



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item 2C

Date: February 27, 2012
Memo to: Members of the IPSASB
From: Grant Macrae and John Stanford
Subject: Conceptual Framework: Phase 2: Elements and Recognition

Objectives of Session

1. The objectives of the session are to:
 - **Consider** the five outstanding questions in the Consultation Paper, *Elements and Recognition in Financial Statements* (CF—CP2) and **provide** directions on the approach to these areas in the Exposure Draft (CF—ED 2) on this phase of the project;
 - **Consider** further the issue of ownership interests and **provide** directions on the approach in CF—ED 2;
 - **Consider** further the issue of enforceability in relation to the definition of a liability and **provide** directions on the approach in CF—ED 2;
 - **Consider** further the issue of deferrals, including whether deferred outflows and deferred inflows should be defined as elements and the characteristics of such definitions and **provide** directions on the approach in CF—ED 2; and
 - **Consider** and **provide** directions on preliminary outline draft of a preliminary outline of CF—ED 2.

Agenda Materials

Agenda Item 2C.1: Issues Paper: *Residual Questions and Further Analysis of Ownership Interests*

Agenda Item 2C.2: Issues Paper, *Enforceability as a Characteristic of the Liability Definition and Approach to Deferred Outflows and Deferred Inflows*

Agenda Item 2C.3: Preliminary Outline Exposure Draft(ED): *Elements and Recognition in Financial Statements*

Other relevant materials previously posted:

Staff Summary and Collation of responses received to CF—CP2 (previously posted with September 2011 agenda materials);

Organization of questions in Specific Matters for Comment into 6 themes (previously posted with December 2011 agenda materials); and

A copy of CF—CP2; and

A copy of all submissions received.

Background

2. The Consultation Paper, Elements and Recognition in Financial Statements (CF—CP2) contained 19 specific matters for comment (SMCs). A number of these SMCs contained multiple questions: in total there were 38 questions. At the December 2011 meeting the questions were categorized into six themes. Tentative views have been formed on 33 of these questions. Five questions are still outstanding and it is necessary to agree positions at this meeting in order to direct development of CF—ED2.
3. At the December meeting the IPSASB explored the issue of whether net assets/net liabilities are residual amounts, residual interests or ownership interests. It was tentatively agreed that that, for most public sector entities, net assets /net liabilities is a residual amount. However, Members directed that certain entities needed to be considered further, particularly (i) entities set up with a view to future sale to the private sector and (ii) entities or activities that are not directly accountable to citizens, but where the governing body is appointed by a controlling entity or the entity of which the activity is part.
4. Agenda Item 2C. 1 considers and makes proposals for the five outstanding questions and discusses further the issue of ownership interests and considers whether ownership interests, contributions from owners and distributions to owners should be defined as elements.
5. At the Brasilia meeting it was also directed that there should be:
 - Further consideration of the need for elements for deferred inflows and deferred outflows, and, if so, the characteristics of such elements; and
 - Further consideration of aspects of enforceability in the context of the definition of a liability including: (i) exploration of what 'legally enforceable' means; and (ii) further analysis of obligations which would be enforceable subject to the elapse of time.
6. Agenda Item 2C.2 deals with these issues and makes proposals for the approach in CF—ED2. A preliminary draft outline of CF—ED2 is provided at Agenda Item 2C.3.
7. The issues outlined in paragraphs 3-6 and an outline of in CF—ED2 have been discussed by the TBG at two teleconferences with a further teleconference scheduled prior to the meeting. Staff is grateful to the members of the TBG for their input and support and for the amount of time that they have devoted to this phase of the Framework.

RESIDUAL QUESTIONS AND FURTHER ANALYSIS OF OWNERSHIP INTERESTS

Objectives of Paper

1. The objectives of this session are to:
 - **Consider** and **make** recommendations for the five remaining questions in the Phase 2 Consultation Paper (CF—CP2) that were not considered at the September 2011 and December 2011 meetings; and
 - **Consider** further whether an ownership interest might exist for certain types of entity and whether ownership interest, contributions from owners and distributions to owners should be defined as elements.

Background

2. As indicated in Agenda Item 2C.0, there were CF—CP2 19 specific matters for comment (SMCs) in CF—CP2. A number of these SMCs contained multiple questions: in total there were 38 questions. Tentative views have been formed on 33 of these questions. Five questions are still outstanding and it is necessary to agree positions at this meeting in order to allow further development of CF—ED2. Two relate to Theme 6: Residual Interests and Ownership Interests, two relate to Theme 3: Asset and Liability Definitions — Past Events and Other Attributes and the remaining question relates to an enforceable claim to benefits linking a resource to a specific entity in the context of assets in Theme 2: Duties, Responsibilities, Powers and Rights.
3. At the December meeting it was agreed tentatively that net assets /net liabilities is a residual amount rather than a residual interest or an ownership interest. However, it was suggested that an ownership interest might exist for certain types of entity, in particular (i) entities that have been specially created with a view to possible disposal to the private sector in the future and (ii) entities (or operations/activities) for which the governing body is appointed and not directly elected. It was suggested that such ownership interests might exist in entities/operations/activities that are not Government Business Enterprise (GBEs) as well as GBEs. GBEs are currently outside the scope of the Framework.

Remaining Questions

Theme 2: Duties, Responsibilities, Powers and Rights

4. The remaining question in this theme is:

SMC 2(b): Enforceable Claim to Benefits linked to Specific Entity

Does an entity's enforceable claim to benefits or ability to deny, restrict, or otherwise regulate others' access link a resource to a specific entity?
5. At the September 2011 meeting it was tentatively agreed after consideration of SMC 1 (a) that control should be used as the primary criterion for associating an asset with a specific entity.

