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Transition to the Accrual Basis of Accounting: Guidance for Public Sector Entities

Third Edition

International Federation
of Accountants

International Federation of Accountants
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This Study was prepared by the International Federation of Accountants (IFAC). Its mission is to serve the public interest, strengthen the worldwide accountancy profession and contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession's expertise is most relevant.

Information about the International Federation of Accountants and copies of this Study can be found at its website, http://www.ifac.org.

This Study includes discussion of International Public Sector Accounting Standards, Exposure Drafts and Invitations to Comment issued as of January 31, 2010.

This Study may be downloaded free-of-charge from the IFAC website at http://www.ifac.org. The approved text is published in the English language.

IFAC welcomes any comments you may have regarding this Study. Comments may be sent to the address above or emailed to publicsectorpubs@ifac.org.

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The International Public Sector Accounting Standards Board (IPSASB), formerly the Public Sector Committee, of the International Federation of Accountants (IFAC) has developed a set of International Public Sector Accounting Standards (IPSASs). The majority of the accrual basis IPSASs are based on International Financial Reporting Standards (IFRSs) published by the International Accounting Standards Board (IASB). Quotes and extracts from IFRSs are reproduced in this publication with the permission of the IFRS Foundation.

The approved text of IFRSs is that published by the IASB in the English language, and copies may be obtained directly from IASB Publications Department, 30 Cannon Street, London EC4M 6XH, United Kingdom.

E-mail: publications@ifrs.org

Internet: http://www.ifrs.org

Public Sector Performance (NZ) Ltd

The first edition of the Study was prepared by Public Sector Performance (NZ) Ltd (http://www.pspnz.co.nz) on behalf of the Public Sector Committee of the International Federation of Accountants.[1]

New Zealand Institute of Chartered Accountants

The third edition of the Study was revised by the New Zealand Institute of Chartered Accountants on behalf of the International Public Sector Accounting Standards Board.

[1] Where relevant, references to the International Public Sector Accounting Standards Board in this document also include its predecessor, the Public Sector Committee.

DISCLAIMER

While every effort has been made to ensure accuracy, none of the organizations or individuals involved in the preparation or revision of this Study (including Public Sector Performance (NZ) Ltd and any principal or employee of Public Sector Performance (NZ) Ltd, the New Zealand Institute of Chartered Accountants and IFAC) shall be liable on any ground whatsoever to any party in respect of decisions or actions they may take as a result of using this Study. The information contained in this publication should not be treated as a substitute for advice concerning individual situations or circumstances.

FOREWORD

The IPSASB has developed accrual basis International Public Sector Accounting Standards (IPSASs) and a comprehensive IPSAS on reporting under the cash basis of accounting. These IPSASs establish an authoritative set of independent international financial reporting standards for the public sector. Application of the IPSASs will improve both the quality and comparability of financial information reported by public sector entities around the world. This is likely to lead to better-informed assessments of the resource allocation decisions made by public sector entities, improved financial management and enhanced transparency, and accountability. The IPSASB considers that the IPSASs are an integral element in the efficient functioning of the international economy and of reforms directed at promoting social and economic development.

Many constituents of the International Federation of Accountants' International Public Sector Accounting Standards Board have adopted, or are in the process of adopting, the accrual basis IPSASs. The increasing interest in the adoption of IPSASs has highlighted a need for guidance on this process. This Study was prepared primarily to meet the need for guidance on the transition from the cash to the accrual basis but may also be useful for constituents currently reporting on an accrual basis and considering the adoption of IPSASs.

Public sector entities will find the Study useful as they deal with the many and complex technical, systems and cultural issues that need to be addressed to implement an accrual system.

The Study identifies key requirements of IPSASs, issues to be addressed in the adoption of the accrual basis of accounting and alternate approaches that can be adopted in implementing the accrual basis of accounting in the public sector. It also identifies other sources of useful guidance on issues not dealt with by IPSASs. This Study does not establish new or additional authoritative requirements and should not be considered a substitute for the IPSASs themselves.

This Study is updated periodically to reflect newly issued IPSASs and other additional implementation issues and experiences. This is the third edition. The most recent version will be available on the IPSASB website. Suggestions for subsequent editions of this Study may be sent to publicsectorpubs@ifac.org.

Andreas Bergmann
Chairman
International Public Sector Accounting Standards Board
International Federation of Accountants

January 2011

TRANSITION TO THE ACCRUAL BASIS OF ACCOUNTING: GUIDANCE FOR PUBLIC SECTOR ENTITIES

CONTENTS

PART I—INTRODUCTION

This Study is intended to assist public sector entities in the process of adopting, or considering adopting, accrual basis International Public Sector Accounting Standards (IPSASs). The Study is primarily intended to assist public sector entities transitioning from the cash to the accrual basis but it may also be useful for entities currently reporting on an accrual basis and considering the adoption of IPSASs or entities complying with the financial reporting requirements of the Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting* and disclosing certain accrual basis information.

The Study includes a discussion of all IPSASs issued as at January 31, 2010 and certain topics not addressed by current IPSASs or Exposure Drafts. Where the Study discusses topics not addressed by current IPSASs or Exposure Drafts, the requirements of other authoritative accounting pronouncements such as International Financial Reporting Standards (IFRSs) are used to illustrate the practical implementation issues associated with that topic. IFRSs are published by the International Accounting Standards Board (IASB). The majority of the accrual basis IPSASs are based on IFRSs to the extent appropriate for the public sector. The use of IFRSs or other standards to illustrate such topics does not necessarily reflect the views of the IPSASB on any issue. The Study is not an accounting manual, nor does it attempt to establish authoritative accounting practices or standards.

Part I of this Study addresses general issues associated with the transition to accrual accounting, including factors influencing the nature and speed of the transition, options in respect of the transition paths, and the management of the transition process. It also considers issues associated with the identification, design, and delivery of training.

Chapter 1: Introduction

Key Points

- This Study will assist public sector entities wishing to report on the accrual basis of accounting in accordance with the accrual basis International Public Sector Accounting Standards (IPSASs). It is primarily intended to assist public sector entities transitioning from the cash to the accrual basis of accounting but it may also be useful for entities currently reporting on an accrual basis and considering the adoption of IPSASs or entities complying with the financial reporting requirements of the Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting* and disclosing certain accrual basis information.
- The Study discusses topics covered by current accrual basis IPSASs. It also discusses certain topics not yet addressed by the International Public Sector Accounting Standards Board (IPSASB).
- This Chapter summarizes some of the benefits associated with the adoption of accrual accounting by public sector entities.
- The IPSASB is seeking input from readers regarding their experiences in moving from a cash basis to an accrual basis of accounting. Such input will influence subsequent editions of this Study.

Introduction

1.1 This Study was issued by the IPSASB, an organ of the International Federation of Accountants (IFAC). IFAC is an organization of national professional accountancy bodies that represent accountants employed in public practice, business and industry, the public sector, and education. The IPSASB focuses on the financial reporting needs of national, regional, and local governments, related governmental entities (other than Government Business Enterprises), and other international governmental organizations,[2] and the constituencies they serve. It addresses these needs by issuing and promoting benchmark guidance, conducting educational and research programs, and facilitating the exchange of information among accountants and those who work in the public sector.

1.2 The IPSASB has prepared this Study in order to assist public sector entities wishing to report on the accrual basis of accounting in accordance with IPSASs.

1.3 The guidance in this Study includes:

(a) An overview of the wider context in which the transition to the accrual basis of accounting may occur;

(b) A discussion of various transition paths that entities choosing an incremental implementation process may adopt;

(c) Identification of the main tasks associated with recognition of assets, liabilities, revenues, and expenses, including issues associated with identification and measurement of those elements;

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2 For the purposes of this Study, these various entities are referred to as "public sector entities."

(d) Some implications of adopting accrual basis IPSASs; and

(e) Practical suggestions based on the experience of other entities and jurisdictions and electronic links to papers documenting these experiences.

International Public Sector Accounting Standards

Accrual Basis Standards

1.4 The IPSASB has developed a set of IPSASs on financial reporting under the accrual basis of accounting for the public sector. The majority of the accrual basis IPSASs are based on International Financial Reporting Standards (IFRSs), with appropriate modifications for application in the public sector[3] but others deal with public sector specific topics such as non-exchange revenue (taxes and transfers). The IPSASB is also developing a conceptual framework for the public sector to underpin its work. The full text of the accrual basis IPSASs, Exposure Drafts currently on issue, and details of other IPSASB projects are available online at http://www.ifac.org/publicsector.

1.5 The main purpose of this Study is to help entities intending to move from the cash basis to the accrual basis of accounting and to comply with the accrual basis IPSASs. This Study is not an accounting manual, nor does it attempt to establish authoritative accounting practices or standards.

1.6 In relation to topics where no IPSAS has yet been developed, this Study uses IFRSs or national accounting standards to illustrate the types of reporting requirements an entity may face. This does not imply a considered position of the IPSASB on those topics. Rather, it reflects the requirements of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*. IPSAS 3 explains that management will need to use its judgment in developing an accounting policy that provides information that is relevant and reliable. In the absence of an IPSAS on a particular issue, IPSAS 3 requires that entities initially refer to, and consider the applicability of, other IPSASs dealing with similar and related issues, and the definitions, recognition and measurement criteria for elements described in other IPSASs. Entities may also consider the most recent pronouncements of other standard-setting bodies (for example IFRSs) and accepted public or private sector practices, but only to the extent that they do not conflict with the IPSASs.

Cash Basis Standard

1.7 Although the focus of this Study is on the transition to the accrual basis, some parts of the Study may also assist readers interested in the Cash Basis IPSAS. Appendix B of this Chapter explains the relevance of specific Chapters of this Study for entities intending to comply with the Cash Basis IPSAS. In addition, Appendix B of Chapter 4 illustrates accounting policies that may be required in order for an entity to comply with that Standard.

3 Such modifications can include the elimination of unnecessary differences between the requirements of financial reporting standards and the Government Finance Statistics Manual (GFSM 2001).

Other Sources of Guidance on Accrual Accounting

1.8 The IPSASB's publications on accrual accounting in the public sector (IPSASs, Studies, Occasional Papers and Information Papers) may be downloaded free of charge at the IFAC online bookstore (http://www.ifac.org).[4]

1.9 Where possible, this Study provides web site references for documents referred to in the Study. Appendix A to this Chapter provides examples of web sites with information on aspects of public sector financial reporting.

Auditing Guidance

1.10 Although this Study refers to some issues where entities and auditors will need to work together, it does not focus on auditing issues. The International Organization of Supreme Audit Institutions (INTOSAI) provides a collection of professional standards and best practice guidelines for Supreme Audit Institutions. INTOSAI's *Financial Audit Guidelines* consist of International Standards of Supreme Audit Institutions (ISSAI), which cover relevant areas or processes included in financial audits and describe how best to apply International Standards of Auditing (ISA) in the public sector environment. The ISSAIs consist of a practice note providing guidance on applying the ISAs in financial audits of public sector entities and a corresponding ISA. The ISSAIs are available at http://www.issai.org.

Structure of the Study

1.11 A wide range of transitional paths between the cash and accrual bases is possible. This Study is structured in a way that is intended to be useful to readers, whatever the transition path they are contemplating. The Study also acknowledges that the extent of information currently available on assets and liabilities and the reliability of that information will vary greatly among jurisdictions and individual entities. Readers are encouraged to use the Study as a tool to help them identify which steps in the transition their entity has already addressed/completed and the areas in which further work is required.

1.12 The Study has four main parts as follows:

(a) Introduction (Chapters 1 to 3): This part addresses general planning and project management issues;

(b) General Financial Reporting Issues (Chapters 4 and 5): This part deals with the selection, development, and approval of accounting policies, and issues associated with the definition and identification of reporting entities;

(c) Financial Statement Elements (Chapters 6 to 8): This part outlines the broad steps required for the identification, recognition, measurement, and disclosure of assets, liabilities, revenues, and expenses. The broad approaches outlined in these Chapters could be adapted and applied to particular items; and

4 Some early publications are available in hard copy only.

(d) Specific Topics (Chapters 9 to 22): This part highlights implementation issues associated with specific IPSASs, and provides guidance in relation to a selection of topics not addressed, or only partially addressed, by existing IPSASs.

