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Submitted to: www.ifac.org

Dear Stephenie

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

Introduction

The New Zealand Accounting Standards Board (NZASB) is pleased to submit its comments on the Conceptual Framework Exposure Draft 2, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements* (ED). The ED has been issued for comment in New Zealand and as a result you may also have received comments directly from New Zealand constituents.

General Comments

The NZASB compliments the International Public Sector Accounting Standards Board (IPSASB) on its leadership and progress in developing a Conceptual Framework (Framework) for general purpose financial reporting by public sector entities.

The development of this Framework is extremely important to New Zealand given the External Reporting Board's (XRB) decision to base its accounting standards for public benefit entities (which comprise public sector entities and "private" not-for-profit entities) on International Public Sector Accounting Standards (IPSASs). As such, it is critical to us that the Framework that underlies IPSASs is conceptually robust, coherent and appropriate for public sector entities in New Zealand.

We note that the International Accounting Standards Board (IASB) has recently recommenced its work on a conceptual framework for for-profit entities. We encourage the IPSASB and the IASB to work closely together in developing their conceptual frameworks as the two Boards are likely to be considering similar issues. We consider that the development of the conceptual frameworks, particularly in relation to elements and recognition, is too important for the two Boards to be working independently of each other. Ideally, the IPSASB and IASB Frameworks should only contain different concepts that result from sectoral differences.

Specific Comments

The NZASB's main concern with the ED relates to the proposal to define deferred inflows and deferred outflows as elements and the consequential impact of this proposal on other aspects of the proposed Framework. Our concerns with the proposal to define deferred inflows and deferred outflows as elements are summarised below. We discuss our concerns in greater detail in Specific Matter for Comment 5.

Proposal to define deferred inflows and deferred outflows as elements

The NZASB appreciates that, in proposing to define deferred inflows and deferred outflows as separate elements, the IPSASB is attempting to solve a common and fundamental problem in the public sector. We acknowledge the IPSASB's attempt to ensure that public sector entity financial statements portray transactions, such as multi-year grants, in a meaningful manner.

However, we strongly disagree with the IPSASB's proposal to define deferred inflows and deferred outflows as elements. In our view, elements in financial statements should represent "real-world" economic phenomena[1]. Deferred inflows and deferred outflows do not represent real-world economic phenomena but are merely accounting constructs. We consider that a Framework should not elevate such accounting constructs to the status of elements.

We consider that general purpose financial reports (GPFRs) and financial statements should include both financial and non-financial information to faithfully represent the activities of an entity, that is, the information should inter-relate to "tell the story" of the entity. The proposed approach appears to use non-financial information as the primary determinant of the financial information that is recognised in financial statements. In our view, the proposal creates confusion about the objectives of the Statement of Financial Position and the Statement of Financial Performance and the information they are intended to impart. The proposed concept of "net financial position" is confusing and the intended meaning of financial performance is now unclear.

The IPSASB's rationale, as stated in paragraph BC40, is to show separately flows that relate to specified future reporting periods, rather than including them in the Statement of Financial Performance of the current reporting period. Restricting the deferred flows to non-exchange transactions with one form of time-based restrictions makes the concept underlying deferred flows unclear when assessed against the stated rationale. The completeness and usefulness of such "current period" information is questionable.

We consider that deferred flow information would be better imparted through a presentational approach. That is, user-needs would be better served through presentation of the relevant financial and non-financial information in a separate statement or as a separate section of the primary financial statements detailing such flows. In this regard, we consider the IPSASB has not provided a robust enough reason for dismissing a presentational approach and we support the alternative view of Ms Jeanine Poggiolini as set out in the ED.

If the IPSASB proceeds with the proposal to recognise deferred inflows and deferred outflows as elements, the Basis for Conclusions should contain a clearer discussion of the problem that the proposal is trying to solve, together with a more robust and conceptual basis for why and how, for public sector entities, the proposed approach:

[1] By "economic phenomena" in this context, we mean events and transactions that relate to the exchange, production, consumption, distribution and/or transfer, of goods, services, resources and/or obligations.

