International Public Sector Accounting Standards Board™

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Meeting:	International Public Sector Accounting Standards Board	**Agenda Item 5**	For:
			☐ Approval
Meeting Location:	Toronto, Canada		☒ Discussion
Meeting Date:	June 23–26 , 2015		☐ Information

Consequential Changes from Phase 1 (Chapters 1-4) of Conceptual Framework

Objective(s) of Agenda Item

1. The objective of this agenda item is to:

   (a) Consider and approve the proposed approach to amendments to IPSAS and RPGs arising from Chapters 1-4 of the Conceptual Framework.

Material(s) Presented

Agenda Item 5.1	Issues Paper: Consequential Changes from Phase 1 (Chapters 1-4) of Conceptual Framework

Action(s) Requested

2. The IPSASB is asked to:

   (a) **Consider** the rationale for the proposed amendments discussed in the Issues Paper; and

   (b) **Approve** the proposed approach

Prepared by: John Stanford (June 2015)

Issues Paper – Consequentials from Chapters 1-4 of the Conceptual Framework

Introduction

1. At its March 2015 meeting the IPSASB approved a limited scope project to make amendments to current International Public Sector Accounting Standards (IPSASs) and Recommended Practice Guidelines (RPGs), as a result of the Phase 1 Chapters (1-4) of the Conceptual Framework (the Framework) .

2. The first four chapters of the Framework cover role and authority; objectives and users; the qualitative characteristics (QCs) and constraints on information included in general purpose financial reports (GPFRs) (from here on the constraints); and the reporting entity. The chapters were published in January 2013, prior to inclusion in the complete Framework that was published in October 2014.

3. The project proposes changes in the following areas:

    - Qualitative Characteristics and Constraints on Information Included in General Purpose Financial Reports;
    - Hierarchy in IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors;* and
    - Replacement of term "economic entity" with term "group entity."

Background

4. This section considers previous discussion by the IPSASB of the replacement of the QCs and constraints in the literature with those in the Conceptual Framework.

5. IPSAS 1, *Presentation of Financial Statements*, contains a summary of the QCs of financial reporting and the constraints on relevant and reliable information that were adopted by the IPSASB when IPSAS 1 was approved in 2000. These QCs and constraints were drawn from the International Accounting Standards Committee's 1989 Conceptual Framework.

6. Following approval of the Phase 1 chapters of the Framework at the December 2012 meeting, the IPSASB considered a staff proposal that Appendix A should be withdrawn and that references to Appendix A elsewhere in the IPSASB literature and a replication of Appendix A in non-authoritative implementation guidance in IPSAS 18, *Segment Reporting*, should be revised or deleted. Staff noted that, following approval of Chapter 3, *Qualitative Characteristics,* of the Framework, there would be two sets of QCs and constraints in the IPSASB literature, and that this would be potentially confusing to users. Staff expressed a view that the QCs in Chapter 3 of the Framework had been developed by members over a lengthy period, with an extensive due process. This included explanation in the Framework Phase 1 ED of the differences between Appendix A of IPSAS 1 and the QCs proposed by the Board as their replacement. Staff expressed a view that the withdrawal of Appendix A and consequential amendments could be considered as editorial changes that did not require exposure.

7. Members did not support the withdrawal of Appendix A without due process, because such an approach would have been inconsistent with the IPSASB's public position that the Framework is

non-authoritative and that changes to the existing suite of IPSASs would not be made without further and full due process. Members therefore decided that Appendix A in IPSAS 1 should not be withdrawn in early 2013. In order to ensure that users were made aware of how the two sets of QCs and constraints in the literature related to existing pronouncements and IPSASs and RPGs under development, staff was directed to include a clear statement above Appendix A of IPSAS 1 on the operation of the QCs and constraints in IPSAS 1.

