



**INTERNATIONAL FEDERATION
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Agenda Item **6**

Date: May 24, 2011
Memo to: Members of the IPSASB
From: Annette Davis
Subject: Entity Combinations and draft Project Brief for Consolidations and Joint Arrangements

Objective of this Session

- To **discuss** and **provide directions** on issues relating to entity combinations.
- To **review** and **approve** a project brief on consolidations and joint arrangements.

Agenda Material

- 6.1 Issues Paper: Use of the term “operation” and revised definitions
- 6.2 Issues Paper: Distinguishing between different types of entity combination and potential methods to account for them
- 6.3 Memo: Draft Project Brief for Consolidations and Joint Arrangements
- 6.4 Draft Project Brief: Consolidations and Joint Arrangements

Background

1. This session is split into two parts. The first part covers issues relating to entity combinations. In particular, the use of the term “operation” and possible alternatives, and proposed revisions to the definitions agreed on at the March 2011 meeting (in Agenda Paper 6.1). Agenda Paper 6.2 deals with a method of distinguishing between different types of entity combinations and potential methods to account for them.
2. The issues already considered by the IPSASB and the working decisions made are set out in Appendix A. Appendix B includes an extract of the draft minutes from the March 2011 meeting relating to entity combinations.
3. It should be noted that a suggestion from the March 2011 meeting that this project should also consider the accounting treatment of a transaction or other event in which there is a separation of entities. Staff has not yet considered this issue and will do so later in 2011.

4. The second part of this session (Agenda Papers 6.3 and 6.4) covers a draft Project Brief for approval on the revision of:
 - (a) IPSAS 6, *Consolidated and Separate Financial Statements*;
 - (b) IPSAS 7, *Investments in Associates*; and
 - (c) IPSAS 8, *Interests in Joint Ventures*.

Appendix A: Issues Already Considered by the IPSASB and Working Decisions

March 2011

- The IPSASB agreed that the project would include consideration of the accounting treatment of both the recipient and transferor in an entity combination.
- The IPSASB agreed on the working definition for recipient and transferor, as follows:

“A **recipient** is the entity that obtains control of the entity or operation that is transferred or is the entity that is the result of the entity combination where one or more entities combine.”

“A **transferor** is the entity that transfers one or more of its entities or operations to another entity.”
- The IPSASB agreed on the working definition for “a combinations of entities and/or operations under common control”:

“**An entity combination in which all of the combining entities and/or operations are ultimately controlled by the same entity or entities both before and after the entity combination.**”
- The IPSASB agreed that the scope of the project includes the formation of a jointly-controlled entity where it is formed with existing entities and/or operations, and the transfer of a GBE from one public sector entity to another.

November 2010

- The IPSASB agreed the revised Project Brief.
- The IPSASB agreed on the working definition of an entity combination as:

“**The bringing together of separate entities and/or operations into one entity.**”
- The working definition of an entity combination initially used the term “reporting entity” rather than “entity.” The IPSASB agreed on this change because IPSASs do not define either “reporting entity” or “entity” or specify the difference between entity and reporting entity.

June 2010

- The IPSASB agreed to revise the Project Brief on Entity Combinations initially agreed upon at the March 2007 meeting.

April 2010

- The IPSASB agreed not to progress ED 41, *Entity Combinations from Exchange Transactions* to a standard because the split between exchange and non-exchange entity combinations could not be clearly articulated and therefore was not considered to be workable.

Appendix B: Extract from Draft Minutes of March 2011 Meeting

8. ENTITY COMBINATIONS

Discuss Issues (Agenda Item 9)

The IPSASB considered issues relating to the scope of the project.

Explanation of the term “operation”

The working definition of an entity combination is “the bringing together or separate entities and/or operations into one entity.” The staff proposed that the term “operation” in the working definition been replaced by the description of an operation rather than having a separate definition of operation. The IPSASB discussed this proposal and there was general support for having a separate definition so that the working definition of an entity combination remains short and concise. The IPSASB agreed that perhaps a more appropriate term could be found. Members suggested considering “component of an entity,” “separable part of an entity,” or “operation”. The term “function” was also suggested; however it was noted that a “function of government” has a specific meaning in Government Finance Statistics (GFS)¹ and so its use may be problematic. Staff will consider which term is most appropriate.

On which entity does this project focus?

The staff proposed that the entity which is the focus of this project should be the entity that gains control of another entity or the resulting entity where two or more entities combine in a transaction or other event that gives rise to an entity combination. The IPSASB discussed this proposal. The IPSASB agreed that the accounting treatment in the entity that loses control of, or transfers, an entity (i.e., derecognition of an entity) should also be included in the scope of the project because the current suite of IPSASs does not contain guidance on this aspect of an entity combination.

A Member suggested that this project should also consider the accounting treatment of a transaction or other event in which there is a separation of entities. There was general agreement that this item should also be included in the scope of the project.

Terminology

The staff proposed that additional terminology be used to ensure that each type of entity combination is referred to consistently, and to easily and consistently identify the entities and operations involved in an entity combination. The terms proposed were “transferor”, “transferee” and “recipient”. The IPSASB considered that transferor and recipient are appropriate terms to use. The term transferee was not considered necessary.

¹ GFSM 2001 defines “functional classification” as “the classification used to identify the purpose, or socioeconomic objective, for which an expense was incurred or a nonfinancial asset was acquired.”

The IPSASB noted that the System of National Accounts (SNA)² uses the term transfer to mean a non-exchange type transaction whereas the term, for the purposes of this project, includes both exchange and non-exchange transactions. The IPSASB agreed that a footnote should be included in the Consultation Paper to highlight this difference.

Common control

The staff proposed that the working definition for “a combination of entities and/or operations under common control” is “an entity combination in which all of the combining entities and/or operations are ultimately controlled by the same party or parties both before and after the entity combination and that control is not transitory”.

Members made the following comments.

- That introducing new terminology “the same party or parties” was unnecessary and could be replaced by “the same entity or entities.”
- That the final phrase “and that control is not transitory” was not necessary.

The IPSASB agreed to the following amended working definition for “a combination of entities and/or operations under common control”:

“An entity combination in which all of the combining entities and/or operations are ultimately controlled by the same entity or entities both before and after the entity combination.”

Is the formation of a joint venture within the scope?

The staff outlined that one type of formation of a joint venture—a jointly controlled entity—is within the scope of the working definition of an entity combination even though the Project Brief has a specific exclusion for formations of joint ventures.

The IPSASB agreed that the project should include the formation of jointly controlled entity, and that the wording should be amended to make it clear that only the formation of a jointly controlled entity is within the scope of the working definition of an entity combination.

Is a transaction or other event that involves a GBE and gives rise to an entity combination within the scope?

The staff outlined an example where a GBE is part of an entity combination, i.e., where a national government transfers a GBE to a provincial, state, or local government. The IPSASB agreed that the accounting treatment in the transferor (i.e., the national government in the example) is included in the scope of the project because of its decision to propose guidance for both the recipient and transferor in an entity combination.

² SNA 2008 defines “transfer” as “a transaction in which one institutional unit provides a good, service or asset to another unit without receiving from the latter any good, service or asset in return as a direct counterpart.”

ENTITY COMBINATIONS

Objective of this Issues Paper

- To **discuss and provide directions** on the use of the term “operation” and proposed revisions to the definitions of the parties to an entity combination.

The Term “Operation”

1. The working definition of an entity combination is:
“The bringing together of separate entities and/or operations into one entity.”
2. At the IPSASB’s March 2011 meeting, Staff proposed that the term “operation” in the working definition be replaced by the description of an operation rather than having a separate definition of operation. The IPSASB discussed this proposal and there was general support for having a separate definition so that the working definition of an entity combination remains short and concise. The IPSASB agreed that perhaps a more appropriate term could be found. Members suggested considering “component of an entity,” “separable part of an entity,” or operation.
3. This section of the Issues Paper explores what the term is meant to define and which of these three terms is the most appropriate to use.

What is the Term meant to Define?

4. The term “operation” or an equivalent term is necessary in the working definition of an entity combination so that parts of, or components of, an entity being brought together into one entity meet the definition of an entity combination. For example, a ministry, authority or department, program or activities in a particular region may not be entities but instead form a part of an entity. Where these “parts” of an entity are transferred they meet the definition of an entity combination.
5. At the March 2011 meeting, the description of the term “operation” was:
“An integrated set of activities, assets and/or liabilities that is conducted and managed for the purpose of achieving the entity’s objectives, either by providing economic benefits or service potential.”
6. This description is based upon the term “business” from IFRS 3, *Business Combinations*. The definition of business is “an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.”
7. The term “business” was amended to:
 - (a) Include the notion of the provision of goods and services as a purpose of an operation because this is a major activity of most public sector entities

- by the use of the phrase “either by providing economic benefits or service potential”;
- (b) Include circumstances in which a public sector operation may involve activities directed at the management of liabilities rather than use of assets for the delivery of services by the use of the phrase “activities, assets and /or liabilities”; and
 - (c) Exclude the notion that an operation is “capable of” being conducted and managed.
8. Staff considers that the first two amendments are necessary for the description to be relevant to public sector entities. However, the third amendment to exclude the notion of being “capable of” was an oversight by Staff. Therefore, Staff considers that these words should be inserted. The revised description is:
- “An integrated set of activities, assets and/or liabilities that is capable of being conducted and managed for the purpose of achieving the entity’s objectives, either by providing economic benefits or service potential.”**

Question 1 for the IPSASB:

Do you agree with the revised description of the definition set out in paragraph 8?

Which Term to Use?

9. This section of the Issues Paper considers three terms that could be used: “component of an entity,” “separable part of an entity,” or “operation.”

Using the Term “Component of an Entity”

10. The term “component of an entity” has a potential disadvantage because it is defined in IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. This definition is not currently part of IPSASs because the IPSASB does not have an equivalent standard to IFRS 5. At present, the lack of guidance on this topic is not a priority for the IPSASB. However, this situation may change in the future and IPSASs could include a definition for “component of an entity” that is different from what is being proposed for the entity combinations project.
11. The term “component of an entity” is defined in IFRS 5 as:
- “A **component of an entity** is operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.”
12. The term “component of an entity” as it is used IFRS 5 relates to a component of an entity being a cash-generating unit or a group of cash-generating units being held for use in the entity. Cash-generating units are defined in IPSAS 26, *Impairment of Cash-Generating Assets* as the “smallest identifiable group of assets held with the primary objective of generating a commercial return that generates cash inflows from continuing use that are largely independent of the

cash inflows from other assets or groups of assets.” This definition is based on the definition in IAS 36, *Impairment of Assets*.

13. The focus of the definition of a cash-generating unit is on cash flows generating a commercial return. So IFRS 5’s definition of a “component of an entity” has a different focus from its possible use in the entity combinations project. If the IPSASB does commence a project to develop an IPSAS based on IFRS 5, then the term “component of an entity” may need to be replaced with another term.