6. The majority of respondents to SMC 2(b) supported the view that an entity's 'enforceable claim to benefits or ability to deny, restrict, or otherwise regulate others' access does link a resource to a specific entity. A number of those who expressed reservations considered that an ability to deny, restrict, or otherwise regulate others' access is an indicator of control rather than an essential characteristic (e.g., Respondents 18, 20 and 30) or is not of itself sufficient to give rise to an asset (e.g., Respondents 14 and 26). As with the characteristics of the definition of a liability an issue arises as to what enforceability entails. Consistent with the view expressed in the separate Issues Paper (Item 2C.2) enforceability goes beyond narrow legal sanctions, but does not include moral obligations that cannot be enforced by a counterparty.
7. Respondent 7 challenged the use of the term 'regulate' on the grounds that regulation does not equate to control and can be misinterpreted. Staff agrees with this point. Staff questions whether 'regulate' in this context has a fundamentally different meaning to 'restrict' and takes the view that its usage does not clarify the discussion and inevitably leads to potential and unnecessary confusion with the regulatory role of government. Staff therefore advocates that it is not used. If it is decided to continue to retain the term 'regulate' Staff thinks it important to emphasize that (i) the ability to regulate access is an indicator rather than a determinant of control and in the absence of future service potential or economic benefits flowing to the entity does not give rise to an asset and (ii) regulate in the context of the definition of an asset is not synonymous with the formal regulatory function of government that was discussed in the *Key Characteristics* ED.
8. Staff supports those who argue or imply that enforceability of a claim to benefits or service potential or the ability to deny or restrict others' access are indicators or exemplars of control rather than an essential characteristic that should be incorporated in the definition. This is because such characteristics must be accompanied by the future flow of service potential or economic benefits to the entity. In fact it is difficult to see how control exists if an entity cannot deny or restrict access to a resource. Staff considers that the example in paragraph 2.38 of CF—CP2 contrasting access to outer space and natural resources under government land is clear and persuasive. In the former case the government cannot have an asset of the resource (outer space), because it cannot restrict or regulate access, whereas in the latter case an asset may exist because control of the resource allows the government to deny or restrict access. Therefore while the phrase "ability to deny or restrict others' access" will not be included in the proposed liability definition it will be used in accompanying guidance.

Action Required

Do Members agree that:

- The ability to deny, restrict or otherwise regulate others' access is an indicator or exemplar of control rather than an essential characteristic that should be incorporated in the definition; and
- Guidance should not use the term 'regulate'?

Theme 3: Asset and Liability Definitions-Past Events and Other Attributes

9. The remaining questions in this theme are:

SMC 1(a): Definition of Asset

Should the definition of an asset cover all of the following types of benefits—those in the form of:

- (i) Service potential;*
- (ii) Net cash inflows; and*
- (iii) Unconditional rights to receive resources?*

SMC 6(a): Definition of Liability

Should the definition of a liability cover all of the following types of obligations?

- (i) Obligations to transfer benefits, defined as cash and other assets, and the provision of goods and services in the future.*
- (ii) Unconditional obligations, including unconditional obligations to stand ready to insure against loss (risk protection).*
- (iii) Performance obligations.*
- (iv) Obligations to provide access to or forego future resources.*

Definition of an asset

10. At the September meeting it was agreed that the definition of an asset should cover service potential and economic benefits. The notion of net cash inflows is inherent in 'economic benefits' and the IPSASB reaffirmed at the December meeting that the definition of an asset should include the phrase 'service potential and economic benefits', rejecting a counter proposal that the phrase 'economic benefits including service potential' should be used instead. On reflection Staff considers that the phrase in the formal definition should be 'service potential or economic benefits indicating that an asset may arise when an item embodies either service potential or economic benefits rather than both. Staff notes the view of some members of the Elements Task Based Group (TBG) that the term 'economic benefits or other service potential should be used' as this conveys that economic benefits is a sub-set of service potential rather than vice-versa.
11. At consultation a majority of those expressing a view on SMC 1(a) supported the inclusion of all three of the types of benefits highlighted in SMC 1(a). However, while there were few reservations about service potential and net cash inflows, a significant minority of respondents expressed reservations about unconditional rights to receive resources. These misgivings generally reflected a view that the phrase could be interpreted too widely in a public sector context and lead to the right to tax being considered an asset (Respondent 8). In similar vein, Respondent 6 commented that "unconditional rights to receive resources in the future should not be included as a benefit. Those rights could be accounted for in a sustainability report but not in the financial statements." Respondent 3 considered that unconditional rights to receive benefits should be covered by the definition only if contractually specified.

12. The issue of unconditional rights to receive resources was discussed in paragraphs 2.20-2.23 of CF—CP2. Paragraph 2.21 noted that current standard-setting practice has been to include unconditional rights as assets to the extent that the entity has paid for the unconditional promise in a contract, or that the rights develop an acknowledged market value while being held.
13. Staff does not propose to include unconditional rights in the definition of an asset, but to explain that under certain conditions; primarily those highlighted in paragraph 12, unconditional rights might give rise to assets.
14. Paragraph 2.21 went on to note the current global standard-setting practice of not recognizing what were termed the asset and liability aspects of executory contracts. Paragraph 2.22 challenged existing practice and suggested that current approaches to executory contracts might not provide all the information required by users. Staff acknowledges that the current treatment of executory contracts whereby such contracts do not give rise to assets and only give rise to liabilities if the terms of the contract are onerous to one of the parties is conceptually questionable. A case can be made that executory contracts give rise to assets and liabilities for both parties to the contract; for example one party has a right to resources in the form of goods and services and an obligation to sacrifice resources when those goods and services are delivered, while the other party has the right to a resource in the form of a cash payment and an obligation to deliver the contractually specified goods and services.
15. On balance Staff considers that existing global practice related to executory contracts should not be modified in the Framework, because (i) it is highly questionable whether the recognition of rights and obligations as assets and liabilities related to a potentially large number of executory contracts meets users' needs and is in accordance with the qualitative characteristics of understandability and faithful representation; and more convincingly (ii) rights and obligations under executory contracts relate to future operations and activities rather than those of the reporting period. Staff considers it worth pointing out that in its future standard setting the IPSASB needs to consider whether further disclosures on executory contracts should be considered in order to meet the objectives of financial reporting.
16. There is an issue of how such an approach relates to lease accounting. Currently, under IPSAS 13, *Leases*, lessors are required to recognize lease payments receivable under a finance lease as assets in their statements of financial position. It may not be immediately clear why such payments should be recognized as assets for leasing arrangements but not for other arrangements where, seemingly, a right to receive benefits is matched with an equal obligation to transfer resources. Currently paragraph 49 of IPSAS 13 explains that the asset (receivable) is treated by the lessor as "repayment of principal and finance revenue to reimburse and reward the lessor for its investment and services." In contrast operating leases are currently treated as executory contracts, whereby the lessee's right to use the leased asset is conditional on making payments and the obligation to make payments is conditional on the lessor continuing to provide access to the asset throughout the lease term.

17. The IASB's 2009 Discussion Paper, *Leases-Preliminary Views*, argued that, from the perspective of lessee, the asset is the right to use the leased asset and the liability is the obligation to pay for that right. Such an approach can be justified in terms of the 'control' characteristic of the definition of an asset that the IPSASB has tentatively adopted, as the lessee controls the right to use the leased asset at the inception of the lease, thereby restricting the access of others to that right. The past event is the inception of the lease and service potential (in the case of an asset held primarily for service delivery) or economic benefits (in the case of a cash-generating asset) will flow to the lessee.

Action Required

Do Members agree that:

- The ED should not include unconditional rights in the definition of an asset, but explain in supporting guidance that under certain conditions unconditional rights might give rise to assets; and.
- The ED should take the view that executory contracts do not give rise to assets and only give rise to liabilities if the terms of the contract are onerous to one of the parties.

