measurement techniques to estimate the amount recognized.

Should we address existence uncertainty?

8. Addressing existence uncertainty is a major issue if GPFS are to provide a faithful representation of the transactions and other events they purport to represent. Existence uncertainty relates to the issue of depicting an item in the GPFS for the first time when it qualifies for recognition (initial recognition) and when that item no longer exists when it qualifies for derecognition.
9. Transactions are the most common basis for recognizing and derecognizing items. For example, paying an employee's salary for services received. Other events are also easy to determine when an item qualifies for recognition. For example, a fire may cause an asset (e.g., a building) to be derecognized and another asset to be recognized (the proceeds from the insurance settlement). In other cases, it is more difficult to determine whether a transaction or event has resulted in an item that should be included in the GPFS. For example, difficulties can arise in determining when the announcement of a new transfer program results in a liability.
10. All of the standard setters acknowledge that uncertainty about the actual results of transactions or events is pervasive. Uncertainty about whether and how a transaction or other event will effect financial position and performance often requires judgment.
11. The UK ASB notes that uncertainty can be countered by assessing the available evidence. The more evidence there is about an item and the better the quality of that evidence, the less uncertainty there will be over the existence of an item that meets the definition of an element. By reviewing and assessing the available evidence, a determination is made as to whether the item should be included in the GPFS.
12. From an asset perspective, existing IPSAS, unlike IPSAS 19, do not provide specific guidance. IPSASs rely on the definition of an asset and the use of the term "expected to flow." Although contingent assets have some unique characteristics, the guidance supporting when a contingent asset is recognized is a very high bar for determining when to interpret "expected to flow":

"Contingent assets are not recognized in financial statements since this may result in the recognition of revenue that may never be realized. However, when the realization of revenue is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate."
13. From a liability perspective, IPSAS 19 notes that in some cases it is unclear whether there is a present obligation.

"In these cases a past event is deemed to give rise to a present obligation, if taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date."

14. This could lead an entity to different conclusions about when an asset or liability exists from the point of view that an asset may only exist when it is “virtually certain” as opposed to the approach used for determining when a present obligation exists which is much broader than “when it is more likely than not.”.
15. The UK ASB, whether it is for public benefit entities or for-profit entities, does not seem to make this distinction between assets and liabilities:
“If a transaction or other event has created a new asset or liability or added to an existing asset or liability, that affect will only be recognized if sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability.”
16. The UK ASB approach does not provide a “bright line” to deciding when an item exists or not. Instead it relies on the assessment of available evidence to support the conclusion.
17. Most of the other standard setters deal with existence under the definitions of the elements themselves as the recognition criteria use by them typically begins with the assumption that the item has met the test of being an element.
18. From an asset perspective, the IPSASB could consider using the same approach as it did for liabilities:
“A past event is deemed to give rise to a resource, if taking account of all available evidence, it is more likely than not that a resource exists at the reporting date.”
19. The advantage of this approach is that it treats assets and liabilities in the same light and provides similar guidance on when an asset exists as it does liabilities. The disadvantage is that it could change existing practice, if the narrower criterion in contingent assets has been used for all assets.

What is meant by an expected inflow or outflow in the element definitions?

20. From the point of view of the IPSASB’s element definitions, only those resources and obligations where there is an expectation that benefits will flow (to or from the entity) would qualify as meeting the definition of an element.
21. Levying a tax on an individual, for example, would meet the asset test however, if the entity levying the tax knows that the taxpayer is unable to pay for various reasons, it would fail to meet the element definition because there would not be an expectation that benefits would flow to the public sector entity. Similarly, from a liability point of view, a public sector entity may have a loan payable that it knows will be repaid by receiving future resources from the lender. In this case there would be no “expectation of a future outflow of resources” and would not meet the test of being a liability. However, there is a wide range of possibilities that exist between knowing and not knowing.
22. The use of the phrases “expected to flow (to or from),” “may be obtained” and “which may result in the transfer or use of assets” contained in the element