Using the Term “Separable Part of an Entity”

14. The term “separable part of an entity” could be used. This term is not defined in IPSASs but it has been used in IPSAS 31, *Intangible Assets* to further explain when an intangible asset is identifiable. It describes “separable” as being where an asset “is capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so.”¹
15. The use of “separable” in IPSAS 31 is not inconsistent with its proposed use in the working definition of an entity combination. Staff has not identified any potential disadvantages with using “separable part of an entity” in the working definition of an entity combination.

Using the Term “Operation”

16. A potential disadvantage to using the term “operation” is that IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* uses a similar term “foreign operation.” A foreign operation is defined as “an entity that is a controlled entity, associate, joint venture, or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.”
17. This project excludes from its scope associates and joint ventures that are not jointly controlled entities. To minimize the potential confusion of having two definitions including the term “operation” words such as “for the purposes of this Standard” could be added at the beginning of the description to make it clear that the definition relates only to the Standard or Standards resulting from this project.
18. Another potential disadvantage is that the IASB define a similar term “discontinued operation” in IFRS 5. The definition is:

“**A discontinued operation is a component of an entity** that either has been disposed of or is classified as held for sale and:

(a) Represents a separate major line of business or geographical area of operations;

¹ IPSAS 31, paragraph 19(a).

- (b) Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations; or
 - (c) Is a subsidiary acquired exclusively with a view to resale.”
19. When the IASB was finalizing the requirements in IFRS 3, the proposal in ED 3 was to use the term “operation” in the definition of a business combination. The IASB replaced “operation” with “business” specifically because it did not want any possible connection between the notion of an “operation” in the definition of a business combination and the notion of a “discontinued operation” in IFRS 5².

Summary and Staff View

20. Staff considers that because the term “component of an entity” could be included in an IPSAS based on IFRS 5, the term should not be used.
21. Staff does not have a view on whether the term should be “separable part of an entity” or “operation.” Set out below is what the amended definition of an entity combination would be if either of these terms is adopted.
- “The bringing together of separate entities and/or operationsseparable parts of an entity into one entity.”**
- “The bringing together of separate entities and/or operations into one entity.”**
22. If the term “operation” is kept, the definition would need to start with “for the purposes of this Standard” so that it is not confused with term “foreign operation” in IPSAS 4 and the term “discontinued operation” if an IPSAS is developed based on IFRS 5.
23. If the term “separable parts of an entity” (in plural to be consistent with the wording of the rest of the definition of an entity combination) is used it has the advantage of not being similar to other definitions already used in IPSASs and does not have the potential to complicate a future project on non-current assets held for sale and discontinued operations. However, it is a more cumbersome term to use.

Question 2 for the IPSASB:

Do you agree that the term “component of an entity” should not be used?

Question 3 for the IPSASB:

What do you consider is the appropriate term to use to describe:

“An integrated set of activities, assets and/or liabilities that is capable of being conducted and managed for the purpose of achieving the entity’s objectives, either

² IFRS 3, Basis for Conclusions, paragraph BC11, March 2004.

by providing economic benefits or service potential”:

- (a) Separable part of an entity; or
- (b) Operation?

Proposed Revisions to Definitions of the Parties to an Entity Combination

24. At its March 2011 meeting, the IPSASB agreed that two additional working definitions should be used to help describe the parties involved in an entity combination. Whilst writing the Issues Paper on distinguishing between different types of entity combination and potential methods to account for them (Agenda Paper 6.2), Staff considered that the wording of these additional definitions could be improved.
25. In particular, the working definition for a recipient could be split into two definitions so that there is a clear distinction between:
 - (a) An entity combination where one entity gains control of another entity and/or operation. The term “recipient” is used in this type of entity combination; and
 - (b) An entity combination where two or more entities combine where none of the combining entities gain control of the other entity or entities. The term “resulting entity” is used in this type of entity combination.
26. In addition, a working definition is proposed for combining entity. The proposed changes are set out in Table 1 below.

Table 1: Proposed Revised Definitions

A combining entity is an entity that combines with another entity to form the resulting entity.
A recipient is the entity that obtains control of the entity or operation that is transferred or is the entity that is the result of the entity combination where one or more entities combine.
A recipient resulting entity is the entity that obtains control of the entity or operation that is transferred or is the entity that is the result of the entity combination where one <u>two</u> or more entities combine.
A transferor is the entity that transfers one or more of its entities or operations to another entity.

Question 4 for the IPSASB:

Do you agree with the proposed amendments and additions to the definitions for the entity combinations project?

If not, why not?

ENTITY COMBINATIONS

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Objective of this Issues Paper

- To **discuss and provide directions** on distinguishing between different types of entity combination and potential methods to account for them.

Introduction

1. The working definition of an entity combination is:
“The bringing together of separate entities and/or operations¹ into one entity.”
2. The purpose of this project is to determine the accounting treatment where a transaction or other event meets this definition for entities that adopt accrual basis IPSASs.
3. This Issues Paper addresses the following topics:
 - (a) Where an entity gains control of another entity, the accounting treatment for the entity that gains control (the recipient) and for the entity that loses control (the transferor) of, or transfers, an entity or operation; and
 - (b) Where two or more entities combine, the accounting treatment for the entity that is a result of the entity combination (the resulting entity) and for the entities that combine (the combining entities).
4. Appendix A includes existing definitions in IPSASs that may be relevant to the project.

What is the Appropriate Accounting Treatment for Each Type of Entity Combination?

5. Previously, the IPSASB examined whether different types of entity combinations could be separated based on whether they resulted from exchange or non-exchange transactions. After extensive debate, the IPSASB agreed that this distinction cannot be clearly articulated and therefore should not be used.
6. In this Issues Paper, the approach to distinguishing between different types of entity combinations starts with the description in the Project Brief of the types of entity combination included in the scope of this project²:
 - (a) An existing or newly established entity gaining control of one or more entities;
 - (b) An existing or newly established entity gaining control of the operations of another entity or entities; or
 - (c) Two or more entities combining [either in an existing or newly established entity] where none of the combining entities gain control of the other combining entity or entities.

¹ At its March 2011 meeting, the IPSASB directed Staff to consider whether “operation” is the appropriate term to use, or whether another term such as “component of an entity” or “separable part of an entity” would be better. This analysis is in Agenda Paper 6.1.

² Project Brief, paragraph 1.4.

7. The three types above can be grouped into two types of entity combination:
 - (a) One entity gains control of one or more entities and/or operations during the reporting period (sub-paragraphs (a) and (b)); or
 - (b) Two or more entities combining into a resulting entity where none of the combining entities gain control of the other combining entity or entities during the reporting period (sub-paragraph (c)).
8. These two types of entity combinations are analyzed further below.

A1: One Entity Gains Control of another Entity or Operation not Under Common Control

9. Where one entity gains control of another entity or operation and they are not under common control, the accounting treatment of an entity combination relates to:
 - (a) The recognition and initial measurement of the assets received and liabilities assumed by the recipient³;
 - (b) The recognition and presentation of the difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any); and
 - (c) The information to disclose (disclosures are not dealt with in this Issues Paper and will be considered later in 2011).
10. The accounting treatment of this type of entity combination is also considered for the transferor. However, the method of consolidation used to recognize the entity that the recipient has gained control of in its consolidated financial statements is outside the scope of this project and is dealt with in IPSAS 6, *Consolidated and Separate Financial Statements*⁴.
11. This section of the Issues Paper refers to a recipient gaining control of an “entity or operation” but applies equally to an individual entity or operation or several entities or operations. In addition, this Issues Paper refers to the consolidated financial statements of the recipient or transferor but applies equally to a recipient’s individual financial statements where it gains control of an operation or a transferor’s individual financial statements where it loses control of an operation.

Recipient Accounting

12. A recipient could gain control of the following types of entities or operations:

³ Agenda Paper 6.1 includes an explanation of the definitions proposed for this project.

⁴ At the June 2011 meeting a draft Project Brief on the revision of IPSAS 6 will be presented for approval.

- (a) A public sector entity or operation that is not a Government Business Enterprise⁵ (GBE);
 - (b) A public sector entity or operation that is a GBE (hereafter referred to as a GBE, rather than “a public sector entity or operation that is a GBE”);
 - (c) A private sector for-profit entity or operation; or
 - (d) A private sector not-for-profit entity or operation.
13. A private sector not-for-profit entity has similar objectives to most public sector entities in that they provide goods and services to the public in non-exchange transactions. Staff considers that the type of entity or operation captures the essential characteristics or nature of an entity or operation. Using the type of entity or operation to further distinguish between types of entity combinations has the advantage of being a matter of fact rather than a subjective assessment.
14. The different types of entity or operation that the recipient could gain control of (referred to as “newly controlled entity or operation”) will be used to help determine the appropriate measurement basis or approach for an entity combination.

What is the Appropriate Measurement Basis or Approach?

15. Existing IPSASs use a number of different measurement bases for initial recognition and measurement, dependent upon the type of asset or liability being measured and include (in no particular order):
- (a) Cost, e.g., investment property, property, plant, and equipment and intangible assets;
 - (b) Fair value, e.g., financial assets and financial liabilities, and assets such as property, plant, and equipment, where they are acquired through a non-exchange transaction;
 - (c) Fair value less costs to sell, e.g., biological assets; and
 - (d) Best estimate of the expenditure required to settle a present obligation, e.g., provision.
16. Existing IPSASs also use other measurement bases for subsequent measurement, again dependent upon the type of asset being measured, such as value in use, replacement cost, recoverable service amount and recoverable amount.
17. For those assets that are not held at fair value at the reporting date, amounts in the entity’s statement of financial position are stated at carrying amount, which is the amount recognized in the statement of financial position, after deducting any accumulated depreciation and accumulated impairment losses thereon. For those liabilities that are not held at fair value at the reporting date, amounts in the

⁵ The definition of a GBE is in IPSAS 1, *Presentation of Financial Statements*. This definition is set out in Appendix A. At the June 2011 meeting, a draft Project Brief on GBEs will be presented for approval. If it is approved, the project may change the definition of a GBE.

entity's statement of financial position are stated at carrying amount, which is the amount recognized in the statement of financial position. Carrying amount is not a measurement basis as such and so will be referred to as a measurement approach.

