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Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
277 Wellington Street West, 6th Floor
Toronto, Ontario
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Dear Sir/Madam:

Re: Consultation Papers – Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities

Thank you for the opportunity to comment on the two Consultation Papers covering Elements and Recognition in Financial Statements and Measurement of Assets and Liabilities in Financial Statements.

The Manitoba Government supports your initiative to develop a Conceptual Framework which can be applied in developing future International Public Sector Accounting Standards (IPSAS) for General Purpose Financial Statements (GPFS). We understand that IPSASB has not provided preliminary views on the issues so as to solicit as many comments as possible from the various stakeholders. We have chosen to comment on the two Consultation Papers together.

The final development of the Conceptual Framework should be driven by the primary objective of General Purpose Financial Statements (GPFS). The objective of financial reporting in the public sector should be to provide information to users for:

1. Evaluating the government's management of its financial resources in the accounting period; and
2. Assessing whether the resources were managed within the legislated limits.

The primary user of GPFS in the public sector is the general public. The goal of the Conceptual Framework should be to provide useful information to the users of GPFS. The Conceptual Framework should strive for the proper balance between IPSASB's qualitative characteristics for financial information. Financial information in GPFS should faithfully represent the economic position of the government as best as possible but it should also be verifiable and comparable between jurisdictions. But just as important GPFS should provide relevant, timely and understandable information to the general public.

We wish begin by stating that only 4 elements are required in a Conceptual Framework for public sector accounting:

1. Assets;
2. Liabilities;
3. Revenues; and
4. Expenses.

The Consultation Paper discusses other possible elements such as deferred outflows and inflows and ownership or equity interests. The Conceptual Framework should allow for the deferral of cash outflows and inflows. This would better align financial reporting with the objective of determining whether resources were managed within approved budgets. However deferred outflows and inflows should only be allowed on the statement of financial position if they meet the characteristics of a liability or asset.

The concepts of ownership and equity interests are inappropriate for a Conceptual Framework for public sector accounting. We are of the view that any net asset position simply represents resources that can be used to provide services to the general public in the next accounting period. A net liability position represents the requirement to raise additional net revenues for past operations in future accounting periods.

ASSETS

Assets should have **all three** essential characteristics:

1. Embody a future benefit that allows a government to generate future net cash flows or provide goods and services;
2. The government can control access to the benefit or restrict access to others; and
3. A transaction or event giving rise to government's control of the benefit has already occurred.

1) The Substance of an Asset:

Assets are economic benefits that either have service potential or generate net cash flows.

The definition of a benefit should also include the unconditional right to receive resources in the future. Protection against losses through insurance coverage would be an example of an unconditional right to receive resources in the future. This however should not include contracts for the future delivery of goods and services at a specified price. This does not represent an unconditional right to receive resources in the future since the government would also has an equal unconditional promise to deliver economic resources in the future. If the public entity has negotiated a favorable price for the future delivery of goods and services then the entity's prudent management of its resources will be evident when it provides the services to the public.

2) How to Determine if it is an Asset of the Reporting Entity:

To be considered an asset of the government, the government has to be able to control the economic benefit. Control is described as the ability of the government to utilize the resource for its benefit and to determine the nature and manner of its use. Control could also be further defined as having the ability to determine how to use the assets (i.e. access to rights); the ability to deny others access to the economic benefit (i.e. restrict or deny access of others); and having enforceable claims to a resource (i.e. enforceable claim to benefits). These are all refinements on the concept of control.

It is important to note that a government's control, enforceable claims to benefits or ability to deny, restrict, or otherwise regulate others' access only serves to link a public sector entity to an economic benefit. For the economic benefit to be considered to be an asset under the control of the government it is necessary to have a prior transaction or event.

3) Past Transaction or Event

The Consultation Paper discusses if the occurrence of a past event or transaction, which gave rise to the government's control of the economic benefit, is necessary, or is it simply sufficient for the economic resource to be present at the balance sheet date. We strongly believe that the occurrence of a past transaction or event, which gave rise to the government's control of the economic benefit, is a necessary characteristic of an asset.

The Consultation Paper makes the argument that the inability to identify a past transaction may lead to the non-recognition of an asset, or past transaction or events may have resulted in an asset that no longer exists. There is always an event or transaction that led to the government's control of the asset. For most assets the

transaction or event is very easy to identify. The vast majority of public sector assets result from incurring expenditures that will be used to provide services to the public at a later date.

Another example of a past transaction or event be the government granting access to natural resources to another party. An example would be royalties collected by governments for the extraction of timber, minerals and other natural resources. We would not view it appropriate for governments to accrue natural resources as an asset at the reporting date.

