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30 April 2013

Dear Ms. Fox

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

The global organization of Ernst & Young is pleased to respond to the request of the IPSASB (or the Board) to comment on the above Exposure Draft (ED or proposal).

General comments

We support and commend the Board's efforts in developing an accounting conceptual framework specific to the public sector and its objective to set high-quality public sector accounting standards in order to strengthen transparency and accountability of public sector finances.

We would strongly encourage the Board to be closely connected to the development of the International Accounting Standards Board's (IASB) conceptual framework and consider the relevance and appropriateness of the decisions taken by the IASB for the IPSASB's conceptual framework. While we acknowledge that there will be some public-sector specific standards and requirements for public-sector transactions, the concepts underpinning the elements, recognition and measurement should be coherent and consistent between both frameworks.

We generally agree with the direction of the project except for the area highlighted below.

Defining deferred inflows and deferred outflows as separate elements

Although we understand the issue that the Board is seeking to address, we disagree with defining deferred inflows and deferred outflows as elements as described in paragraphs 5.1 – 5.6 of the ED and highlight some of the reasons here. More detailed discussion is included in our response to Specific Matter for Comment (SMC) 5 in the appendix to this letter.

We consider it important that the conceptual framework contains elements that represent real-world phenomena, rather than accounting constructs that do not exist in the real world.

Also, although the Board has attempted to limit the circumstances in which deferred inflows or deferred outflows arise (only from non-exchange transactions), the limitation serves to demonstrate that these resemble exceptions rather than defined elements developed on a sound conceptual basis.

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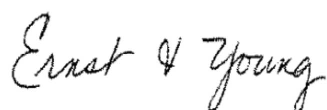
Time-based restrictions placed on inflows or outflows could provide entities with structuring opportunities to delay recognition of revenue or expenses. For example, an entity that received funding to undertake a particular project is not required to return the funds if they are not spent as specified. This 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, even though there is no obligation to return the funds if they are not spent during that period. Firstly, we are not convinced that there is any conceptual rationale that explains why the two types of restrictions should result in different accounting treatments. Secondly, it would be possible for an entity to negotiate a project-based restriction for a time-based restriction in order to achieve a desired accounting outcome, without changing the substance of the arrangement.

We would like to emphasize that concepts outlined in the conceptual framework should be applicable to a range of transactions and events. Further, principles in the conceptual framework should not be designed to accommodate or achieve specific outcome(s) for particular group(s) of transactions. We suggest that in instances where the Board believes departures from the principles in the framework are required; it would be more appropriate to deal with such departures at a standard level, rather than at the conceptual framework level.

Please find our responses to the specific matters for comments set out in the appendix to this cover letter. Should you wish to discuss the contents of this letter with us, please contact Thomas Müller Marqueś-Berger at (+49) 711 9881 15844 or Serene Seah-Tan at (+44) 20 7980 0625.

Yours faithfully



Appendix – Responses to the specific matters for comments

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

We agree with including both the notions of service potential & economic benefits into the definition of an asset. As mentioned in the Basis for Conclusions (BC) paragraph 8, there are different views on the meaning of these terms; therefore we agree that having both notions in the definition of an asset in the public sector context would encapsulate a public sector entity's objective(s) to deliver goods and services, and/or to generate net cash inflows. Nevertheless, we have included the following suggested clarifications to the discussion of *Assets* in section 2 of the ED:

- Paragraph 2.2 (4th sentence) states 'The benefits can arise directly from the resource itself or from the rights to the resource.' This sentence seems to have confused 'rights' with 'resources'. This is an important point when determining the *nature* of an entity's asset. Where an entity has the right to use a physical/intangible object, that right of use is the resource that the entity controls, not the object itself. This could be rectified by the following suggested wording 'The benefits can arise directly from the physical or intangible object itself or from the rights to the object.'

- In paragraph 2.6(b), the discussion of control is very 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 paragraph 2.6(b) is applied. We suggest rewording paragraph 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."

- We would also suggest that the Board discuss the issue of control over an entity in the body of the conceptual framework. We acknowledge that the Board is currently in the midst of the revision of IPSASs 6-8, but it would be useful to include a discussion on this issue, and the fact that it could differ quite significantly between jurisdictions. In practice, there are often difficulties in differentiating between 'administrative', 'operational', 'political influence' and 'judicial' control. For example, in countries where democracy is less mature or where the sovereign has extensive authority, it can often be difficult to determine control at the whole of government or federal government level. Hence a discussion of the key factors for preparers to consider when analyzing control as the basis for consolidation would be helpful.