- definitions can be subject to individual judgments. Yet, this is a fundamental aspect of the definitions of assets and liabilities.
23. Most of the standard setters have focused on what is meant by “expected to flow” in the recognition criteria by referring to the “probability” of the benefits flowing in, or out of, the entity. However, this may be causing some confusion as the word “expected” has a different meaning than the word “probable.”
 24. The PSAB and the South African ASB use the word “expected” is used in the recognition criteria mirroring the term used in the element definitions. However, this may be more broadly interpreted than the use of the word “probable.”
 25. The expectation of a flow of resources has been included in the definitions to generally address the uncertainty associated with the future economic benefits or service potential being realized or having to be sacrificed by a public sector entity. For example, while it is expected that an asset will result in future economic benefits or service potential flowing to the entity, it is not always certain, as taxes receivable may need to be written off or service potential may become impaired. Likewise for a liability it will not always result in an outflow of resources. Some loans payable, for example, maybe forgiven.
 26. The concept of “expected” or “probable” is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits or service potential associated with the item will flow to, or from, the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits or service potential are made based on the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed by an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognize the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits or service potential is recognized.¹
 27. The degree of uncertainty relating to the asset and the inflow of benefits is addressed throughout various IPSASs. From an asset perspective, IPSAS 9, “Revenue from Exchange Transactions”, IPSAS 16, “Investment Property” and IPSAS 17, “Property, Plant and Equipment” all refer to:
“It is probable that the future economic benefits or service potential associated with the asset will flow to the entity.”
 28. The degree of uncertainty relating to the liability and the outflow of benefits is addressed in IPSAS 19:
“An outflow of resources or other event is regarded as probable if the event is more likely than not to occur, that is, the probability of the that the event will occur is greater than the probability that it will not.”

¹ South Africa ASB.

29. But, IPSAS 19 also indicates:
- “Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the “possibility” [emphasis added] of an outflow of resources embodying economic benefits or service potential is remote.”*
30. Therefore, the degree of certainty required is described differently than is required in the definitions of an asset and liability and throughout the IPSASs.
31. The degree of certainty, as explained by various standard setters, and within specific standards themselves, is described using several terms that are similar. Terms and phrases such as “expected,” “probable,” “likely,” “more likely than not,” and “the probability that the event will occur is greater than the probability that it will not” have all been used.
32. There are benefits to using the same terms in the definitions, recognition criteria and contingency sections across standards and to add more explicit clarity of the term or terms used. Confusion and inconsistencies that could result otherwise would be minimized.

What are the alternatives?

33. One alternative to consider is whether the recognition criteria should be based on the contingent asset approach that the benefits must be “virtually certain” to flow. It has the advantage of reducing the level of judgment required surrounding the recognition of items.
- “Items are recognized in the financial statements when it is virtually certain that the entity will receive resources or give up resources.”*
34. Including virtually certain as the criterion for the flow of benefits would exclude a number of assets and liabilities that are recognized now. For example, unless it was virtually certain that a lawsuit was going to be settled against the entity, the amount could not be recognized. While this may make the information in the GPFS more reliable, this approach may result in relevant information being excluded from recognition. For example, some of the benefit to be derived from some property, plant and equipment may not be virtually certain that it is going to be realized and therefore, would not be included in the GPFS.
35. Alternatively, if the recognition is based on a “more likely than not” criterion it allows the preparer of the GPFS to assess all of the facts surrounding the item to determine whether it is more than likely than not that an item exists and should be recognized. This could result in additional assets being recognized in the GPFS than there are now. Those contingent assets that are excluded from recognition now until it is “virtually certain that inflows will be realized” would now form part of the recognition in the GPFS. Those less than likely would be excluded. It does however focus on making a determination of the series of facts and surrounding circumstances to decide.

“Items are recognized in the financial statements when it is probable [more likely than not] that the entity will receive resources or give up resources.”

