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PSAB Public Sector Accounting Board
CCSP Conseil sur la comptabilité dans le secteur public

June 7, 2011

Technical Director
International Public Sector Accounting Standards Board
International Federation of Accountants
277 Wellington Street West
Toronto, Ontario M5V 3H2 CANADA

Re: PSAB Staff Comments on Consultation Paper (CF-CP2) "Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements"

Thank you for the opportunity to provide input on the proposals in this Consultation Paper (CF-CP2). We feel that this is the critical piece of the conceptual framework project and potentially the one where there will be the most difficulty in garnering consensus. In particular, a decision regarding the approach to financial performance for public sector entities has the potential to fundamentally re-shape public sector generally accepted accounting principles (GAAP) depending on the direction chosen.

Responses to the Specific Matters for Comment in CF-CP2 are set out in Appendix A to this letter. Additional comments about the CF-CP2 by paragraph are provided in Appendix B.

Further, we wish to encourage the IPSASB to integrate the key characteristics of the public sector more fully into the final framework.

The key characteristics of the public sector are the primary reason that the IPSASB chose to do its own conceptual framework project rather than leveraging and converging with the evolving IASB-FASB private sector conceptual framework. Unique aspects of the public sector are mentioned in the CF-CP2 but their implications are not simply and fully set out. The "Key Characteristics of the Public Sector" Exposure Draft approved by the IPSASB at its March 2011 meeting is a critical, overarching umbrella document that needs to be explicitly linked to all phases of the framework. It is important that Phase 2 content not be finalized until such cross-references are incorporated. The key characteristics document should be the touchstone document in the CIA[1] parts of the IPSASB's timetable for the conceptual framework.

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[1] As defined in the IPSASB Conceptual Framework Timetable, CIA means: "consider issues arising from other phases of the project". It is scheduled to occur in June 2012 (Phase 1) and Dec 2012 (Phases 2-4).

We appreciate the opportunity to comment on this Consultation Paper. It is the most fundamental piece of an international public sector conceptual framework. We are very supportive of your conceptual framework initiative and wish you success in integrating this piece of the framework with the other phases and the key characteristics document.

Please note that these comments are the views of PSAB staff and not those of the Public Sector Accounting Board (PSAB). In addition, the comments made in this response are generally consistent with the existing conceptual framework in the Public Sector Accounting (PSA) Handbook. PSAB has initiated a project to review the concepts underlying financial performance in that framework and may be in a position to share developments in that project with the IPSASB in the future.

Sincerely,

Martha Jones Denning

Martha Jones Denning, CA
Principal
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Appendix A
Responses to Specific Matters for Comment

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?

Yes. But for unconditional rights to receive resources, it would seem most appropriate to only include those cases where the entity has paid for the unconditional promise or the rights develop an acknowledged market value while being held. When the unconditional promise to receive benefits is coupled with an equal unconditional promise to transfer economic resources to the supplier in the future, neither the asset nor the liability aspects of such executory contracts should be recognized.

Consider an unperformed executory contract to purchase a fire truck. Neither the fire truck nor the obligation to pay for the fire truck would be recognized. However, the executory contract itself might have value and that value may change before the contract is performed. The value of such a contract may have changed since the contract was signed – much liked a derivative contract, and it may be appropriate to recognize such value changes. Once a choice has been made to recognize such value changes for derivatives, then conceptually, it is difficult to exclude them for other contracts. However, we recognize that there are practical difficulties in applying such a concept to many executory contracts. In contrast to derivatives, there may not be an active market for such contracts so monitoring and recognizing value changes may be difficult and costly. And, there is typically less variability associated with such contracts, so the information that would come from re-measuring these contracts at each financial reporting period may not be that meaningful.

(b) What term should be used in the definition of an asset:
(i) Economic benefits and service potential; or
(ii) Economic benefits?

"Economic benefits" alone should be used. This term encompasses the concepts of both future net cash flow and future service potential. The benefit of future service potential is economic in nature as described in CF-CP2.

The two concepts don't need to be articulated separately. In cases where they have historically been set out separately, it is likely that the framework was an adaptation of a private sector framework and the public sector nuances were more in the nature of add-ons so that the differences and changes were apparent. In a purely public sector framework, it can be recognized that net cash flows and future service potential are both types of economic benefits and only the term "economic benefits" can be used to encompass both.