- Paragraph 2.8 – the penultimate sentence sets out 4 points in time when an event gives rise to an asset of an entity. It is not clear what the difference is between events (c) and

(d) – can the entity have a right to collect tax before the other party has an obligation to pay tax? The last sentence in this paragraph indicates that event (c) gives rise to an asset, yet the other party has no obligation to pay tax if (d) has not occurred. If (c) and (d) are two distinct events that can happen at different points in time, does this mean that, for example, a local council announcing that the rates it will levy on ratepayers next year, creates a present right to collect those rates? Although, in general, the existence of an asset does not necessarily mean that a counterparty with a corresponding liability must also exist (and vice versa), in the specific example of taxes, if an entity has "exercised its power to create a right" to collect taxes (i.e. event (c) has occurred), it is unclear in what circumstances this event would occur earlier than event (d). Given the final sentence in paragraph 2.8 indicates that event (c) is the triggering event for an asset to arise, it would be helpful to clarify the distinction between event (c) and event (d).

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?

Before we get into the more specific question asked in SMC 2, we want to emphasize our strong support for the IPSASB re-starting its project on social benefits. We believe that the development of the elements phase of the conceptual framework is at an adequately mature stage for the Board to re-commence its discussion on social benefits.

Further, given that the key public sector issue in the liabilities area is whether a government has a liability for future social benefit payments, we would have expected clearer discussion in the conceptual framework. Nonetheless, we find the discussion of non-legal binding obligations helpful for users dealing with such a difficult issue. If the Board feels that it is not in a position to discuss the nature of social benefits within the conceptual framework at all, we would prefer the Board to avoid ambiguity in the discussion within the non-legal binding obligation section. In particular, paragraph 3.12, second sentence, appears to be suggesting that an obligation does not arise until a claimant has met the eligibility criteria. But this does not address:

- Situations where the meeting of that criteria is outside the entity's control – for example, if payment of a pension is dependent on the individual reaching the specified retirement age, it's outside the government's control whether or not citizens would live to reach the required age.
- Let's say a person meets the eligibility criteria (e.g. reaches retirement age), does that mean there is a liability for all future pension payments? Or has the Board taken the view that a person must keep on meeting that criteria (e.g. stay alive) for a liability for future payments to exist?

Although some might argue that the points in the bullets above are standards-level questions, it's one of the most significant unresolved issues in the public sector; we would have expected the conceptual framework to discuss the principles surrounding such 'non-

enforceable' obligations (social benefits encompassing for example health care and childcare benefits) that a government has to her citizens.

If the Board should decide that future social benefit payments, especially for pensions, are not present obligations of governments, this conclusion should be reconciled to why there is acceptance that entities have a present obligation for employee pension payments.

Also, the discussion of pensions above relate to the broader question of conditional versus unconditional obligations – if a future payment is subject to the counterparty first meeting specified conditions, does that mean that a present obligation does or doesn't exist? What if the meeting of those conditions is totally outside the entity's control?

Regarding the relationship between funding and the existence of a present obligation, paragraph 3.12(c) does not address the question of this link. Some proponents argue that future social benefit payments are not a present obligation because they are conditional upon the availability of funding at the time. In our view, the availability of funding to settle the obligation generally has no impact on whether a present obligation exists. An exception would be where a lack of funding is both likely and well-known, such that other parties do not expect the entity to be able to settle. In effect, this situation relates to paragraph 3.10(b) – for example, if it's well known that maintaining the current level of spending on pensions is unsustainable in the long term, it's likely that citizens may not expect to receive a pension (or the same amount of pension) in the future.

a) We generally agree with the definition but suggest some wording modifications to clarify what we thought is the intended meaning of the definition. The definition of liability could be better expressed if the reference to an 'outflow of service *potential* or *economic benefits*' be changed to 'outflow of resources (including services) from the entity'. It is the resource itself that is capable of being transferred and not the service potential or economic benefits of a resource.

Paragraph 3.7 on economic coercion – we suggest that the Board consider expanding the discussion to include the issue of political coercion, i.e. just because a government might feel politically compelled to do something, that doesn't mean that a present legal obligation exists. For example, pledging to provide funds to another party often does not give rise to a legal obligation to provide that funding.

The discussion of sovereign power in paragraph 3.9 is helpful, as this is a key difference between the public and private sectors. However, paragraph 3.9 appears inconsistent with paragraph 3.12(b). While paragraph 3.9 indicates that liabilities exist based on current legislation, paragraph 3.12(b) seems to imply that liabilities don't exist if the government can change the legislation before the obligation has to be settled. The discussion in paragraph 3.12(b) is also inconsistent with BC33.

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

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

As discussed earlier in our cover letter and further in our response to SMC 5 on deferred inflows and deferred outflows, we suggest modifying the definition of revenue and expenses by removing any references to deferred inflows and deferred outflows in the existing definitions in paragraphs 4.1 and 4.2.

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) As mentioned previously, although we understand the issue that the Board is attempting to address, we disagree with including these as elements in the conceptual framework, as we do not find the justification brought forward to define these as elements sound or convincing. One justification for deferred inflows and outflows is the passage of time. The existence of other elements in the framework is based on the occurrence of a past transaction of event. Deferred inflows and outflows arise as a consequence of time, and the reasons for delaying the recognition of these revenues and expenses, is so that they are used in the period specified by the transferor, but an entity need not use the resources in that period for revenue or expenses to be recognized in that period. This reinforces the view that control either existed (in the case of deferred inflows), or was lost (in the case of deferred outflows), in earlier reporting periods. This view is consistent with the dissenting view of Jeanine Poggiolini (alternative view (AV) 7-11).