8. The 2013 and 2014 Handbooks therefore included the following wording at the top of Appendix A:

> **The IPSASB issued Chapter 3, Qualitative Characteristics of the Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the *Framework*) in January 2013. Chapter 3 details the qualitative characteristics (QCs) of information included in general purpose financial reports (GPFRs) and the pervasive constraints on information included in GPFRs.**
>
> **The QCs in this Appendix continue to apply to existing pronouncements unless stated otherwise. The QCs in the *Framework* will be applied in the development of future pronouncements. Potential changes to pronouncements resulting from the issue of the *Framework*, including the potential withdrawal of this Appendix will be considered following completion of the *Framework*.**

9. The current version of Appendix A is shown as an appendix to this Issues Paper.

Issue 1: Qualitative Characteristics and Constraints on Information Included in General Purpose Financial Reports

10. The background to the QCs and the constraints has been provided in paragraphs 1-5 above. One option is that Appendix A should be replaced with a revised appendix summarizing the new QCs and constraints. Staff does not support such an approach, because staff considers that preparers and other constituents should consider the full text of Chapter 3 of the Framework, rather than a summary. Staff therefore proposes that Appendix A in IPSAS 1 and references to Appendix A elsewhere in the suite of IPSASs should be deleted. Those identified are:

- The contents page of IPSAS 1
- Paragraph 13 of IPSAS 3
- Paragraph 15(c) of IPSAS 18, *Segment Reporting*
- Paragraph 27 of IPSAS 24, *Presentation of Budget Information in Financial Statements*
- Implementation Guidance in IPSAS 18, which replicates most of Appendix A of IPSAS 1.

11. The Framework adopted the QC "faithful representation" rather than "reliability" and explained that "faithful representation is attained when the depiction of the phenomenon is complete neutral and free from material error." Staff therefore proposes that the term "reliability" is replaced by "faithfully representative" except for recognition criteria (discussed in paragraphs 12-18 below).

12. There is a specific issue relating to recognition. Currently the recognition criteria in IPSASs are that (a) it is probable that future economic benefits or service potential associated with an item will flow to the entity and (b) the cost or fair value of the item can be measured reliably.

13. These recognition criteria are not consistent with the Framework. Chapter 6 of the Framework states that the recognition criteria are that:

- An item satisfies the definition of an element; and
- Can be measured in a way that achieves the QCs and takes account of constraints in information in GPFRs

14. Recognition is outside the scope of this project. Staff is reluctant to make piecemeal changes to the recognition criteria. However, the retention of "reliability" is problematic, because reliability is no longer a QC and it is therefore it is questionable what it means. Staff considers that there are three possible approaches.

Approach One: Retain "reliably"

15. Under this approach the reference to "reliably" would be retained with a footnote under the first reference to note that "The QC of "faithful representation" is similar to the QC of "reliability" and that, in advance of further changes to recognition criteria in IPSASs the term "reliably" has been retained here and elsewhere in recognition criteria until the recognition criteria are considered in more detail.

Approach Two: Replace "reliably" with "faithfully representative"

16. This approach would make an interim amendment to recognition criteria by replacing the "reliably" with "in a faithfully representative manner".

Approach Three: Bring recognition within the scope of this project

17. While this might be considered to be the most straightforward approach, Staff considers that recognition is more appropriately addressed when the changes to the elements are considered. Modification of the recognition criteria also has a consequential impact in other areas; for example the discussion of a provision in IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets,* and the definition, and subsequent discussion, of a contingent liability in IPSAS 19. In the view of staff it would be more appropriate to consider such changes in the context of reviewing the approach to liabilities in the literature.

18. On balance staff would prefer to retain "reliable" in recognition criteria with a footnote on first reference.

Matter for Consideration

1. The IPSASB is asked to **confirm**:
   - The withdrawal of Appendix A in IPSAS 1, *Presentation of Financial Statements*, and that references to Appendix A elsewhere in the suite of IPSASs should be deleted; and
   - The replacement of the terms "reliable" and "reliability" with the terms "faithful representation" and "faithfully representative", except for the retention of "reliable" in recognition criteria, until amendments to existing recognition criteria in IPSASs are considered in more detail, with an explanatory footnote; or **provide** alternative directions.

