Office of the
Auditor General
of Canada

Bureau du
vérificateur général
du Canada

30 October 2020

International Public Sector Accounting Standards Board

International Federation of Accountants
277 Wellington Street West
Toronto, ON M5V 3H2

Re: Exposure Draft 72, *Transfer Expenses*

Thank you for the opportunity to comment on the above Exposure Draft. I am responding on behalf of the Office of the Auditor General of Canada.

We are pleased to submit to the Board our response below to the specific questions posed in the Exposure Draft.

Sincerely,

Lissa Lamarche, CPA, CA
Assistant Auditor General

Specific questions posed by IPSASB:

Specific Matter for Comment 1:

The scope of this [draft] Standard is limited to transfer expenses, as defined in paragraph 8. The rationale for this decision is set out in paragraphs BC4–BC15.

Do you agree that the scope of this [draft] Standard is clear? If not, what changes to the scope or definition of transfer expense would you make?

Yes, we agree that the scope of this [draft] Standard is clear.

Specific Matter for Comment 2:

Do you agree with the proposals in this [draft] Standard to distinguish between transfer expenses with performance obligations and transfer expenses without performance obligations, mirroring the distinction for revenue transactions proposed in ED 70, *Revenue with Performance Obligations*, and ED 71, *Revenue without Performance Obligations*?

If not, what distinction, if any, would you make?

No, we do not agree with the proposals in this [draft] Standard to distinguish between transfer expenses with performance obligations and transfer expenses without performance obligations. We do not think that any distinction should be made when accounting for transfer expenses. In our view transfer expenses with performance obligations should be accounted for in the same way as transfer expenses without performance obligations. We think that making a distinction between transfer expenses with performance obligations and without performance introduces unnecessary complexity both from an accounting and budgeting perspective.

IPSAS 23 distinguished between exchange and non-exchange transactions as the primary determination of accounting treatment which was often difficult to apply in practice. As discussed below, we find that the distinction in this [draft] Standard between transfer expenses with performance obligations (when transferring goods or services to a third-party beneficiary) and transfer expenses without performance obligations will also be difficult to apply. In Canada, public sector standards treat all transfer expenses in the same way. Once paid, all transfers are expensed, with no possibility for deferral by the transfer provider.

While consistent with the approach taken for the revenue side, we find that this distinction from the transfer provider perspective may not faithfully represent the substance of the underlying transaction, especially if the transfer recipient is using this funding to fulfill its stated mandate. In addition, we think that this approach to single out transfer expenses with performance obligations may open the door to accounting for expenses as assets by the transferor until the transfer recipient has delivered on its objectives. Third-party beneficiaries are often the recipients of goods and services from government programs. Conceptually, we do not see a difference in the substance of the underlying transaction of providing a good or service to a third-party beneficiary versus providing a good or service that benefits third-parties but that are not specifically named in a binding arrangement.

For example, we do not see why a transfer from a government to a housing corporation to provide housing to third-party beneficiaries should be treated differently than a transfer from a government to a housing corporation to provide social housing programs as in both cases third-parties benefit from the government program. Under the proposal, the transfer expenses in the first scenario would be accounted for as a transfer expense with performance obligations (assuming monitoring occurs) whereby the expense would be recognized as the performance obligation is satisfied whereas the second example would be accounted for as a transfer expense without performance obligations whereby the expense would be accounted for at the earlier of

when the transfer provider has a present obligation and when the transfer provider has lost control of the resources. We do not think that these scenarios should be accounted for differently when in reality the objectives of the funding government and transfer recipient are fundamentally the same.

We also see a lack of clarity around whether transfer expenses with performance obligations preclude situations where the transfer provider transfers cash to a transfer recipient that will then distribute that cash to a third-party beneficiary to be used to acquire a good or service. For example, the Government provides funding to a transfer recipient that provides cash benefits to third-party beneficiaries under a government program, other than a social benefit program. It is unclear why that scenario would be accounted for differently from a scenario where the transfer recipient provides a good or service directly to a third-party beneficiary under a government program.

