

Memo

30. maj 2011
ØKO/SRH/BJJ

Comments to the Consultation Paper concerning Elements and Recognition in Financial Statements

Below, the comments from the Danish Agency for governmental management are divided into a number of general comments and a number of specific comments regarding the recognition of assets/liabilities and revenues/expenses.

1. General comments

Generally, the Danish Agency for governmental management agrees to the idea about making guidelines for how each item in the accounts should be identified and classified. We also find that all assets and liabilities must be identified.

Although all assets and liabilities must be identified, that does not mean that all assets and liabilities should also be included in the entity's financial Statement.

The decision whether assets and liabilities should be included in the financial statement must be decided on the basis of whether the costs by making a precise and complete measurement commensurate with the benefits associated with such a practices, cf. our comments to the Consultation Paper concerning Measurement of Assets and Liabilities in Financial Statements.

In that light we only use cost based accounting in relation to the running operation of the entity.

In Denmark the purpose of the financial statements of the central government agencies is to support the monitoring and comparison of the performance and application of resources in the institutions. In addition, the Danish accounting requirements supports good business management in the public sector.

The content of financial statements should form the basis for pricing on public services and measurement of the use of appropriations. Hence, only revenue and expenses as well as assets and liabilities are recognised in the financial statements with value, if the items are part of operating activities. Visibility of pricing and the focus on operating activities are the reasons why e.g. donations do not impact the income statement and why heritage assets do no impact the balance sheet with value.

Furthermore we find it important to underline that the recognition of assets and liabilities must be based on definitions which are precise and not too wide as you otherwise risk too use disproportionate many resources in identifying and measuring items which are not relevant in relation to the financial statement.

2. Specific comments concerning elements and recognition of assets and liabilities

The Consultation Paper concerns the following main topics regarding elements and recognition of assets and liabilities:

1. What type of benefits and obligations should assets and liabilities include?
2. Is it sufficient to state that an asset or a liability is a "present" resource, or should there be a past event that occurs and which approach should be used to associate an asset or a liability with a specific entity?
3. Are public sector rights as those associated with the power to tax and levy fees are they assets only when those powers are exercised or is there an intermediate event that is more appropriate – and are public sector entity obligations such as those associated with its duties and responsibilities as a government, perpetual obligations, obligations only when they are claims, or is there an appropriate intermediate event that is more appropriate?

What type of benefits and obligations should assets and liabilities include?

IPSAS paper discusses the definition of assets and liabilities from a resource view and discusses it from 3 different angles.

1. Recognition of assets/liabilities on the basis of matters only concerning the running operation of the entity
2. Recognition of assets/liabilities on the basis of matters also concerning state activities such as early retirement and pension obligations and the right to collect taxes
3. Recognition of assets/liabilities from a socio-economic perspective – the general registration framework which includes natural resources, sustainability and so on

According to the Danish model, we only use cost based accounting in relation to the running operation of the entity.

This is partly because the primary purpose of the cost based accounting is to support the ongoing financial management by compiling the resources needed for handling the entity's task. At the same time it is very important to us that the registration support the ability to maintain a tight appropriation control.

In Denmark the early retirement obligations and pension obligations are not included in the financial statement, in the same way as the natural resources or assets and liabilities related to socio-economic activities are not included in the financial statement.

Is it sufficient to state that an asset or liability is a "present" resource, or must there be a past event that occurs and which approach should be used to associate an asset or a liability with a specific entity?

The consultation paper discusses different approaches how to link assets and liabilities to the accounting entity and discusses a number of different approaches how to determine whether an asset or a liability can be said to belong to the accounting entity:

1. The accounting entity has control of the asset/liability
2. The accounting entity has the economic ownership and thus has the access to benefits but also derives risks of the asset
3. The accounting entity can restrict or deny the ownership of the asset for others

The term accounting entity is not a unique term and the definition of an asset/liability must therefore vary depending on whether you are preparing an institutional account, a ministry statement or a balance of the entire state.

In preparing the Danish government accounts there is a number of different assets and liabilities which do not appear in each institution's balance sheet, for example, the total state overviews of loans and long term receivables, securities and capital deposits, guarantees etc.