Issue 2: Selection of Accounting Policies and Hierarchy in IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*

19. Paragraphs 12-15 of IPSAS 3 provide guidance on the selection of accounting policies where there is not an IPSAS that specifically applies to a transaction, event or condition. These paragraphs are shown in Appendix B. IPSAS 3 further provides a hierarchy of sources that management shall refer to and consider the applicability of when determining an accounting policy where there is no governing IPSAS.

20. Paragraph 12 of IPSAS 3 states that:

    In the absence of an IPSAS that specifically applies to a transaction, other event, or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:

    (a) **Relevant to the decision-making needs of users; and**

    (b) **Reliable, in that the financial statements:**

    (i) **Represent faithfully the financial position, financial performance, and cash flows of the entity;**

    (ii) **Reflect the economic substance of transactions, other events, and conditions and not merely the legal form;**

    (iii) **Are neutral, i.e., free from bias;**

    (iv) **Are prudent; and**

    (v) **Are complete in all material respects.**

21. This paragraph was drawn from IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors.* Staff consider that, in accordance with the objectives of financial reporting in the Framework the reference to relevance in paragraph 12(a) of IPSAS 3 needs to include accountability as well as decision-making.

22. As discussed in paragraph 11 of this Issues Paper, the Framework includes faithful representation rather than reliability as a QC. Staff do not consider that the reference to "reliable" in paragraph 12 of IPSAS 3 needs to be retained. Furthermore paragraph 3.10 of the Framework states that "faithful representation is attained when the depiction of a phenomenon is complete, neutral, and free from material error." Because completeness, neutrality, and freedom from material error are inherent in the concept of faithful representation it is questionable whether there is a need to refer to them directly in IPSAS 3.

23. On balance Staff considers that the inclusion of the explanation of faithful representation from the Framework in IPSAS 3 will be useful to readers. Therefore Staff proposes that paragraph 12 of IPSAS 3 should be revised as follows:

    In the absence of an IPSAS that specifically applies to a transaction, other event, or condition, management shall use its judgment in developing and applying an accounting policy that results in information that:

    (a) **Is relevant to the needs of users for information for decision-making and accountability purposes; and**

    (b) **Represents faithfully a transaction, other event or condition in the financial statements in the depiction of the transaction, other event or condition is:**

(i) Complete;

(ii) Neutral; and

(ii) Free from material error

24. Similarly, Staff think that it is appropriate to draw on the explanation of the relationship between faithful representation and substance over form and prudence in a revised paragraph 13 as follows:

> Paragraph 12 requires the development of accounting policies to ensure that the financial statements provide information that meets the qualitative characteristics of relevance and faithful representation. Information that faithfully represents an economic or other phenomenon depicts the substance of the underlying transaction, other event, activity or circumstance. That substance is not necessarily always the same as its legal form. Prudence is reflected in neutrality. There is a need to exercise caution when dealing with uncertainty.

25. Paragraph 14 of IPSAS 3 states that:

> **In making the judgment, described in paragraph 12, management shall refer to, and consider the applicability of, the following sources in descending order:**
>
> (a) **The requirements in IPSASs dealing with similar and related issues; and**
>
> (b) **The definitions, recognition and measurement criteria for assets, liabilities, revenue and expenses described in other IPSASs.**

26. In the view of staff the reference to "other IPSASs" in paragraph 14(b) of IPSAS 3 should be modified to refer to the Conceptual Framework, because definitions of these elements are provided in the Framework.

27. In paragraph 15 of IPSAS 3 Staff consider that, in light of the publication of the Framework, the reference to the IASB's Conceptual Framework is no longer appropriate and should be deleted. Staff consider that the references to IFRSs, and Interpretations issued by the IASB's International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC) should be retained as these are useful sources for preparers to consider.

