

CONCEPTUAL FRAMEWORK FOR GENERAL PURPOSE FINANCIAL REPORTING BY PUBLIC SECTOR ENTITIES:

ELEMENTS AND RECOGNITION IN FINANCIAL STATEMENTS

DRAFT EXPOSURE DRAFT

1 Introduction

Purpose of this Exposure Draft

- 1.1 This Exposure Draft (ED) proposes the definitions of elements used in the general purpose financial statements (hereafter financial statements) of governments and other public sector entities¹ and provides further explanation about these definitions. It also deals with recognition.

Elements and their Importance

- 1.2 Elements are the building blocks from which financial statements are constructed. These building blocks provide an initial point for recording, classifying and aggregating economic phenomena and activity in a way that provides users with information that meets the objectives of financial reporting² and in accordance with the qualitative characteristics (QCs) of financial reporting³. The elements also provide the link to the financial statements. Determining which definition an item meets will, subject to the satisfaction of recognition criteria, also determines the financial statement in which the item is displayed.
- 1.3 Elements are broad classes of items that share common characteristics. They are not the individual items themselves. The elements defined in this ED determine which data are presented in the financial statements and the generic types of such data. Sub-classifications of individual items within an element and aggregations of combinations of elements can enhance the understandability of the financial statements. Issues of presentation and display are addressed in Phase 4 of the Conceptual Framework.

Elements and General Purpose Financial Reports

- 1.4 This ED defines the elements that are to be reported in the financial statements. However, the Conceptual Framework recognizes the importance of providing information for other areas of general purpose financial reporting, not just the financial statements. In due course it is likely that the IPSASB will develop definitions for economic phenomena in other reporting areas.

Elements defined in the ED and approach to recognition

- 1.5 The elements that are defined in this ED are:

- (a) Assets;
- (b) Liabilities;
- (c) Revenue;
- (d) Expenses;
- (e) Deferred inflows;
- (f) Deferred outflows;
- (g) Contributions from owners; and

¹ The term “public sector entities” is used hereafter in the Framework unless the discussion is about characteristics that specifically affect government, such as the sovereign power to make, amend and repeal legal provisions.

² The objectives of financial reporting as stated in Phase1 of the Framework are accountability and decision-making.

³ The QCs are relevance, faithful representation, comparability, verifiability, timeliness and understandability.

- (h) Distributions to owners.
- 1.6 The ED discusses the characteristics of net position. Net position differs from net assets (assets less liabilities) in that it reflects deferred inflows and deferred outflows. Net position is regarded as a residual amount. Net position is the aggregate of an entity's assets and deferred outflows less an entity's liabilities and deferred inflows at the reporting date.⁴
- 1.7 In dealing with recognition, this ED provides explanations of existence uncertainty in the context of the definitions of asset and liabilities and discusses measurement uncertainty in the separate section on recognition.

Relationship to International Accounting Standards Board Framework and the Statistical Bases of Accounting

- 1.8 The core text concludes with boxed comparisons with the International Accounting Standards Board's (IASB) Framework and comparisons with Statistical Bases of Financial Reporting.

⁴ This can be represented in the formula $A + DO - (L + DI) = \text{NET POSITION}$.

2 Assets

Definition

- 2.1 An asset is a present resource with service potential or economic benefits that an entity presently controls as a result of a past event.

A Present Resource

- 2.2 A present resource is an item that generates a flow of future benefits to the entity. In order to be a present resource that resource must be controlled by the reporting entity (see the section on presently controls). Physical form is not a necessary condition of an asset. The benefits can arise directly from the resource or from the rights to the resource.