- better meets the objectives of general purpose financial reporting;
- better meets the needs of users; and
- meets the qualitative characteristics of the information that is presented in GPFRs.

The above issues and our other comments are discussed more fully in the Appendix to this letter. If you have any queries or require clarification of any matters in this submission, please contact Lay Wee Ng (LayWee.Ng@xrb.govt.nz) or me.

Yours sincerely

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APPENDIX

Response to Specific Matters for Comment

Specific Matter for Comment 1:
Do you agree with the definition of an asset? If not, how would you modify it?

In general, we support the definition of an asset. However, the IPSASB may wish to consider whether it is necessary to include “past event” in the definition of an asset. In this regard, we recommend that the IPSASB monitors developments on this issue at the IASB with the objective of aligning the definitions of an asset in the IPSASB and IASB Frameworks.

We acknowledge that past events give rise to assets and liabilities and the requirement for a past event may, in certain circumstances, give greater clarity in determining when assets and liabilities exist. However, in our view, the identification of a past event is not always required in order for an asset to exist: whether or not an asset exists could be determined by reference to present circumstances.

We note that paragraph 2.8 of the ED uses “past event” to limit the economic phenomena that could be classified as an asset. As illustrated in paragraph 2.8, it can be difficult to unambiguously identify the past event in the public sector. For example, assets associated with the power to tax could emerge in different forms over time. We acknowledge that a past event may be a useful indicator that an asset exists but we do not consider that it is always an essential pre-requisite for the identification of an asset. The requirement for a past event can also be viewed as a recognition issue and such uncertainty might be better addressed in section 7 as part of “existence uncertainty”.

The discussion of control in paragraph 2.6(b), in our view, is too broad. It focuses on power without linking it back to the notion of the entity deriving benefits from the resource. For example, a government’s legislative or regulatory powers could result in all resources in the government’s jurisdiction being considered to be under the control of the entity if the wording in 2.6(b) is applied. We suggest rewording 2.6 and combining (a) and (b) along the following lines:

> “*Control of the resource entails the ability of the entity to use the resource (or direct other parties on its use) so as to derive the benefit of the service potential or economic benefits embodied in the resource*.”

Paragraph 2.7 sets out the indicators of control. The indicator “the ability to deny or restrict access to the resource” may inappropriately result in certain assets such as public roads, parks and public walkways being excluded from the definition of assets if it is read too literally. For example, an entity may consider that it does not control a main road because it argues that it cannot, in practice, permanently deny access to that road. It may be necessary for the Framework to include further guidance on this indicator.

Specific Matter for Comment 2:
(a) Do you agree with the definition of a liability? If not, how would you modify it?
(b) Do you agree with the description of non-legal binding obligations? If not, how would you modify it?

(a) In general, we support the definition of a liability. However, as with our comment on the definition of an asset, the IPSASB may wish to consider whether it is necessary to include “past event” in the definition of a liability. We recommend that the IPSASB monitors developments on this issue at the IASB with the objective of aligning the definitions of a liability in the IPSAB and IASB Frameworks.

In our view, it may not be necessary to include a requirement that there have been a past event in the definition of a liability. The point in time when an entity has no realistic alternative to avoid an obligation may not necessarily coincide with or require a "past event". Further, the inclusion of past event in the definition is inconsistent with the requirement to recognise non-legal binding obligations as liabilities as these may not arise from a readily identifiable past event.

In relation to the definition of a liability in paragraph 3.1, we suggest that the reference to the outflow "of service potential or economic benefits from the entity" be changed to "of resources from the entity". It is the resources that are transferred, not the service potential of those resources. Transferring of resources will include services.

We consider it might also be useful to clarify that enforceability (in paragraph 3.7) also does not include "political coercion".