Matter for Consideration

2. The IPSASB is asked to **confirm** the proposed changes to paragraphs 12, 13, 14, and 15 of IPSAS 3; or **provide** alternative directions.

Replacement of term economic entity with group entity

28. In discussing the key characteristics of a reporting entity in Chapter 4, the Framework uses the term "group reporting entity". IPSAB's literature uses the term "economic entity", which is defined in IPSAS 1 as meaning "a group of entities comprising a controlling entity and one or more controlled entities." The term "economic entity" is used extensively throughout the suite of IPSASs and has most recently been used in IPSASs 34-38, *Interests in Other Entities*.

29. The Framework adopted a high level concept of the reporting entity derived from the objectives of financial reporting and acknowledged that this high level concept would be developed and fully explored at the standards level. In the view of Staff the definition of an economic entity is not at odds with the Framework. It is a term that has been in the literature since the first IPSASs were published in 2000 and reflected a view that a public sector specific term was appropriate to denote a controlling entity and one or more controlled entities. Nevertheless, Staff considers it

confusing to use different terms in the Framework and at standards level for what is the same phenomenon.

30. Staff therefore proposes that the defined term "economic entity" should be replaced with a definition of a group reporting entity as "a controlling entity and one or more controlled entity," and that references to an "economic entity" and the references to an "economic entity" should be changed to a "group entity."

Matter for Consideration

3. The IPSASB is asked to **confirm** that the defined term "economic entity" should be deleted from IPSAS 1 and replaced with a new defined term "group reporting entity" and that references to an "economic entity" should be changed to a "group entity"; or **provide** alternative directions.

Approach to Exposure of Proposed Changes

31. Staff consider that it would be most straightforward and cost efficient for both constituents and staff to include the proposed changes outlined in this Issues Paper in a broader Improvements ED, which will also include (a) minor changes derived from the IASB's ongoing Improvements project and (b) non-IFRS-related minor changes identified by members, staff and constituents.

Matter for Consideration

4. The IPSASB is asked to **confirm** the proposed approach for exposing changes arising from Chapters 1-4 of the Framework to public comment; or **provide** alternative directions.

Next Steps

32. If the IPSASB supports the changes identified in this Issues Paper the proposed changes to IPSAS and RPGs will be brought to the September 2015 meeting for approval and inclusion in the broader Improvements ED.

Appendix A

Summarization of QCs and Constraints in IPSAS 1

Qualitative Characteristics of Financial Reporting

This Appendix is an integral part of IPSAS 1.

The IPSASB issued Chapter 3, *Qualitative Characteristics* of the *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (the *Framework*) in January 2013. Chapter 3 details the qualitative characteristics (QCs) of information included in general purpose financial reports (GPFRs) and the pervasive constraints on information included in GPFRs.

The QCs in this Appendix continue to apply to existing pronouncements unless stated otherwise. The QCs in the *Framework* will be applied in the development of future pronouncements. Potential changes to pronouncements resulting from the issue of the *Framework*, including the potential withdrawal of this Appendix, will be considered following completion of the *Framework*.

Paragraph 29 of this Standard requires an entity to present information, including accounting policies, in a manner that meets a number of qualitative characteristics. This guidance summarizes the qualitative characteristics of financial reporting.

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability, and comparability.

Understandability

Information is understandable when users might reasonably be expected to comprehend its meaning. For this purpose, users are assumed to have a reasonable knowledge of the entity's activities and the environment in which it operates, and to be willing to study the information.

Information about complex matters should not be excluded from the financial statements merely on the grounds that it may be too difficult for certain users to understand.

Relevance

Information is relevant to users if it can be used to assist in evaluating past, present, or future events or in confirming, or correcting, past evaluations. In order to be relevant, information must also be timely.

Materiality

The relevance of information is affected by its nature and materiality.

Information is material if its omission or misstatement could influence the decisions of users or assessments made on the basis of the financial statements. Materiality depends on the nature or size of the item or error, judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic that information must have if it is to be useful.