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?**

A control approach should be used to associate an asset with a specific entity.

While it is true that control may be difficult to apply in some cases because it requires judgment to ascertain the existence of control, indicators of control could be developed to assist in the judgment process. In addition, although control may be seen as applying to an asset as a whole, in reality the concept can be applied to individual rights that make up the whole. This idea can be illustrated by a components approach such as that taken in the Canadian PSA Handbook Guideline PSG-5, *Sale-Leaseback Transactions*[2] Further, the existing asset definition used by the Financial Accounting Standards Board (FASB) in the U.S. is a control-based definition. And yet the possibility of assets being separable into components parts is recognized in FASB CON 6, Appendix B, paragraph 185, which states:

> The definition of assets focuses primarily on the future economic benefit to which an entity has access and only secondarily on the physical things and other agents that provide future economic benefits. Many physical things and other agents are in effect bundles of future economic benefits that can be unbundled in various ways, and two or more entities may have different future economic benefits from the same agent at the same time or the same continuing future economic benefit at different times. For example, two or more entities may have undivided interests in a parcel of land. Each has a right to future economic benefit that may qualify as an asset under the definition in paragraph 25, even though the right of each is

[2] "The components approach assumes that the sale and leaseback can be separated objectively by comparing the terms and conditions of the sale-leaseback to its related fair value information. The comparison enables each component part of the transaction to be accounted for according to its economic substance. The components of a sale-leaseback transaction include the property, lease liability, revenues and expenses (including gains and losses), and any other assets or liabilities that may result from the transaction." PSG-5, *Sale-Leaseback Transactions*, paragraph 6.

> subject at least to some extent to the rights of the other(s). Or, one entity may have the right to the interest from an investment, while another has the right to the principal. Leases are common examples of agreements that unbundle the future economic benefits of a single property to give a lessee a right to possess and use the property and give a lessor a right to receive rents and a right to the residual value. Moreover, a mortgagee may also have a right to receive periodic payments that is secured by the leased property.

A risks and rewards approach requires an entity to dissect certain arrangements for the purposes of identifying the individual risk and rewards to make a determination of whether an asset is associated with an entity. It requires that an entity make an assessment of all related factors to determine whether the asset is of the entity. Without the anchor of control, it could result in range of possibilities given the varying degrees of risks and rewards associated with an asset.

We feel that the concepts of control and risks and rewards are not completely separable. Doesn't an entity that controls an asset have access to the rights and rewards of the asset and also bear the risk of loss associated with the asset? Is it not possible for an entity to control only part of a bundle of future economic benefits? We feel that the concepts used to associate an asset with an entity should be fairly comparable to the concepts used to include an entity in a group reporting entity. However, the asset definition will need to make the decision regarding the specifics of association at the concepts level whereas the specifics of association for the reporting entity have been left (in the Phase I ED) for consideration at the standards level. The high level concepts in the Phase I ED are "the authority and capacity to direct the activities of other entities" and "the capacity to benefit or be exposed to a financial burden or loss". We agree with this approach for the entity and feel that a similar approach is appropriate for associating an asset with an entity too. This approach might eventually result in a control approach to the entity as well at the standards level. For example, the PSA Handbook defines control for the purposes of its reporting entity standard as:

> "Control is the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities."

In associating an asset with an entity, IPSAS 23 states:

> "**Control of an asset** arises when the entity can use or otherwise benefit from the asset in pursuit of its objectives and can exclude or otherwise regulate the access of others to that benefit."

This IPSAS 23 definition can be built on for use in the new framework. It does not encompass the risk of loss that may be associated with control of an asset and that risk aspect needs to be added. It also does not recognize that the future economic benefits associated with an asset may be unbundled and controlled by more than one entity. These refinements might be appropriate in developing the asset definition for the public sector conceptual framework.

(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?

We feel that the requirement for an entity to have a legally enforceable claim in order to control access to the benefits may not, of itself, be considered an essential characteristic of an asset. However, the enforceability of the rights may be an appropriate indicator for linking a resource and a specific entity. See comments regarding "indicators of control" in (a) above.