1.13 This Study has been published in the interest of providing assistance to support the adoption of accrual accounting. Readers are invited to propose suggestions or provide material for inclusion in future editions of this Study at publicsectorpubs@ifac.org. As noted below, Occasional Papers outlining the experience of various jurisdictions and the links to publicly available material from various jurisdictions may also be useful.

Other Publications

1.14 IFAC has published a number of papers documenting case studies from specific jurisdictions on their transition to the accrual basis of accounting. Papers published to date are:

(a) Occasional Paper 1, *Implementing Accrual Accounting in Government: The New Zealand Experience*;

(b) Occasional Paper 2, *Auditing Whole of Government Financial Statements: The New Zealand Experience*;

(c) Occasional Paper 3, *Perspectives on Accrual Accounting*;

(d) Occasional Paper 4, *The Delegation of Public Services in France, An Original Method of Public Administration: Delegated Public Service*;

(e) Occasional Paper 5, *Resource Accounting: Framework of Accounting Standard Setting in the UK Central Government Sector*;

(f) Occasional Paper 6, *The Modernization of Government Accounting in France: The Current Situation, The Issues, The Outlook*;

(g) Occasional Paper 7, *Governmental Accounting System in Argentina*; and

(h) Information Paper, *The Road to Accrual Accounting in the United States of America*.

1.15 The IPSASB invites public sector entities to share their experiences in adopting accrual accounting. Future Information Papers could explain the nature of an entity's transition to accrual accounting in the context of its environment and any reforms relevant to financial management. A change to accrual accounting rarely occurs in isolation—often the introduction of accrual accounting will be merely a subset of a much larger reform project, and the nature of these wider reforms can often have an impact on the speed and style of transition to accrual accounting. Changes may occur within the context of a widespread decentralization of government functions alone, or in combination with the development of an integrated financial management information system (IFMIS, the integration of the basic financial functions and responsibilities within a single information system).

1.16 Information Papers may include explanation of the background to the introduction of accrual accounting, the nature of accounting and management arrangements prior to the reforms, and changes to the legislative framework, accounting system and budgeting system within the entity. An explanation of the planned implementation strategy and reasons for selecting that strategy would be helpful to jurisdictions trying to determine their own implementation strategy. At a more detailed level, accounting policy issues and issues associated with the identification, recognition and measurement of particular assets, liabilities, revenues, and expenses would be of interest. In addition, the Information Papers could include, where relevant, a description of whole-of-government reporting issues and an explanation of the role of internal and external auditors during the transition.

Benefits of Accrual Accounting

1.17 The IPSASB has commented extensively on the benefits of accrual accounting for public sector entities in Studies, Papers and various presentations.[5] Khan and Mayes also discuss the reasons for moving from the cash to the accrual basis of accounting (Khan and Mayes, 2009). In order to provide some context for readers who are not familiar with these other publications, this section contains a summary of the benefits of reporting on the accrual basis.

1.18 The information contained in reports prepared on an accrual basis of accounting is useful both for accountability and decision-making. Financial reports prepared on an accrual basis allow users to:

(a) Assess the accountability for all resources the entity controls and the deployment of those resources;

(b) Assess the financial position, financial performance, and cash flows of the entity; and

(c) Make decisions about providing resources to, or doing business with, the entity.

1.19 At a more detailed level, reporting on an accrual basis of accounting:

(a) Shows how an entity financed its activities and met its cash requirements;

(b) Allows users to evaluate an entity's ongoing ability to finance its activities and to meet its liabilities and commitments;

(c) Shows the financial position of an entity and changes in financial position;

(d) Provides an entity with the opportunity to demonstrate successful management of its resources; and

(e) Is useful in evaluating an entity's performance in terms of its service costs, efficiency, and accomplishments.

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5 Refer to Studies 5, 6, 8–11, Occasional Papers 1, 3, 5–7 and an Information Paper *The Road to Accrual Accounting in the United States of America*.

Financial Position

1.20 Accrual accounting provides information on an entity's overall financial position and current stock of assets and liabilities. Public sector entities need this information to:

(a) Demonstrate accountability to the public for their management of assets and liabilities recognized in the financial statements;

(b) Plan for future funding requirements of asset maintenance and replacement;

(c) Plan for the repayment of, or satisfaction of, existing liabilities; and

(d) Make decisions about the level of assets and debt held in the context of financing the services they wish to provide.

1.21 Accrual accounting requires entities to maintain complete records of assets and liabilities. It facilitates better management of assets, including better maintenance, more appropriate replacement policies, identification and disposal of surplus assets, and better management of risks such as fluctuations in the value of liabilities. The identification of assets and the recognition of depreciation and amortization help managers to understand the impact of using fixed assets in the delivery of services, calculate service fees (where applicable), and encourage managers to consider alternative ways of managing costs and delivering services.

1.22 Accrual accounting provides a consistent framework for the identification of existing liabilities, and potential or contingent liabilities. The recognition of obligations meeting the definition of a liability and the criteria for recognition:

(a) Compels public sector entities to acknowledge and plan for the settlement of all recognized liabilities, not just borrowings;

(b) Provides information on the impact of existing liabilities on future resources;

(c) Means that it is possible to allocate responsibility for the management of all liabilities; and

(d) Provides necessary input for public sector entities to assess whether they can continue to provide current services and the extent to which they can afford new programs and services.

1.23 Accrual accounting highlights the impact of financing decisions on net assets/equity and may lead public sector entities to take a longer term view when making financing decisions than is generally possible when relying on cash or modified cash reports. Information on net assets/equity also means that public sector entities may be held accountable for the financial impact of their decisions on both current and future net assets/equity. Changes in an entity's net assets/equity between two reporting dates reflect the increase or decrease in its wealth during the period, under the particular measurement principles adopted and disclosed in the financial statements. Under the accrual basis of accounting, the financial statements will include a statement of financial position[6] which

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6 In this Study the terms statement of financial position and statement of financial performance are used. A variety of terms may be used to describe these statements include balance sheet, statement of net assets, statement of surplus (deficit) and income statement.

discloses information about assets and liabilities. The residual figure, net assets/equity, can comprise some or all of the following components:

(a) Contributed capital;

(b) Accumulated surpluses and deficits; and

(c) Reserves (for example revaluation reserve; foreign currency translation reserve).

Financial Performance

1.24 Accrual accounting provides information on revenues and expenses, including the impact of transactions where cash has not yet been received or paid. Accurate information on revenues is essential for assessing the impact of taxation and other revenues on the government's fiscal position. Information on revenues helps both users and public sector entities themselves to assess whether current revenues are sufficient to cover the costs of current programs and services.

1.25 Public sector entities need information about expenses in order to assess their revenue requirements, the sustainability of existing programs, and the likely cost of proposed activities and services. Accrual accounting provides public sector entities with information on the full costs of their activities so that they can:

(a) Consider the cost consequences of particular policy objectives and the cost of alternative mechanisms for meeting these objectives;

(b) Decide whether to fund the production of services within sub-entities, or whether to purchase goods and services directly from third party entities;

(c) Consider the costs of particular services in relation to user fees; and

(d) Allocate responsibility for managing particular costs.

1.26 Accrual accounting provides better information than cash accounting on the actual cost of specified services delivered by entities and whether current resources are sufficient to sustain the level of service delivery.

1.27 Accrual accounting allows an entity to:

(a) Recognize the total costs, including depreciation of physical assets and amortization of intangible assets, of carrying out specific activities;

(b) Recognize all employee-related costs and to compare the cost of various types of employment or remuneration options;

(c) Assess the most efficient way of producing goods and services and of managing the resources over which they have been delegated authority; and

(d) Determine the appropriateness of cost-recovery policies.

Cash Flows

1.28 Accrual accounting provides comprehensive information on current cash flows and certain projected cash flows, including the cash flows associated with debtors and creditors. It can therefore lead to better cash management and may assist in the preparation of more accurate cash budgets.

1.29 IPSAS 2, *Cash Flow Statements* permits cash flows from operating activities to be reported using either the direct method or the indirect method. Under the direct method major classes of gross cash receipts and gross cash payments are disclosed. Under the indirect method net surplus or deficit is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of revenue or expense associated with investing or financing flows. IPSAS 2 encourages the use of the direct method as it provides information that may be useful in estimating future cash flows.

References

International Federation of Accountants (IFAC)
http://www.ifac.org/

IPSAS 1, *Presentation of Financial Statements*, May 2000[7]

Cash Basis IPSAS *Financial Reporting Under the Cash Basis of Accounting*, January 2003

Study 5, *Definition and Recognition of Assets*, August 1995

Study 6, *Accounting for and Reporting Liabilities*, August 1995

Study 8, *The Government Financial Reporting Entity*, July 1996

Study 9, *Definition and Recognition of Revenues*, December 1996

Study 10, *Definition and Recognition of Expenses/Expenditures*, December 1996

Study 11, *Governmental Financial Reporting: Accounting Issues and Practices*, May 2000

Occasional Paper 1 *Implementing Accrual Accounting in Government: The New Zealand Experience*, October 1994

Occasional Paper 2 *Auditing Whole of Government Financial Statements: The New Zealand Experience*, October 1994

Occasional Paper 3 *Perspectives on Accrual Accounting*, May 1997

Occasional Paper 4 *The Delegation of Public Services in France, An Original Method of Public Administration: Delegated Public Service*, September 2001

Occasional Paper 5 *Resource Accounting: Framework of Accounting Standard Setting in the UK Central Government Sector*, June 2002

Occasional Paper 6 *The Modernization of Government Accounting in France: The Current Situation, The Issues, The Outlook*, January 2003

Occasional Paper 7 *Governmental Accounting System in Argentina*, January 2004

Information Paper: *The Road to Accrual Accounting in the United States of America*, March 2006

International Organization of Supreme Audit Institutions (INTOSAI), *General Introduction to the INTOSAI Financial Audit Guidelines*, Endorsement Version
http://www.issai.org/composite-344.htm

International Organization of Supreme Audit Institutions (INTOSAI), *International Standards of Supreme Audit Institutions* (ISSAI)
http://www.issai.org/composite-188.htm

Khan, A., and Mayes, S., *Transition to Accrual Accounting*, Technical Note, International Monetary Fund, Fiscal Affairs Department, September 2009
http://www.imfbookstore.org/

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7 The effective date of an IPSAS and the effective date of any consequential amendments to that IPSAS are set out in the IPSAS.