18. The Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements* (Measurement CP), discusses historical cost, market value, and replacement cost measurement bases. It also discusses the deprival value concept which does not describe a single measurement basis, but rather a means by which a basis be selected that is relevant to the circumstances. The Measurement CP considers that there is no single measurement basis that is appropriate in all circumstances⁶. To minimize the drawbacks of using different measurement bases, it considers that a particular basis is selected only where this is justified by economic circumstances⁷.
19. Market value is not separately considered as a measurement basis because Staff considers that market values are a sub-set of fair value. This is because fair value will equal market value where a market exists for a particular asset. Where a market does not exist, then fair value is estimated.
20. In the context of the consolidated financial statements of the recipient, the items to be measured when a transaction or other event results in an entity combination are the individual assets and liabilities received on the date that the entity combination takes place⁸. In other words, the measurement basis or approach needs to be appropriate for the initial recognition and measurement of individual assets and liabilities.
21. In many instances, a transaction or other event that gives rise to an entity combination in the public sector will not include the transfer of any consideration. For an entity combination, its cost is the amount of consideration transferred. Therefore, where no consideration is transferred the cost basis cannot be used. Where consideration has been transferred, a measurement basis or approach is needed for determining the allocation of that cost to the individual assets received and liabilities assumed.
22. Staff considers, for the reasons stated above, that cost and market value are not appropriate measurement bases to use for an entity combination. Measurement bases that relate to subsequent measurement are also inappropriate. Therefore, the measurement approach and basis that Staff considers should be explored for use in the consolidated financial statements of the recipient for the newly controlled entity or operation are, carrying amount and fair value. This is because they are already used in IPSASs, and Staff considers that they are appropriate for the entity combinations project.

⁶ CF CP Measurement, paragraph 1.5.

⁷ CF CP Measurement, paragraph 1.6.

⁸ The difference arising from the individual assets received and liabilities assumed, and the consideration transferred (if any) is dealt with in a later section of this Issues Paper.

Question 1 for the IPSASB:

Do you agree that carrying amount and fair value are the most appropriate measurement basis and approach that are available for consideration?

(Note that the fresh start method is considered for types of entity combinations where two or more entities combine.)

If not, what other measurement bases or approaches should be considered?

23. To assess the relative merits of carrying amount and fair value, the discussion below considers each in the context of the objectives of financial reporting and the qualitative characteristics proposed in the Conceptual Framework Exposure Draft 1 (CF–ED 1), *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Role, Authority and Scope; Objectives and Users; Qualitative Characteristics; and Reporting Entity*. CF–ED 1 proposes that the objectives of financial reporting by public sector entities are to provide information about the entity that is useful to users of GPFRs for accountability purposes and for decision-making purposes⁹. The qualitative characteristics of information included in general purpose financial reports of public sector entities are relevance, faithful representation, understandability, timeliness, comparability, and verifiability. The constraints on information are materiality, cost-benefit and the need to achieve an appropriate balance between the qualitative characteristics. The section on qualitative characteristics in CF–ED 1 is set out in Appendix B.

Carrying Amount

24. The *Glossary of Defined Terms* defines carrying amount, as follows.
- “**Carrying amount of an asset** is the amount at which an asset is recognized in the statement of financial position, after deducting any accumulated depreciation and accumulated impairment losses thereon.”
- “**Carrying amount of a liability** is the amount at which a liability is recognized in the statement of financial position.”
25. Where a recipient gains control of another entity or operation, the amounts recognized in the consolidated financial statements of the recipient could be the carrying amount of the individual assets and liabilities recognized by the transferor; in other words, the amounts recognized in the financial statements of the entity or operation that was transferred. Using the carrying amount has the advantage of having a high degree of verifiability because the amounts are already known and are readily available. This minimizes the time and cost to prepare the recipient’s consolidated financial statements. Further, users will find this information easily understandable.

⁹ CF–ED 1, paragraph 2.1.

26. The disadvantages of using the carrying amount are that assets and liabilities may be overstated or understated in relation to their fair value. In other words, the amounts do not faithfully represent the value of the assets received or the liabilities assumed. The use of carrying amount could result in very similar assets and liabilities being recognized at different amounts, dependent upon the carrying amounts in the transferor's consolidated financial statements. This decreases the comparability of the recipient's consolidated financial statements with other entities that have similar assets and liabilities.
27. Furthermore, there may be additional assets and liabilities that have not been recognized in the financial statements of the newly controlled entity or operation, e.g., an internally-generated intangible asset, such as software. This contrasts with using fair value as a measurement basis, because all identifiable assets and liabilities are recognized under that basis. If the carrying amount is not a faithful representation, it is unlikely that it will be relevant to users for decision-making and accountability purposes because it does not provide a complete picture of the resources the recipient gained control of as a result of the entity combination.
28. Staff considers that the advantages and disadvantages of using the carrying amount are the same for each of the four types of newly controlled entity or operation listed in paragraph 12.
29. The disadvantages of using the carrying amount could be minimized by requiring the recipient to:
 - (a) Perform an impairment test on the assets of the newly controlled entity or operation to ensure that they are not overstated¹⁰;
 - (b) Perform a review of the liabilities assumed to ensure that they are not understated; and
 - (c) Assess whether there are identifiable assets and liabilities which were not recognized by the transferor that need to be recognized by the recipient and recognize them.
30. If the recipient performs these tasks, they, in effect, change the measurement approach to a "modified" carrying amount approach. Consideration would also need to be given as to whether these tasks alter the cost-benefit assessment in using a "modified" carrying amount approach.
31. The modified carrying amount approach does not address the understatement of assets or the overstatement of liabilities. For example, assets recognized using this approach may be recognized at an amount that is significantly less than their fair value. This could be considered a disadvantage of using this measurement approach and an advantage of using fair value as a measurement basis.

¹⁰ Imposing a requirement for an impairment test would require a consequential amendment to IPSAS 21, *Impairment of Non-Cash-Generating Assets* and IPSAS 26, *Impairment of Cash-Generating Assets*.

Fair Value

32. The *Glossary of Defined Terms* defines fair value, as follows.

“The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”
33. In its consolidated financial statements, the recipient could recognize all identifiable assets and liabilities of the newly controlled entity or operation at fair value. The advantage of recognizing all identifiable assets and liabilities of a newly controlled entity or operation is that it provides users with a measure of the current value of the resources it gained control of as a result of the entity combination. This information will be a faithful representation and be relevant to users for decision-making and accountability purposes. Fair value also meets the qualitative characteristic characteristics of comparability and verifiability.
34. The disadvantages of using fair value vary depending on how difficult it is to determine the fair value of the individual assets received and liabilities assumed in the newly controlled entity or operation. Public sector entities and private sector not-for-profit entities may have significant numbers of specialized assets for which there is an absence of a deep and liquid market. For many liabilities, it is unlikely that there will be any kind of market in which to obtain a market value. In this situation, fair value would need to be estimated. For assets, there are several approaches that can be used to estimate fair value, such as depreciated replacement cost, reproduction cost or service units approach. An estimate of fair value is usually costly and time consuming to prepare and may not be verifiable. It is less likely that users will understand the limitations of making an estimate and its underlying assumptions. Some would argue that where there is an absence of a deep and liquid market, the costs of determining fair value may be prohibitive and this has an obvious impact on the cost-benefit constraint.
35. Where a newly controlled entity or operation is a private sector for-profit entity or operation, there may be no disadvantage to using fair value because these types of entities or operations usually have objectives to earn a return on investment. The assets they hold to do this are usually non-specialized in nature so fair values are easily obtainable based on actual market values at little cost.
36. Furthermore, in jurisdictions that require their private sector for-profit entities to adopt IFRSs, the acquisition of another entity is measured at fair value. Staff has not identified any public sector specific reason/s for not adopting the same measurement basis.
37. Where a newly controlled entity or operation is a GBE the situation is more complex because a GBE “sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery.” Additionally, GBEs adopt IFRSs to prepare their financial statements, the rationale being that they are similar to private sector for-profit entities and no distinction is made as to whether they have a profit objective or a full cost recovery objective. Where a recipient gains control of a GBE that has a profit objective, this could be seen as being a

- similar situation to gaining control of a private sector for-profit entity. Then, the use of fair value has the same advantages and disadvantages.
38. In contrast, where the GBE has service objectives and operates on a full cost recovery basis, the use of fair value would have the same advantages and disadvantages as if it were a public sector entity or operation (without being a GBE).
39. Staff is unaware of methods to minimize the disadvantages of using fair value where there is an absence of a deep and liquid market. This is of particular relevance for newly controlled entities or operations that are public sector entities or operations, or private sector not-for-profit entities or operations because these types of entities are likely to hold assets of a specialized nature.

Question 2 for the IPSASB:

Is the discussion on carrying amount and fair value complete, balanced and fair?
If not, why not?

Question 3 for the IPSASB:

Are the methods identified to minimize the disadvantages of carrying amount appropriate?
If not, why not?

Question 4 for the IPSASB:

Do you agree that the methods identified to minimize the disadvantages of carrying amount:

(a) Should be used whenever there is an entity combination that uses carrying amount as its measurement approach?; and

(b) Should be referred to as “modified carrying amount”?

If not, why not?

Existing Requirements for Similar Transactions

40. Existing IPSASs include requirements for the receipt of individual assets and liabilities. Generally, assets received in exchange transactions are recognized initially at cost¹¹ or fair value¹² whereas assets received in non-exchange

¹¹ For example, investment property (IPSAS 16.26), property, plant, and equipment (IPSAS 17.26) and intangible assets (IPSAS 31.31).

¹² For example, some financial assets (IPSAS 29.45).

transactions are required to be recognized at fair value¹³. The rationale for the use of fair value when the acquisition of an asset arises from a non-exchange transaction is that there is no other practical method to measure the asset. Generally, liabilities are initially measured at the best estimate of the expenditure required to settle a present obligation¹⁴ or fair value¹⁵.

41. There are at least two reasons why transactions or other events giving rise to an entity combination are different from the acquisition of individual assets or assumption of liabilities and therefore why a different measurement basis or approach should be considered. The first is that the IPSASB has agreed that it is not possible to distinguish between exchange and non-exchange entity combinations whereas, for individual assets and liabilities, this distinction can be made. The second reason is that, in an entity combination, the carrying amounts are known (because there is access to the accounting records) whereas, in the acquisition of an asset from a non-exchange transaction, the carrying amount of the asset is unlikely to be known.

Staff View

42. In the consolidated financial statements of the recipient, Staff considers it is appropriate to use modified carrying amount where a recipient gains control of a public sector entity or operation or a private sector not-for-profit entity or operation. The reason for this view is because it is a practical and low cost approach that is easily understandable and the use of modified carrying amount minimizes some of the disadvantages of using carrying amount.
43. In the consolidated financial statements of the recipient, Staff considers it is appropriate to use fair value where the recipient gains control of a private sector for-profit entity or operation because the advantages of fair value outweigh the advantages of carrying amount for these types of entities or operations. Fair value is the same measurement basis that a private sector for-profit entity would use for a business combination and Staff does not consider that there is a public sector specific reason to depart from this measurement basis. It is also consistent with the measurement basis used for the acquisition of an asset in a non-exchange transaction.
44. Staff does not have a view on the measurement basis or approach for a GBE because this type of entity or operation can have a profit objective, which could be seen as similar to private sector for-profit entities or operations, or it can have a full cost recovery objective, which could be seen as similar to public sector entities or operations that are not GBEs. As Staff is proposing the use of a different measurement basis or approach dependent on the type of newly controlled entity or operation that the recipient gains control of as a result of an

¹³ For example, inventories (IPSAS 12.16), investment property (IPSAS 16.27) and property, plant, and equipment (IPSAS 17.27).