ED 72.10 specifies (emphasis added) that the transfer recipient provides <u>goods or services</u> to a third-party beneficiary and goods or services are included in the definition of a transfer expense in ED 72.8 with a footnote that says that references to goods or services are to be read as incorporating references to assets - of which cash is an asset. However, ED 70 does not appear to include binding arrangements for the transfer of cash and thus it is unclear if ED 72 is meant to include the transfer of cash for a transfer expense with performance obligations. Therefore, we think that the IPSASB should clarify whether transfer expenses with performance obligations are meant to include transfers of cash to third-party beneficiaries.

Related to this lack of clarity, we also see practical difficulties in applying this [draft] Standard when multiple levels of government are involved with an ultimate third party beneficiary. For example, the Canadian Federal Government provides funding to a province who provides funding to a provincial agency that ultimately provides goods or services to a third party beneficiary. It is unclear how the [draft] Standard would be applied when determining whether this is a transfer expense with performance obligations or not.

One final area to note is the possible impact on the government's budgeting process. We think the proposals in this [draft] Standard will introduce unnecessary complexity in the budgeting process because the transfer provider would now be dependent on the actions of the transfer recipient to determine the timing of transfer expense recognition.

In conclusion, we find that the proposed distinction introduces additional complexity in accounting for transfer expenses which may not justify the benefit for the reasons outlined above. We question whether this distinction would represent faithfully the substance of the underlying transaction and would lead public sector entities to amend their binding arrangements to specify third-party beneficiaries in order to achieve a desired accounting outcome. We think that the [draft] Standard attempts to stretch the definition of an asset in order to force symmetrical accounting and does not consider substance over form when accounting for transfers. We would encourage the IPSASB to reconsider its proposal in this area.

Specific Matter for Comment 3:

Do you agree with the proposal in this [draft] Standard that, unless a transfer provider monitors the satisfaction of the transfer recipient's performance obligations throughout the duration of the binding arrangement, the transaction should be accounted for as a transfer expense without performance obligations?

No, we do not agree with the proposal that, unless a transfer provider monitors the satisfaction of the transfer recipient's performance obligations throughout the duration of the binding arrangement, the transfer should be accounted for as a transfer expense without performance obligations because we think that all transfers should be accounted for in the same way. As noted in our response to Specific Matter for Comment 2, we do not think that a distinction should be

made between transfer expenses with and without performance obligations and we do not think that monitoring should be linked to the concept of control.

Furthermore, we note that ED 72.13(d), AG27, and BC38 seem to imply that monitoring of the satisfaction of the transfer recipient's performance obligations throughout the duration of the binding arrangement is the choice of the transfer provider. If the entity does not choose to monitor satisfaction of the transfer recipient's performance obligations, the transfer is accounted for as a transfer expense without performance obligations. We think this approach introduces the ability for a public sector entity to alter its operating results by choosing or not choosing to monitor satisfaction of a transfer recipient's performance obligations.

In BC53, IPSASB concluded that a resource would never be controlled by the transfer provider in a binding arrangement that requires a transfer recipient to construct an asset (assuming no third party beneficiary). However in BC31, a transfer provider does control a resource that is an enforceable right under a binding arrangement to have goods or services transferred to a third party beneficiary because the "transfer provider will have the means to ensure that the resource is used to achieve the transfer provider's objectives". We think the same argument used to support asset recognition in the case where there is a third party beneficiary could be applied in the first instance and thus there is an inconsistency of the definition of control being applied in these two transfer type scenarios; we do not believe that the case for control has been made in either fact pattern.

In our view, the existence of a third-party beneficiary does not change the relationship between the transfer provider and the transfer recipient and thus should not lead to a different accounting treatment. We note, however, that IPSASB's conclusion with respect to whether control exists is further dependent on whether the transfer provider chooses to monitor the satisfaction of the performance obligations. The argument seems to further link the concept of control to the monitoring criterion because without it, the transfer provider is required to account for the resource as a transfer expense without performance obligations (i.e. no control exists). For asset recognition, we believe that linking monitoring to control in this manner equates to determining control on the basis of whether an entity chooses to exercise control or not. Control should be independent of whether or not an entity chooses to exercise its control. In other words, control is a matter of fact and should not be determined based on a choice as this could lead to manipulation or bias in financial reporting. We encourage IPSASB to reconsider whether allowing the transfer provider to decide to exercise control or not conflicts with the theory underlying the asset definition.