Müller-Marqués Berger, T., *IPSAS Explained, A Summary of International Public Accounting Standards*, 2009

Overseas Development Institution, Cape Conference 2007, *Tales of the Unexpected: PFM Reform in Difficult Environments* (Chile, Cambodia, Bangladesh) http://www.odi.org.uk/events/details.asp?id=286&title=tales-unexpected-public-financial-management-reform-difficult-environments#report

Appendix A

Web Site References

Australia

Australian Accounting Standards Board
http://www.aasb.gov.au

Australian National Audit Office
http://www.anao.gov.au

Australian State and Territory Governments (general entry point)
http://www.gov.au

Department of Finance and Administration (Commonwealth Government of Australia)
http://www.finance.gov.au

Department of Treasury and Finance (Tasmania)
http://www.treasury.tas.gov.au/

New South Wales Treasury: Office of Financial Management
http://www.treasury.nsw.gov.au

Department of Treasury and Finance (Victoria)
http://www.dtf.vic.gov.au/

Canada

Government of Ontario
http://www.ontario.ca/en/residents/index.htm

Auditor General of Canada and the Commissioner of the Environment and Sustainable Development
http://www.oag-bvg.gc.ca

Public Works and Government Services Canada
http://www.pwgsc.gc.ca

Public Sector Accounting Standards Board
http://www.psab-ccsp.ca/

Treasury Board of Canada Secretariat
http://www.tbs-sct.gc.ca

Treasury Board of Canada Secretariat: Financial Information Strategy
http://www.tbs-sct.gc.ca/fin/fis-sif

France

Ministry for the Budget, Public Accounts and the Civil Service
http://www.performance-publique.gouv.fr/le-budget-et-les-comptes-de-letat/approfondir/les-nouvelles-normes-et-etats-financiers-de-letat.html

National standard setter (Conseil de normalisation des comptes publics)
http://www.performance-publique.gouv.fr/le-budget-et-les-comptes-de-letat/approfondir/les-nouvelles-normes-et-etats-financiers-de-letat/comites/conseil-de-la-normalisation-des-comptes-publics.html

National audit body (Cour des comptes)
http://www.ccomptes.fr

Hong Kong

Government of the Hong Kong Special Administrative Region: Treasury
http://www.info.gov.hk/tsy
http://www.try.gov.hk/internet/ehhome.html

India

Government Accounting Standards Advisory Board
http://www.gasab.gov.in/interpretation.asp

International Organizations

Accounting and Auditing Organization for Islamic Financial Institutions
http://www.aaoifi.com

Asian Development Bank
http://www.adb.org

European Commission
http://ec.europa.eu/

International Accounting Standards Board
http://www.ifrs.org

International Federation of Accountants
http://www.ifac.org

International Fund for Agricultural Development
http://www.ifad.org

International Journal of Government Auditing
http://www.intosaijournal.org/index.php

International Monetary Fund
http://www.imf.org

International Monetary Fund, Public Financial Management Blog
http://blog-pfm.imf.org/pfmblog/#

International Organization of Supreme Audit Institutions
http://www.intosai.org

Organisation for Economic Co-operation and Development: Public Governance and Management
http://www.oecd.org

The World Bank Group
http://www.worldbank.org

United Nations System, Finance and Budget Network
https://fb.unsystemceb.org/reference/05/

Wikipedia – International Public Sector Accounting Standards
http://en.wikipedia.org/wiki/International_Public_Sector_Accounting_Standards

Jamaica

The Ministry of Finance and the Public Service
http://www.mof.gov.jm/budget_memo/2004/appdx02.shtml

Cabinet Office
http://www.cabinet.gov.jm/areas_responsibility/modernisation/managing_results

Korea

The Korean Institute of Certified Public Accountants
http://www.kicpa.or.kr/servlet/web.bbs.BBSLE?selMenu=09&menu_code=053&operation=detail&ID_NUM=1281665683306
http://www.kicpa.or.kr/servlet/web.bbs.BBSLE?selMenu=09&menu_code=053&operation=detail&ID_NUM=1282723501000

Korea Research Institute for Local Administration (KRILA)
http://www.krila.re.kr/english/?code=research&subp=0101&bbsid=e_research0101&lcode=&mcode=&gbn=viewok&cate=&ps=10&sp=&sw=&gp=7&ix=2568

Lithuania

Ministry of Finance of the Republic of Lithuania
http://www.finmin.lt/web/finmin/home

Malta

Ministry of Finance, the Economy and Investment
http://www.finance.gov.mt/page.aspx?site=MFIN&page=special

Mexico

Instituto Mexicano de Contadores Públicos, A.C.
http://www.imcp.org.mx

New Zealand

New Zealand Government Online
http://www.govt.nz

New Zealand Society of Local Government Managers
http://www.solgm.org.nz

Office of the Controller and Auditor-General of New Zealand
http://www.oag.govt.nz

The Treasury
http://www.treasury.govt.nz

Slovak Republic

Ministry of Finance
www.finance.gov.sk

South Africa

National Treasury
http://www.finance.gov.za

Office of the Auditor General
http://www.agsa.co.za

South African Reserve Bank
http://www.resbank.co.za

The South African Institute of Chartered Accountants
http://www.saica.co.za

The Institute for Public Finance and Auditing
http://www.ipfa.co.za

South Asia

The World
Bankhttp://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/0,,pagePK:180619~theSitePK:136917,00.html

Sweden

Ekonomistyrningsverket (Swedish National Financial Management Authority)
http://www.esv.se

Riksrevisionsverket (Swedish National Audit Office)
http://www.riksdagen.se/templates/R_Page____6163.aspx

Switzerland

Federal Finance Administration
http://www.efv.admin.ch

United Kingdom

The Chartered Institute of Public Finance and Accountancy
http://www.cipfa.org.uk

Government Financial Reporting Manual: HM Treasury
http://www.hm-treasury.gov.uk/frem_index.htm

HM Government: HM Treasury
http://www.hm-treasury.gov.uk

National Audit Office
http://www.nao.gov.uk/

Resource Accounting and Budgeting: HM Treasury
http://www.hm-treasury.gov.uk/resource_accounting_and_budgeting_about_us.htm

Whole of Government Accounts Programme
http://www.wga.gov.uk

United States

Defense Finance and Accounting Service
http://www.dfas.mil

Financial Accounting Standards Board
http://www.fasb.org

Federal Accounting Standards Advisory Board
http://www.fasab.gov

Governmental Accounting Standards Board
http://www.gasb.org

U.S. Government Accountability Office (U.S. GAO)
http://www.gao.gov

Appendix B

Relevance of this Study for Cash-Based Accounting

This Appendix summarizes the relevance of various Chapters of this Study for entities wanting to prepare cash basis financial statements, in accordance with the Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting*.

PART I—INTRODUCTION		
Chapter 1	Introduction	General relevance.
Chapter 2	Managing the Process	General relevance—to the extent that accounting changes are planned.
Chapter 3	Skills Assessment and Training	The specification of competencies can occur within entities applying the cash basis. However, the guidance in the Chapter is not generally relevant unless significant changes in skills required are envisaged.

PART II—GENERAL FINANCIAL REPORTING ISSUES		
Chapter 4	Accounting Policy Issues	The Chapter contains examples of accounting policies that may be required in order for an entity to prepare cash basis reports.
Chapter 5	Reporting Entity Issues	General relevance.

PART III—ELEMENTS		
Chapter 6	Assets	Not required for cash basis reporting. Relevant to the extent that an entity maintains records of certain assets, discloses information about them as encouraged in the Cash Basis IPSAS, and wishes to begin planning for the introduction of accrual accounting.

PART III—ELEMENTS		
Chapter 7	Liabilities	Not required for cash basis reporting. Relevant to the extent that most entities operating under the cash basis of accounting maintain comprehensive records of debt and borrowings and disclose them as encouraged in the Cash Basis IPSAS.
Chapter 8	Revenues and Expenses	Not required for cash basis reporting. Relevant to the extent that entities intend to make additional disclosures on revenue and expenses incurred during the period.

PART IV—SPECIFIC TOPICS		
Chapter 9	Cash	General relevance.
Chapter 10	Intangible Assets	Not required for cash basis reporting. Relevant to the extent that entities intend to make additional disclosures about intangible assets.
Chapter 11	Impairment of Assets	Not required for cash basis reporting.
Chapter 12	Agricultural Produce and Biological Assets	Not required for cash basis reporting. Relevant to the extent that entities intend to make additional disclosures about agricultural produce and biological assets.
Chapter 13	Financial Instruments	Not required for cash basis reporting. Relevant to the extent that entities intend to make additional disclosures about financial instruments.
Chapter 14	Employee-Related Liabilities	Not required for cash basis reporting. Relevant to the extent that entities intend to make additional disclosures about employee-related liabilities.

PART IV—SPECIFIC TOPICS		
Chapter 15	Liabilities Arising from Social Policy Obligations	Not required for cash basis reporting. Relevant to the extent that entities intend to make additional disclosures about liabilities arising from social policy obligations.
Chapter 16	Non-Exchange Revenue	Not required for cash basis reporting. Relevant to the extent that entities intend to make additional disclosures about non-exchange revenue.
Chapter 17	Foreign Currency	Relevant for entities that need to translate foreign exchange cash flows and balances.
Chapter 18	Segment Reporting	Not required for cash basis reporting. Relevant for entities intending to disclose information about segments under the cash basis accounting.
Chapter 19	Related Party Disclosures	Relevant for entities intending to make related party disclosures as encouraged in Part 2 of the Cash Basis Standard.
Chapter 20	Disclosure of Financial Information about the General Government Sector	Relevant for entities intending to provide additional disclosure on the general government sector.
Chapter 21	Presentation of Budget Information in Financial Statements	Relevant for cash basis reporting.
Chapter 22	Entity Combinations	Not generally relevant for cash basis reporting.

Chapter 2: Managing the Process

Key Points

This Chapter:

- Outlines some of the broader issues that can affect the speed and style of transition to the accrual basis;
- Discusses possible transition paths, including options for dealing with audit requirements during the transition period;
- Discusses features of a successful transition;
- Suggests that an entity have regard to the materiality of various assets and liabilities in determining its short-term strategy and consider alternative ways of generating the information required about other assets and liabilities;
- Identifies a number of issues relating to the adoption of accrual budgeting; and
- Discusses considerations in developing a chart of accounts to support the preparation of accrual financial statements.

Introduction

2.1 This Chapter outlines some of the broader issues that can affect the speed and style of transition to the accrual basis. Although the focus of this guidance is the management of accounting change, the adoption of accrual accounting does not occur in isolation and the style of transition is affected by the context within which it occurs.

2.2 Factors that may influence the nature and speed of the transition to accrual accounting include:

(a) The system of government and the political environment;

(b) Whether the reforms are focused solely on accounting change or whether they encompass other wider scale reforms;

(c) Whether the changes are being driven from the top down, or bottom up. For example, changes driven by the top level of government may be mandatory for all entities within that government and may have fixed time frames. This Chapter discusses the adoption of accrual accounting for both the individual entities that form the public sector and the government as a whole (regardless of whether whole-of-government financial statements are prepared). However, many of the comments in this Chapter are equally relevant for individual entities planning for the transition to accrual accounting;

(d) The current basis of accounting used by the entity, the capability of existing information systems, and the completeness and accuracy of existing information, particularly in relation to assets and liabilities;

(e) Any change to the basis of accounting for budgeting;

(f) The level of political commitment to the adoption of accrual accounting; and

(g) The capacity and skills of the people and organizations responsible for implementing the changes.

2.3 This Chapter contains more detailed discussion of certain key factors and how they can influence the style of transition. It also outlines various transition options.

2.4 The key drivers for successful implementation of accrual based IPSASs are very similar to those required for implementation of the cash basis IPSAS. The following factors have been identified as being key drivers for implementation of IPSASs:

(a) Having the support and political will of the government;

(b) Strengthening the standard setting and regulator bodies;

(c) Building capacity within the profession; and

(d) Having a clear strategy for implementation with clear deadlines (ACCA, 2009).

The Economy and the System of Government

2.5 This section sets out some observations on factors that may influence the reform process in different settings. The subheadings used (for example, developed countries) are not necessarily comprehensive or mutually exclusive.

Developed Countries

2.6 IFAC Occasional Papers and Information Papers referenced in this Chapter describe the process by which governments in some developed countries have adopted accrual accounting. Christiaens, Reyniers and Rollé discuss the adoption of accrual accounting by European governments (Christiaens, Reyniers and Rollé, 2010).

2.7 The factors influencing the transition in developing countries vary greatly. This section is therefore limited to considering the impact of two common political systems on the transition process: presidential systems and parliamentary systems.

2.8 In a presidential system, a single person is democratically elected as leader of the executive (the arm of government that performs the day-to-day management role) for a prescribed period of time. That person is not subject to removal by the legislature other than in exceptional circumstances. This separation of powers between the executive and the legislature means that the legislature provides an independent review of the merits of proposed legislation. Such independence is a strength of the presidential system. However, it can also lead to delays or blocks to the passage of legislation. Where proposed financial reforms require changes in legislation, detailed planning, including the development of a communication strategy for the legislature, may be required to enhance the likelihood of the legislation being passed within a certain time frame. In addition, any proposals to require legislative review of budgets and financial statements under the revised financial system would need to take into account the internal processes of the legislature and the possible time required for such reviews to occur.

2.9 In a parliamentary system of government, the government is formed by the political party that is able to gain the most votes from the members of Parliament in a one-chamber parliament, or the governing chamber in a two-chamber parliament. The government does not necessarily control a majority of votes in the Parliament, and therefore cannot always guarantee that its legislation will be passed. There may be significant debate of issues within the Parliament, but a government that wishes to proceed with financial management reforms usually controls the executive and has sufficient numbers within Parliament to secure the passage of legislation. A key aspect of the early stages of transition within a parliamentary system is ensuring that there is sufficient political commitment by the governing party/parties to the reforms. Once this support has been obtained it is also important to focus on providing information to opposition parties to allow for informed debate of proposals and to "buy-in" support from key opposition members. Transition times can be significantly faster under a parliamentary system.

