

Conceptual Framework Exposure Draft Summary Phase 2 of 4—Elements and Recognition in Financial Statements

This summary provides an overview of the Phase 2 Exposure Draft (ED), *Elements and Recognition in Financial Statements*.

Project objectives:

The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities is establishing and defining the concepts to be applied in developing IPSASs. This ED on Phase 2 sets out the concepts related to elements of financial statements and their recognition.

The project and stage:

In September 2008 the IPSASB published the first Consultation Paper (CP) in this project on the objectives, the scope, the qualitative characteristics of financial reporting and the reporting entity. Following consideration of respondents' comments the IPSASB issued an ED in December 2010. Separate CPs on Phase 2: *Elements and Recognition in Financial Statements* and Phase 3: *Measurement of Assets and Liabilities in Financial Statements* were issued at the same time.

The IPSASB considered comments on these CPs and issued EDs on both phases in November 2012. A CP on Phase 4: *Presentation in General Purpose Financial Reports* was issued in January 2012. The IPSASB also issued an ED, *Key Characteristics of the Public Sector with Potential Implications for Financial Reporting*, in April 2011.

Next steps:

The IPSASB seeks feedback to guide it in further developing the concepts related to elements of financial statements and their recognition.

Comment deadline:

The ED is open for public comment until April 30, 2013.

Why is the IPSASB Undertaking this Project?

The purpose of the IPSASB's Conceptual Framework project is to develop concepts, definitions, and principles that respond to the objectives, environment and circumstances of governments and other public sector entities, and therefore, are appropriate to guide the development of IPSASs and other documents dealing with financial reporting by public sector entities.

Many of the current IPSASs are based on International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), to the extent that the requirements of those IFRSs are relevant to the public sector.

The IASB has a project to develop an improved Conceptual Framework for profit-oriented entities. This project has been recently reactivated and the IPSASB is closely monitoring it. The IPSASB's Conceptual Framework is not an IFRS convergence project, and the purpose of the IPSASB's project is not to interpret the application of the IASB Framework to the public sector.

The concepts underlying statistical financial reporting models, and the potential for convergence with them, will be considered by the IPSASB in developing its Conceptual Framework. The IPSASB is committed to minimizing divergence from the statistical financial reporting guidelines where appropriate.

Although all the components of the Conceptual Framework are interconnected, the project is being developed in phases.

To meet the objectives of financial reporting, information is needed that encompasses financial and non-financial information, past and prospective information and reporting on compliance. General Purpose Financial Reports (GPFRs) are more comprehensive than public sector general purpose financial statements (GPFSS). GPFSSs are focused on the financial portrayal of past transactions and events, which affect financial position at a point in time and financial performance for a specified period.

This ED deals with concepts that apply to the elements of general purpose financial statements under the accrual basis of accounting and their recognition.

Elements are the basic building blocks of financial statements needed to meet the information needs of the identified users of these financial reports. This ED defines these elements and proposes recognition criteria.

What are the Elements and their Definitions?

Eight elements are proposed and defined in the ED. The definitions reflect the wide range of activities and circumstances of public sector entities.

Neither net assets nor net financial position are elements. Net assets is the difference between assets and liabilities. Net financial position is the difference between assets and liabilities after deducting deferred inflows and adding deferred outflows.

Assets

An asset is a resource, with the ability to provide an inflow of service potential or economic benefits that an entity presently controls, and which arises from a past event.

Ownership Contributions

Ownership contributions are inflows of resources to an entity, contributed by external parties that establish or increase an interest in the net assets of the entity.

Deferred Inflows

A deferred inflow is an inflow of service potential or economic benefits provided to the entity for use in a specified future reporting period that results from a non-exchange transaction and increases net assets.

Liabilities

A liability is a present obligation that arises from a past event where there is little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity.

Ownership Distributions

Ownership distributions are outflows of resources from the entity, distributed to external parties that return or reduce an interest in the net assets of the entity.

Deferred Outflows

A deferred outflow is an outflow of service potential or economic benefits provided to another entity or party for use in a specified future reporting period that results from a non-exchange transaction and decreases net assets.

Revenue

Revenue is (a) Inflows during the current reporting period, which increase the net assets of an entity, other than: (i) Ownership contributions; and (ii) Increases in deferred inflows; and (b) Inflows during the current reporting period that result from decreases in deferred inflows.

Expenses

Expenses are (a) Outflows during the current reporting period which decrease the net assets of an entity, other than: (i) Ownership distributions; and (ii) Increases in deferred outflows; and (b) Outflows during the current reporting period that result from decreases in deferred outflows.

Essential Characteristics of Assets, Liabilities, Revenue and Expenses

An item must meet the essential characteristics of the definition of an element in order to be considered for recognition.

Assets

As the primary objective of most public sector entities is to deliver goods and services, generally in non-exchange transactions, the definition of an asset includes both inflows of service potential and economic benefits.

An asset does not need to have physical form. Many assets such as buildings, equipment and inventories are tangible while others such as rights to a resource are intangible. Financial assets such as bonds and derivatives are a further category of assets that do not have physical form.

