Accounting Standards Board

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CANADA

25 June 2011

Dear Stephenie

Re Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements

1. The Accounting Standards Board (ASB) welcomes the opportunity to respond to the above Consultation Paper (CP). We would like to highlight the following points.

2. As stated in other comments letters to the IPSASB Conceptual Framework project, we think it would be unfortunate for the IPSASB and IASB frameworks to diverge markedly without due justification and consider that the revenue and expenses approach would be a radical departure from the Conceptual Frameworks of other standard-setters. Therefore, we support the assets and liability approach. However, we acknowledge the importance of clear reporting of income and expenses particularly in relation to the delivery of services. In our view, however, this can be accommodated within an asset and liabilities framework with, if necessary, explained by narrative or other disclosure.

3. We recommend that the IPSASB consider defining an asset in terms of 'rights or other access to receive future economic benefits' rather than for example 'resources controlled by the entity'. This may affect analysis of cases where more than one entity has rights to use a single resource and can more easily be applied where the asset is itself, simply a right for example, where an entity holds an option.

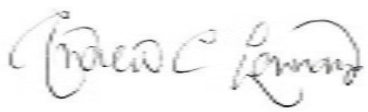
4. We recommend that the IPSASB reconsider using the terms revenue and expenses as the terms for flows of assets and liabilities as confusion may arise as to whether they include ‘one off’ items and suggest the terms ‘gains or losses’

5. We consider it essential that the framework should set out robust recognition criteria to avoid financial statements being cluttered with items of dubious relevance. There must be adequate evidence that an element exists before it is recognised.

6. The above points are enlarged upon in our responses to the Specific Matters for Comment set out in the Appendix.

7. If it would be helpful to discuss these comments, please contact Joanna Spencer j.spencer@frc-asb.org.uk or me.

Yours sincerely



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IPSASB Consultation Paper on Elements and Recognition

Specific Matters for Comment (‘SMCs’)

Specific Matter for Comment 1:

(a) 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?

ASB response

The definition of an asset should be broad enough to include items that provide any of the above types of economic benefits. However, it is not these benefits themselves that form the present asset that is reported in the GPFS, and not all prospects of future benefits are assets at the reporting date. As noted in our response to SMC 2, in our view an asset should be defined in terms of <u>*rights*</u> *to future economic benefits.*

It is important that it is clear that ‘net cash inflows’ should include a saving of future cash outflows. This is particularly important where assets are employed in the provision of services for which no fee, or a fee less than cost is charged.

(b) What term should be used in the definition of an asset:

- (i) Economic benefits and service potential; or
- (ii) Economic benefits?

ASB response

As stated above, it is important that the definition of an asset should include items that provide service potential as one type of economic benefit. It is questionable, however, whether it is necessary or appropriate that the definition specifically refer to ‘service potential’. We do not believe that the existence of assets that provide only service potential is a distinguishing feature of the public sector: commercial entities often hold assets that do not directly contribute to the receipt of cash inflows.

Specific Matter for Comment 2

(a) Which approach do you believe should be used to associate an asset with a specific entity:

(i) Control;

(ii) Risks and rewards; or

(iii) Access to rights, including the right to restrict or deny others' access to rights?

ASB response

The ASB's Statement of Principles for Financial Reporting *defines assets as 'rights or other access to future economic benefits controlled by an entity as a result of past transactions or events'. Our experience has shown that the focus on rights, rather than resources, is valuable. A definition in terms of 'resources controlled by an entity' can create the misleading impression that once a resource has been identified, the accounting issue is to determine the entity of which that resource is an asset. This sort of confusion is evidenced by the example in paragraph 2.36 of the Consultation Paper, It is correct to observe that the fiber optic cable is not the entity's asset, but the entity may have a right to use the cable, which is an asset. (We note that this discusses the use of the notion of 'right' to establish a link to the asset; in contrast, we are suggesting that it is the right itself that is the asset). Confusions of this kind have arisen in the course of IASB's work on leasing and on Service Concession Arrangements.*

A definition based on the notion of a resource can also be confusing where the potential asset is, itself, simply a right, for example, where an entity holds an option.