Without reiterating all the points already made in the cover letter, we don’t believe that the limitation of circumstances in which deferred inflows and outflows arise would be sufficient to prevent entities from structuring and manipulating clauses in an arrangement to achieve a desired accounting outcome.

Additionally, using the passage of time to determine when debits are treated as deferred debits or expenses (or deferred credits or revenue) appears to be inconsistent with the views on the passage of time expressed in paragraph 3.8 – which states that ‘Claims that are unconditionally enforceable *subject to the passage of time* therefore *are* enforceable obligations in the context of the definition of a liability’ [emphasis added]. In order words, there seems to be an inconsistent application of the ‘passage of time’ requirement between

the definition of liabilities and deferred inflows and outflows. Also, flows resulting from exchange transactions that are deferred to specified future periods are not considered to be deferred flows. As such, the principle underlying the recognition of deferred inflows and deferred outflows seems unclear.

From the definition and example of deferred inflow and outflow (in paragraphs 5.2 & 5.4) a transferor who has already transferred a grant to a transferee, would not be recording that transfer upfront as an expense if there were restrictions on when the transferee can utilize the grant and vice versa. From a control perspective, it seems difficult to argue that the transferor still has control over the grant. Furthermore, would presentation of that outflow on the transferor's statement of financial position as a deferred outflow provide more useful information to a user? In particular, would it provide a representationally faithful presentation of the entity's financial position? Unless the transferor has 'clawback' provisions on the grant, (i.e. the grant is not unconditionally given to the transferee and the transferee has to refund the grant at any point in time that it breaks any clauses in the arrangement), it seems hard to argue that the transferor should not be recognizing a current outflow as an expense in the period that the grant is transferred, regardless of the period to which the grant relates.

Also, did the Board intend to convey the notion of 'continued involvement' from the transferor of the grant in the definitions of deferred inflows and outflows, i.e. the time-based restrictions on these flows indicate that control of the grants are not fully transferred until the transferee has unconditional rights to the grant? If so, wouldn't these be a subset of revenues/expenses, instead of elements in their own right?

Although accounting standards and practices sometimes result in deferred debits and credits being recorded on the statement of financial position, for various reasons, a conceptual framework should contain conceptual principles that are transaction neutral and applicable to a range of transactions and events, with necessary departures from the conceptual framework dealt with at the standards level.

Also, we find the justification in BC40-BC43 contradictory and unconvincing. For example, BC42 rejects a presentational approach, on the grounds that it would have to be considered at a standards-level, which might lead to inconsistency, while arguing in BC43 that it's necessary to include deferred inflows and outflows as elements to avoid such standards-level inconsistency. If it is valid to include guidance in the conceptual framework to avoid standards-level inconsistency, then why couldn't guidance on the presentational approach be included in the conceptual framework to avoid standards-level inconsistency?

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) As mentioned previously, we do not support defining deferred inflows and outflows as separate elements. Consequentially, it would not be necessary to include a definition for net financial position.

b) &c) We agree with the decision to define ownership contributions and ownerships distributions for the reasons in paragraphs 6.5 and 6.6. However, we believe this section can be further expanded to help users better distinguish the difference between when an owner is making capital contributions versus funding that should be treated as revenue. It is also unclear to us, whether the Board intended that in all circumstances, where a contributor does not have a right to a return on investment (as described in paragraph 6.7), that such contributions be treated as revenue?

d) The Board could consider providing a definition for ownership interests or expand on the discussion of ownership interests.

In distinguishing owners from non-owners, considering the right to a return is crucial, but equally important (perhaps more so after what was observed during the financial crisis on structured entities) that ownership not only give rise to rights to returns but also obligations on outstanding liabilities.

Specific Matter for Comment 7

Do you agree with the discussion on recognition? If not, how would you modify it?

This section discusses existence uncertainty and measurement uncertainty as recognition criteria, but it’s unclear whether there is any particular recognition threshold. It would be helpful if the IPSASB further explain existence uncertainty in the recognition criteria. In certain cases, it may be uncertain whether an asset or liability exists, therefore further guidance on whether an explicit probability threshold should be applied in such cases, what the threshold should be (e.g. virtually certain, probable) and whether the threshold for an asset should be the same as for a liability, would be helpful to constituents.

Further, the comments in paragraph 7.5 include reference to 'sufficient' but there is no indication of whether this is intended to create a recognition threshold. In particular, does it infer that an item should not be recognized if it cannot be measured with a 'sufficient' level of faithful representation? We also think that measurement uncertainty belongs in the measurement section of the conceptual framework (see our comment letter on ED 3 *Measurement of Assets and Liabilities in Financial Statements*), in helping entities choose between the different measurement attributes.