The question in Matter 2 (a) uses the term "associate" and the question in Matter 2 (b) uses the term "link". We are not sure if the intent for each term is the same. Does "associate" mean that the concept will be included in the definition of an asset and "link" mean that the concept will be an indicator of whether an asset is associated with an entity? Or do they mean the same thing?

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

We do not suggest additional requirements. Rather we suggest development of indicators of control when control is defined as something that encompasses the following ideas:

> **Control of an asset** arises when the entity can use or otherwise benefit from the asset in pursuit of its objectives, can exclude or otherwise regulate the access of others to that benefit, and is exposed to any risk of loss related to the 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?

Yes – it is sufficient to state that an asset is a "present" resource.

However, the occurrence of a past transaction or event may be crucial evidence that prompts an entity to evaluate whether it has a present resource resulting from that transaction or event. Perhaps indicators that a public sector entity should consider in evaluating if it has a present resource to be recognized as a asset might be an option here (see same suggestion for liabilities below).

We do not believe that the role of a past transaction or event should be eliminated from the guidance surrounding the asset definition but do not believe that it is a defining characteristic of an asset.

<u>**Specific Matter for Comment 4**</u>

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?

Public sector entity rights and powers, such as the power to tax, only have the potential to create assets for the public sector entity when they are exercised. The power to tax represents an intention to levy tax in the future. It does not represent a present resource. An asset does not exist yet. Nor has there been a past transaction or event that would prompt an entity to look for the existence of an asset – that would only happen once the tax has been authorized and levied. The power to tax or license represents an ability to obtain assets by imposing taxes or fees but is not in itself an asset.

A power to tax or license is not a present economic resource because such powers are not capable of producing inflows of cash, cash equivalents or goods and services to the public sector entity nor are they yet capable of providing services to the entity or its constituents. Unless it has been exercised, the power to tax or license cannot be used for the production of goods, provision of services or consumption by the entity. It cannot be used to purchase goods or services or give an entity the right to receive goods or services or the right to use others' assets.

<u>**Specific Matter for Comment 5**</u>

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

No.

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

Consider possible linkages with the Exposure Draft, "Key Characteristics of the Public Sector", approved at the March 2011 meeting. For example, consider the effect of regulation and whether this government power has the ability to create assets or liabilities for the government. We don't believe it does but feel that explicit cross referencing with the Key Characteristics ED would strengthen the substance of the framework as one designed for the public sector. Perhaps each document issued could have a table that indicates the implications of the key characteristics for the principles set out in the document. This summary table could then be used when all of the pieces of the framework are put together to develop a matrix that outlines all of the implications of the key characteristics of the public sector.

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.

The definition of a liability should definitely include obligations to transfer benefits, defined as cash and other assets, and the provision of goods and services in the future, and performance obligations. The other two suggested types of obligations are more problematic and their inclusion in the scope of a public sector definition of a liability may not be appropriate. We share some of the concerns raised in the CP regarding their inclusion.

For the reasons set out in paragraphs 3.18-3.20, we do not feel that there is theoretical support for the definition of a liability to cover obligations to provide access to or forego future resources. In the example cited, it would seem that the government should recognize revenue for the lump sum sale of the right to charge a toll for use of the road.

We are also concerned with the notion that the liability definition could cover unconditional obligations, including unconditional obligations to stand ready to insure against loss (risk protection). We believe that the last sentence of paragraph 3.14 is correct to state that in the public sector in particular it may be difficult to draw a distinction between a conditional obligation and a stand-ready unconditional obligation.

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

Yes – the requirement for a settlement date should absolutely be an essential characteristic of a liability. One of the aspects that distinguish a liability from equity is the requirement for a settlement date. We feel that inclusion of the phrase “settlement on the occurrence of a specified future event” in the definition of a liability would address those situations, such as lawsuits, where the settlement date is not yet known.

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?

Yes. The obligation to sacrifice economic benefits must be to a third party. It is necessary that the entity or individual exist at the financial statement date. It is not necessary, however, for the public sector entity to know the specific identity of the party or parties involved, as the obligation may be to the public at large or to a specific group of recipients.