2.10 Regardless of whether a parliamentary or presidential system is in effect, some jurisdictions operate under systems where the legislation and regulations underpinning government budgeting and reporting are particularly detailed and are regarded as fundamental aspects of the constitution. This can have an impact on the transition in that it may be very difficult to bring about changes in existing legislation and regulations. In such cases, individual entities may be encouraged to adopt accrual accounting, while maintaining existing budgetary systems. Under this entity-by-entity approach, formal political approval of the changes may not be required, and less centralized management of the reforms occurs. However, each individual entity would still need to develop a set of accounting policies and may need guidance on the source and application of authoritative accounting standards. Where financial information from such entities is likely to be consolidated in the future, early specification of certain accounting policies by central entities may prevent problems at a later date.

Transitional Economies

2.11 Transitional economies are often undergoing rapid economic and institutional change and may regard financial management reform as a necessary step in the ongoing redevelopment of the public sector. To this extent, there may be political support for proposed changes. The political acceptance of change means that widespread reform (for example, major changes to the system of financial management, and the adoption of accrual accounting across all types of government entities) is more likely.

2.12 Some transitional economies will have records of assets purchased. The existence of relatively complete asset records makes the identification and recognition of assets a much easier task. Asset accounting policies still have to be developed and applied (for example, recognition thresholds need to be applied to existing asset records) but much less time and resources need to be devoted to asset identification and validation.

2.13 The World Bank and the IMF have been actively involved over the last several years in supporting the governments of countries which were formerly part of the Soviet Union and other countries in Eastern Europe to set up and modernize institutional structures to manage public finances as they move from centrally planned to market economies. As part of this work the World Bank and the IMF have assisted several of these governments in setting up the institutional, legal framework and the information systems required to support the Treasury function. The Treasury Reference Model (Hashim and Allan, 2001) describes the progress achieved in some of these projects. Although the Treasury

Reference Model focuses on the reform of treasury systems, treasury reforms frequently go hand in hand with reform of the budgetary and financial reporting systems.

Developing Countries

2.14 The main constraints facing developing countries, in terms of changes to the basis of accounting used by government entities, are likely to be the existing capability of entities in terms of accounting systems and qualified staff, and the resources available within or outside government to develop that capability. Such resource restrictions mean that developing countries may be more inclined to consider step-by-step implementation paths.

2.15 There is some debate over the benefits of delegating management authority as part of financial reforms, particularly in the context of developing countries. This debate is not central to the adoption of accrual accounting and is therefore not addressed in this Study. However, where such delegation occurs in conjunction with the adoption of accrual accounting, the success of the transition to accrual accounting will be linked to the success of the other management reforms.

2.16 Developing countries may be reliant upon external assistance to implement reforms. Where a jurisdiction is reliant upon such assistance (for example, loans or donor aid) to help resource the transition to accrual accounting, the amount and types of assistance available may influence the transition path. For example, aid agencies may be willing to fund certain developments within a limited number of pilot entities or may offer assistance in the form of expert personnel. Some web sites that include details of financial management assistance projects are listed in Appendix C to this Chapter.

2.17 Developing countries may be more inclined to use training strategies that focus on the development of in-house training and the use of entity staff to deliver training (referred to as the "train the trainers" approach). Although the "train the trainers" approach is an option for any jurisdiction, it is particularly useful where resources are limited or where a jurisdiction is bilingual or multi-lingual. The development of multi-lingual training material is still required under this approach.

Transition Paths

2.18 The style and speed of the transition may vary greatly between entities. A wide range of approaches is possible. Possible approaches are discussed below—various combinations of these approaches are also possible.

Gap Analysis

2.19 Before considering alternative transition paths it is necessary to have a clear understanding of the gap between the current system of financial reporting and the desired system of financial reporting (whether this be full accrual IPSAS or the Cash Basis IPSAS). Regional teams within The World Bank have developed a diagnostic assessment tool called the "Gap Analysis" which facilitates a comparison of a country's public sector accounting and auditing standards and practices with international standards. South Asian countries have increasingly begun to use this assessment tool and have prepared country action plans as part of their gap assessment reports (SAFRM, April 2008).

2.20 This assessment tool has also been used by countries such as Azerbaijan, India, Indonesia, and Tajikistan.

Application of the Reforms to Entities within a Government

2.21 The reforms may be applied to all public sector entities within a government, or they may be restricted to certain types of entities. For example, the implementation of accrual accounting may occur on a sector-by-sector basis. It may begin with autonomous and semi-autonomous government entities which already have some responsibility for managing the resources under their control and which are outside the centralized accounting system. Obtaining political approval for changes in the basis of accounting for autonomous entities and subsequently implementing those changes is often easier because the change is less likely to have implications for the existing system of central budgeting and reporting. Alternatively, the changes may focus first on budget sector entities because such entities make up the core of government activities.

2.22 The transition to accrual accounting may be mandatory for certain types of entities, or it may be voluntary for some or all of them. The advantages of allowing entities to choose to adopt accrual accounting are that the individual entities are then motivated and committed to the reform process. However, voluntary transitions can cause difficulties in that the use of different bases of accounting by various entities within a government precludes the preparation of consolidated financial statements for the whole-of-government entity. The use of different bases of accounting by individual entities within a level of government may also involve different budgeting and monitoring regimes. Voluntary choice (also referred to as self-selection) is sometimes used when a small number of pilot entities are sought to trial the reforms. The use of pilot entities allows a government to gain experience in how to deal with the reforms and the problems likely to be encountered, and assists in developing a core of trained personnel.

2.23 It is possible to design different transition paths for different types or sizes of entities. For example, large entities may be delegated authority to design and oversee the development of their financial information systems, whereas smaller entities may be required to follow a centrally determined transition path, including the implementation of specific financial information systems. For example, many Government Business Enterprises (GBEs) will already use the accrual basis of accounting. The transition path for such GBEs would therefore focus on ensuring consistency of accounting policies and other consolidation issues.

Whole-of-Government Reporting

2.24 Where a government decides to implement whole-of-government reporting, there are a number of paths it can take. The first accrual whole-of-government reports can be required at the same time as the first accrual reports from individual entities or they may be delayed for a period to allow more time to focus on the transition by individual entities, the boundaries of the reporting entity and other consolidation issues. Consolidated accrual reports for various sub-sectors of the whole-of-government reporting entity could be produced as an interim step, followed by complete whole-of-government reports. Another option would be to prepare a consolidated cash flow statement as an interim step.

Step-by-Step Implementation

2.25 Accrual accounting requires the recognition of all assets and liabilities which meet the definition of assets and liabilities and satisfy the criteria for recognition of assets and liabilities. However, this does not preclude an entity from choosing to move to the full accrual basis by recognizing assets and liabilities in stages. For example, it is possible to focus first on the recognition of short-term assets and liabilities such as debtors and creditors. Recognition of property, plant and equipment would often occur next, although recognition of property, plant and equipment may occur in stages with those assets that are readily identified and measured being recognized first.

2.26 Similarly, the recognition of liabilities can occur in a step-by-step manner. Public debt is often recognized first because an entity usually has reasonably accurate records of existing borrowings. Pension and other long-term obligations may be recognized in stages.

2.27 Khan and Mayes discuss possible sequencing for the implementation of accrual accounting, including periodic financial reporting by line entities and at the whole of government level (Khan and Mayes, 2009). One of the possibilities put forward by Khan and Mayes is a staged approach with an initial focus on those financial assets and financial liabilities that are simpler to measure.

Accrual Budgeting

2.28 If accrual budgeting is being introduced as part of the reforms (and in some cases it may not be), the change in budgeting processes may occur at the same time as the initial change to accrual reporting. However, in a number of jurisdictions the implementation of accrual budgeting has occurred at least one to two periods after the introduction of accrual reporting. This delay is sometimes required to provide assurance to those responsible for authorization of budgets that the new financial systems can provide reliable information.

Reform Period

2.29 Usually, the resources available or the extent of political commitment will determine the period over which reforms occur. The length of this period may differ from jurisdiction to jurisdiction. Reform periods may be short (say, one to three years), medium (say, four to six years) or long (say, over six years).

2.30 A short reform period may be appropriate where there is strong political support and a limited number of entities. Medium reform periods provide more time for the preparation of detailed implementation plans, the development of accounting policies, and implementation and testing of new systems. They also provide a reasonably long time for the education of groups such as government employees and politicians regarding the changes. The benefits of a long implementation period need to be balanced against the risks of “reform fatigue.” Reform fatigue occurs when those at the forefront of the changes in government entities lose the sense of urgency and enthusiasm needed to implement the reforms, particularly if no benefits emerge early in the process.

2.31 In selecting a time frame for the transition, a government may also establish target dates or stages (milestones) for the achievement of various aspects of the reforms. Entities may be required to meet certain criteria by certain dates in order to progress to the next stage of implementation. For example, entities may be required to have recognized all major assets and liabilities and have operational information systems before they are permitted to implement cash management reforms. Although there may be some benefits in setting challenging milestones, they should still be achievable. Unrealistic timescales have been identified as one of the reasons for many public financial management reform failures (Pretorius and Pretorius, 2008).

2.32 Governments that have adopted accrual accounting have done so over varying time frames and in some cases, in a number of stages. For example, the United Kingdom produced its first accrual accounts for individual departments for 1999–2000 and the first accrual budget for 2001–2002. A staged approach for the preparation of consolidated financial statements for the whole of the public sector was adopted. Whole-of-government accounts are expected to be published for the first time for 2009–2010. The United Kingdom uses the term “resource accounting and budgeting” (RAB) to refer to accrual accounting and budgeting.

Transition and Audit Requirements

2.33 Where an entity is currently required, or will be required, to present audited financial statements the entity will need to consider possible options for meeting audit requirements during the transition period. The acceptability of options will depend upon current and proposed audit requirements including relevant legislative requirements. Options for dealing with audit requirements during the transition period include:

(a) Continuing to prepare audited financial statements under the existing basis of accounting until the transition is complete. This would involve the preparation of parallel reports for a period of time;

(b) An audit report which states compliance with the stated basis of accounting.[8] This option allows an entity to phase in the requirements of accounting standards over a period of time;

(c) Preparing an unaudited and unpublished set of financial statements as a trial run (often in parallel with the production of a set of audited financial statements under the existing basis of accounting);

(d) Publishing an unaudited set of financial statements as an interim step and for a limited number of reporting periods; and

(e) Publishing an audited set of financial statements with some audit qualifications. A government may choose to give a public commitment to resolve these issues over a set period of time.

[8] The audit opinion will reflect that the financial statements are prepared in accordance with the specified policies, except if legislation requires use of the words “fairly presents.”

2.34 The nature of the relationship between the executive and an external or independent auditor will vary across jurisdictions. Although it is essential that auditors maintain their independence, there are many benefits to be obtained from establishing a cooperative working relationship with the auditor at the beginning of the transition process. This could include formally consulting the external auditor over proposed transition paths. An auditor would be unlikely to give an absolute assurance that a particular system or process would meet audit requirements. However, the auditor may be able to provide helpful advice regarding the criteria that would be used in assessing the system or process. If an entity has an internal audit function, that function may be given responsibility for overseeing aspects of the transition and liaising with external auditors.

2.35 The impact of accrual based accounts on public sector audit in Europe is examined in a paper by the Fédération des Experts Comptables Européens (FEE, December 2008). This paper included the following key messages:

(a) The audit of accrual based financial statements is more complex and causes more judgments to be made by the auditor than the audit of cash based financial statements;

(b) Subcontracting all or part of public sector audits to third parties (usually private sector audit firms) can help to bring specialist skills to those audits where those skills are not present in the public sector audit body. It can also ensure that public sector audit bodies maintain their audit methodologies in line with best practice in the private sector;

(c) The auditor (whether private or public sector auditor) should have the relevant public sector and audit knowledge;

(d) Ideally auditors will be responsible for auditing a number of similar entities as this will allow them to obtain appropriate experience of those types of entities;

(e) Professional bodies responsible for performing public sector financial audits may need to review professional syllabi to ensure that they meet the needs of public sector audits;

(f) The application of generally accepted auditing standards is necessary to assure a uniform audit quality. As discussed in Chapter 1, the International Organization of Supreme Audit Institutions (INTOSAI) provides professional standards and best practice guidelines for Supreme Audit Institutions; and

(g) Quality control procedures in audit bodies may need to be enhanced with the introduction of accrual based financial statements, as audit judgments become more significant.