Notwithstanding our position on monitoring, the proposal does not mention the level of monitoring required nor provide any guidance on this important element. We think that some public sector entities may be biased to recognize an asset for transfer expenses when it suits them and thus it would be important for the IPSASB to provide sufficient guidance around the issue. We believe this should include the level and detail of monitoring that would be required in order to ensure that it is consistently applied only when certain elements are present to avoid the manipulation of results to achieve a desired outcome. At a minimum, we think IPSASB should consider articulating the following aspects with respect to monitoring in the illustrative examples:

- The type of monitoring that would be considered acceptable and how it would be evidenced. For example, whether the third-party beneficiary would need to attest to the performance or whether attestation from the transfer recipient would be sufficient.
- Whether the monitoring activities would need to be detailed in the binding arrangement or whether they could be detailed outside of the binding arrangement.
- Distinguishing "monitoring activities" from standard reporting clauses in binding arrangements.

Finally, should the IPSASB decide to continue with its proposal to account for transfer expenses with performance obligations and monitoring when (or as) the transfer recipient satisfies the performance obligation, we recommend that the IPSASB include a requirement for a transfer

provider to decide its approach to monitoring at the inception of the transfer and consistently apply that approach for the duration of the arrangement. We think this approach will help prevent transfer providers from changing their accounting by stopping and restarting the monitoring of a recipient's progress with its performance obligation.

Specific Matter for Comment 4:

This [draft] Standard proposes the following recognition and measurement requirements for transfer expenses with performance obligations:

(a) A transfer provider should initially recognize an asset for the right to have a transfer recipient transfer goods and services to third-party beneficiaries; and

(b) A transfer provider should subsequently recognize and measure the expense as the transfer recipient transfers goods and services to third-party beneficiaries, using the public sector performance obligation approach.

The rationale for this decision is set out in paragraphs BC16–BC34.

Do you agree with the recognition and measurement requirements for transfer expenses with performance obligations? If not, how would you recognize and measure transfer expenses with performance obligations?

We do not agree with the recognition and measurement requirements for transfer expenses with performance obligations. As stated earlier, we think that all transfer expenses should be accounted for in the same way. In our view transfer expenses with performance obligations should be accounted for in the same way as transfer expenses without performance obligations.

The Public Sector Performance Obligation Approach proposed in the ED makes a direct link between the transfer provider and the third-party beneficiary that is receiving the good or service. Unlike the link between a purchaser of goods or services and a provider of goods or services, there is no direct link between a transfer provider and a third-party beneficiary who is not a party to the binding arrangement. In order to contemplate whether the definition of an asset is met, we think that a direct relationship is necessary. In the absence of a direct relationship, the transferring government does not receive economic value in return for the transfer. In addition, by linking expense recognition to the achievement of a transfer provider's objectives, it may open the door to the recognition of other government expenses as assets until such time as the government has met its objectives.

The IPSAS Conceptual Framework defines an asset in paragraph 5.6 as a "resource presently controlled by the entity as a result of a past event." ED 72.BC28 argues that since "the goods or services being transferred will allow the transfer provider to meet its objectives", the "right to have goods or services transferred to the specified third parties will satisfy the definition of a resource as that right will be an item with service potential". BC 31 goes on to state that control arises from the "enforceable right under the binding arrangement" which provides the transfer provider with "the means to ensure that the resource is used to achieve the transfer provider's objectives". In our view, this argument around control could be equally argued for a transfer expense without performance obligations and thus we do not see justification for a difference in accounting treatment. In fact, we find that the rationale provided that justifies recognition of an asset stretches the definition of an asset and could be used to justify the recognition of other government expenses, which allow the transfer provider to meet its objectives, to be recognized as assets until the objectives have been met.

While we agree that the transferring government might control the funding itself, we do not support accounting for the funding differently depending on whether the transfer has performance obligations to third parties or not. In addition, we do not agree that a right to have resources delivered to a third-party represents an item with service potential for the transferring government as outlined in paragraph 5.7 of the IPSAS Conceptual Framework as there is no direct economic

benefit to the transfer provider as a result of the transfer. While we agree that a good or service provided to a third-party enables an entity to achieve its objectives, we do not agree that the right to have goods or services transferred to a third-party embodies that same service potential nor should be used to justify recognition of an asset once payment has been made. As a result, we do not agree that the definition of an asset is met for the transfer provider.