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

Yes. Liabilities are present obligations that embody a duty or responsibility to others, leaving a public sector entity little or no discretion to avoid settlement of the obligation. Having little or no discretion means that a government has no realistic alternative but to settle the obligation. The obligation does not depend on future actions of the government or other transactions or events. The government has given up its freedom to make further choices, judgments and decisions related to the obligation. The absence of a realistic alternative to avoid the obligation is a crucial line in the sand that helps determine when a public sector entity has a liability.

Discretion is the ability to make individual choices, judgments or decisions. Decisions such as budgeting for purchases or transfers and future program expenditures are not present obligations. In these circumstances a public sector entity is not bound to a particular course of action, as the entity has realistic alternatives to change or avoid the obligation through its own actions.

(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?

We agree with approach (c) in paragraph 3.28. The application of constructive obligations must be extended to non-exchange transactions. The key is when an entity cannot realistically withdraw from/avoid an obligation – and this is not conditional on whether the transaction is exchange or non-exchange in nature. However, we acknowledge that determining when discretion has been lost to avoid an obligation in relation to a non-exchange transactions may not be easy.

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?

We believe that it is the existence of the obligation at the financial statement date (i.e., a "present" obligation) that is the key factor.

Similar to our response to Matter 3 above, the occurrence of a past transaction or event may be crucial evidence that prompts an entity to evaluate whether it has a present obligation resulting from that transaction or event. Perhaps indicators that a public sector entity should consider in evaluating if it has a present obligation to be recognized as a liability might be an option here, as was suggested for an asset above. We do not believe that the role of a past transaction or event should be eliminated from the guidance surrounding the liability definition but do not believe that it is a defining characteristic of a liability.

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?

We believe that a government's responsibilities should only be considered obligations of the entity when they lead to enforceable claims. Government responsibilities change. Governments change on a regular basis and so do the programs they establish. Even those responsibilities considered to be "untouchable" are just programs and they can be changed or cancelled, albeit with some political fallout. The existence of a program/responsibility is not sufficient evidence of an obligation. At a minimum, some exercise of authority is required for a government to lose its discretion to avoid an obligation. Indicators such as those suggested in response to Matter 8 might help in ensuring that "perpetual obligations" are not even considered for recognition.

The measurement difficulties for "perpetual obligations" would likely be insurmountable and it would be difficult for such obligations to meet the qualitative characteristics of items to be reported in financial statements.

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

Yes, enforceability of an obligation is important. But we do not believe that it should be identified as an essential characteristic of a liability. It should instead be part of the guidance that explains what “no realistic alternative to avoid the obligation” means.

Enforceability should go beyond the contractual to include legal enforceability through other concepts such as promissory estoppel.

The inclusion of enforceability serves to emphasize the binding nature of the obligation and thus supports the contention that an entity has a liability. Enforceability often includes the notion of consequences for non-performance – explicit or implicit. Implicit consequences are those that are understood because of past experience between the parties to an obligation, or past behaviour of the obligor, and that have resulted in sanctions in the past so they would serve as well as explicit consequences to emphasize the binding nature of the obligation. Without such explicit or implicit consequences, a binding right is not obtained nor a binding obligation undertaken and performance requirements alone may merely reflect the intentions of the two parties rather than a firm commitment.

The notion of enforceability thus reinforces the “no realistic alternative to avoid the obligation” idea underlying the definition of a liability. So it is needed guidance but not an essential characteristic of a liability.

(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?

Yes. If the definition of a liability is that it is a “present” obligation, then there should be guidance explaining this concept that addresses the existence of sovereign powers. The existence of the power alone is not enough – it needs to be exercised at the financial statement date in order for it to have any impact on recognition in the financial statements. The power to repudiate an obligation in the future does not negate the fact that an entity may have a present obligation at the financial statement date. This position is consistent with that taken in this response regarding the power to tax or license and the “perpetual” responsibilities of government.

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?

No.

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

Consider possible linkages with the Exposure Draft, "Key Characteristics of the Public Sector", approved at the March 2011 meeting. Explicit cross referencing with the Key Characteristics ED would strengthen the substance of the framework as one designed for the public sector. Perhaps each document issued could have a table that indicates the implications of the key characteristics for the principles set out in the document. This summary table could then be used when all of the pieces of the framework are put together to develop a matrix that outlines all of the implications of the key characteristics of the public sector.

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)?

