

December 2010

Consultation Paper Summary

Phase 2 of 4—Elements and Recognition in Financial Statements

This summary provides an overview of the Phase 2 Consultation Paper *Elements and Recognition in Financial Statements*

Project objectives:

The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities will establish and define the concepts to be applied in developing IPSASs. This Consultation Paper on Phase 2 discusses issues associated with the elements of financial statements and their recognition.

The project and stage:

In September 2008 the IPSASB published the first Consultation Paper in this project on the objectives, the scope, the qualitative characteristics of financial reporting and the reporting entity. The IPSASB has considered comments on this paper and has issued an Exposure Draft. A separate Consultation Paper on Phase 3: *Measurement of Assets and Liabilities in Financial Statements* has also been issued. A further Consultation Paper is planned on Phase 4: Presentation and Disclosure.

Next steps:

The IPSASB seeks feedback to guide it in developing the concepts for the elements of financial statements and their recognition.

Comment deadline:

The Consultation Paper is open for public comment until June 15, 2011.

Why is the IPSASB undertaking this project?

The purpose of the IPSASB's Conceptual Framework project is to develop concepts, definitions, and principles that respond to the objectives, environment and circumstances of governments and other public sector entities, and therefore, are appropriate to guide the development of IPSASs and other documents dealing with financial reporting by public sector entities.

Many of the current IPSASs are based on International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), to the extent that the requirements of those IFRSs are relevant to the public sector.

The IASB is currently developing an improved Conceptual Framework for private sector business entities that is being closely monitored by the IPSASB. The IPSASB's Conceptual Framework is not an IFRS convergence project, and the purpose of the IPSASB's project is not to interpret the application of the IASB Framework to the public sector.

The concepts underlying statistical financial reporting models, and the potential for convergence with them, will be considered by the IPSASB in developing its Conceptual Framework. The IPSASB is committed to minimizing divergence from the statistical financial reporting models where appropriate.

Although all the components of the Conceptual Framework are interconnected, the project is being developed in phases.

To meet the objectives of financial reporting, information is needed that encompasses financial and non-financial information, past and prospective information and reporting on compliance. General Purpose Financial Reports (GPFs) are more comprehensive than public sector general purpose financial statements (GPFs). GPFs are focused on the financial portrayal of past transactions and events, which affect financial position at a point in time and financial performance for a specified period.

This Consultation Paper focuses just on the elements of GPFs of public sector entities and their recognition. Elements are the basic building blocks of financial statements needed to meet the information needs of the identified users of these financial reports. This paper considers both how these elements might be defined and what criteria might be established for their recognition.

What preliminary decisions has the IPSASB made already?

The IPSASB has made a number of preliminary decisions regarding the objectives and scope of financial reporting that will be crucial in making further decisions about the elements of financial statements.

GPFRs are financial reports intended to meet the information needs of users who are unable to require the preparation of financial reports tailored to meet their specific information needs.

The scope of financial reporting will evolve in response to users' information needs.

GPFRs of public sector entities include, but are more comprehensive than the financial statements currently dealt with in IPSASs. However, financial statements, including their notes, remain at the core of financial reporting.

The objectives of financial reporting by public sector entities are to provide information about the entity useful to users of GPFRs for accountability purposes and for decision-making purposes.

GPFRs of public sector entities are developed primarily to respond to the information needs of service recipients and their representatives and resource providers and their representatives.

Service recipients require information as input to assessments of such matters as whether:

- The entity is using resources economically, efficiently, effectively and as intended, and whether such use is in their interests;
- The range, volume and cost of services provided during the reporting period, and the amounts and sources of their cost recoveries are appropriate; and
- Current levels of taxes or other charges are sufficient to maintain the volume and quality of services currently provided.

Resource providers will require information to enable them to form judgments about such matters as whether the entity:

- Is achieving the objectives established as the justification for the resources raised during the reporting period;
- Funded current operations from funds raised in the current period from taxpayers or from borrowings or other sources; and
- Is likely to need additional (or fewer) resources in the future, and the likely sources of those resources.

What are assets in public sector financial statements?

The three characteristics necessary for a complete definition of an asset relate to:

- The substance of an asset
- How to determine if it is the reporting entity's asset, and
- How to determine if it is an asset at the reporting date

The substance of an asset

Is the substance of an asset the right to benefits or a tangible or intangible resource?