Service Potential or Economic Benefits

- 2.3 The benefits provided by a resource are service potential and economic benefits. Service potential is the capacity of an asset to be used by the entity to provide goods and services in accordance with the entity's objectives. Service potential enables an entity to achieve its objectives without generating net cash inflows.
- 2.4 Public sector assets that embody service potential may include recreational, heritage, community, defense and other assets which are held by governments and other public sector entities and provide goods and services. Such goods and services may be for collective consumption, such as defense, or individual consumption, such as health care and education. Many goods and services may be provided in areas where there is no market competition or limited market competition. The use and disposal of such assets may be restricted. As highlighted in the *Key Characteristics of the Public Sector with an Impact on Financial Reporting* document (*Key Characteristics*) many assets that embody service potential are specialized in nature.
- 2.5 Economic benefits take the form of net cash inflows or reduced net cash outflows. Net cash inflows (or reduced net cash outflows) may be derived from:
- (a) An asset's use in the production and sale of goods and services;
 - (b) The direct exchange of an asset for cash or other resources;
 - (c) An asset's use in settling a liability;
 - (d) An asset serving as a distribution to owners; or
 - (e) Holding an asset in the form of cash itself because of universal acceptance of its capacity to acquire other resources.

An Entity Presently Controls

- 2.6 A further essential characteristic of an asset is that an entity must be able to control the resource at the reporting date. Control is (a) the ability of the entity to utilize the asset's benefits, in the form of service potential or economic benefits, flowing from the resource; (b) the ability to determine the nature and manner of use of the benefits embodied in the resource and (c) the means by which the entity ensures that those benefits meet its own objectives. In assessing whether an entity controls an asset it is possible to consider the following indicators that control exists:

- (a) Legal ownership;
- (b) The ability to access or, conversely, to deny or restrict access to the resource; and
- (c) The existence of an enforceable claim to the benefits arising from a resource.

While these indicators are not conclusive determinants of whether control exists, identification and analysis of them can inform that decision. For example, if an entity cannot deny the access of certain external parties to a resource it is questionable whether the entity has an asset.

- 2.7 Because entities operate in uncertain environments it may be unclear whether an entity controls a resource or the rights to a resource. Such uncertainty is addressed by assessing the available evidence in order to make a neutral judgment about whether an asset exists. The less uncertainty there is about an item and the better the quality of that evidence, the more certainty there will be that service potential and economic benefits will flow to the entity. In evaluating existence uncertainty in the context of assets, preparers review and assess all available evidence to determine whether an asset should be recognized initially, whether it continues to qualify for recognition, or whether there has been a change to an existing asset.

As a Result of a Past Event

- 2.8 The definition of an asset requires that an asset results from a past transaction or event. Entities normally obtain assets by purchasing or producing them. In such cases, identification of the past transaction or event is straightforward. However, other transactions or events may generate assets. In the public sector, past events are often related to powers and rights that are unique to governments and certain public sector entities.
- 2.9 Assets may be created both through non-exchange transactions⁵, and by virtue of exercising sovereign powers. The power to tax or to issue licenses, and to access or restrict or deny access to the benefits embodied in intangible resources like the electromagnetic spectrum, are examples of powers and rights that other non-public sector entities do not have. An essential role of standard setting is therefore to determine the point or event at which such rights or powers give rise to the creation of an asset of the entity.
- 2.10 There are a number of potential points at which such events may occur. Taking the example of a tax, the following different stages in the process may be identified: (a) a general ability to tax; (b) establishment of a power through a statute; and (c) exercising the power to create a right. An asset only arises when the power is exercised to create a right, such as through the levying of a property tax or the occurrence of an identifiable transaction for an indirect form of taxation such as a sales tax.

⁵ In a non-exchange transaction an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange. In an exchange transaction one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value to another entity in exchange.

3 Liabilities

Definition

- 3.1 A liability is a present obligation that arises from a past event where there is little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity.

A Present Obligation

- 3.2 An obligation is a legal, social or moral duty or requirement to act or perform in a particular way to another party. The existence of an obligation is essential to the identification of a liability. However, many obligations and commitments do not give rise to liabilities. Obligations are both conditional and unconditional.

Unconditional Obligations

- 3.3 An unconditional obligation is an obligation that does not require further actions or events.