Revenues and expenses should be determined by changes in net assets, defined as resources and obligations during the current period derived from an asset and liability led approach. This is the current approach in the existing conceptual framework in the Canadian PSA Handbook. However, PSAB has initiated a project to review the concepts underlying financial performance in that framework and may be in a position to share developments in that project with the IPSASB in the future.

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

An asset and liability-led approach is grounded in the recognition of the substance of identifiable economic phenomena when they occur. This approach is most likely to provide the foundation for a theoretically sound, internally consistent set of public sector GAAP with the least inherent subjectivity. We agree with the points set out in paragraphs 4.24-.26 in the CP. We also offer the following elaborations and additional comments.

The FASB in its 1976 conceptual framework papers stated (emphasis added):

> A conceptual framework is a "constitution", a coherent set of interrelated **objectives** and **fundamentals** that can lead to <u>consistent standards</u> and that prescribes the nature, function and limits of financial accounting and financial statements. The **objectives** identify the goals and purposes of accounting. The **fundamentals** are the underlying concepts of accounting, concepts that guide the selection of events to be accounted for, the measurement of those events and the means of summarizing and communicating them to interested parties. <u>Concepts of that type are fundamental in the sense that other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting and applying accounting and reporting standards</u>.[3]

We are concerned that a revenue and expenses-led approach to financial performance may be a more ad hoc, less theoretically defensible basis for the standard setting process. It will fall to the Board to decide what goes into the categories of deferred inflows and outflows and this approach may be inherently subjective, somewhat arbitrary and the results may be inconsistent as these categories will be available for use by different Boards over time facing different issues and different controversies with its constituents. There is potential for these categories to become dumping grounds for items that a Board cannot achieve consensus for reporting in the statement of annual results.

If a revenue-expense-led approach is chosen, the IPSASB will need to establish:

- the basis for setting up a deferral (rules, criteria);
- the basis for recognizing a deferral in the statement of annual results (i.e., when, how and why to release deferrals for recognition in revenue and expenses);
- what the deferrals actually represent to users; and
- what the measures for each of the financial statements mean (i.e., individual financial statement indicators) given the possible variety of items included in the deferral categories.

Some of the arguments presented in favour of a revenue and expense-led approach to financial performance cite the importance of the matching of costs to the period services are provided and the related matching of revenues to the costs they were generated to finance, as well as the need to avoid the distortion of periodic

3 Conceptual Framework for Financial Accounting and Reporting: Elements of Financial statements and Their Measurement, FASB, December 2, 1976

results. The achievement of inter-period/generational equity is also cited as a reason for this approach to be adopted in the public sector so that governments can manage operations to meet this equity objective for the benefit of both current and future taxpayers.

Standards set using a revenue-expense-led approach may be based on practice, experience, and general acceptance that emphasizes a preference for matching and non-distortion of annual results. These concepts are open-ended. It is difficult to set any limits on them and it is a subjective assessment to determine if proper matching and non-distortion have been achieved. Although arguments may be made that a cost recovery or inter-period equity message is provided by the statement of annual results under this approach, what is being measured by the resulting statement of financial position would be difficult to identify.

Accounting must be neutral, and if financial statements are to represent faithfully an entity's annual results, the presence of volatility must be reported to users.

Minimizing the volatile results of actual economic events should be primarily a matter for government/management policy and strategy, rather than for accounting standards. To the extent volatile economic events actually occur, the results should be reflected in the financial statements. This is crucial if the objective of providing information in financial statements for accountability purposes is to be achieved.

Standards based on an asset and liability led view should not be rejected because their implementation might cause a government/entity’s management to make different decisions. One of the two primary reasons for the existence of financial information for users is to help them in making decisions. If stability or volatility of financial results is an important consideration to some users, all the more reason that the degree of stability or volatility should be faithfully reflected in the financial statements.

A February 9, 2011 speech by Hans Hoogervorst, incoming Chair of the IASB, to the European Commission on Financial Reporting and Auditing Conference stated some truths about accounting standard setting that should apply in the public sector too. He stated the following:

- “In my view, transparency is a necessary pre-condition of stability.”
- “Accounting standards can contribute to stability by enhancing transparency.”
- “Accounting standards can also be useful for stability purposes by avoiding artificial noise in the balance sheet and income statement.”

