THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

Response from
The Institute of Chartered Accountants of Scotland to the
International Public Sector Accounting Standards Board

CONCEPTUAL FRAMEWORK: ELEMENTS AND RECOGNITION IN FINANCIAL STATEMENTS

15 June 2011

INTRODUCTION AND KEY POINTS

Introduction

The Public Sector Committee of The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to comment on the International Public Sector Accounting Standards Board's (IPSASB's) consultation paper "Conceptual Framework for general purpose financial reporting by public sector entities: elements and recognition in financial statements". The Public Sector Committee is a broad based committee of ICAS members with representation from across the public services.

The Institute's Charter requires its Committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key points

- While we understand that the IPSASB conceptual framework project is not a convergence project, we would support a Conceptual Framework for public sector entities which only departs from the IASB's Conceptual Framework in areas where there is a clearly justified public sector specific reason for doing so. The timing of the IPSASB project means that key decisions about the Conceptual Framework may be made in advance of commentators' deliberations and IASB decisions regarding its developing Conceptual Framework and as such there may be a risk that the IPSASB Conceptual Framework does not fully reflect these wider deliberations. For example, an IASB discussion paper on Phase B of its conceptual framework project is expected in June 2011, six months later than the publication of this consultation paper on the same topic. We would therefore prefer publication of an exposure daft by the IPSASB on 'Elements and Recognition in Financial Statements' to include consideration of any material published by the IASB in relation to Phase B of its conceptual framework project.

- In our responses, we have attempted to identify and draw attention to developments relating to the IASB's conceptual framework project, highlighting how we perceive these should influence the IPSASB's conceptual framework project. One area where we believe that the direction of travel of the IASB may not be suitable for the public sector is its tentative working definition of an asset: We favour the control approach rather than the access rights approach, favoured by the IASB, which tends to focus more on the legal form of a transaction than on its substance.

Our responses to the specific matters for comment are set out in the following section of our exposure draft.

COMMENTS ON THE CONSULTATION PAPER

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?

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

Response

(a) We agree that the definition of an asset should cover the types of benefit listed in specific matter for comment 1.

(b) We support the use of economic benefits and service potential in the definition of an asset, rather than the single term economic benefits. We understand the reasons why some standard setters encompass service potential within their definition of economic benefits. However, we believe that for public sector entities service potential is a key feature of their asset base.

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?

(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?

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

Response

(a) The intention of the IPSASB's exposure draft on "Service concession arrangements: grantor" (February 2010) is to mirror Interpretation 12 of the International Financial Reporting Interpretations Committee "IFRIC 12: service concession arrangements", which gives guidance on the accounting by operators in service concession arrangements. In mirroring IFRIC 12 the proposed IPSASB standard uses the control approach. We supported this approach in our submissions to the IPSASB on service concession arrangements and believe it better reflects the substance of service concession arrangements relative to the risks and rewards approach. We continue to support the control approach.

(b) We understand that the IASB, in taking forward other aspects of its conceptual framework project, may move away from the control approach to one that is based on legal ownership and which would be consistent with the approach referred to at (a)(iii) of specific matter for comment 2.

The IASB, in agreement with FASB, have tentatively adopted the following working definition of an asset for its conceptual framework project:

"An *asset* of an entity is a present economic resource to which the entity has a right or other access that others do not have."

Although we would favour consistency between the IPSASB's Conceptual Framework and the IASB's Conceptual Framework we do not believe that an approach based on legal ownership would have the desired impact on public sector entity financial statements. We also do not agree with the argument that standards should be developed to avoid difficult judgements: making judgements is a key aspect of the role of the professional accountant.

(c) We have no other comments on specific matter for comment 2.

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?

Response
We would be comfortable if the definition of an asset referred to the occurrence of a past event, as in reality we believe the occurrence of a past event would be inevitable. However, the IASB's tentative working definition of an asset indicates that current thinking is moving away from reference to the occurrence of a past event. Therefore, we would prefer the definition of an asset which is consistent with the IASB's definition, when that is finally determined.

Specific matter for comment 4
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?

Response
We would tend to support a 'power view' rather than a 'rights view' with reference to the creation of an asset. In the example given, we believe that a government entity would need to exercise its power to levy a tax before an asset (i.e. a debtor) could be created. We do not agree that the right of an entity to future benefits from taxes creates an asset. Issues not dealt with in this consultation paper would arise surrounding the completeness and collectability of the resulting debtor.

Specific matter for comment 5
(a) Are there any additional characteristics that have not been identified that you believe are essential to the development of an asset definition?

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

Response
We have no other matters to raise on the definition of an asset.

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.

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

Response

(a) We believe the definition of a liability should only cover obligations to provide assets to or forego resources. In our view the recognition of other types of obligations would distort the reported performance and financial position of public sector entities.

(b) We do not believe that the requirement for a settlement date is an essential characteristic of a liability. We believe that this would lead to public sector entities understating their liabilities.