Reliability

Reliable information is free from material error and bias, and can be depended on by users to represent faithfully that which it purports to represent or could reasonably be expected to represent.

Faithful Representation

For information to represent faithfully transactions and other events, it should be presented in accordance with the substance of the transactions and other events, and not merely their legal form.

Substance Over Form

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they be accounted for and presented in accordance with their substance and economic reality, and not merely their legal form. The substance of transactions or other events is not always consistent with their legal form.

Neutrality

Information is neutral if it is free from bias. Financial statements are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

Prudence

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or revenue are not overstated and liabilities or expenses are not understated.

However, the exercise of prudence does not allow, for example, (a) the creation of hidden reserves or excessive provisions, (b) the deliberate understatement of assets or revenue, or (c) the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

Completeness

The information in financial statements should be complete within the bounds of materiality and cost.

Comparability

Information in financial statements is comparable when users are able to identify similarities and differences between that information and information in other reports.

Comparability applies to the:

(a) Comparison of financial statements of different entities; and

(b) Comparison of the financial statements of the same entity over periods of time.

An important implication of the characteristic of comparability is that users need to be informed of the policies employed in the preparation of financial statements, changes to those policies, and the effects of those changes.

Because users wish to compare the performance of an entity over time, it is important that financial statements show corresponding information for preceding periods.

Constraints on Relevant and Reliable Information

Timeliness

If there is an undue delay in the reporting of information, it may lose its relevance. To provide information on a timely basis, it may often be necessary to report before all aspects of a transaction are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the decision-making needs of users.

Balance between Benefit and Cost

The balance between benefit and cost is a pervasive constraint. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a matter of judgment. Furthermore, the costs do not always fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information was prepared. For these reasons, it is difficult to apply a benefit-cost test in any particular case. Nevertheless, standard setters, as well as those responsible for the preparation of financial statements and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objectives of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

Appendix B

Extract from IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*

Accounting Policies

Selection and Application of Accounting Policies

9. **When an IPSAS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the Standard.**

10. IPSASs set out accounting policies that the IPSASB has concluded result in financial statements containing relevant and reliable information about the transactions, other events, and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave uncorrected, immaterial departures from IPSASs to achieve a particular presentation of an entity's financial position, financial performance, or cash flows.

11. IPSASs are accompanied by guidance to assist entities in applying their requirements. All such guidance states whether it is an integral part of IPSASs. Guidance that is an integral part of IPSASs is mandatory. Guidance that is not an integral part of IPSASs does not contain requirements for financial statements.

12. **In the absence of an IPSAS that specifically applies to a transaction, other event, or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:**

    (a) **Relevant to the decision-making needs of users; and**

    (b) **Reliable, in that the financial statements:**

        (i) **Represent faithfully the financial position, financial performance, and cash flows of the entity;**

        (ii) **Reflect the economic substance of transactions, other events, and conditions and not merely the legal form;**

        (iii) **Are neutral, i.e., free from bias;**

        (iv) **Are prudent; and**

        (v) **Are complete in all material respects.**

13. Paragraph 12 requires the development of accounting policies to ensure that the financial statements provide information that meets a number of qualitative characteristics. Appendix A in IPSAS 1 summarizes the qualitative characteristics of financial reporting.

14. **In making the judgment, described in paragraph 12, management shall refer to, and consider the applicability of, the following sources in descending order:**

    (a) **The requirements in IPSASs dealing with similar and related issues; and**

    (b) **The definitions, recognition and measurement criteria for assets, liabilities, revenue and expenses described in other IPSASs.**

15. **In making the judgment described in paragraph 12, management may also consider (a) the most recent pronouncements of other standard-setting bodies, and (b) accepted public or private sector practices, but only to the extent that these do not conflict with the sources in paragraph 14. Examples of such pronouncements include pronouncements of the IASB, including the *Framework for the Preparation and Presentation of Financial Statements*, IFRSs, and Interpretations issued by the IASB's International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).**