¹⁴ For example, provisions (IPSAS 19.44) and liabilities in respect of the inflow of resources arising from a non-exchange transaction (IPSAS 23.57).

¹⁵ For example, some financial liabilities (IPSAS 29.45).

entity combination, it is not clear which basis or approach is suitable for a GBE. Therefore, Staff would like direction from the IPSASB on this issue.

Question 5 for the IPSASB:

Do you agree that modified carrying amount is the appropriate measurement approach for:

- (a) A public sector entity or operation;
- (b) A private sector not-for-profit entity or operation;

And fair value is the appropriate measurement basis for:

- (c) A private sector for-profit entity or operation.

If not, why not?

Question 6 for the IPSASB:

What do you consider is the appropriate measurement basis or approach for a GBE?

What is the Appropriate Accounting Treatment of the Difference arising from the Net Assets Received or Net Liabilities Assumed and the Consideration Transferred (if any) in the Recipient's Consolidated Financial Statements?

- 45. In the recipient's consolidated financial statements, the individual assets received and liabilities assumed in an entity combination are recognized. This section of the Issues Paper explores possible accounting treatments of the difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any). The amount of the difference arising will be dependent on the measurement basis or approach that has been adopted and it may have the effect of increasing or decreasing the amount of net assets or liabilities recognized by the recipient. Another factor which may affect the difference arising is whether the recipient transfers consideration to the transferor.
- 46. This section of the Issues Paper assumes that the difference arising is calculated as the difference between:
 - (a) The net assets received or the net liabilities assumed using the measurement basis or approach determined in a previous section of this Issues Paper; and
 - (b) The consideration transferred (if any).

Consideration Transferred (if any)

- 47. Consideration transferred refers to the situation where a recipient transfers cash or other assets to the transferor. Consideration transferred can also be the sum of cash or other assets transferred by the recipient and liabilities incurred by the

- recipient, to the transferor. In rare circumstances, consideration transferred may also include equity interests issued by the recipient.
48. Any costs incurred by the recipient in effecting an entity combination are not included in the calculation of consideration transferred. The accounting treatment of these costs is not dealt with in this Issues Paper and will be considered later in 2011.
49. In a situation where the recipient receives net assets and no consideration is transferred, or an amount up to the value of the net assets received is transferred to the transferor, the consideration transferred reduces the difference arising. Where the consideration transferred equals the net assets received, then there is no difference arising. Where the consideration transferred is in excess of the net assets received, the difference arising is a debit.

Possible Accounting Treatment of Difference Arising Where the Recipient Receives Net Assets

50. Where the recipient receives net assets and no consideration is transferred, or an amount up to the value of the net assets received is transferred to the transferor, the difference arising will result in an increase in net assets in the consolidated financial statements of the recipient. This increase in net assets could be recognized as:
- (a) A gain¹⁶ in surplus or deficit; or
 - (b) A contribution from owners.

Gain

51. Where a recipient receives net assets in a transaction or other event that gives rise to an entity combination there is an inflow of economic benefits or service potential which results in an increase in net assets/equity during that reporting period. In other words, the recipient has received an economic gain or an increase in service potential by the receipt of an entity or operation from the transferor. So it makes sense that the difference arising is a gain recognized in surplus or deficit irrespective of the type of newly controlled entity or operation.
52. Further, the treatment of the difference arising as a gain is consistent with the requirement in IPSAS 23, *Revenue from Non-exchange Transactions (Taxes and Transfers)* that an inflow of resources from a non-exchange transaction recognized as an asset shall be recognized as revenue, except to the extent that a liability is also recognized in respect of the same inflow¹⁷.

¹⁶ Staff considered whether the term “revenue” should be used. However, the definition of revenue refers to a “gross inflow” whereas the difference arising as the result of an entity combination is a net amount and therefore the term “gain” is used. This parallels the treatment of the disposal of property, plant, and equipment in IPSAS 17, *Property, Plant, and Equipment* where the gain or loss arising from the derecognition of an item of property, plant, and equipment shall be included in surplus or deficit when the item is derecognized (IPSAS 17.83).

¹⁷ IPSAS 23, paragraph 44.

53. The recognition of a gain is also consistent with the treatment of a gain arising from a bargain purchase in IFRS 3, *Business Combinations*.
54. The presentation of a gain in the statement of financial performance is not dealt with in this Issues Paper and will be considered later in 2011¹⁸.

A Contribution from Owners

55. A transaction or other event that gives rise to an entity combination could be a transaction with owners acting in their capacity as owners and needs to be distinguished from transactions with owners acting in other capacities, e.g., as suppliers or customers. The *Glossary of Defined Terms* defines “contributions from owners,” 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.”
56. IPSAS 1, *Presentation of Financial Statements* requires contributions from owners, where they explicitly give rise to residual interests in the entity in the form of rights to net assets/equity, to be recognized as a direct adjustment to net assets/equity¹⁹. To meet the definition of a contribution from owners, a transaction or other event which gives rise to an entity combination must be a contribution by a party external to the recipient and establish or increase the financial interest in the net assets/equity of the recipient.
57. As ownership interests occur only rarely in public sector entities, it is unlikely that a transaction or other event that gives rise to an entity combination will be a transaction with owners acting in their capacity as owners. The consequence of this means that for most entity combinations, the recipient will recognize the difference arising in surplus or deficit.

¹⁸ Paragraph 99 of IPSAS 1 requires all items of revenue and expense recognized in a period to be included in surplus or deficit unless an IPSAS requires otherwise. However, IPSAS 1 does not preclude the separate presentation of items that are distinct from the ordinary activities of a public sector entity.

¹⁹ IPSAS 1, paragraph 122.

Question 7 for the IPSASB:

Are you aware of an example where an entity combination is a contribution from an owner?

If so, can you please give details of this example to Staff?

Where the Difference Arising is a Debit

58. Where the consideration transferred is in excess of the net assets received, the difference arising is a debit. The debit could be recognized as:
- (a) A loss²⁰ in surplus or deficit; or
 - (b) Goodwill.
59. Existing IPSASs do not include a definition of goodwill or any requirements for its recognition and measurement.
60. International guidance on the requirements for the initial recognition and measurement of goodwill for the for-profit private sector are included in IFRS 3. The requirements for its subsequent measurement are included in IAS 36, *Impairment of Assets*. IFRS 3 requires:
- “The acquirer shall recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below:
- (a) The aggregate of:
 - (i) The consideration transferred measured in accordance with this IFRS, which generally requires acquisition-date fair value (see paragraph 37);
 - (ii) The amount of any non-controlling interest in the acquiree measured in accordance with this IFRS; and
 - (iii) In a business combination achieved in stages (see paragraphs 41 and 42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.
 - (b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this IFRS.”²¹
61. In other words, goodwill is the residual cost of a business combination. IFRS 3 defines goodwill as:
- “An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.”

²⁰ Similar to the reasoning for the use of the term “gain” instead of the term “revenue” above, the term “loss” is used rather than the term “expense.”

²¹ IFRS 3, *Business Combinations*, paragraph 32.

62. IAS 36 requires that goodwill is tested for impairment annually²².
63. The IPSASB's current definition of an asset is²³:
“**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.”
64. Where a debit does arise, does it meet the definition of an asset? The recipient has gained control of another entity or operation as a result of a past event, i.e., the transaction or other event giving rise to the entity combination. The recipient recognizes an increase in net assets but can there be unidentified assets that are not separately recognized?
65. Where the newly controlled entity or operation is a public sector entity or operation or a private sector not-for-profit entity or operation, its assets will be held primarily to provide service potential rather than economic benefits. It seems unlikely that unallocated service potential can occur. So, a debit could simply be an overpayment. If so, it should be expensed in the reporting period in which it occurs. This is consistent with the IPSASB's conclusions in IPSAS 21, *Impairment of Non-Cash-Generating Assets* that it is possible to identify the service potential of individual assets so the creation of a service-generating unit (by analogy from IAS 36's cash-generating unit) is unnecessary. IPSAS 21 requires impairment testing on individual non-cash-generating assets.
66. Where the recipient gains control of a private sector for-profit entity or operation it is likely that consideration is transferred to the former owners of that entity or operation because the former owners are in the for-profit private sector. The conclusion in IFRS 3 is that a debit arising meets the definition of an asset and is therefore recognized as goodwill.
67. If the debit arising does not meet the definition of goodwill, it should be recognized as a loss in surplus or deficit. This treatment could be considered to be similar to the treatment of the off-market portion of a concessionary loan. IPSAS 29, *Financial Instruments: Recognition and Measurement* requires that concessionary loans granted are valued at fair value as the IPSASB considers that this is the most faithfully representative determination of the concession element of the loan. The concessionary loan is separated into its component parts, i.e., the off-market portion and the on-market portion. The off-market portion of the loan is accounted for as an expense in the year the loan is issued because it results in a commitment of resources, in the form of a loan and a subsidy, on day one. The IPSASB is of the view that the initial recognition of this subsidy as an expense on recognition of the transaction provides the most useful information for accountability purposes. For the recipient in an entity combination where the

²² IAS 36, paragraph 10(b).

²³ In December 2010, the IPSASB issued a Consultation Paper, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements*. The result of this project may change the definition of an asset.

newly controlled entity is a private sector for-profit entity or operation, the loss would represent a subsidy.

68. Where the newly controlled entity or operation is a GBE, the recipient could recognize the debit as a loss or goodwill in its consolidated financial statements. If a distinction is made between different types of GBEs, the debit for a GBE with a full cost recovery objective would be recognized as a loss on the grounds that such a GBE is closer to other non-profit-seeking public sector entities. Conversely, for a GBE with a profit objective, the recognition of the debit will depend on the decision made where a newly controlled entity or operation is a private sector for-profit entity.

Possible Accounting Treatment of Difference Arising Where the Recipient Assumes Net Liabilities

69. Where the recipient assumes net liabilities and consideration will be transferred by the transferor to the recipient, to compensate the recipient for assuming net liabilities.
70. Where the recipient assumes net liabilities and no consideration is transferred, or an amount up to the value of the net liabilities is transferred, the difference arising will result in a decrease in net assets in the consolidated financial statements of the recipient. In other words, the recipient has assumed an economic loss by the receipt of an entity or operation from the transferor. This decrease in net assets could be recognized as a loss in surplus or deficit irrespective of the type of newly controlled entity or operation.

Where the Difference Arising is a Credit

71. Where the recipient assumes net liabilities and the consideration transferred from the transferor to the recipient is in excess of the net liabilities assumed, the difference arising is a credit. In other words, the transferor has overpaid the recipient to assume the net liabilities of its newly controlled entity. An example could be where a Provincial government gains control of a GBE from the Federal government and the Federal government transfers consideration in excess of the net liabilities of the GBE so that the Provincial government agrees to assume responsibility for, and control of, the GBE.
72. It seems counter-intuitive to recognize the credit as a gain, but where else could it go?