Are public sector rights as those associated with the power to tax only assets when those powers are exercised or is there an intermediate event that is more appropriate - and are public sector entity obligations such as those associated with its duties and responsibilities as a government, perpetual obligations, obligations only when they are claims, or is there an appropriate intermediate event that is more appropriate?

In Denmark we do not include public sector rights as those associated with the power to pay tax in our financial statements. In the same way we do not include public sector entity obligations such as those associated with its duties and responsibilities as a government.

3. Specific comments concerning elements and recognition of revenue and expenses

The Consultation Paper contains main topics concerning recognition and measurement of revenues and expenses:

- What basic approach should be chosen regarding definition and recognition of revenue and expenses?
- What are the basic characteristics to revenue and expenses?

- Are there other potential elements that should be taken into account as revenue or expenses?
- How should uncertainty be handled in terms of recognition?

The consultation paper introduces two approaches to the substance of the income statement:

- The revenue and expense-led approach
- The asset and liability-led approach

The consultation paper asks the question, **if revenues and expenses should 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).**

In the Danish public sector accounting requirements a modified transaction-based approach (revenue and expense-led approach) has been chosen. This choice is based on the view that purpose of the financial statement is to compare and monitor the application of resources and the performance of central government institutions. Furthermore the purpose of the Danish accounting requirements is to support good business management in the public sector.

The area of donations is an example where Denmark deviates from the pure revenue and expense-led approach, since significant donations are not allowed to affect the income statement as income or expenses regarding depreciations on donated assets. The deviation is based on the purpose stated in the general comments - the ability to estimate pricing on public services. Other reasons for deviating from the basic principles regarding elements and recognition could be considerations regarding the measurement of the use of appropriations.

The Danish requirements aims at creating visibility of the cost related to different activities rather than to ensure a true and fair valuation of balance sheet, because the focus is different from the situation in the private sector where focus is more on company valuation, future earning capacity and financial performance as an expression of return on invested capital.

As mentioned in the general comments in this memo, there are also exceptions regarding heritage assets. The heritage assets do not directly contribute to the production in the public institutions and therefore they are not recognized with value on the balance sheet. Additions to the heritage assets are recognized and measured by cost value, but at the end of the financial year the value is regulated to zero in value to not impact the balance sheet.

Regarding the basic characteristics of revenue and expenses the paper asks the question, **if the definitions of revenue and expenses should be limited to specific types of activities associated with operations.**

The financial statements and the income statement of central government institutions focuses, as mentioned above, on the activities associated with operations in general. The primary target group of financial reports in the public sector has not in relation to accounts focus on a specific operating activity. Therefore the income statement includes all items relating to operations. Amendments to the content of the income statement must have a management purposes and be in demand of the target group of the reporting. There are no immediate plans to narrow or redefine the target group and thus alter the content of the income statement of central government institutions.

In extension to the above the consultation paper discuss, **if there are there other potential elements that should be taken into account as revenue or expenses.**

Recognition of revenue and expenses related e.g. to natural resources or guarantees such pensions are not suitable for each institution's General Purpose Financial Reporting. This information can be reported in the Special Purpose Financial Reporting on a more aggregated level.

Certain obligations and issues of sustainability are economic topics which belong more in a political discussion about economic potential. Moreover, the measurement of these items is difficult and otherwise subject to judgment, which is problematic at the institution level.

An extended reporting could possibly include additional information about developments in the services and activities of institutions in relation to performance targets and performance contracts.

Regarding uncertainty the consultation paper discuss **if recognition criteria should 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.**

In relation to this the Danish public sector requirements follow the Danish national GAAP and e.g. contain the elements debt obligations, provisions and contingent assets/liability. This handles different degrees of uncertainty by using thresholds as

- *probable*
- *more likely than not*

- *possible but not likely.*

However, the public sector accounting requirements deviate regarding impairment as impairment tests are not applied and there has to be a very substantial/significant reason for impairment. This deviation is again based on considerations regarding the Danish appropriation system and to limit the liberty of making judgment in the financial statements of central government institutions.