We do however recognise that the approaches proposed do overlap and that control and rights are directly linked to the risks and rewards associated with having an asset.

(b) 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?

ASB response

In our view, such an enforceable claim or ability would be a right or other access to economic benefits, and the entity would therefore have an asset.

(c) Are there additional requirements necessary to establish a link between the entity and an asset?

ASB response

In our view it is not helpful to consider as separate issues (i) what is the essence of an asset and (ii) what are the links between an entity and a potential asset. Consistently with the views expressed above, we suggest that if the entity has a right to future economic benefits, that right is an asset.

Specific Matter for Comment 3

Is it sufficient to state that an asset is a "present" resource, or must there be a past event that occurs?

ASB response

We understand the argument that, if the definition refers to a "present resource" it is unnecessary to refer a past event. However, we believe that the reference to 'a past event' is helpful. It emphasises that, for an asset to have come into existence there must have been a past transaction or event, and underpins the role of the financial statements in providing an account of historical transactions. An asset may be seen as the link between the past (when it came into existence) and the future (when it will yield economic benefits). Reference to 'a past event' is also helpful in distinguishing mere current expectations of future benefits from rights that have been purchased or otherwise acquired.

Specific Matter for Comment 4

Recognition and measurement criteria aside, are public sector entity rights and powers, such as those associated with the power to tax and levy fees, inherent assets of a public sector entity, are they assets only when those powers are exercised, or is there an intermediate event that is more appropriate?

ASB response

We do not believe that the power to tax and levy fees should be reported as an asset. In our view, it is only the legislature (not the government) that has the right to require taxes and fees, therefore a government should report an asset in respect of tax or fee only when an event that gives rise to a right to receive tax under current legislation takes place.

Specific Matter for Comment 5

(a) Are there any additional characteristics that have not been identified that you believe are essential to the development of an asset definition?

(b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of assets?

ASB response

We have not identified any further issues.

Specific Matter for Comment 6

(a) 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.

ASB response

Any of the above kinds of obligations should be within the definition of a liability.

We have the following additional comments on this section of the Consultation Paper (paragraphs 3.6-3.20).

- *We do not agree with the view expressed in paragraph 3.8 that a liability may exist where it is necessary to expend resources to 'discharge an organizational need'. Such expenditure is incurred to enhance the efficiency of future operations, and not to discharge a liability. (Of course, if an entity's assets are not fit for purpose they may be impaired, but that does not justify the recognition of a liability.)*
- *We agree that unconditional obligations include 'stand ready' obligations whereby an entity is required to provide resources if a future uncertain event occurs. We do not, however, understand how these differ from the conditional obligations addressed in paragraph 3.12.*
- *We do not believe that executory contracts usually give rise to an unconditional obligation to pay the contractually agreed amount. Under such contracts the obligation is to exchange, and there is a liability only if, and to the extent that, the exchange is likely to be unfavourable (in other words, the contract is onerous). In many cases, there is not even an obligation to exchange: more precisely the obligation is EITHER to exchange OR to compensate the other party for any losses that it will suffer (having taken reasonable steps to mitigate those losses) as a result of the entity's failure to exchange.*
- *Consistently with our view on the definition of assets, we believe there is considerable conceptual merit in the accounting described for a service concession arrangement in paragraph 3.20, i.e. the entity recognises that the effect of the transaction is to convey a part of its assets to the private sector entity. We note that this is one of the approaches to lessor accounting proposed in the IASB's recent exposure draft on leases.*

(b) Is the requirement for a settlement date an essential characteristic of a liability?

ASB response

A settlement date is not an essential characteristic of a liability. Uncertainty about the time at which an obligation may be settled, or the ability of the entity to defer settlement, may affect the measurement of a liability, but not its existence.

Specific Matter for Comment 7

(a) Should the ability to identify a specific party(ies) outside the reporting entity to whom the entity is obligated be considered an essential characteristic in defining a liability, or be part of the supplementary discussion?

ASB response

We agree that the definition of a liability should make clear that the entity cannot both be both the party that is obligated and the party to which settlement will be made. Therefore, there is always an external party to whom a liability is owed. However, it is not always the case that a <u>specific</u> external party can be identified. The point is best addressed in supplementary guidance rather than in the definition of a liability.