If the Conceptual Framework required governments to accrue natural resources it would not only be difficult to verify but the information would be of little relevance without also accruing a liability for extracting the resources. This would require governments to develop complex and very subjective estimates. This would likely reduce the timeliness of the information and the comparability of the information between jurisdictions. The information would likely not be understood by the general public and it really doesn't provide any relevant information in assessing the government's management of its financial resources.

We do not agree with the view that a government's right to the benefits from future taxes and fees represents a perpetual asset at every reporting date, even if it was possible to place a value on such an asset. We are of the view that the authority of governments to tax or raise fees does not represent an asset. The authority to raise taxes and levy fees is not a right to future benefits until the government has exercised that right. An asset exists at the reporting date only after the government has passed the legislation and levied the tax for the fiscal period, or has provided the services to the users for a fee.

4) Measurement

We view historical cost as the most appropriate measurement basis for the public sector. The objective of financial reporting is to provide information to the users. Historical cost is verifiable and understood by the users. This enhances the qualitative characteristics of the financial information to the users.

Replacement cost provides more relevant information on capital assets for decision makers. Replacement cost would result in higher amortization expense. The higher amortization expense would better represent the actual cost to the public of using the asset in the accounting period. In a balanced budget environment revenues would be raised to match the higher amortization charges, a non-cash expense, thereby creating larger cash reserves to replace the asset at the end of its useful life.

The difficulty with replacement cost is that for some assets it is very problematic to determine or estimate the replacement cost of an asset. This is especially true for infrastructure assets such as water and sewer treatment plants, roads, streets, bridges and other transportation infrastructure. Changes in technology and regulatory standards further complicate determining the replacement cost of an asset. This would likely reduce the timeliness, comparability and verifiability of financial information.

Market value would be an appropriate measurement basis for some assets on a limited basis such as investments that are traded publicly and have a quoted market price.

<u>LIABILITIES</u>

Obligations are not liabilities unless they have all three essential characteristics:

1. They embody a duty or responsibility to others leaving the government little or no discretion to avoid settlement of the obligation;
2. The settlement of the obligation entails the transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on the occurrence of a specified event, or on demand; and
3. The transactions obligating the government have already occurred.

1) The Substance of a Liability

We agree that the existence of an obligation is a required characteristic to define a liability. An obligation is a duty or responsibility to act or perform in a particular way to another party. The obligation to the other party requires settlement through the future transfer of assets, provision of goods and services or other form of economic settlement.

While all liabilities are obligations, not all obligations are liabilities. An obligation to other parties, in and of itself, is not a liability.

The Consultation Paper distinguished between unconditional and conditional obligations. Conditional obligations are not viewed as liabilities at the reporting date because the condition obligating the government has not occurred. The Public Sector Accounting Board (PSAB) in Canada uses the term contingent liability to describe a conditional obligation. Contingent liabilities are not recorded as a liability until the condition or confirming event occurs, or is viewed as likely to occur.

The Consultation Paper describes unconditional obligations as having uncertainty as to whether the obligation will even have to be settled, but no uncertainty as to existence of the obligation. Our view is that if the obligation does not embody the future sacrifice of assets then if fails to meet an essential characteristic of a liability. If the settlement of the obligation is uncertain, because it is dependent on a future event, then it is a conditional obligation or contingent liability.

Guarantees against losses for floods, crop failures, export receivables, etc. are described as stand-ready obligations. We view a stand-ready obligation to compensate a future loss as a conditional obligation that should be accrued as a liability only when the insurable loss or other necessary conditions occurs, or is viewed as likely to occur.

A performance obligation is an obligation in an agreement between the government and another party to transfer assets or provide a service to the other party. Agreements by the government to provide access to assets to other parties or to forgo future assets are also performance obligations. The PSAB refers to performance obligations as contractual obligations or commitments. We agree that performance obligations are obligations since they represent a duty or responsibility to others and embody the future sacrifice of assets. However to be recorded as a liability they have to be present obligations at the reporting date. Commitments to future expenditures would not be a liability since the government still has realistic alternatives to change or avoid the obligation through its own actions.

We view a settlement date as a required characteristic of a liability. If there is no settlement date then the obligation can't be a liability since there will be no future sacrifice of economic benefits. In most cases the settlement date is on demand or on the occurrence of a specified event. The government does not need to determine the exact date the liability will be settled. The determination of the specified event and its eventual occurrence is sufficient to be recognized as a settlement date. For example governments who provide severance benefits to their employees do not know the exact date the employee will leave. But there is no uncertainty that one day the employee will end his employment with the government and the obligation will have to be settled.