Definition of a liability

18. SMC 6(a) highlighted four types of obligation and asked whether they should be covered in the definition of a liability. The question and accompanying analysis in Section 3 of CF—CP2 was complex and, more than any other question, the response is not straightforward to analyze. In some cases it seems that respondents were not entirely clear what was being proposed and had reservations about what certain terms, such as 'stand-ready', 'conditional' and 'unconditional' mean in the context of public sector obligations (e.g., Respondent 2 indicated that it did not understand how a stand-ready obligation differs from a conditional obligation. The last sentence of paragraph 3.14 of CF—CP2 indeed acknowledged this ambiguity).
19. Only a small minority (5 or 15%) of the 33 respondents providing comments supported the definition of a liability covering all four types of obligation. Obligation type (iv) - obligations to provide access to or forgo future resources-provoked considerable reservations on the grounds that an obligation to provide access to future resources does not involve a sacrifice or outflow of resources (e.g., Respondent 30 but also Respondents 13, 14, 18, 19, 26, and 31). Respondent 1 supported the rights approach outlined in paragraph 3.20 of CF—CP2 and considered that a type (iv) obligation is inconsistent with this approach.
20. There was also a general reservation that type (i) and type (ii) obligations could lead to the liability definition covering an obligation to supply goods and services in the future. Such concerns led some respondents to emphasize the importance of identification of a past event (e.g., Respondents 5, 15, 20 and 26) or the existence of enforceable claims (e.g., Respondent 24).

21. At the December 2012 meeting it was tentatively agreed that the definition of both assets and liabilities should include a 'past event'. This might partially alleviate the concerns of those respondents who felt that the question, in particular the inclusion of the provision of future goods and services in type (i) obligations was suggesting that the liability definition cover the wholesale provision of goods and services in the future. Determining what that past event is will be a standards level consideration. Use of the word 'present' in the definition might also alleviate concerns.
22. Staff understands those respondents who found the distinction between a conditional obligation and a stand-ready obligation difficult to grasp. This may have been due to the potential tension between the assertion in paragraph 3.12 that "an unconditional obligation includes stand-ready obligations" and the previously noted conclusion in paragraph 3.14 that "it may be difficult to draw the distinction between a conditional obligation and a stand-ready obligation." The point in paragraph 3.12 that "although there may be uncertainty about the future outflow of benefits, there is no uncertainty about whether an obligation in fact exists" may also have been confusing as it may suggest that a liability can exist where there is no future outflow of resources or future economic sacrifice.
23. The notion of a stand-ready obligation was developed by the IASB in its project to revise IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. It should be noted that this project is currently deactivated. In that project IASB staff provided the following explanation of stand-ready obligations:
- "Liabilities for which the amount that will be required in settlement is contingent on the occurrence or non-occurrence of a future event are sometimes referred to as 'stand ready' obligations. This is because the entity has an unconditional obligation to stand ready to fulfill the conditional obligation *if* the uncertain event occurs (or fails to occur). The liability is the unconditional obligation to provide a service, which results in an outflow of economic benefits."
24. Many respondents to the IASB consultation on the ED of IAS 37 in 2006 expressed uncertainty about this approach. In particular there was ambiguity about the distinction between a stand-ready obligation and a business risk.
25. Staff considers that the notion of a stand-ready obligation is workable and valuable in certain contractual circumstances, such as the insurance related examples and the example of a derivative contract in a loss position discussed in CF—CP2, and notably in the case of warranties, which is of limited public sector significance. In such circumstances there may be an identifiable past event and an outflow of resources, although the exact identity of the party to whom settlement will be made will not generally be known. However, the notion of a stand-ready obligation does not work well in public sector non-exchange circumstances where it is very difficult to distinguish a stand-ready obligation from a conditional obligation and use of the term gives rise to assumptions that it will lead to liabilities related to the ongoing provision of social benefits. On balance Staff thinks that there should be discussion of stand-ready obligations in the Basis for Conclusions, but not in the body of CF—ED2.

Action Required

Do Members agree that:

- Discussion of stand-ready obligations should be limited to the Basis for Conclusions.

Theme 6: Residual Interests and Ownership Interest

24. The two questions under this theme are:

SMC 12(a): Relationship between Residual/Equity Interests and Revenues and Expenses

Should transactions with residual/equity interests be excluded from revenues and expenses?

SMC 15(b): Treatment of Ownership Interests in Definitions

Should the concept of ownership interests, such as those that relate to minority or non-controlling interests in a GBE, be incorporated in the element definition?

25. Because of their obvious relationship with the broader discussion of ownership interests the analysis related to this theme is considered in the section below devoted to this area (see especially paragraphs 27 and 28).

Ownership Interests

26. At the December meeting the IPSASB explored the issue of whether net assets/net liabilities are residual amounts, residual interests or ownership interests. It was tentatively agreed that that, for most public sector entities, net assets /net liabilities is a residual amount. However, Members directed that certain entities/operations/ /activities needed to be considered further, particularly (i) entities set up with a view to future sale to the private sector and (ii) entities or activities that are not directly accountable to citizens, but where the governing body is appointed by a controlling entity or the entity of which the activity is part. Examples mentioned at the December meeting included (i) the sale of a hospital to a private sector provider ((ii) companies established by local governments that are not Government Business Enterprises (GBEs) and (iii) GBEs. In the case of (i) it was questioned whether disposal of the hospital would have been feasible had the government not had an ownership interest.

27. About two-thirds of respondents to SMC 12(a) considered that transactions with equity interests should be excluded from revenue and expenses. While such a strong view seems emphatic it should

also be noted that almost half of respondents who gave a view on SMC 15 (a) considered that net assets/liabilities constituted a residual amount.