36. The recognition could take a more inclusive approach to assets and liabilities. Anything that meets the tests of being an element would be recognized when there is a possibility that resources will flow into or out of the entity. This would include those items now excluded where the possibility of inflow or outflow is only remote. As long as there is possibility for an inflow or outflow the item would be recognized.

“Items are recognized in the financial statements when it is possible that the entity will receive resources or give up resources.”

37. This could result in certain assets and liabilities being included in GPFS even though the possibly of the benefit flowing is remote. For example, there is always a “possibility” that a water supply can become tainted, this approach could lead one to conclude that if there was simply a possibility of an outflow of resources, a liability would be established.
38. The most objective phrases used seem to be “more likely than not” and “the probability that the event will occur is greater than the probability that it will not”. They seem to indicate that an asset is recognized in the financial statements when the likelihood is 50% +1 that future economic benefits or service potential will flow to an entity. Similarly that a liability is recognized in the financial statements when the likelihood is 50% +1 that future economic benefits or service potential will be given up.
39. These terms are however only used in the IFRSs and IPSAS contingency sections and therefore are not necessarily intended to be applied to either the definitions or recognition criteria included in other parts of these standards.

Should IPSASB remove the notion of “expected to flow” from the element definitions?

40. The concept of expected to flow (inbound or outbound) is included in many element definitions, albeit using different phraseology, to alleviate concerns that the definition would require that the inflow or outflow of future economic benefits or service potential be certain in order to qualify as an asset. This appears to be a recognition question rather than a definitional one.
41. The IPSASB definitions of an asset and liability make reference to the phrase benefits “are expected to flow”. This phrase may have reflected a concern that without including it in the definitions, many would not record assets or liabilities *unless it was certain* that the economic benefits would flow (either inward or outward). For example, “probable” was included in the existing FASB definition in response to constituents’ concerns on earlier proposals that the definition would require that an item be certain in order to qualify as an asset or liability. Since few things in life are certain, the FASB observed that few items that are commonly thought to be assets or liabilities would qualify in accordance with the definition. Similar concerns resulted in the inclusion of *expected* in the IASB definition.

42. Both the IASB and FASB definitions have been misinterpreted as implying that there must be a high expectation of future economic benefits for the definition to be met. Some think that unless there is a high likelihood of economic benefits flowing in or out of the entity, the asset or liability definition is not met. To avoid this continued misinterpretation, the IASB/FASB Conceptual Framework project proposes the working definition of an asset and a liability exclude reference to the expected inflow or outflow of benefit from the definitions. They argue that it is preferable that this “expectation” be built into the recognition criteria rather than being built directly into the definitions themselves.²
43. This was the most favored improvement in the IASB/FASB Conceptual Framework project when they consulted on the definitions from December 2006 to March 2007.
44. The advantage of this approach is to define the elements and their fundamental characteristics and leave the recognition criteria to a separate section. For example, and using IPSASB’s current definition of an asset:

Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

45. This approach is used by the FASAB, the GASB, the UK ASB for public benefit entities and the FASB which the probability of the flow of resources from the definitions of the elements. These standard setters do not provide “probability” guidance related to expected flows in their recognition criteria: For example, the FASAB:

“The basic recognition criteria established in this Statement are (a) the item meets the definition of an element of financial statements and (b) the item is measurable.”

46. This approach relies on the definitions of the elements and the supporting guidance rather than introducing a separate notion of “probability” in the recognition criteria.

“The second essential characteristic of an asset is control, which refers to the ability of the federal government to obtain the economic benefits or services embodied in a resource and to deny or regulate the access of others.”

47. The recognition criterion for determining when a flow is “expected” is not addressed. The important issue is whether or not the public sector entity has control of the future economic benefits.
48. Alternatively, the assessment of the “probability” of the economic benefits or service potential flowing to a public sector entity could be addressed separately in

² IASB/FASB Conceptual Framework, Elements & Recognition – Asset & Liability Definitions, August 20, 2008, pre-ballot draft.

the measurement phase on the framework project. A probability model could be used for estimating amounts.