(b) We agree with the description of non-legal binding obligations, taking into account that the point in time when a non-legal binding obligation becomes a liability may be jurisdiction-specific.

However, if the IPSASB proceeds with the proposal to define deferred inflows and deferred outflows as separate elements, we suggest that the Framework clarifies when an entity should recognise an inflow of funds as a deferred inflow and when an entity should consider the attributes of the non-legal binding obligation in paragraph 3.10 of the ED and recognise a non-legal obligation/liability in respect of that inflow of funds. (Also see our comments under Specific Matter for Comment 5.)

We suggest replacing the word "obligations" in the second sentence of paragraph 3.12 with "expectations by stakeholders".

Specific Matter for Comment 3:
Do you agree with the definition of revenue? If not, how would you modify it?

Consistent with our discussion in the covering letter and in Specific Matter for Comment 5 regarding deferred inflows and deferred outflows, we do not agree with the definition of revenue.

We consider that revenue should be defined as all inflows during the current reporting period, other than ownership contributions, which increase the net assets of an entity.

We consider that the proposed definition of revenue (which excludes increases in deferred inflows and includes inflows during the current reporting period that result from decreases in deferred inflows) will potentially result in revenue being misstated because we do not consider that decreases in deferred inflows are revenues. The proposed adjustments to revenue relate only to a subset of transactions that could be defined as deferred inflows (i.e. those relating to non-exchange transactions associated with specified future periods). We query the usefulness of such a revenue figure as an indicator of the performance of an entity for the period, given that the costs of any related performance for the deferred inflows are not necessarily associated with those periods. (Also see our comments on deferred inflows and deferred outflows under Specific Matter for Comment 5.)

Specific Matter for Comment 4:
Do you agree with the definition of expenses? If not, how would you modify it?

Consistent with our discussion in the covering letter and in Specific Matter for Comment 5 regarding deferred inflows and deferred outflows, we do not agree with the definition of expenses.

We consider that expenses should be defined as all outflows during the current reporting period, other than ownership distributions, which decrease the net assets of an entity.

Similar to our comment about the definition of revenue, we consider that the proposed definition of expenses will potentially result in expenses for a particular reporting period being misstated because we do not consider that decreases in deferred outflows are expenses. The proposed adjustments to expenses relate only to a subset of transactions that could be defined as deferred outflows (i.e. those relating to non-exchange transactions associated with specified future periods). We query the usefulness of such an expense figure as an indicator of the performance of an entity for the period given that the benefits to be derived for the deferred outflows are not necessarily associated with those periods.

Specific Matter for Comment 5:

(a) Do you agree with the decision to define deferred inflows and deferred outflows as elements? If not, why not?

(b) If you agree with the decision to define deferred inflows and deferred outflows as elements, do you agree with the:
   (i) Decision to restrict those definitions to non-exchange transactions? If not, why not?
   (ii) Definitions of deferred inflows and deferred outflows? If not, how would you modify them?

(a) We strongly disagree with the IPSASB's proposal to define deferred inflows and deferred outflows as elements.

Elements in financial statements should represent real-world economic phenomena. Elements should be defined in relation to economic resources and economic obligations (assets and liabilities) and changes in those economic resources and economic obligations (revenues and expenses). Elements should not be items that do not represent real-world economic phenomena but are derived only from accounting constructs. We consider that the inclusion of deferred inflows and deferred outflows as elements in financial statements is not representationally faithful.

The proposal to include deferred inflows and deferred outflows creates confusion about the objectives of the Statement of Financial Performance and the Statement of Financial Position and the information that they are intended to impart. It changes the composition of the elements of assets, liabilities, revenue and expense, and hence of ownership interests/equity.