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?

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

(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?

Response

(a) We believe that there are likely to be circumstances where an entity is obligated to a specific party but does not know the identity of that party, for example, in the UK the health service provides for incidents incurred but not reported which may give rise to a medical negligence claim under IAS 37 'Provisions, contingent liabilities and contingent assets'. In such circumstances it may not always be possible to identify who may submit a claim as a result of an incident.

We do not agree that the example given, in paragraph 3.25, of a liability being due where there is no identified party outside the reporting entity is a robust one. The scenario would not appear to us to give rise to a liability even if a contractor had been identified. If a reporting entity has environmental responsibilities, expenditure in meeting those responsibilities would be part of its ongoing activities with no obligation to transfer resources to the contractor until the contractor undertaking the work had fulfilled their contractual obligations. If a reporting entity has received a fine for creating environmental damage, then a liability would arise at a point in the legal process and the fine would be payable to the court.

(b) We agree that the absence of a realistic alternative to avoid the obligation is an essential characteristic of a liability.

(c) We believe that the second approach in paragraph 3.28 is appropriate for public sector entities. We do not believe the first approach is correct as it would exclude constructive obligations which are not legally enforceable. However, we envisage that a constructive obligation which is not legally enforceable is one which a public sector entity could not realistically withdraw from. We do not believe the third approach is correct and this could encompass political commitments which we do not believe should give rise to liabilities.

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?

Response

We understand that IASB, in agreement with FASB, have tentatively developed the following working definition of a liability as part of stage b of its conceptual framework project:

"A *liability* of an entity is a present economic obligation for which the entity is the obligor."

This indicates that current thinking is moving away from reference to the occurrence of a past event. We would be comfortable if the definition of a liability continued to refer to the occurrence of a past event, as in reality we believe the occurrence of a past event would be inevitable. However, we would ultimately prefer a definition, in this regard, which is consistent with the approach likely to be adopted by the IASB.

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?

(b) Is the enforceability of an obligation 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?

Response

(a) We would tend towards a 'power view' by reference to the legal position at the reporting date in respect of establishing liabilities arising from non-exchange transactions.

(b) We believe that a liability can arise from either a constructive or legal obligation. With regard to exchange transactions we do not believe that there are any special considerations for public sector entities compared to commercial entities.

(c) We would support the definition of a liability arising from a non-exchange transaction to be made with reference to whether a legal or constructive obligation exists at the reporting date.

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?

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

Response

We have no additional comments to make.

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)?

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

Response

(a) We would support an asset and liability-led approach to revenues and expenses.

(b) This is our preferred approach as we believe it better reflects public sector entities stewardship responsibilities. It is also consistent with developments in accounting practice more generally.

Specific matter for comment 12

(a) Should transactions with residual/equity interests 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?

Response

(a) We believe that transactions with residual/equity interests should be excluded from revenues and expenses.

(b) We believe that definitions of revenue and expense should be limited to specific types of activities associated with operations, however described. This view does not preclude the inclusion of unrealised gains and unrealised losses within statements of financial performance.

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?

(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?

Response

We have no additional comments to make.

Specific matter for comment 14

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

(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.

(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?

Response

(a) We agree that deferrals need to be identified on the statement of financial position in some way.

(b) We favour option (b)(iii) whereby deferrals are included as sub-components of net assets/ liabilities.

(c) Not applicable as we support option (b)(iii) over option (b)(i).

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?

(b) Should the concept of ownership interests, such as those that relate to minority or non-controlling interests in a GBE, be incorporated in the element definition?

(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?

Response

(a) We consider net assets/net liabilities to be a residual interest.

(b) We believe that the nature of the residual interest should be made clear in the financial statements.

(c) We have no additional issues to raise.

Specific matter for comment 16

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

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

Response

(a) We agree that transactions with residual/equity interests should be defined as separate elements.

(b) We support the approach taken by the UK Accounting Standards Board in its 'Statement of principles for financial reporting: interpretation for public benefit entities' (2007). Chapter 4 of the Interpretation refers to transactions with residual interests as being contributions establishing a financial interest in the residual interest and distributions to holders of a financial interest in the residual interest. Chapter 4 also defines both of these elements.

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?

(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?

Response

(a) We believe measurement uncertainty should be addressed by requiring a neutral judgement about whether an element exists. As referred to in the consultation paper, this approach will better meet the qualitative characteristics of faithful representation, relevance and comparability.

(b) Not applicable, we support the neutral judgement approach.

Specific matter for comment 18

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

Response

We believe that an asset or liability should be de-recognised if the recognition criteria are no longer met. Therefore, we support uniform evidence thresholds for initial recognition, continuing recognition and de-recognition.

Specific matter for comment 19

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

Response

We believe that recognition criteria should be separate from element definitions. We support this on the grounds that it will provide a clearer framework for accounts' preparers to apply.