Does measurement of an item need to certain?

49. Another criterion identified by other standard setters is that the item must possess a cost or other measure. To recognize an item in GPFS, it is necessary to attach a monetary value to the particular item. This entails two different aspects: the first is choosing an appropriate measurement basis (cost, fair value etc); and the second is relates to the reliability of the measurement itself. The first aspect is considered in Phase 3 of the conceptual framework project.
50. There is a degree of uncertainty associated with the measurement of many amounts recognized in GPFS. However, the use of estimates is an essential part of the preparation of GPFS under an accrual basis of accounting. A decision about the reliability of measurement is a matter of professional judgment. Management consider information such as, the range of reasonably possible amounts, whether the amount could change materially, the impact of other reasonably possible amounts on the resources, obligations and net assets and the possible timing of the impact.
51. The estimation of the amount of an item may be based on information that provides a range of amounts. When a particular amount within such a range appears to be a better estimate than any other, that amount would be used. When uncertainty exists, estimates used attempt to ensure that assets, revenues and gains are not overstated and that liabilities, expenses and losses are not understated. Estimates of the financial effect are determined using professional judgment, supplemented by experience of similar transactions and, in some cases, reports from independent experts. Estimates should include any additional evidence provided by subsequent events occurring after the reporting date.

What do the other standard setters do regarding the reliability of measurement?

52. There is no consistency regarding how measurement is described in the recognition criteria. The IPSASB does not have a general approach for the purposes of recognition and, as a result, different wording has been used in different Standards.
53. The wording used in IPSAS 16, “Investment Property” and IPSAS 17, “Property, Plant and Equipment” require that “the cost or fair value of the item can be measured reliably”. IPSAS 19 uses “a reliable estimate can be made of the amount of the obligation,” and IPSAS 23, “Revenue from Non-exchange Transactions (Taxes and Transfers)” uses “the fair value of the asset can be measured reliably”. These various approaches have been developed at a standards level without having the advantage of general criterion against which it can apply in the individual standards.
54. The PSAB notes that a “reasonable estimate of the amount can be made.” This approach does not specifically identify any particular basis of measurement only that a reasonable estimate can be made. The IASB notes that the use of reasonable

- estimates is essential to the preparation of GPFS but goes further and say that the estimate must be a reliable measure.
55. The SA ASB takes a similar approach to existing IPSASs except that it does not attempt to identify a measurement basis, for example, it says “the item has a cost or value that can be measured reliably.” However, it does not address this notion of a “reasonable” estimate.
56. This has an advantage from the perspective that it includes reliability as part of the measurement consideration. This notion of reliability is also included in other standard setters’ approaches.

Should IPSASB include relevance and reliability in the recognition criteria?

57. The FASB has also included in its recognition criteria the qualitative characteristics of relevance and reliability to ensure that these qualities receive consideration for deciding when an item should be recognized. To be recognized, the information conveyed by including an asset, liability, or change therein in the financial statements must be relevant.
58. Reliability may affect the timing of recognition. The first available information about an event that may have resulted in an asset, liability, or change therein is sometimes too uncertain to be recognized: it may not yet be clear whether the effects of the event meet one or more of the definitions or whether they are measurable, and the cost of resolving those uncertainties may be excessive. Information about some items that meet a definition may never become sufficiently reliable at a justifiable cost to recognize the item. For other items, those uncertainties are reduced as time passes, and reliability is increased as additional information becomes available.
59. Unavailability or unreliability of information may delay recognition of an item, but waiting for virtually complete reliability or minimum cost may make the information so untimely that it loses its relevance.

Should IPSASB include recognition criteria for each of the individual elements?

60. The IASB currently provides additional guidance related to recognition. In this case, the individual definitions of the elements are used as a basis for identifying when those elements are recognized and in which statements. For example:

“Income is recognized in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen and can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities.