The existing purpose of a Statement of Financial Position is to present information about the resources under the control of the entity, obligations of, and claims against, the entity and ownership interests/equity at a particular point in time. The inclusion of deferred inflows and deferred outflows in the Statement of Financial Position is inconsistent with this generally accepted purpose. Consequently, the Statement of Financial Position would not faithfully represent the resources that an entity controls, the obligations of, or claims against the entity, or the entity's ownership interests/equity. The proposal, in our view, elevates the recognition and presentation of (partial) flows over the concept of control that traditionally underlies the Statement of Financial Position.

We recommend that, if the proposal proceeds, the Framework clarifies the purpose of the Statement of Financial Performance and Statement of Financial Position. In this regard, we consider the discussion in paragraph 4.7 of the ED (in relation to Financial Performance) to be inadequate. We recommend a fuller discussion of financial performance under this new basis.

We appreciate that IPSASB is responding to a perceived need for information about revenue received that is intended to be spent in a particular period and what has actually been spent in that period. However, in our view, information about whether an entity's resources were expended as intended for the period, similar to information about the performance of the entity in relation to its budget, is better imparted through a presentational approach rather than through the creation of separate elements. We consider that user-needs will be better served through presentation of the relevant information, in a separate statement or as a separate section of the primary financial statements, detailing such flows.

The IPSASB's rationale for proposing that deferred inflows and deferred outflows be recognised as elements is stated in paragraph BC 40. However, the concept underlying the recognition of deferred inflows and deferred outflows is unclear when assessed against that rationale. As proposed, not all deferred flows will be accounted for consistently. The deferred flows are limited to non-exchange, time-based flows (where the future period the resources can be used has been specified). Flows associated with project-based transactions are not considered to be deferred flows. For example, funding received by an entity that is restricted to a particular project (with no return obligation if not spent as specified) would give rise to immediate revenue recognition. However, if the restriction is based on time (i.e. the funds are to be spent in a particular time period), revenue is deferred. In our view, there is no conceptual basis for creating this difference in the treatment of the two types of restrictions. We think that the proposals could lead to structuring opportunities – for example, by converting a project-based restriction to a time-based restriction in order to achieve the desired accounting outcome without changing the substance of the arrangement.

In this regard, we note that BC45 also states that "*Multi-year grants with no substantive performance obligations and no return obligations would only be presented as deferred inflows or deferred outflows if the period over which those resources can be used is documented and recorded and the resources are actually used in those periods, as specified in the grant agreement*." Notwithstanding any specified restrictions, there is no certainty that the costs associated with the performance or benefits to be derived will necessarily be incurred in the periods specified.

We consider that the IPSASB's justification in BC43 for including deferred inflows/outflows as elements to avoid standards-level inconsistency could equally be used as justification for taking a presentational approach to flows spanning more than one period. Including guidance on a presentational approach in the Framework would avoid both standards-level inconsistency and the creation of items that do not represent real- world phenomena for inclusion in the Statement of Financial Position.

If the IPSASB proceeds with the proposal, we request that the presentation suggestions set out in the alternative view of IPSASB member, Professor Mariano D'Amore, which separates changes in deferred flows from revenue/expenses be given further consideration.

Moreover, the Basis for Conclusions should contain a clearer discussion of the problem that the proposal is trying to solve together with a more robust and conceptual basis for why and how, for public sector entities, the proposed approach:

- better meets the objectives of general purpose financial reporting;
- better meets the needs of users; and
- meets the qualitative characteristics of the information that is presented in GPFRs.

(b) If the IPSASB were to proceed with the proposal to recognise deferred flows as separate elements, we consider that a clearer distinction would need to be made between when an entity recognises a deferred inflow (because the inflows are specified to be used in a future period) and when it recognises a non-legal binding obligation/liability (because through, for example, past practice, it has created a valid expectation).

If deferred flows are limited to non-exchange transactions, the Framework should include definitions for "exchange transactions" and "non-exchange transactions". At the standards level, measurement (and re-measurement) of such deferred flows will also need to be considered.

Specific Matter for Comment 6:

(a) Do you agree with the terms net assets and net financial position and the definitions? If not, how would you modify the terms and/or definitions?