(b) Do you agree that the absence of a realistic alternative to avoid the obligation is an essential characteristic of a liability?

ASB response

Yes.

(c) Which of the three approaches identified in paragraph 3.28 do you support in determining whether an entity has or has not a realistic alternative to avoid the obligation?

ASB response

In our view, the definition of a liability should include all obligations where another party has the right to require settlement. Whilst, in most cases this will be a legal right, it would be too restrictive to require that in all cases the other party should have the ability to enforce settlement at law. Whether a liability should be reported or not should reflect the economic substance: the opinion of lawyers on the likely consequences of obscure precedents of the law of equity should not be required, except perhaps in exceptional cases. If legal enforceability were to be required, it would raise questions about cases where the creditor, although legally entitled to settlement, would be unlikely to incur the cost of legal action to enforce its claim.

But the definition should not encompass future outgoings where the other party has no right to require payment. Although the phrase 'valid expectation' has become established, we believe that it should be clarified. It is not sufficient that the other party may have an expectation that is rational and likely to be fulfilled (and so could be described as 'valid'): it is also necessary that the other party is entitled to rely on settlement.

We do not support the second approach in paragraph 3.28 as we can see no conceptual basis for distinguishing between obligations that result from exchange and non-exchange transactions. However, we acknowledge that the exchange itself may provide evidence of the existence of an obligation.

Specific Matter for Comment 8

Is it sufficient to state that a liability is a "present" obligation, or must there be a past event that occurs?

ASB response

The considerations in respect of liabilities are parallel to those that arise in the case of assets, which we have discussed above in connection with SMC 3.

We understand the argument that, if the definition refers to a "present obligation" it is unnecessary to refer a past event. However, we believe that the reference to 'a past event' is helpful. It emphasises that, for a liability to have come into existence there must have been a past transaction or event, and underpins the role of the financial statements in providing an account of historical transactions. A liability may be seen as the link between the past (when it came into existence) and the future (when it will require an outflow of economic benefits). Reference to 'a past event' is also helpful in distinguishing mere current expectations of future outflows from obligations stemming from past transactions and events.

Specific Matter for Comment 9

(a) Recognition and measurement criteria aside, are public sector entity obligations such as those associated with its duties and responsibilities as a government, perpetual obligations, obligations only when they are enforceable claims, or is there an appropriate intermediate event that is more appropriate?

ASB response

In our view, a liability for financial reporting purposes only exists where another party has an enforceable claim.

(b) Is the enforceability of an obligation an essential characteristic of a liability?

ASB response

Yes, but not necessarily <u>legal</u> enforceability. See our answer to SMC 7, above.

(c) Should the definition of a liability include an assumption about the role that sovereign power plays, such as by reference to the legal position at the reporting date?

Where a sovereign government has a legal obligation, the possibility that it might use its sovereign power to 'walk away' does not justify omitting that liability. A liability should continue to be reported until the legislature passes new legislation that relieves the administration of the liability.

Specific Matter for Comment 10

(a) Are there any additional characteristics that have not been identified that you believe are essential to the development of a liability definition?

(b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of liabilities?

ASB response

We have not identified any further issues.

Specific Matter for Comment 11

(a) Should revenues and expenses be determined by identifying which inflows and outflows are "applicable to" the current period (derived from a revenue and expense-led approach), or by changes in net assets, defined as resources and obligations, "during" the current period (derived from an asset and liability-led approach)?

ASB response

We believe that the elements of financial performance should be defined in terms of changes in net assets (excluding transactions with equity interests), and not in terms of inflows and outflows that are "applicable to" the current period.

Adoption of a revenue and expense-led view would be a radical departure from the Conceptual Frameworks adopted by other standard-setters. Therefore, it should, in our view, only be contemplated if the case to change that approach is compelling enough, that is, there are clear deficiencies in the asset and liability-led approach that cannot be resolved by any other means.

We agree that information on financial performance is of great significance, and developing the most useful means of conveying that information is one of the most important challenges for accounting standard-setters.