Conditional Obligations

- 3.4 A conditional obligation may be one of two types. The first type requires the occurrence of a future event. For the second type, there has been a past event but a further event is required in order for the obligation to become unconditional. Unless that further event takes place a liability does not arise at the reporting date. All conditional obligations that give rise to liabilities must become unconditional at some point in order for the obligation to be “present.”

Past Event

- 3.5 The complexity of public sector programs and activities means that, particularly for social or moral obligations, there are a number of potential points in the development, implementation and operation of a program at which an obligation may arise. It is therefore essential to identify a past event in order to determine whether a commitment or obligation is a present obligation. Where an arrangement has a legal form a past event may be identified relatively straightforwardly, such as when a contract is entered into. In other cases it may be far less easy to identify the past event and identification involves analysis of when an entity has little or no realistic alternative to avoid an outflow of resources.

Little or No Realistic Alternative to Avoid

Legal, Social and Moral Obligations

- 3.6 Legal (or equivalent), social and moral obligations arise from both exchange and non-exchange transactions. An obligation must be to an external party in order to give rise to a liability. An entity cannot be obligated to itself, even where it has publicly communicated an intention to behave in a particular way. Identification of the external party to which the obligation is owed is an indication of the existence of an obligation giving rise to a liability. However, it is not essential to know the identity of the external party before the time of settlement in order for a present obligation and liability to exist.
- 3.7 Many binding arrangements that give rise to obligations include settlement dates. The inclusion of a settlement date may provide an indication that an inflow gives rise to a liability and is not a contribution from an owner (see Section 6). However, there are many agreements that do not

contain settlement dates. The absence of a settlement date does not preclude an obligation giving rise to a liability.

Legal Obligations

- 3.8 Enforceability is primarily a legal construct relating to arrangements that are binding within a country or internationally. Many exchange transactions are contractual in nature and therefore enforceable though the laws of contract or equivalent. There are jurisdictions where government and public sector entities cannot be legally obligated, but where there are alternative processes with equivalent effect. Obligations that are binding through such alternative processes embody the characteristic of enforceability. For some types of non-exchange transactions, mechanisms for legal enforcement may not be straightforward and judgment will be necessary to determine whether an obligation is legally enforceable. Where it is determined that an obligation is legally enforceable there can be no doubt that an entity has no realistic alternative to avoid the obligation and that a liability exists.
- 3.9 Legal obligations might extend to bodies with quasi-legal powers such as regulatory agencies. However, enforceability does not include “economic coercion,” where although the public sector entity is not under a legal obligation to settle, the economic consequences to the entity of refusing to do so are such that the entity may not have a realistic alternative but to settle an obligation. Economic coercion may, however, give rise to a liability arising from a social or moral obligation (see below paragraphs 3.12–3.14).
- 3.10 Some obligations related to exchange transactions are not strictly enforceable by an external party at the reporting date, but will be enforceable with the elapse of time without the external party having to meet further conditions—that is to say having to take any further action—prior to settlement. Claims that are unconditionally enforceable subject to the elapse of time therefore are enforceable obligations in the context of the definition of a liability.
- 3.11 Sovereign power is the ultimate authority of a government to make, amend and repeal legal provisions. Sovereign power is not a rationale for the non-recognition of obligations that, otherwise, meet the characteristics of a liability. The position should be assessed at each reporting date to consider if the legal position has changed and to determine whether a liability still exists.