Must the benefits or resources be economic; i.e., scarce or restricted?

Is there an asset where economic benefits are obtained through service potential and where no cash is generated; how should service potential be defined and considered?

Is there an asset where economic benefits are obtained through unconditional rights; how should such items as unconditional risk (insurance) protection and rights under executory contracts be considered?

Is it the reporting entity's asset?

What are the most appropriate criteria to use to determine if it is the reporting entity's asset?

- Control?
- Risks and rewards?
- Access to rights?
- Ability to restrict or deny access of others to rights?
- Enforceable claims to benefits?
- Are additional criteria needed?

Is it an asset at the reporting date?

Should existence at the reporting date be part of the element's definition or be identified as a separate recognition criterion?

Is it necessary to specify that an asset arises from a past transaction or event?

Where the benefits or resource develops over time, e.g., from a political promise, through legislation, through conditions being met, when is the most appropriate recognition point?

Are taxes an inherent right of governments at every reporting date, i.e., a perpetual asset, or must the taxpayers meet the conditions required by the legislation before assets are considered to exist?

What are liabilities in public sector financial statements?

The three characteristics necessary for a complete definition of a liability relate to:

- The substance of a liability
- How to determine if it is the reporting entity's liability, and
- How to determine if it is a liability at the reporting date

The substance of a liability

Is the substance of a liability an economic obligation, even if future economic sacrifice might not be required to settle?

Is an unconditional obligation, including unconditional obligations to stand ready to ensure against loss, a liability?

Is an obligation to perform in a specified manner a liability?

Is an obligation to provide access to, or forego resources in the future, a liability?

Is the notion of requiring settlement by a certain date useful to the definition of a liability?

Is it the reporting entity's liability?

What are the most appropriate criteria to use to decide if an item is the reporting entity's liability?

- The entity's duty or responsibility to another entity?
- Absence of a realistic alternative for the entity to avoid the obligation due to:
 - Its legal enforceability?
 - Its legal enforceability, and other constructive and equitable obligations associated with exchange transactions?
 - Its legal enforceability and all other obligations from which the entity cannot realistically withdraw, including those associated with non-exchange transactions?

Is it a liability at the reporting date?

Should existence at the reporting date be part of the element's definition or be identified as a separate recognition criterion?

Is it necessary to specify that a liability arises from a past transaction or event?

Where the obligation develops over time, e.g., from a political promise, through legislation, through conditions being met; when is the most appropriate recognition point?

How should IPSASs approach reporting public sector financial performance?

Why report financial performance?

The statement of financial performance is used to gain an understanding of the sources, allocations and consumption of resources, as well as any claims to the resources of the entity during the period.

Such information facilitates assessments of the entity's resource requirements, the purposes to which resources were used, and the nature and extent of the revenue raising activities.

The net results over the period provide a measure of whether the revenues recognized were sufficient to meet the costs incurred during the reporting period.

Two underlying approaches

The Consultation Paper considers two different approaches to financial performance. Different definitions of the elements related to financial performance and financial position may result from these approaches.

One approach measures financial performance as the net result of all changes in the entity's economic resources and obligations during the period (asset and liability-led approach),

The other approach measures financial performance as the result of the revenue inflows and expense outflows more closely associated with operations in the current period (revenue and expense-led approach)

Implications

Different approaches to financial performance result in different definitions of the elements of revenue and expense. This, in turn, may suggest the need to define other elements related to financial position, such as deferred inflows and deferred outflows.

Therefore the IPSASB needs to determine if the measure of financial performance should be based on a process of allocating inflows and outflows to particular periods (a revenue and expense-led approach) or based on changes in the period in the net economic resources/obligations of an entity (an asset and liability-led approach) and whether, and how, those approaches can be reconciled.

What are revenues and expenses in public sector financial statements?

The most critical issue is how revenues and expenses should be associated with the reporting period. Is the association based on changes in assets and liabilities (defined as resources and obligations) during the period, or an association with the goods and services provided in the period and the taxes levied and other inflows generated to cover the cost of those goods and services?

Based on changes in assets and liabilities?

The measure of financial performance is grounded in terms of real economic phenomena. Assets and liabilities represent resources and obligations that can be observed and verified directly.

All items that represent changes in the net resources of the entity between the financial reporting dates are included in the measure of financial performance, resulting in a relevant and reliable metric to assess accountability.