- "Stability should be a consequence of greater transparency rather than a primary goal of accounting standard setters."
- "What accounting standard setters can also not do is to pretend that things are stable when they are not."

An asset and liability-led approach is not a "balance sheet" view that aims to diminish the value of the annual results statement. The asset and liability-led approach is an annual results viewpoint with the discipline of having the annual surplus/deficit be the result of changes in assets and liabilities. Measuring annual results as the difference in net assets provides an anchor to resolving difficult accounting questions and the anchor to sound financial reporting. By ensuring that items that do not meet the definitions of assets and liabilities are not recognized on the statement of financial position, this approach also ensures that changes in these "*whatchmacallits*" do not flow through the operating statement and distort/manage annual results.

Matching is not an objective in itself nor is it a fundamental requirement of accrual accounting. The asset and liability-led approach to financial performance does allow matching as long as it does not create items on the statement of financial position that do not meet the definition of an asset or a liability.

The argument that a revenue-expense-led approach is necessary to achieve inter- period/generational equity generally looks at this equity from a very high level and with a forward-looking emphasis. The concept of inter-period/generational equity is usually described as evaluating the extent to which future taxpayers will have to deal with the fiscal consequences of current policies

We feel that the IPSASB needs to examine the concept of inter-period or inter-generational equity and its role, if any, in general purpose financial statements (GPFS) and general purpose financial reports (GPFRs) before it is incorporated into any IPSAS or other guidance issued by the IPSASB.

GPFS: The emphasis in the Canadian framework is to ensure that the full cost of services in the accounting period is reflected in the financial statements and that the full extent of a government's revenue raising for the period is reflected in the statements. **The question of cost recovery is a policy question and the standards do not presume that this is an objective in any particular year.** The extent of taxation and other revenue raising in a particular year is a public policy decision. The financing of government activities is not an accounting decision. The financial statements report the full extent of the government's revenue raising in the year, the full cost of services provided in the year, whether the government is maintaining its net assets in a particular year and the impact of the year's activities on the government's net debt as well as cash flow. Cost recovery is not an objective of the required financial statements in the PSA Handbook, and it is questionable whether such an assessment is possible at the high summary level of the financial statements.

At the whole of government reporting level, a cost recovery objective may be seen as requiring inter-generational or inter-period equity. Some argue that financial statements can provide information about whether inter-generational or inter-period equity has been maintained. And, balanced budget requirements and the matching of revenues and expenses are often seen as integral to maintaining such equity. If users say that they want inter-period equity, they mean it only in the simplest sense. And, they tend to mean not passing on a burden to their children – they don't consider that they might be paying for benefits received by past generations. Most discussions of inter-period or inter-generational equity are future-focused.

Inter-generational equity or even inter-period equity may be good concepts in theory but are very difficult to achieve in practice. **And again, a decision to manage government finances in order to achieve "inter-generational equity" or "inter-period equity" is a policy decision, not an accounting one. The financial statements cannot provide an assessment of whether this is achieved, nor should accounting standards make the assumption that this is government's intention.** In particular, assessments of such equity would go way beyond the operating statement of a government. Full information about the costs of services provided in a particular year might be good input into such an assessment and the extent to which a government is maintaining the net resources it needs to continue to provide services might also be good input information. But financial statements merely present a picture of what happened financially during the year (statement of operations, statement of change in net debt, statement of cash flow) and what resources/liabilities remain at the end of the year (statement of financial position). In Canada, government financial statements have a financial capital maintenance concept (in monetary terms – i.e., not adjusted for changes in purchasing power), which at most, tells users whether the government has maintained its net assets in financial terms after the activities of the accounting period have been taken into account. Good robust financial statements provide only part of the accountability picture for governments. Assessments of policy achievement and "inter-generational equity" or "inter-period equity" are beyond the scope of financial statements.

GPFRs: However, such assessments might not be beyond the scope of broader government accountability reporting. If the IPSASB believes that assessment of inter-period/generational equity is an objective of financial reporting (all financial reporting in the public sector not just governments) then it should explicitly address how and where such an assessment might be provided.

Finally, we do not believe that it is possible to define revenue and expenses without reference to change in assets. Even a liability definition generally refers to a sacrifice of economic benefits/resources.