Social or Moral Obligations

- 3.12 Liabilities can also arise from social or moral obligations. A social or moral obligation differs from an enforceable obligation in that the party to whom the obligation exists cannot take legal action to enforce settlement. A social or moral obligation that gives rise to a liability embodies the following characteristics:
- (a) The entity has indicated to other parties by an established pattern of past practice, published policies, or a sufficiently specific current statement that it will accept certain responsibilities;
 - (b) As a result of such an indication, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities; and
 - (c) The entity has little or no realistic alternative to avoid settling the obligation arising from those responsibilities.
- 3.13 Taking as an example a program to provide a service to eligible claimants there are a number of points at which a social or moral obligation may arise. These include, but are not limited to:

- (a) Making of a political promise such as an electoral pledge;
- (b) Announcement of a policy;
- (c) Introduction (and approval) of budget (which may be two distinct points); and
- (d) Budget becoming effective (in some jurisdictions the budget will not be effective until an appropriation has been effected).

3.14 The point at which a social or moral obligation or commitment gives rise to a present obligation critically depends on how binding the commitment or obligation is perceived to be. Factors that are likely to impact on judgments whether the obligation or commitment is sufficiently binding that other parties can validly conclude the entity has little or no discretion to avoid an outflow of service potential or economic benefits include:

- The nature of the past event that gives rise to the commitment. There is a rebuttable presumption that a promise made in an election is unlikely to give rise to a present obligation because an electoral pledge very rarely (a) creates a valid expectation on the part of external parties that the entity has an obligation at the time the promise is made to honor the pledge; and (b) creates an obligation which the entity has little or no realistic alternative but to settle. However, an announcement made in the legislature by a majority government, which is virtually certain to introduce and secure passage of the necessary budgetary provision may be considered binding.
- The ability of the entity to modify or change the commitment before it crystallizes. For example, the announcement of policy will generally not give rise to an obligation which cannot be modified before being implemented. Similarly, if a commitment is made that is contingent on future events occurring, there may be discretion to avoid an outflow of service potential or economic benefits before those events occur.
- The ability of the entity to honor the obligation or commitment. There is a positive correlation between the availability of funding to settle a particular obligation and the creation of a present obligation. Where both a budget line item has been approved and linked funding is assured through, for example, an appropriation, the availability of contingency funding or a transfer from a different level of government, there is a rebuttable presumption that a present obligation exists. Conversely, if it is unlikely the public sector entity can muster the resources required to honor the obligation, there is unlikely to be a valid expectation on the part of affected parties that it will discharge such commitments or obligations.

Uncertainty over the Existence of a Liability

3.15 It can be uncertain whether the definition of a liability has been satisfied, in particular whether an entity has little or no realistic alternative to avoid an obligation requiring an outflow of service potential or economic benefits. Uncertainty is addressed by assessing the available evidence in order to make a neutral judgment about the existence of a liability. The less uncertainty there is about whether entity has a viable alternative to avoid a commitment or obligation and the better the quality of that evidence, the more certainty there will be that a liability exists at the reporting date.

An Outflow of Service Potential or Economic Benefits from the Entity

3.16 A liability must involve an outflow of service potential or economic benefits from the entity. An obligation or commitment that can be settled without an outflow of resources is not a liability.

4 Revenue and Expenses

Definitions

- 4.1 Revenue is an increase in net assets during the reporting period other than contributions from owners and deferred inflows.
- 4.2 Expenses are a decrease in net assets during the reporting period other than a distribution to owners and deferred outflows.

Increases and Decreases in Net Assets

- 4.3 Revenue and expenses can arise from exchange and non-exchange transactions, other events such as price changes, unrealized increases and decreases in the value of assets, and the consumption of assets through depreciation and impairments.
- 4.4 The definitions of revenue and expenses encompass all increases and decreases in net assets other than contributions from owners and deferred inflows. Such increases in net assets may arise in both (a) the course of the ordinary activities of the entity, and (b) outside the course of the ordinary activities of the entity.
- 4.5 Revenue includes only the inflow of resources by the entity that it can use to meet its objectives. Amounts collected on behalf of external parties are resources which do not result in increases in net assets. Therefore, they are excluded from revenue.
- 4.6 An inflow of resources from a non-exchange transaction recognized as an asset is recognized as revenue, except to the extent that a liability is also recognized in respect of the same inflow.