An asset must result from a past transaction or other event. An entity must have control of the resource at the reporting date. Indicators of control are: (a) legal ownership; (b) access to or the ability to limit access; (c) the means to ensure resources are used to achieve its objective; and (d) enforceable rights to service potential or economic benefits.

Liabilities

Legally binding (or equivalent) obligations give rise to liabilities. In addition some non-legal obligations may also be binding and give rise to liabilities. A non-legal binding obligation gives rise to a liability when:

- (a) The entity has indicated to other parties that it will accept certain responsibilities;
- (b) As a result of such an indication, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities; and
- (c) The entity has little or no realistic alternative to avoid settling the obligation arising from those responsibilities.

A past event is essential to determine whether an obligation is a present obligation.

Revenue and Expenses

A focus on the current year activities of a public sector entity is important in providing information for the primary users of financial statements and achieving the objectives of financial reporting.

It is therefore important for transparency and accountability that financial statements distinguish separately flows that relate to the reporting period from flows which relate to another specified reporting period.

A public sector entity is accountable for raising revenue and for the use of that revenue. The difference between revenue and expenses is the entity's surplus or deficit for the period, and is the primary indicator of financial performance.

Essential Characteristics of Deferred Inflows, Deferred Outflows, Ownership Contributions and Ownership Distributions

The IPSASB believes that it is also necessary to define deferred inflows, deferred outflows, ownership contributions and ownership distributions as elements.

Deferred Inflows and Deferred Outflows

Deferred inflows and deferred outflows are separate elements in order to distinguish the flows related to the reporting period from flows which relate to another reporting period.

Deferred inflows and deferred outflows are restricted to certain non-exchange transactions with stipulations on the reporting period in which they are to be used. For example a property tax levied and collected in one period that is required by law to be spent in a specified future period would be reported as a deferred inflow. Multi-year grants with no substantive performance obligations and no return obligations would only be presented as deferred inflows or deferred outflows if the period over which those resources can be used is documented and recorded for example in a grant agreement.

When the specified future reporting period occurs, the flows are no longer deferred. A decrease in a deferred inflow would be recognized as revenue. A decrease in a deferred outflow would be recognized as an expense. Limiting the use of deferred inflows and deferred outflows to specified circumstances is consistent with the aim of providing information to users about the impact of external restrictions on an entity's ability to use funds in a period.

Ownership Contributions and Ownership Distributions

Contributions made by owners in their role as owners and distributions received by owners in their role as owners need to be distinguished from other transactions.

Ownership interests may arise on, or after, the creation of an entity and can take different forms which may not be equity interests. In the public sector contributions to and distributions from owners are sometimes linked to restructuring of government and take the form of transfers of assets and liabilities rather than cash transactions.

What Recognition Criteria Apply?

Recognition is the process of incorporating in the appropriate financial statement an item that meets the definition of an element and can be measured in a way that meets the qualitative characteristics. Recognition is a distinct stage in the accounting process. Recognition involves an assessment of existence uncertainty and measurement uncertainty.

The failure to recognize items that meet the definition of an element and the recognition criteria is not rectified by the disclosure of accounting policies, notes or other explanatory detail.

Existence Uncertainty

Because entities operate in uncertain environments, it may be unclear whether a transaction or event creates an item that meets the definition of an element.

Existence uncertainty is addressed by assessing the available evidence in order to make a neutral judgment about whether an element exists. If it is determined that an element exists uncertainty about the flows of service potential or economic benefits are taken into account in the measurement of that element.

Measurement Uncertainty

In order to recognize an item in the financial statements, it is necessary to attach a monetary value to the item. This entails choosing an appropriate measurement basis and determining whether the measurement is sufficiently relevant and faithfully representative for the item to be recognized in the financial statements.

The selection of an appropriate measurement basis is considered in the ED, *Measurement of Assets and Liabilities in Financial Statements*.

There may be uncertainty associated with the measurement of many amounts presented in the financial statements and the use of estimates is an essential part of the accrual basis of accounting.

Next Steps:

The deadline for comments is April 30, 2013. During the comment period, the IPSASB members are available to discuss the proposals with a wide range of parties.

How Can I Comment on the Proposals?

The ED includes Specific Matters for Comment (SMC) on which the IPSASB is seeking views.

Respondents may choose to answer all SMCs or just a selected few. The IPSASB welcomes comments on any other matters respondents think we should consider in forming our views.

Comment letters will be posted on the IPSASB website.

The IPSASB will carefully consider all feedback and, as usual, discuss responses to the proposals at its public meetings after the comment period has ended.

The IPSASB plans to issue the final chapters on elements and recognition in financial statements, reflecting its actions to address respondents' comments, in 2014.

Stay Informed

The IPSASB will announce on its website the dates and location of meetings to discuss feedback on the ED.

To stay up to date about the project, please visit: <https://www.ifac.org/public-sector/projects/public-sector-conceptual-framework>