Notwithstanding our position on this matter that all transfer expenses with or without performance obligations meet the definition of an expense rather than an asset, we would prefer that IPSASB use the “other resource” category outlined in the Conceptual Framework if they wish to pursue this accounting. We find this approach to be more transparent than trying to stretch the definition of an asset.

We note, however, that AG95 does allow for the recognition of an asset by a transfer provider in the narrow circumstance whereby a transfer provider retains control of the resource prior to the point in which the transfer provider has a present obligation to make the payment. With the exception of this narrow circumstance, we do not agree that an asset should be recognized for any transfers once payment has been made.

Specific Matter for Comment 5:

If you consider that there will be practical difficulties with applying the recognition and measurement requirements for transfer expenses with performance obligations, please provide details of any anticipated difficulties, and any suggestions you have for addressing these difficulties.

As noted in our response to Specific Matter for Comment 2 and 3, we think there will be practical difficulties as follows:

- Distinguishing between transfer expenses with and without performance obligations when the transfer recipient is simply fulfilling its mandate. We also see practical difficulties in applying this [draft] Standard when multiple levels of government are involved with an ultimate third party beneficiary. For example, the Canadian Federal Government provides funding to a province who provides funding to a provincial agency that ultimately provides goods or services to a third party beneficiary. It is unclear how the [draft] Standard would be applied when determining whether this is a transfer expense with performance obligations or not. We do not think that such a distinction should be made as it may result in different accounting for transfers that are substantively the same.
- Monitoring the satisfaction of the transfer recipient’s performance obligations. Additional guidance should be provided to clearly distinguish between the level and nature of monitoring.

We also find that the structure of the standard is cumbersome and difficult to follow given the volume of requirements devoted to accounting for transfer expenses with performance obligations. We think there may be an opportunity to further streamline the standard.

Specific Matter for Comment 6:

This [draft] Standard proposes the following recognition and measurement requirements for transfer expenses without performance obligations:

(a) A transfer provider should recognize transfer expenses without performance obligations at the earlier of the point at which the transfer provider has a present obligation to provide resources, or has lost control of those resources (this proposal is based on the IPSASB’s view that any future benefits expected by the transfer provider as a result of the transaction do not meet the definition of an asset); and

(b) A transfer provider should measure transfer expenses without performance obligations at

the carrying amount of the resources given up?

Do you agree with the recognition and measurement requirements for transfer expenses without performance obligations?

If not, how would you recognize and measure transfer expenses without performance obligations?

Yes, we agree with the recognition and measurement requirements for transfer expenses without performance obligations. However, we view this circumstance as a narrow exception. As such, we think that IPSASB should more clearly define the circumstances in which this prepayment would apply otherwise we see a risk of manipulating the clauses of agreements in order to avoid recording an expense right away.

However, we note that paragraphs 98 and 99 as well as paragraphs AG98 to AG102 of ED 72 address transfer expenses without performance obligations subject to appropriations, requiring the transfer provider to consider substance over form in determining whether it has a present obligation to transfer resources prior to the appropriation being fully authorized. As noted in our response to Specific Matter for Comment 8, the authority to pay has been a particularly challenging area under Canadian public sector accounting standards. We think that IPSASB should consider explicitly linking the concepts in this ED to the additional guidance found in Chapter 5 of the IPSAS Conceptual Framework which discusses liability recognition.

While we acknowledge that this ED provides some guidance in this area, we find that the guidance and illustrative examples do not go far enough to help users sufficiently make the substance over form assessment. The illustrative examples seem to be very black and white when in reality the situations are not as clear. We think that the IPSASB should expand the guidance and develop more illustrative examples to include factors that could be considered when assessing substance over form rather than simply referring back to the standard which does not provide further application guidance. Without such guidance, we believe this could lead to differences in application and interpretation similar to what we have seen in the past for entities following Canadian public sector accounting standards.

Specific Matter for Comment 7:

As explained in SMC 6, this [draft] Standard proposes that a transfer provider should recognize transfer expenses without performance obligations at the earlier of the point at which the transfer provider has a present obligation to provide resources, or has lost control of those resources. ED 71, *Revenue without Performance Obligations*, proposes that where a transfer recipient has present obligations that are not performance obligations, it should recognize revenue as it satisfies those present obligations. Consequently, a transfer provider may recognize an expense earlier than a transfer recipient recognizes revenue.