28. The main issues are whether the Conceptual Framework can give direction to the IPSASB on (i) identifying entities in which an ownership interest might exist and, if so; (ii) whether an ownership interest should be defined as a separate element; (iii) what that definition should be and (iv) whether 'contributions from' and 'distributions to' owners should also be separately defined.
29. Staff considers that it may be difficult to identify entities in which an ownership interest exists with precision. At the consolidated national or whole of government level ownership interests will not exist, except for minority interests. There can be a presumption that an ownership interest exists in a GBE. Elsewhere, in a small number of cases, an entity may be established with a view from the outset that it will be developed with the intention of being sold for operation as a commercial enterprise or by a private sector not-for-profit entity. Such intent may be signaled by the establishment of a formal equity structure and may include the existence of minority interests. However, an intention to dispose of an entity or operation may depend on changes of political control. For example an operation established to deliver services by a government of a particular political complexion as an integral component of the public sector may be identified as appropriate for disposal for either ideological or pragmatic fiscal reasons by a successor government. This is the sovereign prerogative of government and it is not clear that such a decision is dependent upon the existence of an 'ownership interest'. Staff considers that the Conceptual Framework should acknowledge that ownership interests may exist in the public sector and provide non-prescriptive indicators of when such interests might exist.
30. Having established that 'ownership interests' do exist in the public sector, albeit it in limited and infrequent circumstances, the next issue is whether (i) 'ownership interests' need to be defined as a separate element, (ii), if so, the characteristics of such a definition; and (iii) whether further elements in the form of contributions from and distributions to owners need to be defined.
31. If defined as elements, ownership interests would likely include (a) an establishment of a financial interest in the residual amount; (b) entitlement to distributions of economic benefits or service potential; and (c) entitlement of distributions of any excess of assets over liabilities in the event of the entity being wound up.
32. The alternative to the development of separate elements is to assert in the Framework that net assets/liabilities is a residual amount, but that there may be a limited number of cases where "ownership interests" exist and that sub-classifications of net assets/net liabilities need to be deployed in order to provide information on such interests, including minority ownership interests. This was the approach outlined in paragraph 5.26 of CF—CP2. This paragraph also notes the possibility of identifying further items such as capital maintenance adjustments and fair value changes that would be separately identified in net assets/net liabilities.
33. Resource providers and service recipients are not just interested in the services delivered by public sector entities and their cost. They are also likely to be interested in the long term efficiency of the

entity, its capability to deliver services in the future and in the net resources that may be available for redirection, restructuring or alternative disposition. Some, but not all, jurisdictions describe this interest as an ownership interest or residual interest. Because of such an interest it is generally relevant to distinguish from revenues and expenses, those contributions and distributions that are made to increase or decrease operating and financial capacity, and it may be appropriate to provide for sub-classifications of the residual amount, e.g. in the case of minority interests. The view of the TBG and Staff is that the ED should recognize that such an interest exists, but does not consider it possible or necessary to precisely define it. Consistent with this view it is not intended to define 'contributions from owners' or 'distributions to owners'.

Action Required

Do Members agree that:

- While indicators of entities/operations in which ownership interests exist can be identified it is not possible to provide an exhaustive list of circumstances in which ownership interests exist; and
- The ED should not propose that ownership interests are defined as a separate element but should recognize that such an interest exists in limited circumstances?

ENFORCEABILITY AS AN ESSENTIAL CHARACTERISTIC OF THE LIABILITY DEFINITION AND APPROACH TO DEFERRED OUTFLOWS AND DEFERRED INFLOWS

Objectives of Paper

1. The objectives of the paper are to:
 - Agree on the characteristics of enforceability and a description;
 - Determine whether enforceability should be an essential characteristic of a liability for all obligations or only for obligations arising from exchange transactions; and
 - Consider recommendations from the TBG and staff on the approach to deferred outflows and deferred inflows.

Enforceability of Obligations

2. This section of the paper discusses:
 - What "enforceable" means; and
 - The consequences of making enforceability an essential characteristic of the definition of a liability.

Describing Enforceability

3. Enforceability is primarily a legal construct. For definition purposes enforceability relates to arrangements that are legally binding within a country or internationally. However, there are jurisdictions (e.g. Switzerland) where government and public sector entities cannot enter into legal obligations, but where there are alternative processes with equivalent effect. Obligations that are binding through such alternative processes would embody the characteristic of enforceability.
4. Many exchange transactions are contractual in nature and therefore enforceable though the laws of contract or equivalent.
5. For some types of non-exchange transactions, mechanisms for legal enforcement may not be straightforward and judgement will be necessary to determine what is enforceable.
6. Where government is a grantor or provider of resources in a non-exchange transaction, an obligation will often become enforceable when eligibility requirements have been met by the recipient. Up to that point a government is free to change/withdraw any offer of resources. The power to enforce may extend beyond narrow legal (or equivalent) enforceability. It could be held by regulators or by professional bodies with sufficient sanction to be recognized as being effective and hence deemed to be enforceable. Enforceability therefore goes beyond narrow legal sanctions but does not include moral obligations that cannot be enforced by counterparty.

Action Required

Do Members agree with this description of enforceability?

7. Some consider that the description of enforceability extends to the coercive but non-legally enforceable power of other bodies such as trade unions. This view is based on the assumption that certain bodies can take action to ensure that obligations are settled and that the reporting entity cannot realistically avoid settling such obligations. Staff considers this to be too broad a definition, but this was not the consensus of the TBG.

Action Required

Do Members agree with this wider description of enforceability?

Consequences of making enforceability an essential characteristic of liability

8. At the December 2011 meeting Members directed that the effect of making enforceability an essential characteristic of the liability definition for obligations arising from both exchange and non-exchange transactions should be further examined.

Obligations arising from exchange transactions

9. For many exchange transactions an obligation becomes enforceable when the transaction is entered into or on the date when the underlying transaction takes place. In such circumstances it will be clear there is a liability. For example, numerous employee benefits may not be enforceable by the employee at the reporting date. If enforceability is an essential characteristic of a liability such obligations would not be recognized as liabilities at that point. Such obligations do, however, represent claims on the resources of the reporting entity and will become enforceable with the elapse of time. If such obligations are not recognized until strictly enforceable it is highly questionable whether the objectives of financial reporting are being met and user needs satisfied.

Obligations arising from non-exchange transactions

10. For non-exchange transactions the main consequence of making enforceability at the reporting date an essential characteristic of a liability is that constructive obligations¹ will not meet the definition of a liability, because they are not enforceable at the reporting date. This is illustrated by considering a recent example where a central government offered formal support to its citizens following a national disaster. Following earthquakes it became clear that a local insurance company would be unable to meet all the claims from policyholders and, before the end of the reporting period, the New Zealand Government (NZG) gave specific notice of its intention to make offers to insured homeowners to purchase land and property in the worst affected areas. Formal offers were subsequently made to individuals after the end of the reporting period. For year-end accounting NZG treated the notice as a constructive obligation, because the offers had been publicly communicated, the homeowners had a valid expectation that NZG would act as announced and NZG had no realistic alternative to settling that obligation.² However if enforceability at the reporting date is a key characteristic of a liability, an obligation arising in a non-exchange context such as the above would not be recognized as a liability and hence would not have been treated as an expense of the period.

¹ This analysis makes the assumption that constructive obligations are not enforceable. Staff is aware of the view that certain constructive obligations are enforceable through legal mechanisms such as promissory estoppel.

² For analytical purposes some of the detail has been omitted.