Contributions From and Distributions to Owners

- 4.7 Section 6 discusses ownership interest and provides definitions of contributions from owners and distributions to owners.

Deferred Inflows and Deferred Outflows

- 4.8 Revenue and expenses do not include deferred inflows and deferred outflows. Section 5 provides definitions of deferred inflows and deferred outflows.

5 Deferred Inflows and Deferred Outflows

Definitions

- 5.1 A deferred inflow is an increase in net assets provided to the reporting entity for use in a future reporting period that arises from a non-exchange transaction.
- 5.2 A deferred outflow is a decrease in net assets provided to another entity for use in a future reporting period that results from a non-exchange transaction.

Increases and Decreases in Net Assets Provided to and from the Reporting Entity

- 5.3 A deferred inflow is an inflow of resources that results in an increase of net assets. Such an inflow has a neutral effect on the reporting entity's net position.
- 5.4 A deferred outflow is an outflow of resources that results in a decrease of net assets. Such an outflow has a neutral effect on the reporting entity's net position.

Use in a Specified Future Reporting Period

- 5.5 A deferred inflow is to be used by the reporting entity in one or more future reporting periods. An example of a deferred inflow is a multi-year grant transferred to the reporting entity that contains no conditions, but a specific stipulation by the transferor that it is to be used to finance the general activities of the entity over one or more future reporting periods.
- 5.6 A deferred outflow is to be used by the transferee in one or more future reporting periods. An example of a deferred outflow is a multi-year grant transferred by the reporting entity that contains no conditions, but a specific stipulation by the transferor that it is to be used for the general activities of the entity over one or more future reporting periods.

Resulting from a Non-exchange Transfer

- 5.7 Deferred inflows and deferred outflows arise only from non-exchange transactions. Increases or decreases in net assets related to exchange transactions are accounted for as revenue and expenses, except contributions from owners or distributions to owners.

6 Net Position, Contributions from Owners, and Distributions to Owners

Net Position

- 6.1 Net position is the difference between assets and liabilities after deducting deferred inflows and adding deferred outflows. For most public sector entities net position is a residual amount. This residual amount represents the net resources available for providing goods or services in future periods or, in the case of a negative net position, the future resources necessary to meet claims from the past provision of goods or services. Therefore, a negative net position indicates that insufficient taxation or other forms of revenue have been generated at the reporting date to meet the expenses of the entity and raises the question about how the shortfall will be addressed in future periods, whether from increased revenue, reductions in expenses or a combination of both.
- 6.2 Ownership interests are not defined in this Framework, because of their rarity at entity level. Although there is a presumption that ownership interests exist in Government Business Enterprises, these are outside the scope of IPSASs. Elsewhere, in a small number of cases, an entity may be established with an intention from the outset that it will be developed in order to be sold for operation as a commercial enterprise or by a private sector not-for-profit entity. Such an intention may be signaled by the establishment of a formal equity structure and may include the existence of minority interests.
- 6.3 At the consolidated national or whole of government level, sub-classifications of net position may include non-controlling interests.
- 6.4 However, it is important to distinguish inflows of resources from owners and outflows of resources to owners, in their capacity as owners, from revenue, expenses, deferred inflows and deferred outflows. In addition to the capital injections and dividend payments that may occur with GBEs, in some jurisdictions it is relatively common for assets to be transferred between public sector entities for no consideration. Therefore contributions from owners and distributions to owners are defined in paragraphs 6.5 and 6.6.

Definitions

- 6.5 Contributions from owners are inflows of resources that establish a financial interest in the net assets/net liabilities of the entity by conveying entitlement to distributions of future service potential or economic benefits and to distributions of any excess of assets over liabilities in the event of the entity being wound up. The entitlement can be sold, exchanged, transferred or redeemed.
- 6.6 Distributions to owners are future service potential or economic benefits distributed by the entity to its owners, either as a return on investment or as a return of investment.