The discussion in the Consultation Paper envisages 'financial performance' being encapsulated in a single number (for example, in paragraph 4.4). While it may be the case that in practice attention is excessively focussed on 'the bottom line' we question whether a single number can ever convey significant information about a large and diverse organisation. Rather than attempt to provide a better 'bottom line' in our view it is likely to be more productive to secure useful information on relevant components of financial performance. In addition, financial reports need to be supplemented by narrative reports drawing attention to significant features of financial performance (such as expenses that will provide benefits in the future but do not result in recognised assets) and also to non-financial measures of performance.

(b) What arguments do you consider most important in coming to your decision on the preferred approach?

ASB response

In addition to the points made in connection with our response to (a) above, we find particularly cogent the arguments in paragraph 4.25: the asset and liability-led view is relatively robust, free from subjectivity and avoids the considerable difficulties of defining "applicability to the current period".

Specific Matter for Comment 12

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

ASB response

Whilst we agree that residual/equity interests should be excluded from revenue and expenses, we are of the view that there are a number of issues in relation to residual/equity interests that need to be further explored.

For example, some public sector bodies may receive funding from another part of government in order to support their activities and, perhaps less commonly, pay over surplus funds to a higher level of government. It is important that such transactions are excluded from the definitions of revenues and expenses. The exclusion should only be for transactions with such parties in their capacity as owners.

(b) Should the definitions of revenue and expense be limited to specific types of activities associated with operations, however described?

ASB response

The terminology adopted in the Consultation Paper for the elements that relate to flows, that is 'revenue' and 'expenses' is, in our view, likely to lead to considerable confusion, because those terms are often used in a more restricted sense. 'Revenue', for example, is frequently used to refer to inflows from ordinary activities—the amount reported in the private sector as 'turnover' or 'sales'. Endless arguments arise about, for example, whether the sale of a non-operating asset for more than its book value (or the settlement of a dispute for less than that previously recognised) give rise to 'revenue'—even where the parties to the discussion are agreed that the credit should be recognised in the statement of financial performance, but in a way that distinguishes from normal operations.

The ASB's Statement of Principles for Financial Reporting *avoids this by using the terms 'gains' and 'losses' to describe the elements that relate to financial reporting. Supplementary discussion might add that 'revenues' are one kind of gain and 'expenses' are one kind of loss.*

We strongly recommend that the IPSASB considers adopting general terms such as 'gains' and 'losses' for these elements. We recognise that this would be a departure from the usage in IASB's <u>current</u> Conceptual Framework, but would hope that IASB will make a similar change when it addresses the elements in its work on its Conceptual Framework.

Specific Matter for Comment 13

(a) Are there any additional characteristics that have not been identified that you believe are essential to the development of definitions of revenues and expenses?

ASB response

We have not identified any further issues.

(b) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the definitions of revenues and expenses?

ASB response

We have not identified any further issues.

Specific Matter for Comment 14

(a) Do deferrals need to be identified on the statement of financial position in some way?

(b) If yes, which approach do you consider the most appropriate? Deferred outflows and deferred inflows should be:

(i) Defined as separate elements;

(ii) Included as sub-components of assets and liabilities; or

(iii) Included as sub-components of net assets/net liabilities.

ASB response

As stated in our answer to SMC 11, we oppose the inclusion of deferrals in the statement of financial position. If, however, they are to be included it is essential that they are clearly and separately identified. This would require that they are <u>both</u> defined as separate elements and separately presented from net assets/net liabilities,

(c) If defined as separate elements, are the definitions of a deferred outflow and deferred inflow as set out in paragraph 5.8 appropriate and complete?

ASB Response

No. The definitions need to specify what is meant by "applicable to the reporting period".

Specific Matter for Comment 15

(a) Do you consider net assets/net liabilities to be a residual amount, a residual interest, or an ownership interest?

ASB response

In principle, we consider net assets/net liabilities to be simply a residual amount. In many cases there is little information content in this amount. However, as noted in our response to SMC 12, it is important that changes in this amount due to transactions with 'owners' are reported transparently.

(b) Should the concept of ownership interests, such as those that relate to minority or noncontrolling interests in a GBE, be incorporated in the element definition?