Implementation Plans

2.36 Having selected a transition path, an entity then needs to develop an implementation plan to enable it to achieve its goals. Appendix A to this Chapter contains the key headings for a generic implementation plan that indicates many of the issues that need to be considered.

Successful Transition

2.37 The transition to accrual accounting is a major project for most governments. Like any large-scale project, it requires careful planning and management. Transition is likely to be smoother and faster when the following features are present:

(a) A clear mandate;

(b) Political commitment;

(c) The commitment of central entities and key officials;

(d) Adequate resources (human and financial);

(e) An effective project management structure;

(f) Adequate technological capacity and information systems; and

(g) The use of legislation.

2.38 This section discusses each of these features. The Chapter also includes references to other works which set out the pre-conditions for the adoption of accrual accounting and factors that influence the success of accrual accounting projects.

A Clear Mandate

2.39 There is a need for a clear mandate from the appropriate level of the government stating what the reforms will encompass, the expected timing and the authority of various government bodies to initiate the changes required. A clear mandate gives relevant officials and entities the power to initiate change and oversee the reforms.

Political Commitment

2.40 Political commitment from both the governing body, or those elected representatives who oversee the governing body, and the opposing party is generally required to secure initial approval for the proposed changes and to provide continuing support for the changes when obstacles or opposition are encountered. Changing the basis of accounting requires considerable resources. If political commitment is not established early in the process, inability to overcome problems later in the process may result in scarce resources being wasted. Because transition may occur over a period of years there may be a change of government or changes within a government during the transition period. It is therefore important to continue to liaise with key politicians throughout the process.

Commitment of Central Entities and Key Officials

2.41 One reason the active support and leadership of top governmental officials and politicians is required is that changes to the basis of accounting, together with other financial management reforms such as the devolution of authority for resources, involve changes to the power structure. Key people who are prepared to publicly stand by the changes may also fulfill the role of “fixers” when things go wrong. Although such key people are essential, it is necessary to guard against the risk of the project failing if a key person withdraws support or is no longer available. Financial reforms may also require a change in the culture of the public service. For example, an individual may be given more responsibility for financial management and be expected to understand and use new types of financial information. Such culture changes take time and effort. The "buy-in" of top officials can help this process.

Adequate Resources (Human and Financial)

2.42 A variety of skills are required to manage and maintain a change to the accrual basis of accounting. Identification of the types of skills required, and planning to ensure the availability of those skills is critical to the success of the transition. An entity will generally need:

(a) Individuals with project management and change management skills;

(b) Individuals with an understanding of and experience in accounting policy issues and systems requirements;

(c) Key personnel who understand the interrelationships between the different elements of the reform process;

(d) Individuals with the ability to record data in an accrual accounting system and to extract and explain information from the system. This would normally involve both the recruitment of additional staff and additional training for existing staff (Chapter 3, Skills Assessment and Training, discusses these issues in more detail); and

(e) Adequate funding for additional resources required, including additional staffing, acquisition of specialist skills, and the development and installation of financial information systems.

An Effective Project Management Structure

2.43 Project management generally involves splitting the project into separate components that can then be managed by individuals with the appropriate skills and experience. A reform project should have:

(a) A documented framework or philosophy. The agreed approach needs to be documented to form a consistent base for the communication of the reforms, to assist staff to understand the reasons for the changes and the approach being taken, and to ensure that actual implementation is in accordance with these decisions;

(b) A formal implementation plan. The nature of the implementation plan will vary depending upon the style and scale of the reforms. Examples of implementation plans (key headings only) for the adoption of accrual accounting are included in Appendix B to this Chapter;

(c) A clear allocation of responsibility for each task and the respective roles and responsibilities of key entities and officials;

(d) Project milestones together with procedures for monitoring the performance of entities and individuals against those milestones. Some jurisdictions (for example, the Philippines and Thailand) have developed "trigger points," which are a series of documented criteria that entities must meet at certain stages of the project. These trigger points form the basis for deciding whether devolution of resources will occur, and the audit report on each stage highlights areas where risks exist and where remedial action may be necessary;

(e) An approval process detailing who has authority for particular decisions;

(f) Formal communication and coordination mechanisms to distribute information to, and collect information from, entities; and

(g) Entities need to know which, if any, additional costs they will receive additional funding for. At a whole-of-government level the additional cost of a major project will need to be incorporated in the budget process.

Adequate Technological Capacity and Information Systems

2.44 The adoption of accrual financial reporting in conjunction with other public sector reforms often involves changes to a wide range of information systems. Entities contemplating a transition to accrual accounting need to perform an assessment of all existing systems that link to the financial reporting system. For example, changes may be required to the following systems:

(a) Revenue;

(b) Purchase acquisition;

(c) Travel;

(d) Grants and benefits;

(e) Human resources and payroll;

(f) Fixed assets;

(g) Property management;

(h) Inventory;

(i) Debt;

(j) Budget;

(k) Non-financial; and

(l) Internal controls and risk management.

2.45 The assessment of existing systems could include the following issues:

(a) The information currently held within the systems;

(b) The additional information required (including an assessment of the information required in order to comply with accrual basis IPSASs);

(c) To what extent centralized systems should be decentralized (this will be dependent upon the policy framework underlying any wider reforms);

(d) The current degree of integration of financial and other systems compared to the degree of integration desired; and

(e) Whether existing systems should be replaced or adapted, and if systems are to be replaced, should the replacement be with an "off the shelf" system or a custom design system.

2.46 Where a government is planning to introduce a new financial management system, it may need to consider redesigning its existing record-keeping systems in order to make sure that they support its financial management systems. Tools for assessing existing arrangements and systems are described in Barata, Cain and Routledge (2001). Such tools include the use of assessment worksheets which require the reviewer to assess matters such as whether the record-keeping system restricts access to records by unauthorized staff and whether an auditor can easily trace transactions from originating documents, manual transaction registers, journals and ledgers, through to successive summarization.

2.47 The evolution of national financial management systems in Korea is discussed by Cheungsuk (Cheungsuk, 2010).

Use of Legislation

2.48 The process of drafting legislation and consulting key groups on the proposed changes has a number of benefits. The use of legislation provides formal authority for the changes and demonstrates the strength of the government's commitment to the changes. The consultation process that usually accompanies legislative changes provides an opportunity to inform and educate other political parties and influential groups within government of the benefits of the changes. The drafting of legislative represents an additional step in the planning and development process. As such, it provides an opportunity to review the proposed changes to ensure they are comprehensive and consistent. As noted earlier in this Chapter, under the entity-by-entity approach, formal political approval of changes to the system of financial reporting and financial management may not be required.

Conclusion

2.49 A number of accrual accounting adoption projects have taken longer than expected or have stalled for various reasons. The experiences of others can inform those embarking on such projects. This Chapter therefore includes some references to documents and websites that document the experiences of individual countries. For example, a course in Financial Planning and Management, developed for use in Somalia, considers the lessons that can be learnt from information systems implementation failures (Somali Financial Management and Planning Online Distance Learning Course, 2006).

2.50 Entities that provide financial assistance to governments for reform projects often make outcome reports available on their websites. Examples of such websites are provided in the references to this Chapter.

Focusing Effort to Use Resources Wisely

2.51 Most entities planning a transition to accrual accounting have limited resources. It is therefore essential that the entities use those resources as efficiently and effectively as possible. Good project management, including clear identification of goals, responsibilities, timelines, and dependencies, is an important aspect of using resources wisely.

2.52 The application of materiality can have a significant impact on aspects of the transition, particularly the speed of the transition. Information is material if its omission or misstatement could influence the decisions or assessments of users made on the basis of the financial statements. For example, obtaining complete and accurate opening balances is one of the first steps in implementing the accrual basis. Identifying and valuing all assets and liabilities can take considerable time. However, it is a fundamental step in the process and, if an entity is seeking an unqualified audit report, the opening balances must be supported by reliable records and appropriate valuations. In establishing the opening balances, the concept of materiality can assist with the identification of those assets and liabilities that will be subject to the highest level of external scrutiny.

2.53 Less-material assets and liabilities still need to be identified and valued in a manner that is acceptable to the auditors. However, it may be possible to produce acceptable short-term information using approaches that require less time and resources than the approaches used for other assets and liabilities. Possible interim solutions which may be acceptable in some situations include:

(a) Using an approximation of the final intended valuation method;

(b) Using samples to determine the reliability or accuracy of information rather than verifying the information held on each item; and

(c) Temporarily omitting specific categories of assets or liabilities from the statement of financial position.

2.54 The concept of materiality can also be used to help structure the consolidation process and the amount of time and effort that goes into calculating the consolidation adjustments. If a particular category of inter-entity transactions is immaterial, the transactions may not need to be eliminated on consolidation. Similarly, if differences between accounting policies do not have a material impact, it may not be necessary to perform adjustments to align the accounting policies of entities within the consolidated financial statements.

2.55 Interim approaches, such as those outlined above, can help an entity make significant and observable progress in short time frames. However, an entity will need to consider whether such approaches will still allow it to meet its objectives, such as an unqualified audit opinion.

Accrual Budgeting

2.56 This Study focuses on the adoption of accrual financial reporting. However, a number of jurisdictions that adopt accrual accounting for financial reporting also adopt accrual budgeting and authorization systems (OECD, 2000 and Blöndal, 2004). The *OECD Journal on Budgeting* contains regular articles on public sector budgeting in specific jurisdictions as well as more general articles about accrual budgeting issues (for example, whether an accrual budgeting system can serve the needs of good fiscal policy (Robinson, 2009)).

2.57 An accrual budget might be supported by forecast financial statements including a projected statement of financial position, statement of financial performance, and cash flow statement. The forecast financial statements, including the assumptions used in preparing those statements, may be subject to review by a legislative body. Ideally formal budget appropriations or authorizations will be consistent with, or linked to, the figures presented in the forecast financial statements.[9]

2.58 The adoption of accrual accounting does not have to be accompanied by the adoption of accrual budgeting. Some jurisdictions and international organizations have chosen to retain existing budgeting systems, or have deferred the adoption of accrual budgeting until future periods. For example, the Tasmanian Government undertook a phased introduction over three years (Tasmania Department of Treasury and Finance, 2000).

2.59 The Occasional Papers published by IFAC document the decisions made by a range of governments. For example, Occasional Paper 5, *Resource Accounting: Framework of Accounting Standard Setting in the UK Central Government Sector* highlights some of the key arguments influencing the decision to adopt an accrual system, not just for financial reporting, but also for budgeting. It is sometimes argued that the benefits of adopting accrual accounting are unlikely to be fully achieved unless the accrual reforms also encompass accrual budgeting (Khan and Mayes, 2009).

2.60 Chapter 21 discusses the requirements of IPSAS 24, *Presentation of Budget Information in Financial Statements*.

Documentation of Accrual Budgeting Practices and Issues

2.61 The OECD is a reliable source of information on the budgeting practices of OECD countries. For example OECD (2009) provides an overview of accrual accounting and budgeting practices in Member countries. A report by the United States GAO (GAO, 2007) provides a narrative description of accrual budgeting in various countries.

2.62 Technical issues associated with the adoption of accrual budgeting have been discussed by Blöndal (2004). Issues discussed by Blöndal include the treatment of non-cash items in appropriations, cash management systems, controlling capital assets acquisitions and opening balance sheet values. As Blöndal notes, these issues relate directly or indirectly to the capitalisation and depreciation of assets. Blöndal also discusses the implications of accrual budgeting for fiscal policy setting and the impact of accrual budgeting on the role of parliament.

2.63 The GAO report (GAO, 2007) examines the challenges and limitations that have been discovered in the use of accrual budgeting and how certain countries have responded to those challenges and limitations.

2.64 A Canadian research report (CICA, 2009) addresses current issues facing Canadian federal, provincial, and territorial governments preparing appropriations documents (appropriations/estimates) and accrual-based budget documents, including the reconciliation of budgets to financial statements in accordance with the relevant Canadian financial reporting requirements.