2) Liability of the Reporting Entity

The absence of a realistic alternative to avoid the settlement of the obligation is an essential characteristic of a liability. The characteristic links the obligation to the public sector entity. The absence of a realistic alternative should not only include legally enforceable obligations but also situations where the government has created a valid expectation among others that the obligation will be settled. Situations where the government still has choice on how to act would not represent a lack of discretion or reasonable alternatives to avoid the obligation. Budgeted acquisitions or future program expenditures are not present obligations since the government still has discretion to avoid the obligation through its own actions.

3) Liability at the Reporting Date

Governments have many future obligations but only present obligations at the reporting date should be accrued as liabilities. The event or transaction obligating the government must have already occurred as of the reporting date to be accrued as a liability. In most situations the event can be easily identified. For exchange transaction

the goods or services, including the services of employees, have already been provided to the government. Commitments to future program expenditures are not liabilities at the reporting date because the government still has the discretion to avoid the obligation through its own actions. Contractual obligations are also not liabilities unless the contracted party has provided good and/or services by the reporting date.

At times the government may have conditional obligations. The determination of whether or not the conditional obligation is a liability at the reporting date will be confirmed by a future event that is not within the government's control. If the occurrence of the condition or future event is not determinable then the government does not have a liability at the reporting date. If the confirming event occurs before the release of the GPFS, or is even simply likely to happen, then the conditional obligation is a present obligation at the reporting date and should be recorded as a liability.

REVENUES & EXPENSES

Most of this section was devoted to contrasting the **Asset & Liability Led (A&L) Approach** against the **Revenue and Expense Led (R&E) Approach**. The approach that you prefer determines what you consider to be the primary elements of GPFS. Under the R&E approach revenues and expenses are the primary elements and are seen as inflows and outflows that are applicable to the period. In contrast, under the A&L approach changes in your assets and liabilities determines the operating results for the period. Changes in the assets and liabilities are simply seen as inflows and outflows during the period.

Both approaches have their strong points. Supporters of both approaches do agree that the statement of financial performance is important in meeting the objectives of financial reporting in the public sector. The objective of financial reporting in the public sector is to provide information to the users for:

1. Evaluating the government's management of its financial resources in the accounting period; and
2. Assessing whether the resources were managed within the legislated limits.

The first objective suggests the need for governments to properly manage its physical assets and liabilities as best as possible. The function of governments is to provide public goods and services. It can thus be argued that financial statements should be grounded in real economic substance so as to provide users with relevant information on the net resources available for future operations. The A&L approach is better suited for meeting the first objective of financial reporting.

The R&E approach is favored because it reduces volatility on the statement of performance. The R&E approach is better aligned with the second objective of financial reporting. The second objective views the budget as playing the most significant role in the accountability cycle of the government. The budget is the publicly communicated document against which the general public evaluates the operating results for the period.

It is our view that the Conceptual Framework should be equally aligned with both objectives. We prefer the R&E approach but we feel it is important to assign cash flows to the applicable period. However we also strongly believe that the statement of financial position should only include assets and liabilities that have real economic substance. Deferred inflows and outflows should only be included on the statement of financial position if they meet the characteristics we previously described for liabilities and assets. We therefore do not see any need to include deferred outflows and deferred inflows as separate elements of financial statements.

As an example of our suggested approach we will use a transfer to the government received on the last day of a fiscal year. The purpose of the grant can be either for operating a specific program with stipulated objectives; or acquiring or constructing a capital asset.

Under the A&L approach the government's net assets have increased by the amount of the transfer. The transfer is reflected as revenue on the statement of performance even though the government has not incurred an expenditure towards the purpose of the transfer. Under the R&E approach the transfer would be deferred thereby having no net effect on the net assets at the reporting date. The deferred inflow can be brought into income and be properly matched with the related expenditures in future accounting periods.

Using our example it is our view that the transfer represents an asset to the government at year end but also meets the criteria of a liability.

1. The government has a duty or responsibility to the transferor leaving the government little or no discretion but to use the funds as stipulated by the transferor.
2. The settlement of the obligation entails the expenditure of the funds within the timeframe stipulated by the transferor.
3. The transactions obligating the government have already occurred. The government was eligible for the transfer and/ transfer has been received or is receivable as of the reporting date. This would make the transfer a present obligation.

The Conceptual Framework chosen should try to balance the two objectives of financial reporting as best as possible. Both objectives are important and cannot be properly balanced by selecting one approach over the other. We believe that the approach selected has to provide useful information to users for both objectives.

Other Comments

We would again like to express our concerns regarding the proposed scope of the Conceptual Framework. We like to emphasize that the type and extent of information on service delivery performance should be at the government's discretion. This type of information is highly subjective and is based on assumptions and estimates. Including this information within the scope of the Conceptual Framework will expose the information to the same level of assurance as GPFS. This will create significant issues for governments as well as the audit community.

We would like to again thank you for the opportunity to comment on the Conceptual Framework.

Yours truly,

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Province of Manitoba