Question 8 for the IPSASB:

Is the discussion on recognition of the difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any) in an entity combination complete, balanced and fair?

If not, why not?

Summary and Staff View

73. Where the recipient gains control of another entity or operation, the difference arising is calculated as the difference between the net assets received or the net liabilities assumed and the consideration transferred (if any). Table 1 below sets out where the difference arising could be recognized broken down by the amount of consideration transferred.

Table 1: Treatment of Difference Arising

Consideration Transferred	Treatment of Difference Arising²⁴	
	Recipient Receives Net Assets	Recipient Assumes Net Liabilities²⁵
No/nominal	Gain	Loss
Some	Gain	Loss
Amount equaling NA or NL	–	–
Amount in excess of NA or NL	Loss or Goodwill ²⁶	Gain?

74. Staff considers that where the recipient gains control of another entity or operation and the difference arising is less than or equal to the amount of net assets received or the net liabilities assumed, the difference arising is a gain or loss irrespective of the type of newly controlled entity or operation.
75. Staff does not have a view on where the difference arising should be recognized, i.e., as a loss or as goodwill, when the difference arising is greater than the amount of net assets received or as a gain when the difference arising is greater than the net liabilities assumed. Staff would like direction from the IPSASB on this issue.

Question 9 for the IPSASB:

Do you agree that where the recipient gains control of another entity or operation, and the difference arising is less than or equal to the amount of net assets received or the net liabilities assumed, the difference arising is a gain or loss?

If not, why not?

²⁴ The treatment of the difference arising in two jurisdictions is set out in Appendix C.

²⁵ In this instance, the consideration transferred is from the transferor to the recipient.

²⁶ It may be that the decision on whether it is a loss or goodwill will depend on the type of newly controlled entity.

Question 10 for the IPSASB:

What do you consider is the appropriate treatment of the difference arising when it is greater than the amount of:

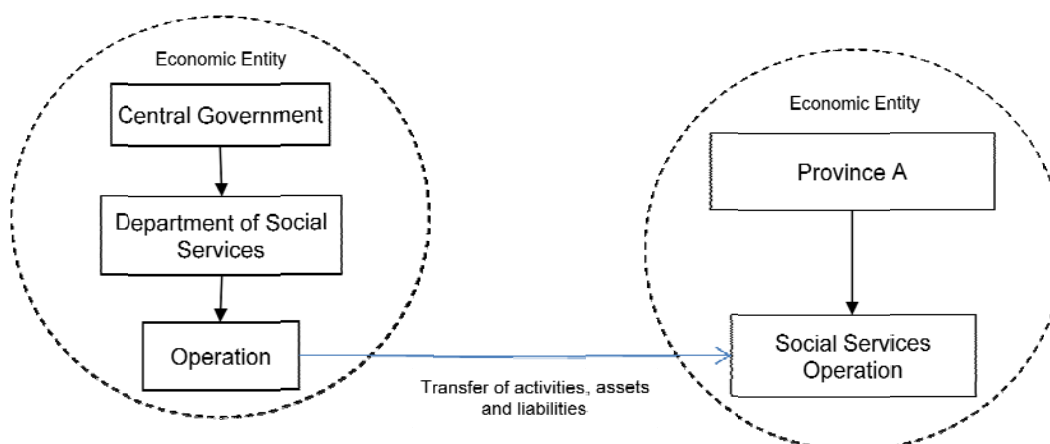
- (a) Net assets received: Loss or goodwill; or
- (b) Net liabilities assumed: Gain?

Transferor Accounting

Scope

76. At its March 2011 meeting, the IPSASB agreed that the scope of the entity combinations project should include the accounting treatment in the entity that loses control of an entity or operation (i.e., derecognition of the entity or operation that is transferred) where the loss of control arises from an entity combination. An example of this situation is illustrated in Diagram 1 below.

Diagram 1: Losing Control of an Operation not under Common Control



77. Diagram 1 above illustrates an entity combination between entities that are not under common control. The Department of Social Services within the Central government transfers an operation to Province A. Province A is the recipient and the Department of Social Services is the transferor. The accounting treatment of the loss of control of an entity or operation, in this example, the Social Services Operation, is within the scope of this project.
78. However, not all types of loss of control of an entity or operation are encompassed in this project. A controlling entity may lose control of a controlled entity without an entity combination occurring. For example:
- (a) The closure of an entity's operations;

- (b) The decrease in an interest in a controlled entity which becomes an interest in an associate, jointly-controlled entity or investment;
 - (c) The piecemeal sale of an asset, groups of assets, settlement of a liability or groups of liabilities that results in the closure of an entity or operation; or
 - (d) The separation of an entity (this aspect is not dealt with in this Issues Paper and will be considered later in 2011).
79. A transferor may lose control of a controlled entity or operation to a recipient that is a private sector entity. Where this situation occurs, it must meet the definition of an entity combination to be within the scope of this project. The accounting treatment in the recipient is not in the scope of this project because the recipient does not apply IPSASs.
80. A transferor may find it difficult to ascertain whether the private sector entity considers the transaction to be an entity combination. There may be an issue as to whether it is sensible or reasonable to obligate the transferor to determine its accounting treatment of the loss of a controlled entity or operation to a private sector entity by reference to this third-party entity. Staff is unsure as to whether this type of entity combination should be in the scope of this project. Staff would like direction from the IPSASB on this issue.

Question 11 for the IPSASB:

Does the scope of the entity combinations project as it relates to transferors reflect the directions of the IPSASB at the March 2011 meeting?

If not, why not?

Question 12 for the IPSASB:

Do you consider that where a transferor loses control of an entity or operation by transferring it to a private sector entity that it should be within the scope of this project?

If so, how should the transferor determine this transaction or other event meets the definition of an entity combination?

Existing Requirements

81. IPSAS 6,^{27, 28} *Consolidated and Separate Financial Statements* includes requirements where a controlling entity loses control of a controlled entity,

²⁷ The requirements of IPSAS 6 relating to a controlling entity's loss of control of a controlled entity are set out in Appendix C.

²⁸ At the June 2011 meeting a draft Project Brief on the revision of IPSAS 6 will be presented for approval. If it is approved, the project will consider whether the more comprehensive requirements relating to the loss of control of a subsidiary in the underlying IFRS are appropriate for public sector entities.

- irrespective of how control is lost. It requires the inclusion of the revenue and expenses of that controlled entity in the consolidated financial statements until the date on which the controlling entity loses control of the controlled entity. IPSAS 6 also requires that the difference between the proceeds from disposal (if any) and the controlled entity's carrying amount at the date of disposal is recognized in the consolidated statement of financial performance as a gain or loss on disposal of a controlled entity.
82. IPSAS 6 also includes accounting requirements where a controlling entity retains an interest in the formerly controlled entity. IPSAS 6 requires that, from the date the controlled entity ceases to be a controlled entity, it is accounted for according to the relevant accounting standard dependent upon the type of interest retained. For example, where formerly controlled entity becomes an investment, IPSAS 29 applies.
83. The question is whether the existing requirements of IPSAS 6 are appropriate where a transferor loses control of a controlled entity in an entity combination. If it is agreed that these requirements are not appropriate, then IPSAS 6 may need to be amended.

Other Considerations

84. There is international guidance for private sector for-profit entities on non-current assets held for sale in IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*. IFRS 5 requires an entity to classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use²⁹. These assets are to be measured at the lower of carrying amount and fair value less costs to sell, and depreciation on such assets ceases³⁰.
85. The IASB considers that providing information about assets and groups of assets and liabilities that are to be sold benefits users by assisting them in assessing the timing, amount and uncertainty of future cash flows³¹. The change in measurement basis reflects the change in how an entity will recover its investment in the asset, i.e., from continuing use to recovery through sale.

Mirror of Proposed Measurement Basis or Approach for Recipient

86. Should a transferor use the same measurement basis or approach as the recipient in the same entity combination? Where the entity being transferred is a public sector entity or operation, the recommendation, in a previous section of this Issues Paper, is for the recipient to use modified carrying amount. Where the entity being transferred is a GBE, the Staff has asked the IPSASB for direction as to whether modified carrying amount or fair value (or both dependent upon the

²⁹ IFRS 5, paragraph 6.

³⁰ IFRS 5, paragraph 1(a).

³¹ IFRS 5, paragraph BC17.

- character of the GBE) is the appropriate measurement approach or basis for the recipient to use.
87. Modified carrying amount and fair value are different to the approach in IPSAS 6 for derecognition of a controlled entity as it requires that assets and liabilities are derecognized at their carrying amount. It is also different from approach in IFRS 5 which requires a disposal group to be held at the lower of carrying amount and fair value less costs to sell.

What is the Appropriate Measurement Basis or Approach for Derecognition of the Entity or Operation?

88. Where a transferor loses control of an entity or operation in a transaction or other event that gives rise to an entity combination, it must derecognize the assets and liabilities that are a part of the entity combination.
89. IFRS 5 is limited to situations where assets are held for sale whereas many entity combinations in the public sector do not arise from sales. This could be seen as a disadvantage to adopting an approach similar to IFRS 5 because the accounting treatment for the transferor in an entity combination would still need to be determined.
90. The measurement basis or approach adopted by a transferor needs to be appropriate for the derecognition of an entity or operation. Derecognition is a different situation from the recognition of an entity or operation and should not mirror the measurement basis or approach adopted by the recipient.
91. The measurement basis or approach adopted by a transferor needs to reflect derecognition of an entity or operation that is no longer controlled. If the transferor either applies fair value or the modified carrying amount to the assets and liabilities of the entity or operation to be derecognized prior to the transfer, it will require time and cost to be expended for an entity or operation that the transferor no longer controls. Is it sensible to require a transferor to undertake this exercise? Where remeasurement to fair value is used, this information may be useful to users as it reflects the value of the resources the transferor has given up. However, it seems likely that the cost to ascertain fair value would outweigh the benefits to users of this information.

Staff View

92. Staff considers that the appropriate measurement basis for a transferor in an entity combination is carrying amount because this is consistent with the requirements of IPSAS 6. Other proposals, such as the adoption of the method used in IFRS 5 only provide a partial solution because it only applies to disposal groups that are held for sale. Staff also considers that mirroring the measurement basis or approach adopted by the recipient is unnecessary in this situation because the derecognition of an entity or operation is different from the recognition of an entity or operation even though it occurs from the same transaction or other event, i.e., an entity combination.

Question 13 for the IPSASB:

Do you agree that where a transferor loses control of an entity or operation in a transaction or other event that gives rise to an entity combination, it must derecognize the assets and liabilities that are a part of the entity combination at carrying amount?

If not, why not?

What is the Appropriate Accounting Treatment of the Difference arising in the Transferor?