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9 The process of budgeting and seeking formal approval of anticipated use of resources from a legislative or oversight entity varies between jurisdictions and between sectors within a jurisdiction. Some jurisdictions refer to authorizations to spend money or use resources as appropriations. This Study tries to use terminology that encompasses this diversity.

2.65 This Chapter identifies some issues that jurisdictions adopting accrual budgeting should consider. Chapter 2 of this Study discusses a range of issues associated with the implementation of accrual accounting. Many of the same issues will also be relevant to the implementation of accrual budgeting.

Impact on Approval and Decision-Making Processes

2.66 Governments adopting accrual budgeting need to decide whether to make minimal short-term changes to the appropriation system or to review and enhance the current financial management legislation to fully support an accrual budgeting regime. If legislative change is required then the timescale is likely to be longer.

2.67 If the appropriation process is redesigned those concerned will need to ascertain what type of control parliament or the approving body wants to exercise over specific expenditures, or revenues. They will also need to consider what supporting information is required by key decision-makers. In addition to providing information on the cash flow implications of a budget decision, an accrual budgeting system can provide decision-makers with information on the impact of that decision on debt and operating surplus/deficit.

2.68 Decision-makers may also be faced with new decisions. Because accrual budgeting highlights the immediate expense associated with decisions to gift assets, write-off debt or issue concessionary loans, these decisions need to be built into the budget decision-making process.

2.69 Accrual budgeting raises interesting questions about the extent to which non-cash expenses such as depreciation are funded. For example, should an entity receive additional funding if its depreciation expense increases due to a revaluation of an asset? These issues need to be considered in the context of the budget process so that entities understand which fluctuations in expenses will be funded and which will not (refer to The Federal Finance Administration, 2008 and Queensland Government Treasury, 2002)).

Impact on Fiscal Measures

2.70 Although the adoption of accrual budgeting does not require that fiscal measures be accrual based, because the budgeting system provides information on fiscal measures, the adoption of accrual budgeting is likely to lead to a reassessment of how fiscal policy is formulated and the range of fiscal measures used.

2.71 Accrual budgeting offers a range of, but does not mandate any particular, analytical measures for fiscal policy. Key indicators from the financial statements, such as operating balance, cash balance, and net worth, may be used as fiscal indicators. Individual jurisdictions make decisions about the extent to which they require cash budgeting information within their accrual budgeting framework and the particular measures that they will use. Accrual budgeting may even encourage the use of a wider range of indicators. Khan discusses the ways in which certain governments have used the information provided by accrual budgets to select fiscal indicators (Khan, forthcoming).

2.72 Both GFSM 2001 and European System of National and Regional Accounts (ESA 95) recommend certain accrual-based fiscal policy measures. GFSM 2001 identifies net operating balance as a summary measure of the ongoing sustainability of government operations, and the net lending/borrowing as an indicator of the impact of government activities on other sectors of the economy.

2.73 Robinson discusses issues that may arise in implementing sound fiscal policy under an accrual budgeting system (Robinson, 2009).

Budgeting for Gains and Losses

2.74 Changes in the carrying amount of assets and liabilities arising from revaluation, impairment or foreign currency fluctuations can cause difficulties. In the short-term entities may be unable to control their exposure to such variations. If the formal budget approval process places limits on total expenses, unexpected changes in asset valuations could result in entities breaching approved budgets. However, it is possible to design an approval system that incorporates an automatic approval process for certain changes in assets and liabilities.

Budget Classification

2.75 Any changes to the budgeting system provide an opportunity to review the budget classifications. If the budget classification is compatible with GFSM 2001 and ESA 95 requirements the need for ad-hoc adjustments is limited.

Canada

2.76 Canada, as a case study, illustrates some interesting implementation issues. The experience of the Government of Canada illustrates that the process of adopting accrual budgeting can be lengthy. Despite ongoing discussion over a number of years regarding the use of accrual accounting in appropriations and budgeting, and strong support from the Canadian Office of the Auditor General and a key parliamentary committee, the House of Commons Committee on Public Accounts for this proposal, various Governments did not commit fully to the idea of full accrual appropriations and accrual budgeting at a department-wide level.

2.77 Factors that have contributed to this lack of enthusiasm have included the complexity and cost of the project. The complexity is heavily influenced by the need to redesign the appropriation process and the information provided to support appropriations.

2.78 In 2006 the Standing Committee on Government Operations and Estimates recommended that the Government adopt full accrual accounting for budgeting and appropriations (House of Commons, Canada, 2006). The Committee also made more detailed recommendations regarding implementation. The Committee's suggestions are set out in its report to the Government and include:

(a) The establishment of a Project Implementation Office with a clear mandate and responsibilities for implementing accrual accounting in budgeting and appropriations;

(b) The development of a training and communications plan for financial officers (which highlights the new possibilities afforded by accrual accounting through an emphasis on the management of public resources, assets, and liabilities);

(c) The provision of information sessions for Members of Parliament so that they may become familiar with the general principles of accrual accounting and the changes it brings about in the budgetary and estimates documents;

(d) A proposed timescale of five years for the completion of the project; and

(e) Consultation with members of Parliament about the proposed format for presenting information about appropriations.

2.79 The Government subsequently proposed a two-phased approach to the use of accrual accounting in appropriations and department-level budgeting (Government of Canada, 2007). The Government proposed that the first phase focus on the development of a model of accrual-based appropriations and budgeting and the second phase focus on implementation of the model. The Government noted that evidence from the recent meetings of the Standing Committee on Government Operations and Estimates on the issue of accrual budgeting and appropriations suggested that five years is a reasonable timeframe for development of a model and the implementation of ensuing changes to systems, processes and legislation as well as the development and provision of guidance on the new model.

2.80 In line with the Government's proposed adoption of accrual appropriations and budgets ten pilot departments have since presented their annual business plan on an accrual basis.

Chart of Accounts

Introduction

2.81 The development of a new chart of accounts is a key step in the adoption of accrual accounting. A well-planned chart of accounts can assist in the efficient generation of financial information for a variety of purposes.

2.82 A chart of accounts is a systematic coding system for the classification and coding of transactions and events within the accounting system. It defines the organization of ledgers used within the accounting system. The types of classifications provided for by a chart of accounts may include economic, functional, administrative, and regional classifications as well as more detailed classifications for cost centers, programs, projects, outputs, and outcomes.

2.83 The chart of accounts is not used solely in the preparation of external financial statements. It may also be used to support the preparation of internal management reports, the preparation of regulatory information and the tracking of expenditure against budgets and the preparation of fiscal reports (for example, Government Finance Statistics Manual (GFSM) 2001,[10] the European System of Accounts (ESA) 1995, and System of National Accounts (SNA), 2008). In order to eliminate the unnecessary reclassification of

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[10] A 2008 version of GFSM is expected to be published shortly.

financial data or duplicating the entry of data, it is helpful if the chart of accounts can support a range of governmental reporting requirements.

2.84 Once established, the chart of accounts becomes a fundamental component of the processing of financial information from simple tasks like paying bills to complex activities such as financial reporting. Because it is embedded in the processing activities of the entity, it becomes costly to change. It is therefore essential that the chart of accounts is carefully designed to allow for change and growth and to meet the various reporting needs of the entity. Accordingly, in developing a chart of accounts, at a minimum, entities need to consider:

(a) The requirements of IPSASs regarding disclosure of assets, liabilities, revenues, expenses and cash flows;

(b) The need for definitions to be sufficiently clear that transactions are classified appropriately;

(c) Whether, either now or in the future, the chart of accounts is also intended to support the monitoring of spending against budgets (even if the budget remains on the cash basis);

(d) Whether, either now or in the future, the chart of accounts is also intended to support a government's fiscal reporting;

(e) The process by which the chart of accounts will be updated annually to take account of new developments in financial reporting;

(f) The extent to which individual entities should be able to modify or add to the chart of accounts; and

(g) Any relevant legislative requirements.

Budget Classification

2.85 In a well-designed system, the chart of accounts should incorporate the budget classification (Khan and Mayes, 2009). In the same way that the chart of accounts is a systematic coding system for the classification and coding of transactions and events within the accounting system, a budget classification is a systematic coding system for the classification and coding of transactions and events within the budget system. If the chart of accounts incorporates the budget system it will include all the accounts specified in the budget classification, together with other accounts required for accounting and reporting purposes (for example, assets, liabilities and revenues).

2.86 In Argentina the governmental accounting and budget systems are largely integrated. The link between the budget and the chart of accounts and the reporting of differences between budgets and financial reports is discussed in Occasional Paper 7 (IFAC, 2004).

2.87 Khan and Mayes also note that if a government moves to accrual accounting and accrual budgeting simultaneously, then the chart of accounts and the budget classification can be expected to be unified, at the appropriate level of aggregation.

2.88 If a government elects to report on the accrual basis of accounting, but budget on a cash (or modified cash) basis, a combined chart of accounts will be more complicated as it will need to be able to generate both reports on both the accrual basis and cash basis of accounting.

Moving from Cash to Accrual Accounting

2.89 The chart of accounts required by an entity reporting on the cash basis of accounting is simpler than the chart of accounts required for an entity reporting on the accrual basis. However, an entity reporting on the cash basis can adopt a chart of accounts which is compatible with accrual accounting and thereby facilitate a subsequent transition to the accrual basis.

2.90 The Treasury Reference Model recommends that treasury systems should be designed to allow for improvement in the accounting information available to decision-makers (World Bank, 2001). It therefore recommends the adoption of an accrual-based account structure even where a government is proposing to report on the cash basis for some period.

Central Chart of Accounts

2.91 Where a number of individual entities are required to provide information to a central entity for the preparation of consolidated financial statements or for other reporting purposes, it is usual to have a central chart of accounts. However, even in a federal setting, where there is no such reporting requirement, a unified chart of accounts can prove helpful, given the costs of developing a charts of accounts and the desirability of being able to due to generate GFS data in a cost-efficient manner. This central chart of accounts needs to:

(a) Meet the needs of both individual and central entities;

(b) Provide a uniform structure for coding financial transactions; and

(c) Permit sufficient flexibility for individual entities to adapt it to their particular requirements.

2.92 In many countries the chart of accounts is the traditional approach to harmonization of accounting. Some harmonized charts of accounts have been in place for decades. In such a situation, it is strongly advisable to base projects on an improvement of this chart of accounts.

2.93 The central chart of accounts needs to be developed early in the process of adopting accrual accounting to allow individual entities time to tailor it to their own needs. Individual entities need to incorporate the requirements of their chart of accounts when specifying the deliverables required from accounting software. Where the entity plans to purchase accounting software, it is important to ensure that the chart of accounts in the software provides sufficient flexibility for the entity's needs.

2.94 The level of flexibility granted to individual agencies will vary among jurisdictions. In Sweden, a standard chart of accounts was developed but was not made compulsory (Lundquist, 2001). Swedish agencies were permitted to adapt the chart of accounts. In Switzerland, despite its strongly federal structure, the core of the chart of accounts (being the first four digits) is mandatory for all entities.

Legislative Requirements

2.95 There may be legislative or constitutional requirements that govern the chart of accounts. For example, in 1997, the Georgia General Assembly passed the Local Government Uniform Chart of Accounts and Reporting Act. This Act called for the Georgia Department of Community Affairs to develop a uniform chart of accounts to be used by local governments in the state. All of Georgia's county and municipal governments, and organizations controlled by them, are required to comply with the provisions set forth in the uniform chart of accounts.

Maintaining the Chart of Accounts

2.96 Following the development of a new chart of accounts, it is necessary to assign responsibilities for the day-to-day management of the chart of accounts and prevent unauthorized changes. Day-to-day management includes establishing, deleting, or modifying accounts or codes and publishing updates to the chart of accounts. Supporting guidance and monitoring may also be required to ensure consistent use of codes.

2.97 An explanation of how centralized governance and ownership of a chart of accounts can work is set out in Deloitte (2009).