Do you agree that this lack of symmetry is appropriate? If not, why not?

Yes, we agree that this lack of symmetry is appropriate.

In our view symmetrical accounting should not be the focus since a transfer provider and a transfer recipient may not have the same evidence to support recognition of revenue or expense. The recognition of revenues and expenses should reflect the substance of the transaction from the viewpoint of each party involved which may not result in symmetrical accounting.

Specific Matter for Comment 8:

This [draft] Standard proposes that, when a binding arrangement is subject to appropriations, the transfer provider needs to consider whether it has a present obligation to transfer resources, and should therefore recognize a liability, prior to the appropriation being authorized.

Do you agree with this proposal?

If not, why not? What alternative treatment would you propose?

Yes, we agree with this proposal.

We are pleased to see that the IPSASB has specifically addressed appropriations in the proposed standard as this is a particularly challenging issue for Canadian public sector entities. While the ED provides some guidance in relation to the need to assess substance over form, we find that it does not go far enough as noted further in our response to Specific Matter for Comment 6 above.

The illustrative examples (IE188 – IE192) seem to be black and white and thus it is difficult to see what factors were considered when assessing substance over form in the various circumstances.

In the Canadian Federal Government, it is customary for multi-year funding arrangements to include an appropriation clause, which typically states that future transfers under the agreement are subject to there being a Parliamentary appropriation for the fiscal year in which the payment is to be made. There has been much debate as to whether this clause has substance when the government has always paid once the recipient has met its obligations under the arrangement. One could conclude that form does not equal substance unless the government has previously not paid. One could equally conclude that form equals substance until the government has acted in a way that would lead you to conclude otherwise. The accounting treatment is very different depending on the perspective taken.

We also note that in some Canadian jurisdictions it is common for governments to fund large infrastructure projects over periods far longer than the period for which eligible expenditures might occur. For example, a government may fund an infrastructure project for the next 20 years that is subject to an annual appropriation. Eligible expenditures under the agreement occur over 5 years. The transfer provider recognizes 1/20 of the funding each year for 20 years, whereas the eligible expenditures were incurred in years 1 to 5 and it is a matter of public record that the government funded the project. When the government has always paid the transfer recipient under these large infrastructure projects, it is a matter of public record that the government has provided funding for the project, and the eligible expenditures have already been incurred, these circumstances may be an indication that the government has lost control of the transfer and thus the appropriation clause has no substance.

We think that the IPSASB should further explore these and similar situations in order to develop some helpful criteria for assessing whether appropriation clauses in binding arrangements have substance or not. As noted in our response to Specific Matter for Comment 6, we think that IPSASB should consider explicitly linking the concepts in this ED to the additional guidance found in Chapter 5 of the IPSAS Conceptual Framework which discusses liability recognition. Without such additional guidance on assessing substance over form, the principles will be difficult to apply consistently in practice.

Specific Matter for Comment 9:

This [draft] Standard proposes disclosure requirements that mirror the requirements in ED 70, *Revenue with Performance Obligations*, and ED 71, *Revenue without Performance Obligations*, to the extent that these are appropriate.

Do you agree the disclosure requirements in this [draft] Standard are appropriate to provide users with sufficient, reliable and relevant information about transfer expenses? In particular,

(a) Do you think there are any additional disclosure requirements that should be included?

(b) Are any of the proposed disclosure requirements unnecessary?

We have no comments on this Specific Matter for Comment.

Other considerations:

Structure of the [draft] Standard:
We agree with the approach taken in the ED and that the structure and broad principles and guidance are logically set out with the exception that some improvements could be made to the references within the ED. For example, the [draft] Standard itself sometimes makes reference to application guidance paragraphs, but not in all cases. One such example is ED 72.AG24-AG25 which covers paragraphs 11-89 but there is no cross-reference to these application guidance paragraphs in any of those paragraphs within the [draft] Standard. We think it would enhance clarity if there were two-way references between the [draft] Standard and the application guidance section in all cases. This would help users more easily navigate and apply the [draft] Standard. Consideration could also be given in doing the same thing with the illustrative examples.

Other editorial comments:
In IE190-192, there appears to be a typo in the paragraph references. The reference to paragraphs 91-97 should be 91-99.