93. IPSAS 6 requires that the difference between the proceeds from disposal (if any) and the controlled entity's carrying amount at the date of disposal is recognized in the consolidated statement of financial performance as a gain or loss on disposal of a controlled entity.^{32, 33}
94. Staff considers that the requirements in IPSAS 6 for the accounting treatment of the loss of control of a controlled entity are appropriate for the transferor in an entity combination and should be extended to include the loss of control of an operation.

Question 14 for the IPSASB:

Do you agree that the transferor in an entity combination should recognize the difference between the proceeds from disposal (if any) and the controlled entity or operation's carrying amount at the date of disposal as a gain or loss in surplus or deficit?

If not, why not?

A2: One Entity Gains Control of another Entity or Operation under Common Control

Recipient Accounting

95. At its March 2011 meeting, the IPSASB agreed on a working definition for a combination of entities and/or operations under common control:
- “An entity combination in which all of the combining entities and/or operations are ultimately controlled by the same entity or entities both before and after the entity combination.”
96. Where an entity combination takes place between entities under common control, i.e., within an economic entity³⁴, the recipient could gain control of the following types of entities or operations:

³² IPSAS 6, paragraph 51.

³³ IFRS 5 does not include requirements for the gain or loss arising from sale. Instead they are included in IAS 27, paragraph 34(f) and are consistent with the requirements of IPSAS 6.

³⁴ CF-ED 1 uses the term “group reporting entity.”

- (a) A public sector entity or operation; or
- (b) A GBE.

What is the Appropriate Measurement Basis or Approach?

97. The Staff view for the recipient's consolidated financial statements where the entity combinations takes place between entities or operations not under common control, is that modified carrying amount is the appropriate measurement approach where the newly controlled entity or operation is a public sector entity or operation. Staff considers that this approach is also appropriate where the entity combination takes place between entities under common control. The reason for this view is that the reasons for using modified carrying amount are the same as when the entities are not under common control (see paragraph 42).
98. Where the recipient gains control of a GBE, Staff has asked the IPSASB for direction on the appropriate measurement basis or approach. If the measurement basis is fair value does the rationale for the use of fair value change where the entity combination has occurred within an economic entity, i.e., where there is no change external to the economic entity? Fair value is, by definition, an arm's length transaction, so can a fair value be ascertained where the parties to an entity combination are under common control?
99. The recipient in an entity combination needs to measure the individual assets and liabilities of the newly controlled entity or operation. It seems possible that fair values can be readily ascertained for individual assets and liabilities irrespective of the fact that the entities that are party to the entity combination are under common control because it is assumed that a GBE generally has non-specialized assets. Using fair value would be consistent with the existing requirements in IPSASs where fair value is used on the acquisition of an asset from a non-exchange transaction because they do not distinguish between entities under common control and entities not under common control.

Question 15 for the IPSASB:

Do you agree that modified carrying amount is the appropriate measurement approach for a public sector entity or operation (that is not a GBE) where the entity combination takes place under common control?

If not, why not?

Question 16 for the IPSASB:

What do you consider is the appropriate measurement basis or approach for a GBE where the entity combination takes place under common control?

What is the Appropriate Accounting Treatment of the Difference Arising from the Net Assets Received or Net Liabilities Assumed and the Consideration Transferred (if any) in the Recipient's Consolidated Financial Statements?

100. An earlier section of the Issues Paper sets out options for the accounting treatment of the difference arising from an entity combination where it takes place between entities not under common control. One of the differences between this type of entity combination taking place between entities under common control and entities not under common control is that, for entities under common control, the ultimate controlling entity can specify whether, and how much, consideration is transferred.
101. The Staff view for the recipient's consolidated financial statements where an entity combinations takes place between entities or operations not under common control, is that where the difference arising is less than or equal to the amount of net assets received or net liabilities assumed, that difference is a gain or loss in surplus or deficit. For entity combinations under common control, the difference arising can be adjusted because the ultimate controlling entity can specify the amount of consideration transferred. In other words, the amount of any gain or loss or whether there is a gain or loss is under the direct control of the ultimate controlling party. So, although the recipient recognizes a change in net assets, because the entity combination takes place under common control, it may be appropriate to recognize the difference arising directly in net assets/equity.
102. If this approach is adopted, it will need to be a specific requirement because IPSAS 1 requires that all items of revenue and expense (gain or loss) recognized in a period are included in surplus or deficit unless an IPSAS requires otherwise³⁵.

Question 17 for the IPSASB:

Do you agree that the recipient in an entity combination under common control should recognize the difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any) directly in net assets/equity?

If not, why not?

Transferor Accounting

103. The transferor in an entity combination under common control is an entity within the same economic entity as the recipient, i.e., there is no change external to the economic entity. So, for the same reasons given above for the recipient, the difference arising should be recognized directly in net assets/equity.

³⁵ IPSAS 1, paragraph 99.

Question 18 for the IPSASB:

Do you agree that the transferor in an entity combination under common control should recognize the difference between the proceeds from disposal (if any) and the controlled entity or operation's carrying amount at the date of disposal directly in net assets/equity?

If not, why not?

B: Two or More Entities Combine Where None of the Combining Entities Gain Control of the Other Entity or Entities

104. Where two or more entities combine where none of the combining entities gain control of the other entity or entities (hereafter “two or more entities combine”), the accounting treatment of an entity combination relates to:
- (a) The recognition and initial measurement of the assets received and liabilities assumed in the resulting entity;
 - (b) The recognition and presentation of the net assets/equity in the resulting entity; and
 - (c) The information to disclose (disclosures are not dealt with in this Issues Paper and will be considered later in 2011).
105. For the combining entities, the basis of accounting adopted for the preparation of financial statements prior to the entity combination taking place is also considered.

Resulting Entity Accounting

106. The second type (see paragraph 7(b)) of entity combination takes place where two or more entities combine into either an existing or newly established entity. The accounting treatment in the resulting entity is the focus of this section of the Issues Paper.
107. For this type of entity combination only entities are relevant (instead of entities or operations) because an operation is part of an entity. Where two or more operations combine, this occurs as part of an entity or entities and therefore there will be a transferor or transferors. This type of entity combination is discussed in the section above, where one entity gains control of another entity or operation.
108. One of the differences between this type of entity combination and an entity combination where one entity gains control of another entity is that the resulting entity is the result of two or more entities combining on an equal basis, i.e., no entity gains control of another entity. In other words, no recipient can be identified. Some consider that a recipient can always be identified. This is the

approach in IFRS 3 where guidance is included to apply in situations where there is no clear indication as to which of the combining entities is the acquirer³⁶.

109. Another difference is that the economic substance of the resulting entity is that of a new entity, formed from the net assets of the combining entities. However, the structure of the entity combination can differ dependent on other factors such as legislative requirements. For example, a resulting entity can be a combination of two combining entities. The structure of this entity combination can be achieved by either using an existing combining entity as the resulting entity or by forming a new entity to be the resulting entity.

What is the Appropriate Measurement Basis or Approach?

110. The section above dealing with entity combinations where one entity gains control of another entity or operation discusses the use of modified carrying amount or fair value in the consolidated financial statements of the recipient for a newly controlled entity or operation.
111. Staff proposes modifications to the carrying amount measurement approach so that it can be used where a recipient gains control of a public sector entity or operation. In summary, the use of modified carrying amount is proposed because it has the advantage of being readily available, easily verifiable and easily understandable. Including extra tasks to minimize some of the disadvantages of the carrying amount, such as performing an impairment test on the assets received, ensures that they are not overstated.
112. Staff also proposes that fair value is used where a recipient gains control of a private sector for-profit entity or operation. However, fair value cannot be applied in the same way where two or more entities combine because it is only the assets and liabilities of the entity or operation of which control is gained that are measured at fair value, the recipient's existing assets and liabilities remain at their existing carrying amount. So, if fair value is to be used, the resulting entity needs to apply it to all of the combining entities assets and liabilities. This method of accounting has been termed "fresh start" accounting.

Fresh Start Accounting

113. In fresh start accounting³⁷, fair values are attributed to the individual assets and liabilities of all parties to the entity combination, i.e., the combining entities. In addition, assets and liabilities not previously recognized by the combining entities are recognized in the resulting entity.
114. Because this method of accounting uses fair value, it has similar advantages and disadvantages to using fair value described in a previous section of this Issues Paper. An advantage of using fair value is that it provides users with a measure of the current value of the resources arising from the entity combination. This information will be a faithful representation and be relevant to users for decision-

³⁶ IFRS 3, paragraphs 6 and 7, and Appendix B, paragraphs B13–B18.

³⁷ Fresh start accounting does not appear to be currently applied in any jurisdiction.

making and accountability purposes. Fair value also meets the qualitative characteristic characteristics of comparability and verifiability.

115. A disadvantage of using fair value is that, for specialized assets, fair value needs to be estimated rather than being an actual market value. Users may not easily understand how fair value has been calculated. In addition, because the fresh start method applies fair value to the assets and liabilities of all the entities combining, the fair value exercise is much bigger. Some would argue that where there is an absence of a deep and liquid market, the costs of determining fair value may be prohibitive and so for practical cost-benefit reasons this is a disadvantage to using fair value.

Question 19 for the IPSASB:

Is the discussion on fresh start accounting complete, balanced and fair?

If not, why not?

Staff View

116. In the resulting entity, Staff considers it is appropriate to use modified carrying amount for the recognition and initial measurement of the individual assets and liabilities of the combining entities. The reason for this view is because it is a practical and low cost approach that is easily understandable and some of its disadvantages can be minimized.

Question 20 for the IPSASB:

Do you agree that modified carrying amount is the appropriate measurement approach for the resulting entity?

If not, why not?

What Happens to the Net Assets/Equity of the Combining Entities?

117. For the previous type of entity combination, where one entity gains control of another entity or operation, a gain or loss is recognized when there is a difference arising from the net assets received or net liabilities assumed and the consideration transferred (if any).
118. In contrast, this type of entity combination, where two or more entities combine, the combining entities become a part of the resulting entity. The combining entities are a part of the resulting entity and the resulting entity is, in substance, a new entity. There is no inflow or outflow to an existing entity. Instead, there is the formation of a new entity as the combining entities are equal. Therefore, the existing net assets/equity of the combining entities are combined to reflect accumulated surplus or deficit of the resulting entity, consistent with the combining of the individual assets and liabilities of the combining entities into the resulting entity.

Question 21 for the IPSASB:

Do you agree that the net assets/equity of the combining entities is combined into the resulting entity's financial statements?

If not, why not?