Examples

2.98 Information on the development of the charts of account and reporting formats in certain jurisdictions is found in the following:

(a) Bosnia (Vickland and Nieuwenhuijs, 2005);

(b) Bulgaria (OECD, 2004);

(c) Canada (Public Works and Government Services Canada, 2010);

(d) Republic of South Africa (National Treasury, 2004);

(e) Sweden (Lundquist, 2001);

(f) United Arab Emirates (United Arab Emirates, 2005); and

(g) Various (PEM PAL, 2008).

Fiscal Reporting

2.99 Government Finance Statistics (GFS) is an accrual basis reporting system. GFS also imposes requirements for the chart of accounts to be used. Although there are some differences between the requirements of GFSM 2001 and accrual basis IPSASs, it is possible to develop a chart of accounts that can support both sets of reporting requirements. Indeed some governments adopting accrual accounting begin with the GFS chart of accounts and add to it to ensure IPSAS compliance. Examples of projects to develop or revise charts of accounts are listed in Appendix C to this Chapter.

2.100 The IPSASB has recognized the importance of GFS reporting for governments and has worked with the IMF to identify and gradually reduce the main differences between IPSASs, GFSM 2001,the European System of Accounts (ESA 95) and the System of

National Accounts, 2008 (2008 SNA). Some of the differences between IPSASs and other reporting systems are set out in *International Public Sector Accounting Standards (IPSASs) and Statistical Bases of Financial Reporting: An Analysis of Differences and Recommendations for Convergence* (IPSASB, January 2005).

2.101 In order for a chart of accounts to support GFS reporting it will need to include both the economic classification and the functional classifications including Fund, Function/Program, Organizational Unit, Location, Activity, Character and Object in alignment with Classifications of Functions of Government (COFOG).

Other Classification Systems

2.102 Entities that use standard classification systems such as the NATO Supply Code and the North American Industry Classification System (NAICS), may need to align the chart of accounts with these systems.

The Impact of EU Accession on Budgeting, Control and Audit

2.103 The Organisation for Economic Co-operation and Development (OECD) has published a study that describes the experience of certain member states in integrating national and European Community budgetary procedures and requirement*s (OECD 1998a, OECD 1998b).* Preparation for EU membership (for example, additional staff training and the development of new information systems) can be successfully combined with more widespread financial reforms. One implication of EU membership is that generally more emphasis needs to be placed on internal control systems and internal audit.

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Appendix A

Generic Implementation Plan—Key Steps

Project Initiation

- Document project and obtain project approval
- Establish the steering committee
- Prepare detailed project plan(s)
- Establish project team
    - Project sponsor
    - Project manager
    - Project team (team leader/director and other staff)
    - Identify required resources
    - Obtain required resources

Detailed Scoping and Planning

- Document existing processes, procedures, and legislative requirements (including existing accounting policies and systems)
- Identify proposed changes or areas of change (including proposed accounting policies and systems)
- Systems planning
    - Identify structure/ownership of proposed systems
    - Identify system requirements (existing and new systems)
    - Identify control requirements
    - Identify interfaces required
    - Develop the chart of accounts
    - Develop interfaces (if applicable)
- Reporting
    - Develop new reporting requirements
- Audit
    - Liaise with external auditor to assess impact of changes on audit process
    - Identify role of internal audit during the change process
- Develop communications plan

- Prepare training strategies (for example, project team, accrual accounting, and computer literacy)
- Develop change management strategy

Implementation Phase

- Initiate project management responsibilities and reporting structures
- Implement new systems/system changes
- Implement interfaces
- Develop detailed accounting policies
- Develop/amend supporting financial management policies and procedures
- Implement roles and responsibilities
- Deliver training
- Obtain approval to switch to new systems
- Implement other phased projects (for example, the recognition of specific categories of assets or liabilities may be phased)

Reporting

- Develop improved external and internal reporting
- Develop financial and non-financial performance measures
- Review controls and procedures that support the integrity of financial and non-financial information

Appendix B

Sources of Information on Implementation Plans

Plan to implement accrual accounting within a jurisdiction previously using modified accrual accounting: Financial Information Strategy (FIS) in the Canadian Federal Government Implementation Strategy Guide, January 1999
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http://www.gasab.gov.in/pdf/Roadmap_final%20Copy_01%20Dec%2007.pdf

Khan and Mayes (2009) contains a list of key implementation activities and possible phasing of implementation
http://www.imf.org

Report on Assessment of the Existing System of Accounting and Financial Reporting and its Current Capacities, PHP Partners cjsc, September 2008. The report includes an Appendix setting out Steps to be undertaken for developing RA Public Sector Accounting Standards in Armenia.United Nation Agencies' IPSAS Implementation Reports and Plans: This website

provides access to individual United Nations System agencies' IPSAS decision papers and reports, and other material (e.g. guidelines) prepared in connection with their move to IPSAS
https://fb.unsystemceb.org

UNICEF *International Public Sector Accounting Standards (IPSAS) Project Implementation Plan*, July 2009
http://www.unicef.org

United Nations Development Program, UNDP's *IPSAS Adoption Strategy*, September 2009.

This document proposes a strategy for the adoption of IPSAS in the light of UNDP's decision to reschedule its adoption timeline to 2012. It outlines UNDP's approach for achieving its IPSAS goals, summarizes the recent gap analysis, and recommends a phased delivery strategy for IPSAS adoption
http://www.undp.org/

World Meteorological Organisation, *Implementation of International Public Sector Accounting Standards (IPSAS)*, June 2008
ftp://ftp.wmo.int/Documents/SESSIONS/EC/EC-LX/English/DOCs/pdf/d08-2_en.pdf

Appendix C

Web Sites with Details of Financial Management Assistance Projects

http://www.adb.org/Publications

http://www.ausaid.gov.au

http://www.sagric.com.au

http://www.worldbank.org

http://www.dgmarket.com/tenders/

Chapter 3: Skills Assessment and Training

Key Points

- All personnel involved in the transition to accrual accounting should understand the reasons for the change, be capable of implementing the changes they have responsibility for, operate the new systems and procedures, and understand the information produced.
- Entities need to assess the impact of the changes on the competencies required in relevant positions, and develop a strategy which includes, but is not confined to, training for upgrading skills.
- Options for addressing gaps in competency include recruitment, consultants, development of external courses, and training for existing staff.
- Separate outreach activities and information materials are required for educating and creating awareness in groups such as politicians and the media.

Introduction

3.1 This Chapter discusses issues associated with the identification, design, and delivery of training, under the following headings:

(a) Identification of target groups;

(b) Identification of training needs;

(c) Training strategies;

(d) Delivery of training;

(e) Evaluation and assessment;

(f) Cross-training;

(g) Ongoing training;

(h) Lessons learned; and

(i) Informing politicians and the media.

3.2 Although this Chapter focuses on training, some of the issues raised in this Chapter are also relevant in relation to the broader concept of capacity building. Capacity building includes human resource development, organizational development and international and legal framework development. Training is one aspect of human resource development.

3.3 The successful adoption of accrual accounting (in part or in full) and the associated systems changes cannot occur without appropriately trained personnel. In addition, training on the benefits of accrual accounting and general awareness of the reforms and expected benefits is crucial—people need to be convinced of the benefits or they will not see the purpose of the reforms. Such training needs to occur at all levels of government and needs to be at least partially driven and "owned" by individual entities. The development of an effective training strategy and delivery of appropriate training in accordance with that strategy are essential elements of transition risk management. The risks associated with a transition to accrual accounting are that the project will fail to deliver the expected benefits, be over budget or behind schedule. The development of training strategies and the implementation of training programs should therefore be identified as project milestones.

3.4 In common with any major reform or systems change, in order to reap the full benefits of the change, it is important that personnel:

(a) Understand the reasons for the changes, the reform design, the implementation approach and reform implications (training is one way of implementing a communications strategy);

(b) Understand the practicalities of implementing the reforms in their own entity and are able to implement the changes;

(c) Are able to operate systems and procedures following implementation (at both a centralized and decentralized level); and

(d) Are able to use the information generated by new systems.

3.5 In addition to changes in the specific skills required, the implementation of changes to financial management systems may also require cultural or “mind-shift” changes. For example, senior public officials may be expected to assume much greater responsibility for the financial management of an entity and there may changes in the number of employees required. It is important that both the technical and the cultural aspects of change are addressed in the development of communications and training strategies. Entities undergoing widespread changes such as those associated with a transition to accrual accounting may benefit from a structured approach to transitioning individuals, teams, and sub-entities from the current state to the desired future state. This process, which is commonly referred to as change management, is not specifically addressed in this Study but is addressed elsewhere (for example, UNDP, 2006)

Identification of Target Groups

3.6 The identification of target groups and the development of training strategies for each target group mean that training can be customized to the needs of specific groups. The number of target groups identified will depend upon the size of the organization and the resources available. When resources are limited, broader target groups and more generalized training may be necessary.

3.7 Although the nature and composition of target groups will vary across entities, the following examples may assist entities to identify appropriate target groups.

Examples of Target Groups Within a Central Government:

- Politicians and Legislative Users
- Public Oversight Bodies
- Central Entities (for example Audit, Personnel)
- Budget/Finance Analysts in Finance Entities
- Heads of Departments/Entities
- Senior Managers
- Operational Managers
- Finance Managers
- Finance Staff
- General Staff
- Media

Examples of Target Groups Within an Individual Entity[11]:

- Reform Implementation Team
- Senior Management
- Program Managers
- Administration Support to Program Managers
- Senior Finance Managers
- Finance Officers
- Internal Auditors
- System Operators
- Asset Managers (for example, Inventory and Property Managers)
- Functional Support Groups (for example, Purchasing Staff)

3.8 The purpose of training target groups may vary. For example:

(a) Raising awareness of key leaders of the government regarding the role, purpose, and objectives of the reform will reinforce political support; and

(b) Management and other staff need to understand their roles and responsibilities within the context of the reforms, their responsibilities within their sub-systems, and the relationships between the various sub-systems.

[11] Some of these target groups may also be applicable at the whole-of-government level.

Identification of Training Needs

3.9 "Needs" assessment involves identifying discrepancies between existing capacities and the capacities desired following the reforms, and determining the relative priority of discrepancies.

3.10 In order to identify training needs it is necessary to look at the impact of the reforms on the type of skills, knowledge, and behavior (referred to collectively as competencies) required for various types of positions. Many reforms include decentralization of functions and this can have a major impact on the competencies required.

3.11 Competencies are most useful when they are expressed in terms of outputs and behavior. Competencies may be expressed in levels (for example, level 1 could be used to denote core skills, and level 2 could be used to denote advanced skills), but such levels will not necessarily link directly to particular grades within the public sector remuneration system. A mix of competencies, experience, and responsibility usually determines grades and pay of individuals and positions. Although the development of a competence framework may take some time, the existence of a generic framework for certain public sector positions allows individual entities to more easily develop their own competence framework and makes it easier to identify training needs.

3.12 Useful references for the development of competencies include:

(a) *Financial and Accountancy Competences Framework: Report by Working Group* (HM Treasury, 2000). This document includes examples of generic competencies for various financial and accounting positions within the public sector, and explains how those competencies link to relevant national qualifications.

(b) *Principles and Practices in Managing Financial Records: A Reference Model and Assessment Tool* (Barata, Cain and Routledge, 2001). This document provides a skills matrix for assessing the skills and knowledge required at different levels for managing financial records.

(c) *Towards Competent Professional Accountants* (IFAC, 2003). This paper explores the topic of accountant competency, providing an analysis of approaches used by various accountancy institutes around the world. The paper defines the term "competence," provides guidance to accountancy membership bodies in adapting their own qualifications to a competence-based approach, and assesses various issues surrounding competence-based approaches and how they can be addressed. The framework within the paper draws together two different approaches to develop competent professional accountants: the functional analysis which focuses on performance outcomes (accountants performing roles and tasks in the workplace to a defined standard) and a second approach which focuses on capabilities such as knowledge, skills, and abilities.

3.13 Once the skills required under the new system have been identified, these requirements can be compared with the skills and experience available. It may be helpful to differentiate between those skills that are commonly required in the private sector and those that relate exclusively to the public sector. This would be of use if wide-scale recruitment from the private sector were likely.

3.14 When an entity moves from a cash basis to an accrual basis of accounting, it experiences changes in the types of knowledge required, and in the way in which the organization is managed and operates. Under a cash basis of accounting, it is common for many accounting and management functions to be centrally managed and for individual entities to have limited authority over assets and other resources. In this type of environment, accounting skills are not in high demand and as a consequence there may be a severe shortage of personnel with the accounting qualifications required to implement accrual accounting.