ASB response

Where such interests exist:

(i) they will not usually meet the definition of a liability;

(ii) they should be clearly segregated from other parts of the residual interest;

(iii) *the surplus or deficit relating to such interests should be transparent.*

However, minority or noncontrolling interests in a GBE arise only rarely. We suggest that this issue should be dealt with in the development of accounting standards rather than in the Conceptual Framework.

(c) Are there other relevant issues, and particularly unique public sector considerations, that the IPSASB needs to consider in determining the concept of net assets/net liabilities?

ASB response

We have not identified any further issues.

Specific Matter for Comment 16

(a) Should transactions with residual/equity interests be defined as separate elements?

ASB response

Yes. Please refer to our answer to SMC 12 (a).

(b) If defined as separate elements, what characteristics would you consider essential to their definition?

ASB response

As noted in our answer to SMC 12 (a), only transactions that are with parties that are 'owners' in their capacity as owners should be within the definition.

Specific Matter for Comment 17

(a) Should recognition criteria address evidence uncertainty by requiring evidence thresholds; or by requiring a neutral judgment whether an element exists at the reporting date based on an assessment of all available evidence; or by basing the approach on the measurement attribute?

ASB response

We are generally supportive of a neutral judgement approach for recognition criteria.

In our view, robust recognition principles are an essential element of a satisfactory and workable framework that should ensure financial statements are not cluttered with information about assets and liabilities that are of doubtful relevance (such as some intangible assets currently recognised on a business combination). The recognition criteria should require that assets and liabilities are recognised only where there is adequate evidence of their existence, and a measurement basis that can be expected to be sufficiently relevant, reliable and verifiable can be identified.

Relevance is not mentioned in the context of recognition in the IASB's Framework, but FASB Concepts Statement #5 gives as one of its recognition criteria 'It has a relevant attribute measurable with sufficient reliability'. We prefer the FASB's approach, as we do not consider an asset should be recognised if the only practicable measurement attribute is devoid of relevance.

(b) If you support the threshold approach or its use in a situational approach, do you agree that there should be a uniform threshold for both assets and liabilities? If so, what should it be? If not, what threshold is reasonable for asset recognition and for liability recognition?

We do not consider that it would be appropriate for the Framework to specify specific thresholds for the recognition of assets and liabilities in financial statements. The degree of uncertainty that may be tolerated might not necessarily be the same in all cases due to the need to balance reliability and relevance. For example, it might be considered that the relevance of pension obligations is sufficiently high that they should be recognised, notwithstanding a degree of variability in their measurement that would preclude recognition in another case.

In our view, the application of the recognition criteria is best dealt with in the development of accounting standards or, in the absence of an accounting standard, by the professional judgement of the preparer.

As noted in the Phase 1 ED, caution needs to be exercised in dealing with uncertainty (paragraph 3.15). We therefore would expect that standards might in particular cases provide stricter recognition requirements for assets than for liabilities.

Specific Matter for Comment 18

Do you support the use of the same criteria for derecognition as for initial recognition?

ASB response

We believe the most helpful approach is start with the presumption that a recognised asset or liability should continue to be recognised until a new transaction or event suggests that it should be derecognised (for example because it has been disposed of or settled) or its measurement should be changed (for example, as a result of changing prices).

We acknowledge that a possible consequence of this approach is that an entity may continue to recognise items although similar rights and obligations could have been acquired in a different way without giving rise to assets and liabilities. This arguably impairs comparability. However, the advantage is that it permits a fuller and more understandable presentation of the effect of transactions and events of the year on the entity's assets and liabilities. It is also consistent with the objective of accountability that an entity should continue to account for assets and liabilities, unless it is clear that they have been disposed of or settled.

Specific Matter for Comment 19

Should the recognition criteria be an integral part of the element definitions, or separate and distinct requirements?

ASB response

In our view, it is important that the recognition criteria should be separate and distinct from the definitions of an element. The distinction is helpful in clarifying the rationale for including or excluding an item from the financial statements.

For example, an item may not be recognised because there is no appropriate measurement basis but another similar item is newly-acquired and recognised at cost. If the definition of an asset contains recognition criteria, the first item would be an asset but not the second. This would be confusing.