TBG and staff view

11. Such an approach would lead to the omission of information that meets the qualitative characteristics (QCs) of faithful representation and relevance.
12. Having enforceability as an essential characteristic of a liability arising from obligations for exchange transactions would preclude claims on resources being recognized as liabilities unless they are enforceable at the reporting date and would not recognize those which would only be settled with the elapse of time, for example certain employee benefits. Not recognizing such obligations as liabilities will present an incomplete picture of an entity's financial position and performance and will omit information necessary for decision-making purposes. Staff and the TBG have not devised a solution to surmount this problem for obligations arising from exchange transactions. Staff and the TBG do not consider that enforceability should be an essential characteristic of a liability for obligations arising from exchange transactions.
13. Staff and the TBG acknowledge that there are countervailing arguments for making enforceability an essential characteristic of a liability for obligations arising from non-exchange transactions. Adopting such an approach may on occasions lead to the omission of information that meets the QCs of faithful representation and relevance. On the other hand, there can be such a wide and varying interpretation of the phrase 'no realistic to avoid' in a non-exchange context that not including enforceability as a key characteristic undermines understandability and comparability. It is possible that the same or similar transaction will be dealt with differently by two different reporting entities and even by the same reporting entity in two different reporting periods. On balance, Staff and the TBG support the inclusion of enforceability as a key characteristic of a liability for obligations arising from non-exchange transactions. However, it is important to be aware of the consequences of such a decision - in the example in paragraph 10 the NZG would not recognize the obligation as a liability until the accounting period in which the obligation became enforceable.

Action Required

Do Members agree that:

1. Enforceability should be an essential characteristic of a liability for obligations arising from non-exchange transactions;
2. Enforceability should not be an essential characteristic of a liability for obligations arising from exchange transactions?

Options

14. If the staff and TBG recommendation is accepted TBG and staff consider there are two options:
 - Develop separate definitions of a liability for obligations arising from exchange transactions and non-exchange transactions, (including "enforceability" in the definition of a liability arising from non-exchange transactions);or
 - Develop a definition common to both types of obligation and explain in supporting guidance that for obligations arising from non-exchange transactions "no realistic alternative to avoid"

means that an obligation must be enforceable by legal or equivalent means in order to meet the definition.

15. The TBG and staff preference is for a single definition, without mentioning exchange and non – exchange transactions, using guidance to explain that for non-exchange transactions no realistic alternative to avoid means that an obligation needs to be enforceable in a narrow sense, whilst for exchange transactions this includes legal and constructive obligations.
16. Adopting the single definition option, a tentative definition of a liability could be:
“A liability is an obligation arising from a past event, and from which there is no realistic alternative to avoid, the settlement of which is expected to result in an outflow of resources from the entity.”
17. In guidance it would be explained that:
 - A liability for an exchange transaction arises when the constructive obligation or transaction is entered into or on the date when the underlying transaction takes place; It can also arise from a non-contractual legal obligation;
 - Obligations arising from non-exchange transactions must be enforceable in order to meet the definition of a liability; and
 - In each case the power to enforce could be held by a court, a regulator or by a recognized professional body with sufficient sanction over its members to require their compliance with defined standards.

Action Required

Do Members agree with the above views of TBG and staff that a single definition should be developed for liabilities covering both exchange and non- exchange obligations?

Approach to deferred outflows and deferred inflows

18. The purpose of this section is to consider whether (i) the definitions of elements for deferred outflows and deferred inflows are appropriate and (ii) whether a hierarchy of elements provides an approach that is sufficiently tight for standard setting and leads to consistent application by preparers

Introduction

19. Deferred outflows and deferred inflows were discussed in Section 5A of CF-CP2 in the context of whether other elements should be defined in addition to the four fundamental elements. Alternatives were set out in paragraphs 5.6 to 5.11
20. Specific Matter for Comment 14 asked if deferrals need to be identified on the Statement of Financial Position in some way, and if yes, three options were given:
 - (a) Define as separate elements;
 - (b) Include as sub-components of assets and liabilities; or
 - (c) Include as sub-components of net assets/net liabilities.

21. If defined as separate elements, respondents were also asked if the definitions of deferred outflow and deferred inflow in paragraph 5.8 were appropriate and complete?
22. At the December 2011 meeting Members agreed that there was information value in attributing flows to a particular reporting period and that the rationale for additional elements in the form of deferred inflows and outflows should be further explored. Members also reiterated that disclosure is not a substitute for recognition.
23. In order to facilitate the discussion of deferrals, there need to be tentative definitions for the four fundamental elements. These definitions incorporate characteristics that have been agreed at previous meetings. It is not intended to discuss these definitions in detail in this paper. They are provided simply to facilitate discussion of the proposed definitions of deferred inflows and deferred outflows and the hierarchy.

Tentative definitions

- An asset is a resource controlled by an entity as a result of past events and from which service potential or economic benefits are expected to flow to the entity.³
 - (Using the definition developed above) A liability is an obligation arising from a past event and from which there is no realistic alternative to avoid, the settlement of which is expected to result in an outflow of service potential or economic benefits from the entity.
 - Revenue is the gross inflow of service potential or economic benefits applicable to the reporting period when those inflows result in an increase in net assets or a decrease in net liabilities.
 - Expenses are decreases in service potential or economic benefits applicable to the reporting period in the form of outflows or consumption of assets or incurrence of liabilities that result in decreases in net assets or an increase in net liabilities.
24. The definitions of deferred outflow and deferred inflow in CF—CP2 were:
- Deferred outflow (of resources): an entity's consumption of net assets that is applicable to a future reporting period.
 - Deferred inflow (of resources): an entity's increase or acquisition of net assets that is applicable to a future reporting period.

Action Required

Do Members confirm these definitions of deferred outflow and deferred inflow?

The Hierarchy

25. The TBG considers that a hierarchical approach provides some assurance that deferral elements will not be used too broadly. The TBG agreed the starting point for the hierarchy should be whether an item/transaction meets the definition of an asset/liability. If yes, it would be recognized as such.

³ At the December 2011 meeting, after discussion, the Board decided to retain "service potential and economic benefits" as tentatively agreed at the December 2011 meeting. Staff think this should be "service potential or economic benefits" as explained in Agenda Item 2C.1 and have used this wording in this paper. Some TBG members wish to revisit this wording.

There are then two options for the hierarchy, either to consider the item/transaction against the definition of revenue or expenses followed by deferred inflows and deferred outflows, or to consider the item/transaction against the definition of deferred inflows and deferred outflows first. Finally if the item/transaction did not meet any of these definitions then the default position is the item/transaction would be recognized as an outflow/inflow of resources applicable to the current reporting period and therefore as a revenue or expense. The same conclusion is reached using either route. The TBG agreed the first step but had mixed views on the second and third steps. Staff prefers the revenue and expenses step as the second step.

Action Required

Do Members have a preference on the order of the second and third steps in the hierarchy?

26. This section tests the hierarchy in three scenarios. For this purpose the revenue and expenses test is the second step.