(b) Do you agree with the decision to define ownership contributions and ownership distributions as elements? If not, why not?

(c) If you agree with the decision to define ownership contributions and ownership distributions as elements, do you agree with the definitions of ownership contributions and ownership distributions? If not, how would you modify them?

(d) Ownership interests have not been defined in this Conceptual Framework. Do you think they should be?

(a) We agree with the term "net assets" and its definition. This term (and its definition) is generally well understood by users and gives information about the residual interests in an entity.

We do not agree with the term "net financial position" or its definition. The purpose and usefulness of the "net financial position" is unclear. We consider that the introduction of this term will not assist users' understanding of the financial position of an entity.

(b) We strongly support the proposal to define "ownership contributions" and "ownership distributions" as separate elements.

In addition, we recommend that the term "ownership interests/equity" be separately defined as an element, as the residual interest in the assets of the entity after deducting all liabilities. We consider that it is important that all elements in each of the financial statements be defined. The "flow" elements in the Statement of Financial Performance are revenue and expenses. In the Statement of Financial Position, the "stock" elements are "ownership contributions", "ownership distributions" and "ownership interests/equity". In our view, it is conceptually incomplete if "ownership interests/equity" is not defined as an element.

Moreover, in our view, the IPSASB's proposal to limit the Statement of Financial Position elements to "ownership contributions" and "ownership distributions" has significant implications at the standards level for how certain items currently excluded from the Statement of Financial Performance are treated. For example, currently, asset revaluations are recognised in equity. As changes resulting from asset revaluations are neither ownership contributions nor ownership distributions, under the proposals, they will be recognised as revenue. We query whether this is the intention of the IPSASB. We recommend that the Framework clarifies how items in the existing statement of changes in net assets/equity will be treated under the proposals.

(c) We suggest that in defining ownership contributions and ownership distributions as elements, paragraphs 6.3 and 6.4 should be reworded to ensure that the contributions and distributions from/to the external parties are "in their capacity as owners of the entity" to avoid the possibility of, for example, a grant from an external party being considered an ownership contribution.

(d) We consider that ownership interests/equity should be defined as a separate element, this being the residual interest in the assets of the entity after deducting all liabilities.

Specific Matter for Comment 7
Do you agree with the discussion on recognition? If not, how would you modify it?

We agree with the discussion on recognition. However, we recommend that the IPSASB considers whether "past event" should be discussed as part of recognition criteria under "existence uncertainty", rather than as part of the definition of "asset" and "liability". In this regard, we recommend that the IPSASB monitors the IASB's conceptual framework project with a view to aligning the two Frameworks on this issue.

We note that section 7 of the ED discusses existence uncertainty and measurement uncertainty as recognition criteria but does not set out any recognition thresholds or criteria for when an item should be recognised. In our view, existence uncertainty is effectively a means of determining whether an entity presently controls a resource or has a present obligation (that is, part of the definition of an element) and measurement uncertainty is effectively a means of choosing between different measurement bases (that is, part of the measurement). We recommend that the Framework includes guidance on measurement thresholds and criteria.

Other Matters

A Framework should contain conceptual ideals that standards (and practices) can strive towards. It should provide guidance on how issues will be dealt with at the standards level, with any departures from the concepts at the standards-level being appropriately justified.

Given that the major issues in the public sector (as distinct from the for-profit sector) relate to the power to tax and social policy obligations, we consider that the Framework should contain a discussion of, and provide a basis for, identifying the appropriate approach to accounting for, these issues.

We note the statement in paragraph 4.7 of the ED that the surplus/deficit for the period (as currently defined) "is the primary indicator of financial performance." We consider that the

Framework should contain a fuller discussion of the nature of financial performance, including operating surpluses, and what measure of operating surplus (or deficit) is meaningful for the management of public finances. This could include a discussion on whether gains or losses in assets arising from revaluations are qualitatively different in nature from gains and losses from actual flows of resources in and out of entities.