7 Recognition

Recognition Criteria

- 7.1 Recognition is the process of incorporating in the appropriate financial statement an item that meets the definition of an element and can be measured in a way that is sufficiently faithfully representative and relevant.
- 7.2 Recognition is a distinct stage in the accounting process. Therefore the definitions of the elements proposed in this ED do not include recognition criteria.
- 7.3 The conditions that give rise to uncertainty can change. Therefore it is important that uncertainty is assessed at each reporting date
- 7.4 The failure to recognize items that meet the definition of an element and the recognition criterion is not rectified by the disclosure of accounting policies, notes or other explanatory detail. Disclosure can be used to provide information on items that (a) meet many, but not all the essential characteristics of the definition of an element and (b) meet the definition of an element but not the recognition criterion in paragraphs 7.5 and 7.6. Disclosure is appropriate when knowledge of the item is considered to be relevant to the evaluation of the net position of the entity and therefore meets the objectives of financial reporting.

Measurement Uncertainty

- 7.5 In order to recognize an item in the financial statements, it is necessary to attach a monetary value to the item. This entails (a) choosing an appropriate measurement basis and (b) determining whether the measurement is sufficiently relevant and faithfully representative for the item to be recognized in the financial statements. The selection of an appropriate measurement basis is considered in the ED, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Measurement of Assets and Liabilities in Financial Statements*.
- 7.6 There may be uncertainty associated with the measurement of many amounts presented in the financial statements. The use of estimates is an essential part of the accrual basis of accounting. A decision about the relevance and faithful representativeness of measurement involves the consideration of factors such as (a) what amounts are reasonably possible using ranges of outcomes and point estimates; (b) whether additional evidence is available about conditions that existed at the reporting date; and (c) the impact of other reasonably possible amounts on the recognized resources, obligations, and net position. It is also important to consider the possible timing of that impact.

Derecognition

- 7.7 Derecognition is the process of evaluating whether changes have occurred since the previous reporting date that warrant removing an item that has been disclosed previously from the financial statements. In evaluating measurement uncertainty the same criterion is used for derecognition as at initial recognition.

Appendix 1A

The IASB Conceptual Framework (September 2010)

Elements and Recognition in Financial Statements

The International Accounting Standards Board (IASB) develops and publishes International Financial Reporting Standards (IFRSs). IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities.

The IASB Conceptual Framework (issued in 1989 and updated in part in September 2010). It explains:

- The underlying assumption that financial statements are prepared on a going concern basis.
- Financial statements portray the financial effects of transactions and other events by grouping them into broad classes, termed the elements, according to their economic characteristics.
- The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. Equity is the residual interest in the assets of the entity after deducting all its liabilities.
- The elements directly related to the measurement of performance in the income statement are income and expenses.
- Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition namely it is probable that any future economic benefit associated with the item will flow to or from the entity and the item has a cost or value that can be measured with reliability.

Appendix 1B

The Statistical Bases of Reporting of the 1993 System of National Accounts (updated 2008) and Other Guidance derived from it (ESA 95 and GFSM 2001)

Flows and Stocks

The 1993 System of National Accounts (SNA) –as updated in 2008(2008 SNA):

- Describes the flows and stocks that are recorded in the Government Finance Statistics (GFS) system, explaining that all data on units of the general government sector are either flows (mostly transactions) or stocks (assets, liabilities and net worth) before summarizing the accounting rules to record the stocks and flows.
- The elements directly related to the measurement of performance in the income statement are income and expenses.
- Covers concepts, definitions, classifications and accounting rules.
- Defines the assets and liabilities included in the GFSM, provides a classification of types of assets and liabilities, and describes the content of each classification category.
- Defines revenue, provides a classification of types of revenue and the contents of each classification category.
- Defines expense and explains the classification between functional and economic expense and the contents of each category.

The GFSM 2001 and ESA 95 are consistent with the principles of the 1993 SNA. However, at a detailed level, some reporting differences may arise as a result of differences in purpose and specific data needs.