Expenses are recognized in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase in a liability has arisen that can be measured reliably. This means, in effect, that the recognition of expenses occurs simultaneously with the recognition of an increase liabilities or a decrease in assets.”

61. The PSAB and the FASAB do not provide such guidance in the recognition information. The South African ASB, FASB, AASB and NZ FRSB all provide guidance for each of the elements as to when each is recognized as well as providing additional guidance on the application of the elements and recognition criteria. This approach is followed by others including the IASB. The UK ASB takes a different approach by providing guidance only as it relates to revenue recognition. The UK ASB approach to revenue recognition is similar to other approaches that choose to provide additional guidance on recognition of the individual elements.

When should revenue and expenses be recognized?

62. IPSAS 1, “Presentation of Financial Statements” notes that some Standards require some items to be recognized directly in net assets/equity. IPSAS 1 notes that it is important consider all items of revenue and expense in addressing changes in net assets/equity and requires the statement of changes in net assets/equity to highlight an entity’s total revenue and expenses, the individual Standards themselves that require certain gains and losses to be excluded from surplus or deficit do not specifically identify these items as revenue or expense when they are recognized.
63. The IPSASB’s definitions of revenue and expenses refer to changes in assets and liabilities for the purpose of defining these items. Individual IPSASs generally specify when an item of revenue or expense is recognized as part of surplus or deficit and when it recognized directly in net assets/equity.
64. IPSAS 25, “Employee Benefits”, recognizes the portion of actuarial gains and losses for each defined benefit plan is the excess determined in accordance with paragraph 105, divided by the expected average remaining working lives of the employees participating in that plan. However, an entity may adopt any systematic method that results in faster recognition of actuarial gains and losses provided that the same basis is applied for both gains and losses and the basis is applied consistently from period to period. If, as permitted by paragraph 106, an entity adopts a policy of recognizing gains and losses in the period in which they occur, it may recognize them as a separate item directly in net assets/equity provided it does so for all defined benefits plans and all gains and losses.
65. IPSAS 4, “The Effects of Changes in Foreign Exchange Rates”, recognizes gains and losses on monetary items as part of surplus or deficit. Gains and losses arising from exchange rate differences on non-monetary items are recognized depending upon the nature of the change in value. For example, gains losses arising from exchange rate differences on a property held at valuation are recognized directly net assets/equity. Foreign currency gains and losses on foreign operations are recognized in net assets/equity and recognized in surplus or deficit upon disposal.
66. IPSAS 13, “Leases”, recognizes lease revenue from operating leases on a straight-line basis over the term of the lease. Alternatively, if the lease is a financing lease and a sale and leaseback, any excess of sales proceeds over the carrying amount is not recognized as revenue but deferred and amortized over the lease term. If the

- sale and leaseback is an operating lease and the sale price is above fair value, the excess over fair value is deferred and amortized.
67. IPSAS 17, “Property, Plant and Equipment”, recognizes a revaluation increase directly in net assets/equity unless it reverses a revaluation decrease previously recognized in surplus or deficit. IPSAS 21, “Impairment of Non-Cash-Generating Assets”, recognizes impairment losses in surplus or deficit with any reversals of impairment to be recognized in surplus or deficit.
68. Certain gains and losses are treated as part of surplus or deficit while others are considered outside of surplus or deficit and part of net assets/equity and other gains and losses are deferred from recognition in the surplus or deficit. There does not seem to be established general recognition criteria for deciding when an item is part of surplus or deficit or when it is recognized directly in net assets/equity.

Alternative approaches to revenue and expense recognition

69. There are two views as to when revenue and expenses should be recognized:
- (a) To recognize revenue and expense when assets and liabilities change, other than from transactions with owners.
 - (b) To recognize revenue and expense in the period by relating costs incurred with the revenues that they generate or vice versa.