Example 1: Redundancy costs

Government Z took a decision to reduce its workforce in order to have lower operating costs in future periods. It announced its decision to the workforce and made redundancy payments to 3000 employees during the accounting period.

Step one: The outflow did not give rise to an asset because government Z had no control of the resource once it had made the payments.

Step two: The redundancy expense is an outflow relating to the reporting period.

Step three: There is no deferred outflow of resources that is applicable to a future reporting period.

Example 2: Central government transfers an amount to local government so close to end of the reporting period there was insufficient time available for the latter to spend it

Step one: The outflow did not give rise to an asset because central government does not control the resource or right to the resource once it is transferred.

Step two: The outflow is not an expense because the amount will be used to finance the provision of goods and services in the next reporting period.

Step three: Therefore the conclusion is that it is a deferred outflow.

The accounting decision reflects a judgment on how the expenditure will be used for particular purposes. Documentation indicating that central government intends or expects the transferred resources to be used to finance the delivery of goods and services in the next reporting period reinforces this accounting treatment.

Example 3: Public sector entity receives a grant in advance towards financing the construction of a public library requiring repayment only if funds are not used for that purpose. This example covers three accounting years

In year one only the grant is received:

Step one: The inflow of resources gives rise to a liability, because the grant carries a condition that is unfulfilled. Therefore in year one applying the hierarchy you stop at the first step.

Step two: N/A

Step three: N/A

In year two construction begins:

Step one: Cost of construction is shown as an asset.

Step two: The library is not opened yet so there are no revenue costs.

Step three: The grant is transferred from liabilities to deferred inflow.

In year three construction is completed and the library opens:

Step one: The cost of construction is shown as an asset.

Step two: The asset starts to function as a library so operating costs, including depreciation on a straight line basis are shown as expenses.

Step three: There is then a transfer of the grant from deferral to revenue on a straight line basis over the expected life of the asset.

Action Required

Do Members have any other examples against which the hierarchy should be tested in order to confirm that this approach is sufficiently tight for consistent application in standard setting?

Conclusion

27. The TBG and staff view is that deferred inflows and deferred outflows should be defined as elements and that the hierarchy (in an order to be determined by Members) should be used to guide the usage of these elements. The identification of transactions that give rise to deferred inflows and deferred outflows should be determined at the standards level.

Action Required

Do Members agree with the conclusion? Have Members any other comments on the issues raised in this paper and action to be taken?

PRELIMINARY OUTLINE EXPOSURE DRAFT OUTLINE STRUCTURE— ELEMENTS AND RECOGNITION IN FINANCIAL STATEMENTS

1. Objective of paper

The objective of this paper is to:

- Provide a preliminary outline of the Phase 2 Exposure Draft.

2. Executive summary

- Road map to ED

Section One: Introduction

Purpose of ED

- ED details the essential characteristics of elements used in general purpose financial statements (hereafter financial statements) and recognition. Recognition is the approach to incorporating transactions and other economic phenomena that meets the definition of an element in the financial statements.

What are elements and why are they important

- Basic building blocks from which financial statements are constructed and a common starting point for the recording, classification and aggregation of economic phenomena;
- Broad classes of items that share common characteristics not the individual items themselves;
- Sub classifications relate to Phase 4: *Presentation*. CP–CF4 provides guidance on considerations to be taken into account in the presentation of financial information in financial reports;
- Links to Phase 1: Importance of objectives and qualitative characteristics (QCs): recap and emphasize that these are fundamental to financial reporting.

Elements and general purpose financial reports

- Recognition of importance of providing information on “stocks” and “flows” for all areas of financial reporting not just financial statements. In due course will likely require development of definitions for key items and economic phenomena in other reporting areas outside the financial statements e.g. inputs, outputs, outcomes in context of service performance information; inflows and outflows in context of long-term fiscal sustainability; and
- This ED will just focus on the general purpose financial statements (financial statements). This provides a firm foundation for standard-setting activities in the context of the financial statements.

Elements defined in the ED and approach to Recognition

- The elements that are defined in the ED are:

- Assets
 - Liabilities
 - Revenue
 - Expenses
 - Deferred Inflows
 - Deferred Outflows;
- The ED discusses the characteristics of net assets/net liabilities. It does not define elements related to net assets/net liabilities, which it characterizes as a “residual amount”;
- The ED acknowledges that in limited circumstances ownership interests may exist in the public sector and that certain inflows and outflows may relate to such ownership interests. The ED does not propose that “ownership interests” should be defined; and
- Recognition also considered as a separate process after an item or transaction has met a definition. In particular the ED provides guidance on the challenges of element and measurement uncertainty.

Relationship to IASB Framework and Statistical Bases of Accounting

- The core text concludes with a boxed comparison with International Accounting Standards Board’s (IASB) Framework (either updated sections or the 1989 Framework or new sections developed as a result of the IASB-FASB project) and comparisons with Statistical Bases of Financial Reporting; and
- The Framework is not a public sector interpretation of the IASB Framework.

Section Two: Assets

Definition

- An asset is a resource controlled by an entity as a result of past events and from which service potential or economic benefits are expected to flow to the entity.¹

What is a resource?

- The view of an asset as a resource is consistent with the economic concept of a stock but physical form is not a necessary condition. Many assets like buildings and inventories are tangible but others such as patents and emissions allowances are intangible.
- Some resources embody rights to a variety of benefits including use of the resource to provide services or the right to a stream of cash flows generated from its use.
- Legal ownership. An asset can exist without legal ownership of the underlying resources.

Service potential and how it manifests itself

- Service potential is defined by the International Valuation Standards Council as the capacity of an asset to continue to provide goods and services in accordance with the entity's objectives.² Public sector assets that embody service potential may include recreational, heritage, community, defense and other assets which are held by governments/other public bodies and provide goods and services often for general public consumption in areas where there is no market competition. Their use and disposal may be restricted. Many are specialist in nature.
- Differentiation between service potential and economic benefits.
- Benefits in the form of net cash inflows apply to resources such as cash, loans and receivables, inventory for resale (or in the public sector future distribution in non-exchange transactions) and investments. Some public sector bodies generate cash flows from user fees.

What are economic benefits and how they arise?

- Economic benefits convey the notion of scarcity. Other rights to benefits may not be immediately associated with a tangible or intangible resource such as the right to require other parties to make payments or render services. Public sector entities may share in the benefits under a joint venture arrangement with another entity. The substance of an asset may be identified in terms of the economic benefits provided by a resource. Three potential types of benefits are unconditional rights to receive resources; net cash inflows/reduced cash outflows; and service potential.

What control entails, indicators of control and unconditional rights

- Definitions of control-the means by which the entity ensures that the benefits accrue to itself and not to others; Accessing benefits provided by an asset can be through legal ownership but the risks and rewards as well as the legal rights to use them can also be obtained through other mechanisms such as leasing the asset.
- The ability to deny, restrict access e.g. from charges, opening hours.