Reed K. Storey in the FASB Special Report 181-C (January 1998) included the following quote:

> Every conceptual structure builds on a concept that has primacy. That is simply another way of saying some element must be given meaning before meaning can be attached to others. I contend that assets have that primacy. I have not been able to define income without using a term like asset, resources, source of benefits, and so on. In short, meaning can be given to assets without first defining income, but the reverse is not true. That is what I mean by conceptual primacy of assets. No one has ever been successful in giving meaning to income without first giving meaning to assets. [4]

Specific Matter for Comment 12

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

Yes. Transactions with residual/equity interests should be excluded from revenues and expenses.

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

No.

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?

No.

[4] Oscar S. Gellein, "Primacy: Assets or Income?" in *Research in Accounting Regulation,* vol. 6, edited by Gary John Previts (Greenwich, Connecticut: JAI Press, 1992), page 198

(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?

Consider possible linkages with the Exposure Draft, "Key Characteristics of the Public Sector", approved at the March 2011 meeting. Explicit cross referencing with the Key Characteristics ED would strengthen the substance of the framework as one designed for the public sector. Perhaps each document issued could have a table that indicates the implications of the key characteristics for the principles set out in the document. This summary table could then be used when all of the pieces of the framework are put together to develop a matrix that outlines all of the implications of the key characteristics of the public sector.

Specific Matter for Comment 14

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

No. Please see discussion of revenue/expense-led approach to financial performance in Matter 11 above.

(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.

If deferred inflows and outflows are to be reported on the statement of financial position, then they should be defined as separate components. It is important to keep the asset and liability definitions as pure as possible as these are concepts that transcend sector.

If deferred inflows and outflows are defined as separate elements then they can be explained separately and their contribution to financial position and results can be identified and evaluated. If they are defined as separate elements, then the standard setter can set requirements for what is included in each of these categories and when they are released for recognition in annual results.

(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?

Yes – they seem appropriate if such deferrals need to be defined as separate elements.

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?

Net assets/net liabilities are a residual amount and should not be defined as an element of financial statements.

(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?

We do not feel that the concept of ownership interests, such as those that relate to minority or noncontrolling interests in a GBE, should be incorporated in the element definition. Nor do we feel that minority or noncontrolling interests should be reported in government financial statements.

Although this is a standards level decision, we suggest that the IPSASB deal with non-controlling interests using proportionate consolidation. This approach means that minority or noncontrolling interests would not need to be incorporated in the element definition (if net assets/net liabilities were defined as an element).

If the IPSASB does not favour proportionate consolidation, then we would accept the approach set out in paragraph 5.27. That is, defining ownership interest as a separate element, which characterizes net assets/net liabilities as a residual amount that can be interpreted both as an amount available for financing future operations and ownership interests.

(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?

No.

Specific Matter for Comment 16

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

No.

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

The characteristics in paragraph 5.34 (a)-(d) seem appropriate.

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?

Recognition criteria should definitely not address existence uncertainty by basing the approach on the measurement attribute (i.e., the "situational" approach). This approach does not meet the qualitative characteristics of understandability to users unless all items are measured at fair value. This approach should not be adopted for a mixed measurement model.

Requiring a neutral judgment as to whether an element exists at the financial statement date based on an assessment of all available evidence is theoretically sound. However, we are not sure how consistent such an approach will be in application. Neutrality in judgment may be difficult to achieve and judgments may differ among individuals. We also appreciate the cost argument set out in paragraph 6.13 and the concern raised at the end of paragraph 6.12 around the possibility that items with a low probability of existence will be recognized when disclosure may be more appropriate. So this would be our second choice of the three approaches if a threshold approach is not adopted.

Ultimately, our first choice is a standardized threshold approach. We feel that it is the most pragmatic and simplest for users to understand. Consistent definitions of the thresholds and criteria for considering when those thresholds have been met in substance would amplify and assist in the application of this approach.

(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?

There should be a uniform threshold for both assets and liabilities. The threshold in the PSA Handbook, which is currently included in the asset and liability definitions and in the general recognition criteria, is "expected". FINANCIAL STATEMENT CONCEPTS, paragraph PS 1000.56 defines "expected" as:

> "Expected" is used with its usual general meaning and refers to that which can reasonably be anticipated, contemplated or believed on the basis of available evidence or logic but is neither certain nor proved. The use of the word in the recognition criteria is intended to acknowledge that economic activities occur in an environment characterized by uncertainty. It is not intended to accommodate the

> recognition of items that do not meet the definition of one of the elements of financial statements.