Accounting Treatment in the Combining Entities

119. Where two or more entities combine, the process to achieve this may cover more than one reporting period. Although the combining entities know they will be combined with another entity or entities sometime in the future, they still need to prepare general purpose financial statements until the date of the entity combination. Should these financial statements be prepared on a going concern basis?
120. IPSAS 1³⁸ requires that financial statements are prepared on a going concern basis unless there is an intention to liquidate the entity or to cease operating, or if there is no realistic alternative but to do so. The fact that the combining entities will cease to exist on the date of the entity combination may have an effect on the basis of preparation of the financial statements and suggest that the financial statements should not be prepared on a going concern basis.
121. However, an alternative view is that a presumption could be made that the resulting entity will continue to undertake the same activities as the combining entities because the resulting entity needs to fulfill the responsibilities it has accepted from the combining entities. If that is the situation, then the combining entities should continue to prepare their financial statements on a going concern basis, i.e., continue to measure assets and liabilities in accordance with applicable IPSASs, until the date of the entity combination.
122. Staff considers that the combining entities should continue to prepare their financial statements on a going concern basis before the entity combination takes place. This is because the resulting entity continues to undertake the same activities as the combining entities because the resulting entity needs to fulfill the responsibilities it has accepted from the combining entities.

Question 22 for the IPSASB:

Do you agree that the combining entities should continue to prepare their financial statements on a going concern basis until the date of the entity combination?

Draft Flowchart for an Entity Combination

123. Appendix E sets out a draft flowchart that illustrates the types of entity combinations and proposed measurement basis or approach and treatment of the

³⁸ IPSAS 1, paragraph 38.

difference arising. It will be updated and changed dependent upon the IPSASB's view as to its usefulness and decisions relating to the accounting treatment.

Question 23 for the IPSASB:

Do you find the flowchart useful?

Appendix A: Extract of Existing Definitions in IPSASs

Term	Definition	Location
carrying amount (of an intangible asset)	The amount at which an asset is recognized after deducting any accumulated amortization and accumulated impairment losses.	31.16
carrying amount (of investment property)	The amount at which an asset is recognized in the statement of financial position.	16.7
carrying amount (of property, plant, and equipment)	The amount at which an asset is recognized after deducting any accumulated depreciation and accumulated impairment losses.	17.13
carrying amount of a liability	The amount at which a liability is recognized in the statement of financial position.	10.7
carrying amount of an asset	The amount at which an asset is recognized in the statement of financial position, after deducting any accumulated depreciation and accumulated impairment losses thereon.	10.7
control	The power to govern the financial and operating policies of another entity so as to benefit from its activities.	2.8
control of an asset	Arises when the entity can use or otherwise benefit from the asset in pursuit of its objectives, and can exclude or otherwise regulate the access of others to that benefit.	23.7
controlled entity	An entity, including an unincorporated entity such as a partnership, which is under the control of another entity (known as the controlling entity).	6.7
controlling entity	An entity that has one or more controlled entities.	6.7
cost	The amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.	16.7
costs of disposal	Incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.	21.14
costs to sell	The incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. Disposal may occur through sale or through distribution at no charge or for a nominal charge.	27.9
current replacement cost	The cost the entity would incur to acquire the asset on the reporting date.	12.9
distributions to owners	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	1.7

	a return of investment.	
economic entity	A group of entities comprising a controlling entity and one or more controlled entities.	1.7
exchange transactions	Transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange.	9.11
fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.	9.11
fair value less costs to sell	The amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.	21.14
Government Business Enterprise	An entity that has all the following characteristics: (a) Is an entity with the power to contract in its own name; (b) Has been assigned the financial and operational authority to carry on a business; (c) Sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery; (d) Is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and (e) Is controlled by a public sector entity.	1.7
net realizable value	The estimated selling price in the ordinary course of operations, less the estimated costs of completion and the estimated costs necessary to make the sale, exchange or distribution.	12.9
recoverable amount (of an asset or a cash-generating unit)	The higher of an asset's or a cash-generating unit's fair value less costs to sell and its value in use.	26.13
recoverable amount (of property, plant, and equipment)	The higher of a cash-generating asset's fair value less costs to sell and its value in use.	17.13
recoverable service amount	The higher of a non-cash-generating asset's fair value less costs to sell and its value in use.	21.14
value in use of a cash-generating asset	The present value of the estimated future cash flows expected to be derived from the	26.13

	continuing use of an asset and from its disposal at the end of its useful life	
value in use of a non-cash-generating asset	The present value of the asset's remaining service potential.	21.14

Appendix B: Extract from CF-ED 1 on the Qualitative Characteristics of, and Constraints on, Information included in General Purpose Financial Reports

3 Qualitative Characteristics of, and Constraints on, Information included in General Purpose Financial Reports

- 3.1 GPFRs present financial and non-financial information about economic or other phenomena. The qualitative characteristics of information included in GPFRs are the attributes that make that information useful to users and support the achievement of the objectives of financial reporting. The objectives of financial reporting are to provide information useful for accountability and decision-making purposes.
- 3.2 The qualitative characteristics of information included in GPFRs of public sector entities are relevance, faithful representation, understandability, timeliness, comparability, and verifiability.
- 3.3 Materiality, cost-benefit, and achieving an appropriate balance between the qualitative characteristics are pervasive constraints on information included in GPFRs.
- 3.4 Each of the qualitative characteristics is integral to, and works with, the other characteristics to provide in GPFRs information useful for achieving the objectives of financial reporting. However, in practice, all qualitative characteristics may not be fully achieved, and a balance or trade-off between certain of them may be necessary.
- 3.5 The qualitative characteristics apply to all financial and non-financial information reported in GPFRs, including historic and prospective information, and explanatory material or other narrative reporting. However, the extent to which the qualitative characteristics can be achieved may differ depending on the degree of uncertainty and subjective assessment or opinion involved in compiling the financial and non-financial information. The need for additional guidance on interpreting and applying the qualitative characteristics to information that extends the scope of financial reporting beyond financial statements including their notes will be considered in the development of any IPSASs and other pronouncements of the IPSASB that deal with such matters.

Relevance

- 3.6 Financial and non-financial information is relevant if it is capable of making a difference in achieving the objectives of financial reporting. Financial and non-financial information is capable of making a difference when it has confirmatory value, predictive value, or both. It may be capable of making a difference, and thus be relevant, even if some users choose not to take advantage of it or are already aware of it.
- 3.7 Financial and non-financial information has confirmatory value if it confirms or changes past (or present) expectations. For example, information will be relevant

for accountability and decision-making purposes if it confirms expectations about such matters as the extent to which managers have discharged their responsibilities for the efficient and effective use of resources, the achievement of specified service delivery objectives, and compliance with relevant budgetary, legislative and other requirements.

- 3.8 GPFRs may present information about an entity's anticipated future service delivery activities, objectives and costs, and the amount and sources of the resources that are intended to be allocated to providing services in the future. Such future oriented information will have predictive value and be relevant for accountability and decision-making purposes. Information about economic and other phenomena that exist or have already occurred can also have predictive value in helping form expectations about the future. For example, information that confirms or disproves past expectations can reinforce or change expectations about financial results and service delivery outcomes that may occur in the future.
- 3.9 The confirmatory and predictive roles of information are interrelated—for example, information about the current level and structure of an entity's resources and claims to them helps users to confirm the outcome of resource management strategies during the period, and to predict an entity's ability to respond to changing circumstances and anticipated future service delivery needs. The same information helps to confirm or correct users' past expectations and predictions about the entity's ability to respond to such changes. It also helps to confirm or correct prospective financial information included in previous GPFRs.

Faithful Representation

- 3.10 To be useful in financial reporting, information must be a faithful representation of the economic and other phenomena that it purports to represent. Faithful representation is attained when the depiction of the phenomenon is complete, neutral, and free from material error. Information that faithfully represents an economic or other phenomenon depicts the substance of the underlying transaction, other event, activity or circumstance—which is not necessarily always the same as its legal form.
- 3.11 In practice, it may not be possible to know or confirm whether information presented in GPFRs is fully complete, neutral, and free from material error. However, information should be as complete, neutral, and free from material error as is possible.
- 3.12 A depiction of an economic or other phenomenon is complete if it includes all information that is necessary for faithful representation of the phenomenon that it purports to depict. An omission of some information can cause the representation to be false or misleading, and thus not useful to users of GPFRs. For example, a complete depiction of the item "plant and equipment" in GPFRs will include a numeric representation of the aggregate amount of plant and equipment together with other quantitative, descriptive and explanatory material necessary to faithfully represent that class of assets. In some cases, this may include the

disclosure of information about such matters as the major classes of plant and equipment, factors that have affected their use in the past or might impact on their use in the future, and the basis and process for determining their numeric representation. Similarly, prospective financial and non-financial information, and information about the achievement of service delivery objectives and outcomes, included in GPFRs will need to be presented with the key assumptions that underlie that information, and any explanations that are necessary to ensure that its depiction is complete and useful to users.

- 3.13 Neutrality in financial reporting is the absence of bias. It means that the selection and presentation of financial and non-financial information is not made with the intention of attaining a particular predetermined result—for example, to influence in a particular way users’ assessment of the discharge of accountability by the entity or a decision or judgment that is to be made, or to induce particular behaviour.
- 3.14 Neutral information faithfully represents the economic and other phenomena that it purports to represent. However, to require information included in GPFRs to be neutral does not mean that it is not without purpose or that it will not influence behaviour. Relevance is a qualitative characteristic and, by definition, relevant information is capable of influencing users’ assessments and decisions.
- 3.15 The economic and other phenomena represented in GPFRs generally occur under conditions of uncertainty. Information included in GPFRs will therefore often include estimates that incorporate management’s judgment. To faithfully represent an economic or other phenomenon, an estimate must be based on appropriate inputs, and each input must reflect the best available information. Caution will need to be exercised when dealing with uncertainty. It may sometimes be necessary to explicitly disclose the degree of uncertainty in financial and non-financial information to faithfully represent economic and other phenomena.
- 3.16 Free from material error does not mean complete accuracy in all respects. Free from material error means there are no errors or omissions that are individually or collectively material in the description of the phenomenon, and the process used to produce the reported information has been applied as described. In some cases, it may be possible to determine the accuracy of some information included in GPFRs—for example, the amount of a cash transfer to another level of government, volume of services delivered or the price paid for the acquisition of plant and equipment. However, in other cases it may not—for example, the accuracy of an estimate of the value or cost of an item or the effectiveness of a service delivery program may not be able to be determined. In these cases, the estimate will be free from material error if the amount is clearly described as an estimate, the nature and limitations of the estimation process are explained, and no material errors have been identified in selecting and applying an appropriate process for developing the estimate.

Understandability

- 3.17 Understandability is the quality of information that enables users to comprehend its meaning. GPFRs of public sector entities should present information in a manner that responds to the needs and knowledge base of users, and to the nature of the information presented. For example, explanations of financial and non-financial information and narrative reporting of achievements and expectations should be written in plain language, and presented in a manner that is readily understandable by users. Understandability is enhanced when information is classified, characterized, and presented clearly and concisely. Comparability also can enhance understandability.
- 3.18 Users of GPFRs are assumed to have a reasonable knowledge of the entity's activities and the environment in which it operates, to be able and prepared to read GPFRs, and to review and analyze the information presented with reasonable diligence. Some economic and other phenomena are particularly complex and difficult to represent in GPFRs, and some users may need to seek the aid of an advisor to assist in their understanding of them. All efforts should be undertaken to represent economic and other phenomena included in GPFRs in a manner that is understandable to a wide range of users. However, information should not be excluded from GPFRs solely because it may be too complex or difficult for some users to understand without assistance.