¹ Tentative definition based on discussions with Board and TBG to date – see also paragraph 10 of 2C1 for explanation; tentative definition also used in paper 2C2.

² International Valuation Application (IVA) 3, Valuation of Public Sector Assets for Financial Reporting (2007)

Need for past event

- The asset has either been purchased, produced or transferred/donated as a result of a past event

Asset at the reporting date

- After an asset has been recognized initially it must pass recognition tests again at each reporting date in order to continue being reported .

Unique public sector rights or powers

- Governments have unique powers and rights. A government's general ability, power and right to tax represent a key difference from the private sector. There are different stages in the process-(i) a general ability to tax; (ii) a power; (iii) a right; and (iv) the exercise of the right. An asset only arises when the right is exercised.

Unconditional rights to receive resources and circumstances under which such rights give rise to assets

- Unconditional rights to receive resources to the extent that the entity has paid for these in a contract or for example through an insurance policy.

Section Three: Liabilities

Definition

- A liability is an obligation arising from a past event and from which there is no realistic alternative to avoid, the settlement of which is expected to result in an outflow of service potential or economic benefits from the entity.

Distinguishing unconditional and conditional obligations

- An unconditional obligation is one that stands on its own, independent of future events.
- A conditional obligation is one that relies on the possible occurrence of a future event.

Performance obligation

- A performance obligation is an agreement between the government / other public sector entity to transfer a resource to the other party and sometimes referred to as deliverables.

Present obligations and enforceability³

- Enforceability is an essential characteristic of a liability for obligations arising from non-exchange transactions.
- Enforceability is not an essential characteristic of a liability for obligations arising from exchange transactions.
- Enforceability relates to arrangements that are legally binding within a country or internationally. There are jurisdictions where government and public sector entities cannot enter into legal obligations, but where there are alternative processes with equivalent effect. Obligations that are binding through such alternative processes embody the characteristic of enforceability. The power to enforce could be held by a court but may go further than a narrow legal interpretation and could be held by a regulator or by a recognised professional body with sufficient sanction over its members to require their compliance with defined standards.
- It is not necessary to identify a specific party to whom the entity is obligated in order for a liability to exist.
- A settlement date is an indicator of existence of obligation and therefore a liability, but not essential characteristic. Not all obligations will have a settlement date.
- A liability for an exchange transaction arises when the constructive obligation or transaction is entered into or on the date when the underlying transaction takes place; it can also arise from a non-contractual legal obligation⁴. Obligations for non-exchange transactions must be enforceable in order to meet the definition of a liability.

Need for past event

- The complexity of public sector programs and activities means that it is essential to identify a past event. For many public sector programs this will be when all eligibility criteria are satisfied.

³ The substance of this section is dependent on the approach to be agreed on enforceability in paper 2C2.

⁴ See paragraph 17 of 2C2.

Sovereign power to avoid obligations

- Sovereign power is the ultimate authority of a government to make, amend and repeal legal provisions and the complexity of which obligations should be defined as liabilities. Sovereign powers should not be used as a rationale for not recognizing obligations that otherwise meet the characteristics of a liability and the position should be assessed on the basis of the legal position at the reporting date.

Executory contracts

- Executory contracts under which neither party has performed any of its obligations, or both parties have partially performed their obligations to an equal extent currently do not give rise to assets and only give rise to liabilities if the terms of the contract are onerous to one of the parties.⁵

⁵ Tentative position based on paragraphs 14–17 of paper 2C1

Section Four: Revenue, Expenses, Deferred Inflows and Deferred Outflows

Definitions

- Revenue is the gross inflow of service potential or economic benefits applicable to the reporting period when those inflows result in an increase in net assets.⁶
- Expenses are decreases in service potential or economic benefits applicable to the reporting period in the form of outflows or consumption of assets or incurrence of liabilities that result in decreases in net assets.
- Deferred inflows (of resources); an entity's increase or acquisition of net assets that is applicable to a future reporting period.⁷
- Deferred outflows (of resources); an entity's consumption of net assets that is applicable to a future reporting period.⁸

Exchange and non-exchange transactions

- Revenue and expenses can arise from both exchange and non-exchange transactions and other events such as price changes, unrealized increases/decreases in the value of assets/liabilities, depreciation and impairments.

Deferred Inflows and Deferred Outflows

- Deferred inflow of resources as an entity's increase or acquisition of net assets that is applicable to a future reporting period (defined as above).
- Deferred outflow of resources as an entity's consumption of net assets that is applicable to a future reporting period (defined as above).
- Transactions that may give rise to deferrals include
 - Outflows of resources related to the provision of future services and goods, which do not meet the asset definition and are not expenses (depends on ordering of hierarchy⁹);
 - Inflows of resources related to the provision of future services and goods, which do not meet the liability definition and are not revenue (depends on ordering of hierarchy);
 - Time restrictions on applications of inflows of resources, which do not give rise to liabilities;
 - Sale of resources over a future period.

⁶ There may also be a case for reference to long term/capital contributions from owners

⁷ Drafted on basis that deferred inflows and deferred outflows will be defined

⁸ Drafted on basis that deferred inflows and deferred outflows will be defined

⁹ Once Members have decided on hierarchy – paper 2C.2

Hierarchy

- Explanation of the hierarchical approach and those deferrals will need to be justified by reference to the hierarchy at the standards-setting level.
- Explain tests and order of application.¹⁰

¹⁰ Once Members have decided on preference – paper 2C.2

Section Five: Net Assets/Net Liabilities

Net Assets/Net Liabilities as Residual Amount

- For majority of public sector entities net assets/net liabilities is a residual amount. This residual amount represents amounts available to finance future activities in the case of net assets or amounts required in future periods to finance past activities in the case of net liabilities.
- There will be a small minority of entities where net assets/net liabilities represent an ownership interest. Such ownership interests may include minority interests. A sub-classification of net assets/net liabilities is necessary in order to identify such ownership interests. Because they are relatively rare in the public sector such ownership interests are not defined in this Framework.
- Ownership interests will not exist at whole-of-government and consolidated national levels, except for minority interests in controlled entities, such as partially privatized Government Business Enterprises (GBEs).

Ownership Interests

- It is not possible to identify precisely or exhaustively the characteristics of entities where ownership interests exist. Ownership interests exist where there is a formal equity structure. Elsewhere, the following characteristics may provide persuasive but non-binding indicators:
 - Entities set up with a view to future sale to the private sector;
 - Entities or activities that are not directly accountable to citizens, but where the governing body is appointed by a controlling entity or the entity of which the activity is part; and
 - GBEs (issue relating to consolidation).
- An ownership interest incorporates:
 - An establishment of a financial interest in the residual amount;
 - Entitlement to distributions of service potential or economic benefits; and
 - Entitlement of distributions of any excess of assets over liabilities in the event of the entity being wound up.
- Just as ownership interests exist in a small minority of entities, so there will be a minority of transactions that have the character of contributions from and distributions to owners. Such contributions and distributions need to be identified, but the terms are not defined.