We suggest that separate criteria be established at the standards level to deal with contingent assets and liabilities rather than mixing the threshold for their recognition in with the threshold for assets and liabilities. This separation would be less complex and confusing for both users and preparers. The PSA Handbook does not yet address contingent assets. The threshold for contingent liabilities is “likely” and is explained in CONTINGENT LIABILITIES, Section PS 3300 as follows:

> The determination of whether a liability exists at the financial statement date depends on an assessment of the probability of a future event occurring or not occurring confirming that a liability existed at the financial statement date. The uncertainty relating to the occurrence or non-occurrence of the future event(s) can be expressed by a range of probabilities. Three areas of this range are as follows:
>
> (a) likely — the probability of the occurrence (or non-occurrence) of the future event(s) is high;
>
> (b) unlikely — the probability of the occurrence (or non-occurrence) of the future event(s) is slight; and
>
> (c) not determinable — the probability of the occurrence (or non-occurrence) of the future event(s) cannot be determined.

These Canadian thresholds (“expected” and “likely”) are both higher than that used by the IPSASB in its general recognition criteria – i.e., “probable”[5]. The threshold of “probable” has been defined to mean “more likely than not”, which could mean a percentage of 50.1%. This threshold encompasses assets and liabilities and contingent liabilities. The “likely” threshold used for contingent liabilities in the PSA Handbook is usually interpreted to mean greater than 70%. Thus the current International Public Sector Accounting Standards (IPSASs) would already require a public sector entity to recognize more assets, liabilities and contingent liabilities than the PSA Handbook.

We are not sure what threshold to suggest. We request that, if the IPSASB adopts a threshold approach or even a situational approach for the ED on Elements, that the document provide an analysis of the relative merits of/issues associated with, the different possible thresholds.

[5] Within the existing IPSASs, there is a possible inconsistency in interpretation of recognition thresholds in that the term “expected” is used in the element definitions and the term “probable” is used in the general recognition criteria. The term “expected” is not defined in the IPSASs. But probable is defined as “more likely than not”. It is not clear whether the same meaning is attributed to both terms.

Specific Matter for Comment 18

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

We tentatively accept that the general derecognition criteria should be the obverse of the general recognition criteria as a working premise, with the proviso that derecognition requirements for specific financial statement items at the standards level may need to address some unique circumstances and may in application be different than the recognition criteria for a particular financial statement item.

By agreeing, we reluctantly overcome our ingrained and comfortable tendency towards prudence regarding the derecognition of liabilities.

Specific Matter for Comment 19

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

The recognition criteria should not be an integral part of elements definitions. Instead, they should be separate and distinction requirements.

This approach gives the building blocks of the financial statements (the elements) more clarity regarding their nature and substance. It also ensures that any expectation of the inflow or outflow of economic resources can be clearly expressed and described only in one place in the standards. Right now, there are examples in some sets of standards where it is not clear whether the degree of expectation expressed in the elements definitions is the same as that expressed in the recognition requirements, particularly when contingent assets and contingent liabilities are considered.

Appendix B
Detailed PSAB Staff Comments on the Exposure Draft

Paragraph 2.1 – last sentence

This sentence may have to be revised depending on the decision made regarding the definition of deferred inflows and outflows as elements.

Paragraph 2.18 (e)

How can holding cash create net cash inflows – is this interest on the cash held?

Paragraph 2.30

Last sentence is confusing – maybe too many negatives?

Paragraph 2.39

Include assets held in right of the Crown? The rights associated with these should be enforceable – but not by contract.

Paragraph 3.26

Example in the middle of the paragraph is confusing.

Paragraph 4.8

Revenues recognized in the period in which they were intended to finance the related costs – is this association with costs really possible at the summary financial statement level for a national or sub-national government? For example, aren't taxes raised more generally than this?

Paragraph 4.21 – 2nd sentence

Add a "should". That is, "Further, the principle that taxpayers should pay only…".

Paragraph 5.37 – last sentence

Change "would up" to "wound up".