Timeliness

- 3.19 Timeliness means having information available for users before it loses its capacity to be useful for accountability and decision-making purposes. Having relevant information available sooner can enhance its usefulness as input to assessments of accountability and its capacity to inform and influence decisions that need to be made. A lack of timeliness can render information less useful.
- 3.20 Some items of information may continue to be useful long after the reporting period or reporting date. For example, for accountability and decision-making purposes, users of GPFRs may need to assess trends in the financial and service delivery performance of the entity and its compliance with budgets over a number of reporting periods. In addition, the outcome and effects of some service delivery programs may not be determinable until future periods—this may occur in respect of programs intended to, for example, enhance the economic well-being of constituents, reduce the incidence of a particular disease, or increase literacy levels of certain age groups.

Comparability

- 3.21 Comparability is the quality of information that enables users to identify similarities in, and differences between, two sets of phenomena. Comparability is not a quality of an individual item of information, but rather a quality of the relationship between two or more items of information.

- 3.22 Comparability differs from consistency. Consistency refers to the use of the same accounting policies and procedures, either from period to period within an entity or in a single period across more than one entity. Comparability is the goal, and consistency helps in achieving that goal.
- 3.23 Comparability also differs from uniformity. For information to be comparable, like things must look alike, and different things must look different. An over-emphasis on uniformity may reduce comparability by making unlike things look alike. Comparability of information in GPFRs is not enhanced by making unlike things look alike, any more than it is by making like things look different.
- 3.24 Information about the entity's financial position, financial performance, compliance, service delivery achievements, and its future plans is necessary for accountability purposes and useful as input for decision-making purposes. The usefulness of such information is enhanced if it can be compared with, for example:
- The budget of the entity for the reporting period, or prospective financial and non-financial information previously presented for that reporting period or reporting date;
 - Similar information about the same entity for some other period or some other point in time; and
 - Similar information about other entities (for example, public sector entities providing similar services in different jurisdictions).
- 3.25 Consistent application of accounting policies to prospective financial and non-financial information and actual outcomes will enhance the usefulness of any comparison of projected and actual results. Comparability with other entities may be less significant for narrative reporting of management's perception or opinion of the factors underlying the entity's current performance.

Verifiability

- 3.26 Verifiability is the quality of information that helps assure users that information in GPFRs faithfully represents the phenomena that it purports to represent. Supportability is sometimes used to describe this quality when applied in respect of explanatory information and prospective financial and non-financial quantitative information disclosed in GPFRs—that is, the quality of information that helps assure users that explanatory or prospective financial and non-financial quantitative information faithfully represents the phenomena that it purports to represent. Whether referred to as verifiability or supportability, the characteristic implies that different knowledgeable and independent observers could reach general consensus, although not necessarily complete agreement, that either:
- The information represents the phenomena that it purports to represent without material error or bias; or
 - An appropriate recognition, measurement, or representation method has been applied without material error or bias.

- 3.27 To be verifiable, information need not be a single point estimate. A range of possible amounts and the related probabilities also can be verified.
- 3.28 Verification may be direct or indirect. With direct verification, an amount or other representation is itself verified, such as by (a) counting cash, (b) checking records of service response times or records of patients treated, (c) observing marketable securities and their quoted prices, or (d) confirming that the factors identified as influencing past service delivery performance were present and operated with the effect identified. With indirect verification, the amount or other representation is verified by checking the inputs and recalculating the outputs using the same accounting convention or methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, average cost or first-in-first-out).
- 3.29 The quality of verifiability (or supportability if such term is used to describe this characteristic) is not an absolute—some information may be more or less capable of verification than other information. However, the more verifiable is the information included in GPFRs, the more it will assure users that the information faithfully represents the phenomena that it purports to represent.
- 3.30 GPFRs of public sector entities may include financial and other quantitative information and explanations about (a) key influences on the entity's performance during the period, (b) the anticipated future effects or outcomes of service delivery programs undertaken during the reporting period, and (c) prospective financial and non-financial information. It may not be possible to verify the accuracy of all quantitative representations and explanations of such information until a future period, if at all.
- 3.31 To help assure users that prospective financial and non-financial quantitative information and explanations included in GPFRs faithfully represents the phenomena that they purport to represent, the assumptions that underlie the information disclosed, the methodologies adopted in compiling it, and the factors and circumstances that support any opinions expressed or disclosures made should be transparent. This will enable users to form judgements about the appropriateness of those assumptions and the method of compilation, measurement, representation and interpretation of the information.

Constraints on Information Included in General Purpose Financial Reports

Materiality

- 3.32 Information is material if its omission or misstatement could influence the discharge of accountability by the entity, or the decisions that users make on the basis of the entity's GPFRs prepared for that reporting period. Materiality depends on both the nature and amount of the item judged in the particular circumstances of each entity. GPFRs may encompass qualitative and quantitative information about service delivery achievements during the reporting period, and expectations about service delivery and financial outcomes in the future. Consequently, it is not

possible to specify a uniform quantitative threshold at which a particular type of information becomes material.

- 3.33 Assessments of materiality will be made in the context of the legislative, institutional and operating environment within which the entity operates and, in respect of prospective financial and non-financial information, the preparer's knowledge and expectations about the future. Disclosure of information about compliance or non-compliance with legislation, regulation or other authority may be material because of its nature—irrespective of the magnitude of any amounts involved. In determining whether an item is material in these circumstances, consideration will be given to such matters as the nature, legality, sensitivity and consequences of past or anticipated transactions and events, the parties involved in any such transactions and the circumstances giving rise to them.

Cost-Benefit

- 3.34 Financial reporting imposes costs. The benefits of financial reporting should justify those costs. Assessing whether the benefits of providing information justify the related costs is often a matter of judgment, because it is often not possible to identify and/or quantify all the costs or benefits of information included in GPFRs.
- 3.35 The costs of providing information include the costs of collecting and processing the information, the costs of verifying it and/or presenting the assumptions and methodologies that support it, and the costs of disseminating it. Users incur the costs of analysis and interpretation. Omission of useful information also imposes costs, including the costs that users incur to obtain needed information from other sources and the costs that result from making decisions using incomplete data provided by GPFRs.
- 3.36 Preparers expend the majority of the effort to provide information in GPFRs. However, service recipients and resource providers ultimately bear the cost of those efforts—because resources are redirected from service delivery activities to preparation of information for inclusion in GPFRs.
- 3.37 Users reap the majority of benefits from the information provided by GPFRs. However, information prepared for GPFRs may also be used internally by management and result in better management decision making. The disclosure of information in GPFRs consistent with the principles identified in this Conceptual Framework and IPSASs derived from them will enhance and reinforce perceptions of the transparency of reporting by governments and other public sector entities and contribute to the more accurate pricing of public sector debt. Therefore, public sector entities may also benefit in a number of ways from the information provided by GPFRs.
- 3.38 Application of the cost-benefit constraint involves assessing whether the benefits of reporting information are likely to justify the costs incurred to provide and use the information. When making this assessment, it is necessary to consider whether

one or more qualitative characteristics might be sacrificed to some degree to reduce cost.

- 3.39 In developing IPSASs, the IPSASB considers information from preparers, users, academics, and others about the expected nature and quantity of the benefits and costs of the proposed requirements. Disclosure and other requirements which result in the presentation of information useful to users of GPFRs for accountability and decision-making purposes and satisfy the qualitative characteristics are prescribed by IPSASs unless the costs of compliance with those requirements are assessed by the IPSASB to be greater than their benefits.

Balance Between the Qualitative Characteristics

- 3.40 The qualitative characteristics work together in different ways to contribute to the usefulness of information. For example, neither a depiction that faithfully represents an irrelevant phenomenon, nor a depiction that unfaithfully represents a relevant phenomenon, results in useful information. Similarly, to be relevant, information must be timely and understandable.
- 3.41 In some cases, a balancing or trade-off between qualitative characteristics may be necessary to achieve the objectives of financial reporting. The relative importance of the qualitative characteristics in each situation is a matter of professional judgment. The aim is to achieve an appropriate balance among the characteristics in order to meet the objectives of financial reporting.

Appendix C: Existing Guidance on the Treatment of the Difference Arising by National Standard Setters

Public Sector Accounting Board (PSAB) (Canada)

1. The Public Sector Accounting Board (PSAB) in Canada requires that where a government acquires a governmental unit, the excess of the purchase cost over the government's share of the fair value of the net assets acquired, termed a "purchase premium," is recognized as an expense in the period of acquisition (PS 2510.13). The fact that consideration is transferred indicates that the acquiree was not a public sector entity before the acquisition takes place. PSAB has commenced a project to address the accounting treatment for the acquisition of a public sector entity or operation not under common control.
2. Additionally, PSAB requires that a purchase premium arising on an acquisition of a GBE is recognized as an asset (PS 3070.7). The PSAB's definition of a GBE is narrower than the IPSASB's as it includes only those entities that can self-sustain by primarily selling goods and services to outside the government reporting entity.

Accounting Standards Board (ASB) (South Africa)

3. The Accounting Standards Board (ASB) in South Africa requires that an acquirer in a transfer of functions not under common control recognizes the difference between the assets acquired and liabilities assumed and the consideration transferred (if any) in surplus or deficit (GRAP 106.65). The definition of a function is similar to the proposed definition of an operation.
4. An acquirer in a transfer of functions under common control recognizes the difference between the carrying amounts of the assets acquired, the liabilities assumed and the consideration paid (if any) in accumulated surplus or deficit (GRAP 105.39).

Appendix D: Extract from IPSAS 6, Consolidated and Separate Financial Statements

51. The revenue and expenses of a controlled entity are included in the consolidated financial statements from the acquisition date (the relevant international or national accounting standard dealing with business combinations provides guidance on the meaning of the acquisition date). The revenue and expenses of a controlled entity are included in the consolidated financial statements until the date on which the controlling entity ceases to control the controlled entity. The difference between the proceeds from the disposal of the controlled entity and its carrying amount as of the date of disposal, including the cumulative amount of any exchange differences that relate to the controlled entity recognized in net assets/equity in accordance with IPSAS 4, *The Effects of Changes in Foreign Exchange Rates*, is recognized in the consolidated statement of financial performance as the gain or loss on the disposal of the controlled entity.
52. From the date an entity ceases to be a controlled entity, provided that it does not become (a) an associate as defined in IPSAS 7, or (b) a jointly controlled entity as defined in IPSAS 8, it shall be accounted for as a financial instrument. IPSAS 29 provides guidance on the recognition and measurement of financial instruments.
53. The carrying amount of the investment at the date that the entity ceases to be a controlled entity shall be regarded as the cost on initial measurement of a financial instrument.

Appendix E: Draft Flowchart for an Entity Combination