Judgment is not required to determine which transactions and events affecting financial position are included or excluded from any specific period's measure of financial performance. Artificial smoothing of periodic results is avoided.

Based on association with goods and services provided in the period?

The focus on current operations increases the relevance of the statement measuring financial performance.

Costs of services are attributed to the period in which the services are provided; tax and other revenues are attributed to the period in which they were intended to finance the related costs.

Because a public sector entity is accountable for raising revenue and the use of that revenue, this should be the primary indicator of the financial performance of the entity.

Other revenue and expense issues?

Should transactions with residual interest/equity interests be excluded from the definitions?

Should revenue and expenses be restricted to the results of specific activities?

Other elements needed in public sector financial statements?

Aside from the four fundamental elements; assets, liabilities, revenues and expenses, what other items are required to be separately identified as elements in order to provide all the necessary building blocks for a public sector entity's general purpose financial statements?

Deferred outflows and deferred inflows

If revenues and expenses are to be defined with a characteristic that indicates they are “applicable to” the reporting period, and the financial position and financial performance statements are to articulate, then which of the following approaches is most appropriate?:

- Define deferred outflows and deferred inflows as separate elements in the statement of financial position; or
- Broaden the definitions of asset and liability elements to encompass items that are deferrals.

Describe the deferred outflows and deferred inflows as sub-classifications of net assets/net liabilities.

Net assets/net liabilities

Do net assets/net liabilities simply represent a residual amount?

Is there an interest in net assets/net liabilities?

If there is an interest, is that an ownership interest?

If there is an interest, is that a financial interest of resource providers and service recipients in the capability of the entity to finance itself and resource future operations?

Transactions with residual/equity interests

Can contributions by or distributions to external parties be made directly to net assets/liabilities without being a revenue or expense?

Is it necessary for the contribution or distribution to establish or reduce a financial interest in the net assets of the entity?

Is it necessary for a contribution to convey entitlement to distributions of future economic benefits and to distributions of any excess of assets over liabilities in the event of the entity being wound up?

Is it necessary for the interest to be able to be sold, exchanged, transferred or redeemed?

Recognition criteria for public sector financial statements?

Recognition is the process of incorporating an item that meets the definition of an element and can be measured reliably in the relevant financial statement.

Recognition involves the depiction of the item in words and by a monetary amount, and the inclusion of that amount in aggregates or, on rare occasions, as a discrete line item on the face of a financial statement.

An item must meet both the definition of a particular element and the recognition criteria in order to be recognized.

Existence uncertainty

Because entities operate in uncertain environments, it may be difficult to determine whether a transaction or event creates an item that meets the definition of an element.

What approach to dealing with existing uncertainty is the most appropriate?

- Standardized threshold criteria, for example, recognize only if it is “probable” that future economic benefits associated with the item will flow to or from the entity.
- Use all available evidence to make neutral judgments about the element’s existence, based on an understanding of all available facts and circumstances. If it is determined that an element exists, take uncertainty into account in measurement.
- Use threshold criteria or neutral judgments; a situational approach depending on the underlying measurement basis of the element.

Measurement uncertainty

There is inevitably a degree of uncertainty associated with the measurement of many financial statement amounts. The use of estimates is an essential part of the accrual basis of accounting.

The amount recognized must satisfy the qualitative characteristics of faithful representation and reliability. This is often a matter for professional judgment.

The selection of a measurement basis is considered in Phase 3 of the Conceptual Framework project.

Next steps:

The deadline for comments is June 15, 2011.

During the comment period, the IPSASB members are available to discuss the proposals with a wide range of parties.

How can I comment on the proposals?

The Consultation Paper includes specific matters for comment. The IPSASB has not provided tentative views on the issues in order to achieve the widest possible response.

Respondents may choose to answer all questions or just a selected few. The IPSASB welcomes comments on any other matters respondents think we should consider in forming our views.

Comment letters will be posted on the IPSASB website.

The IPSASB will carefully consider all feedback and, as usual, discuss responses to the proposals in public meetings.

The IPSASB plans to issue an Exposure Draft setting out our views in 2012.

Stay informed

The IPSASB will announce on its website the dates and location of meetings to discuss feedback on this Consultation Paper.

To stay up to date about the project please visit: www.ifac.org/PublicSector/ProjectHistory.php?Pr ojID=0066