Further sub-classifications of net assets/net liabilities

- It may also be necessary to introduce further sub-classifications of net assets/net liabilities for items such as changes in the fair value of assets and liabilities.

Section Six: Recognition

Recognition Criteria

- Recognition as process of incorporating an item that meets the definition of an element and can be measured reliably in the relevant financial statement. To be recognized an item must meet both definition and recognition criteria.
- Disclosure no substitute for recognition but can be used to inform readers how uncertainty has been approached.
- Disclosure can also be used to provide information on items that do not meet recognition criteria, but do meet definitions of an element.

Uncertainty

- Existence and measurement uncertainty.
- Existence uncertainty; whether a transaction or event creates an item that meets the definition of an element.
- Existence uncertainty: use all available evidence to make neutral judgements about element's existence.
- Measurement uncertainty: necessary to attach a monetary value to an item:
 - Choice of appropriate measurement basis;
 - Reliability of measurement basis itself;
 - Use of estimates; and
 - Management judgement.
- Need to assess uncertainty at each reporting date i.e. existence and measurement uncertainty can change.

Derecognition

- Process of evaluating whether changes have occurred from previous reporting date that warrant.
- Same criteria used for derecognition as for initial recognition.

Definitions and Recognition Criteria

- Definitions of elements do not include recognition criteria.

Section Seven: Basis for Conclusions

Introduction

Respondents to CF–CP2 questioned why the IPSASB was only addressing elements for the financial statements and suggested that IPSASB should also develop elements for the “more comprehensive” areas of financial reporting outside the financial statements. The IPSASB acknowledged the merits of these views and agrees that there is an urgent need to develop such elements in the future. The IPSASB, however, decided that in order to put its future standard-setting activities for the financial statements on a sound and transparent footing it is important to deal firstly with the development of elements for the financial statements.

Assets

The majority of respondents to CF–CP2 supported the inclusion of both economic benefits and service potential in the definition of an asset. The IPSASB also supported this view and debated whether the definition should be service potential or other economic benefit and concluded the latter.

Close to half the respondents viewed control as being the most appropriate criterion for associating an asset with a specific entity. The IPSASB agreed.

Liabilities

A significant number of respondents to CF–CP2 thought that identification of a past event should be incorporated in the definition of a liability. The IPSASB agreed that a past event was an essential characteristic of a liability.

A very large number of respondents considered that a settlement date is not an essential characteristic of a liability although some considered a settlement date helps to identify a liability. Equally a large majority of respondents stated that the ability to identify a specific third party is not an essential characteristic of a liability. The IPSASB agreed.

The issues of enforceability of obligations and interpretation of what is a realistic alternative to avoiding an obligation are interconnected and need to be considered together. Some respondents had found the wording to be opaque. Consideration was given to whether all obligations both exchange and non-exchange need to be enforceable in order to meet the definition of a liability. Conclusion reached that a common definition possible but clarity required in guidance on what legally enforceable at the reporting date meant and to differentiate obligations which would be enforceable subject to the elapse of time.

Over half of respondents expressed a view that definition of a liability should include an assumption about sovereign power. The IPSASB took the view that the position should be assessed on the basis of the legal position at the reporting date.

Revenue, Expenses, Deferred Inflows and Deferred Outflows

A small majority of respondents to CF–CP2 supported advocating deriving revenue and expenses from changes in assets and liabilities. There had been widely varying views of the impact of the different approaches. Many of those who favored an emphasis on revenue linked it to legal requirements to achieve a balanced budget but the IPSASB expressed doubts about the extent to which such a link should be emphasized and about elevating balanced budget requirements as a principle on which accounting requirements should be based. Instead the economic substance of transactions and events need to be considered. Whilst timing differences may differ more in the public sector than the private sector disclosure should not be regarded as a substitute for recognition.

Over half the respondents who provided comments favored identifying deferrals on the statement of financial position while over one third did not. Many of those opposing the identification of deferrals gave support to determining revenues and expenses by changes in assets and liabilities however a relatively small number of respondents commented on the definitions of deferred outflow and deferred inflow. IPSASB decided that further work needed to be done on this as it was felt that the notion of deferrals is not well understood and the risks associated with such elements need to be mitigated. The hierarchical approach the IPSASB adopts will be important in explaining the stated basis of conclusion.

Net Assets/Net Liabilities

- Rationale for net assets/net liabilities being characterized as a residual amount rather than defining an ownership interest as an element or referring to a residual interest:
 - Acknowledgement of view that ownership interest or residual is used in some jurisdictions by analogy to indicate citizen interest in ability of entity to finance future activities. Explanation that the IPSASB decided not to adopt the term on basis that it introduces undue complexity into the financial statements and therefore does not meet the QC of understandability.
- Acknowledgement of existence of minority interests, but view that such interests can be addressed by sub-classifications of net assets/net liabilities.
- Acknowledgement that in minority of public sector entities net assets/net liabilities will represent an “ownership interest” that is not a minority interest and that some inflows are made with the objective of sustaining or increasing financial capacity over the longer term rather than to support activities in current reporting period. Consistent with previous conclusion, the IPSASB did not consider it necessary for “ownership interest” to be defined.
- Reasons for not defining “contributions from owners” or “distributions to owners” consistent with conclusion that ownership interest should not be defined.

Recognition

- The IPSASB considered whether standard or situational (based on measurement attribute) evidence thresholds should be adopted to address existence uncertainty. Acknowledged that thresholds do not lead to recognition of items that have low or remote likelihood of occurring, which might enhance understandability and that are cost-effective. On balance concluded that an entity should make a neutral judgment about whether an element exists. Such an approach produces better quality information that enhances the likelihood of meeting the QCs of faithful representation, relevance and comparability.
- The IPSASB considered the view that differential recognition criteria should be used for initial recognition and derecognition. Concluded that this is not in accordance with QC of consistency as it would lead to items with different standards of evidence for their existence being recognized.
- Acknowledgement that rationale for integrating recognition criteria into definitions, but view of the IPSASB that meeting the definition and recognition are separate processes. Consequently definitions should not include recognition criteria.

Appendix A: The IASB Conceptual Framework

This section to be prepared for June meeting.

Appendix B: Statistical Bases of Reporting

This section to be prepared for June meeting.

Action Required

Members are asked to confirm this outline of the Phase 2 Exposure Draft or provide alternative directions.