Should revenue and expenses be recognized when there have been changes in assets or liabilities?

70. This approach determines net assets/equity based on the elements assets and liabilities and all changes in those elements are recognized as revenue and expense, except those arising from transactions with owners.
71. Proponents of this approach note:
- Assets and liabilities are fundamental to the entity and should affect all other measurements in the financial statements;
 - Revenue and expenses can only be rigorously defined in terms of changes in assets and liabilities, to permit certain changes in assets and liabilities to be excluded from financial performance is a distortion of financial performance³;
 - Determining when to recognize revenue and expenses by relating them to changes in assets and liabilities is more precise and reliable;
 - Concern over the prospects of an entity claiming an item to be applicable to a future period for the purposes of smoothing revenue and expenses over a number of periods;

³ FASB Discussion Memorandum, Conceptual Framework for Financial Accounting, December 2, 1976, paragraph 56.

- To permit other items that are not changes in assets or liabilities to be included or excluded from revenue and expense requires judgment as to when an item should be recognized as revenue or expense;
 - Attempts to define revenue and expense independently and as a function of the intent to use an asset, for example, in a future period, makes assets and liabilities essentially the fallout of the process of matching revenues and expenses; and
 - It is more reflective of the nature of entities as they need resources, either from owners or from operations, to serve as inputs into the provision of goods and services or outputs which can lead to incurrence of liabilities.
72. This approach does permit allocation in certain circumstances. For example, the use of property, plant and equipment to produce potable water is allocated to the period when the asset is used (amortization). However, it is argued that the application of this form of matching that results under accrual accounting was not intended to allow the recognition of items in the statement of financial position that do not meet the definitions of assets or liabilities. From this perspective, inflows of resources that do not meet the definition of a liability are recognized in revenue even though the intent may be to use those resources in a future period.
73. Under this approach:
- “Revenue, including gains, is recognized when an increase in future economic benefits or service potential related to an increase in an asset or a decrease of a liability has arisen and can be measured reliably. This means, in effect, that recognition of revenue occurs simultaneously with the recognition of increases in assets or decreases in liabilities.*
- Expenses, including losses, are recognized when a decrease in future economic benefits or service potential related to a decrease in an asset or an increase in a liability has arisen that can be measured reliably. This means, in effect, that the recognition of expenses occurs simultaneously with the recognition of an increase liabilities or a decrease in assets.”*

Can revenue and expenses be recognized using some other criteria?

74. Another approach to recognize revenue and expenses is to recognize those changes in assets and liabilities that are applicable to the current period. Those items not applicable to current period are deferred until future periods.
75. Proponents of this approach note:
- Revenue and expenses and the timing of their recognition is the focus of financial accounting⁴;
 - Allocating certain costs and revenues to future periods better reflects the efforts and accomplishments of the period;

⁴ FASB Discussion Memorandum, Conceptual Framework for Financial Accounting, December 2, 1976, paragraph 39.

- Since revenue and expenses is the key focus of financial statements, net assets/equity is determined as a result of when revenue and expenses are recognized;
- Linking recognition of revenue and expense to changes in assets and liabilities often mismatches revenue and expense and can lead to distortion. It is imperative to exclude those gains and losses caused by random events, such as floods or fires, and those gains and losses resulting from remeasurements of financial instruments which cause unnecessary fluctuations in recognized revenue and expense;
- The asset and liability view turns accounting into a valuation process which creates difficulties in determining the most appropriate method of valuation, making it difficult to determine when to recognize revenue and expenses; and
- Recognizing revenue and expenses in this way articulates changes in the items on the statement of financial position as it includes deferred items, and by doing so reduces volatility.

76. Under this approach:

“Revenue is recognized when there has been an acquisition of net assets by the government that is applicable to the reporting period, other than inflows relating to contributions from owners.

Expenses is recognized when there has been a consumption of net assets by the government that is applicable to the reporting period, other than those relating to distributions to owners.”