3.15 However, training will need to focus on more than accounting skills. In the public service, training generally has two different components:

(a) A technical component that reflects the knowledge and skills to be mastered; and

(b) An environmental or organizational component that reflects the values, policies, and practices of the public service.

3.16 In other words, it is not sufficient for personnel to master the technical aspects of accrual accounting and information management. They must understand the reasons for its implementation, as well as the rules, the policies and the new norms of the government. The adoption of accrual accounting is also usually accompanied by devolution of financial management responsibilities to program managers. They cannot take initiative, be critical, or feel accountable if they do not understand the foundation for the changes.

3.17 Once the gaps between the skills and experience currently available and those required to implement and operate the new systems have been identified, the next step is to consider alternative ways of meeting those training needs and, where appropriate, to develop training strategies.

Training Strategies

3.18 Options for addressing the gap between the capabilities of existing staff and the capabilities required include:

(a) Recruitment from the private sector;

(b) Recruitment from other public sector entities;

(c) Use of consultants/contractors;

(d) The development of university (and other courses);

(e) The provision of training to existing staff; and

(f) Seminars and workshops by external audit entities.

3.19 The resources available will determine the appropriateness of various training strategies. For example, limited resources may mean that training takes place over a longer time frame and that existing staff are used to develop and deliver training programs. The types of systems and software chosen will also impact on training strategies. For example, if “off-the-shelf” software solutions or “industry standard” approaches are used, it is likely that either the manufacturer or other private providers will already have developed training material to support the product or approach.

3.20 This Chapter focuses on issues associated with training existing staff.

Recruitment from the Private Sector

3.21 An entity's ability to recruit qualified staff from outside the public sector will depend upon the state of the labor market at that time and the ability of the public sector to meet private sector remuneration and other terms and conditions of employment.

3.22 It will also depend upon whether individuals with private sector experience perceive that they have the appropriate skills and experience to transfer to the public sector environment. Mobility of individuals between the private and public sectors is enhanced when financial reporting and underlying systems requirements are similar in both sectors. There will usually be some differences in financial reporting between the two sectors. However, public sector entities can choose a style of reform that minimizes these differences and increases the likelihood of people, systems, and training resources transferring between sectors.

3.23 The high degree of similarity between many IPSASs and equivalent IFRSs has facilitated the exchange of knowledge and personnel between the public and private sectors. The widespread international adoption of IFRSs means that individuals with a good knowledge of IFRSs are now available in many jurisdictions.

Use of Consultants and Contractors

3.24 In the short term, the use of consultants and contractors may be an efficient way to meet immediate resource needs or to obtain specialized assistance. Some factors to consider in obtaining maximum benefit from consultants include:

(a) The early identification of skilled personnel to work alongside consultants;

(b) The use of a formal agreement to transfer knowledge to permanent staff;

(c) The development of teams and mechanisms so that this knowledge transfer can occur; and

(d) The use of guidelines and monitoring procedures to ensure sustainability in the knowledge transfer.

3.25 Where there is a shortage of consultants in a particular field, the cost of using consultants may be very high relative to the cost of training existing staff. However, even in such cases, there can still be benefits in using a limited number of experienced consultants together with internal staff. For example, the use of experienced systems consultants can reduce the risk of inappropriate configurations and subsequent re-work.

Recruitment from Other Public Sector Entities

3.26 Individuals working for other public sector entities that have recently made a similar transition to accrual accounting are likely to have highly relevant skills and experience.

Development of University (and Other) Courses

3.27 The development of customized public sector courses to be offered by academic or other training institutions requires a significant investment in time and other resources. However, where the number of staff requiring training warrants the development of customized courses, the following benefits can occur:

(a) Increased relevance of training for participants;

(b) Knowledge learned may be directly applied—the learner is not required to assess the extent to which the course material is applicable to the public sector environment;

(c) Following the initial investment in time, little effort is required by the government; and

(d) The course is a long-term resource which can be developed and refined to keep pace with further public sector changes.

3.28 The courses developed in conjunction with academic or training institutions may be general or specific. For example, a general course such as an introductory course in government accounting could be developed. This type of course would then be available to existing government employees and the wider student population, thus increasing awareness of government accounting among potential future employees. More specific courses consisting of a number of modules may be developed for targeted groups of employees. For example, a program could consist of a mixture of core modules and a number of optional modules.

The Provision of Training to Existing Staff

3.29 Training can be provided to existing staff through:

(a) Seminars and workshops provided by professional accounting bodies;

(b) Formal courses offered by academic and other training institutions (such training may be available as part of a formal study leave program);

(c) Courses developed and offered by government training facilities (these courses may also be made available to individual entities who wish to customize the materials); and

(d) Internal seminars, workshops, and conferences by individual entities.

3.30 Possible training topics include:

(a) Overview of reforms;

(b) General awareness of the reforms and anticipated benefits;

(c) General principles of accrual accounting;

(d) Code of ethics/code of conduct;

(e) Corporate governance;

(f) Accrual accounting;

   (i) Government accounting standards and policies;
   (ii) Preparation of financial statements;
   (iii) Meeting internal and external audit requirements;
   (iv) Chart of accounts;
   (v) Accounting for assets;

(g) Management of assets, liabilities, revenue and expenses;
(h) Internal controls under the new system;
(i) Systems training; and
(j) Project management.

3.31 Centrally developed material can be provided to individual entities so that the effort required for customization is minimized. Central entities may also choose to provide details of qualified instructors for various aspects of training. However, individual entities are often responsible for identifying their own training needs and deciding how to meet those needs. For example, where a number of entities are implementing the same financial systems, a central entity or group of entities may organize customized courses and workshops specific to that financial system. However, each entity would normally be responsible for determining the extent of its involvement in such training and in selecting the individuals who are to participate.

Delivery of Training

3.32 Entities have a number of training decisions to make, including:

(a) Training topics and content;
(b) In-house or external provider (or some mix, such as “train the trainers”);
(c) Method of delivery; and
(d) Timing of training.

3.33 Methods of delivery could include a mixture of:

(a) Instructor-led classroom training;
(b) Multi-media computer-based training (CBT) (instructor-led or self-paced);
(c) Online distance learning programs;
(d) Workshops; and
(e) On the job training (internships).

3.34 The choice of training will need to take into account cost, time constraints and the ability of staff to be released from work for training.

3.35 The “train the trainers” approach, whereby an entity’s own staff is trained to act as trainers for other staff is a low cost way of disseminating externally developed material. Benefits of the “train the trainer” approach include:

(a) Lower cost than using consultants to train all personnel;

(b) The training material is understood at an in-depth level by a wider number of entity staff;

(c) Staff may be more receptive to being trained by colleagues;

(d) Where more than one language is used within a jurisdiction this approach makes it easier to provide bilingual or multi-lingual training; and

(e) The trainers become expert resources for the entity and are useful long after the entity has converted to accrual accounting.

3.36 However, the "train the trainers" approach carries some risk. Possible problems with this approach include:

(a) Staff selected to be trainers because they have certain technical competence may not be comfortable in a training role;

(b) Trainers may not deliver the message as well as experienced external trainers; and

(c) Trainers' ongoing responsibilities within the organization may leave them with insufficient time to fulfill a training role.

3.37 Where the "train the trainers" approach is used, the commitment of trainers can be increased by ensuring that they are convinced of the importance of the changes and the need for the training.

3.38 The timing of training is important. If it is too early in the transition process, staff may forget what they learned and need refresher courses. Although general training may commence up to a year prior to implementation, some training (for example, systems training) will be best delivered just prior to implementation. Topics such as using the financial information generated by the new systems may be required both before and after implementation.

Evaluation and Assessment

3.39 A post-implementation review of the training can be used to evaluate the effectiveness of the training provided and assess the need for further training.

3.40 Issues raised by auditors in management letters and opinions may also indicate the extent to which additional training is required.

Cross-Training

3.41 In developing training strategies for various groups of staff, an entity may wish to consider cross training certain groups of staff, for example, accounts payable and purchasing staff. Cross training refers to the practice of training staff in two or more areas. Cross training means that staff is more aware of the links among various activities. It may also permit staff from one area to work in other areas to ease high workloads or staff shortages.

Ongoing Training

3.42 Ongoing financial management training is generally required. A summary of the new system and the financial management responsibilities of various staff need to be built in to induction programs for new staff and regular refresher courses for other staff.

3.43 Following the introduction of accrual accounting, an entity will need to develop policies and procedures to support the operation of systems and the management of financial risks. Up-to-date policy manuals and guidelines are a form of training that assist employees in carrying out their duties.

Lessons Learned

3.44 A study prepared on behalf of the Treasury Board of Canada identified some key “lessons learned” from public sector entities that have already converted to accrual accounting systems (Hickling Corporation, 1997). These lessons learned included the following.

(a) It is almost impossible to overestimate the amount of training required.

(b) Anticipate staff turnover during implementation, since this increases the burden on training and could delay project implementation.

(c) Training is best when using actual data because it is more meaningful to personnel being trained.

(d) Try an integrated training approach which allows participants from different work areas to discuss what they do and how they interface.

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PART II—GENERAL FINANCIAL REPORTING ISSUES

Part II of this Study outlines the steps required to develop accounting policies in accordance with IPSASs. It also applies the guidance in IPSAS 6, *Consolidated and Separate Financial Statements* to illustrate the types of issues that need to be addressed in identifying controlled entities for the purpose of preparing consolidated financial statements.

Chapter 4: Accounting Policy Issues

Key Points

- IPSASs specify the required accounting treatment for certain transactions and events. In the absence of an IPSAS, an entity needs to develop policies based on other authoritative guidance in accordance with IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*.
- The development of accounting policies includes identifying those bodies and individuals with the authority to develop and approve policies for various reporting entities, and establishing an appropriate process for the development and approval of such policies.
- Consultation on proposed accounting policies is a useful quality check and assists with communication.

Introduction

4.1 This Chapter describes some of the key steps involved in developing and approving a set of accounting policies. An early focus on accounting policies is appropriate, as accounting policies affect the subsequent requirements of information systems, training strategies, and communication strategies. For example, entities which have not previously used accrual accounting may have written off property, plant and equipment and intangible assets when the assets were acquired. In such cases, the entity will need to be concerned with establishing reliable cost figures for initial recognition of those assets in accordance with the relevant IPSAS. This may be difficult if there are no records of the initial purchase, construction or development, or receipt of the assets. If an entity decides to subsequently revalue certain classes of property, plant and equipment or intangible asset to fair value, it will also need to develop procedures for obtaining fair values on a regular basis and ensure that the accounting information system is designed to accept revaluations.

Definition of Accounting Policies

4.2 Accounting policies are the specific principles, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statements. Accounting policies explain the application of the requirements in relevant accounting standards to an entity's transactions and balances, and, where an IPSAS permits alternative accounting treatments, which option an entity has selected.

4.3 In developing accounting policies an entity looks first to the requirements of relevant IPSASs. Where there is no IPSAS on a topic, an entity will need to develop policies based on other authoritative guidance in accordance with the requirements of IPSAS 3. IPSAS 3 contains guidance on the selection and application of accounting policies and specifies the accounting treatment for changes in accounting policies.

4.4 IPSAS 1, *Presentation of Financial Statements* requires the disclosure of significant accounting policies in the notes to the financial statements. IPSAS 1, paragraph 134, states, "In deciding whether a particular accounting policy should be disclosed, management considers whether disclosure would assist users in understanding how transactions, other events and conditions are reflected in the reported financial performance and financial position." IPSAS 1 also gives examples of accounting policies that an entity might consider presenting. Appendices 1 and 2 to this Chapter include more extensive lists of topics for which an entity may need to develop an accounting policy or prepare a disclosure statement, for the accrual basis of accounting and the cash basis of accounting, respectively.

4.5 The summarized accounting policies presented in an entity's financial statements focus on significant accounting policies. However, for internal purposes an entity is likely to have a much more detailed description of its accounting policies. In the case of revenue items, the more detailed policies may describe the classification of each type of revenue, the point at which that revenue item is to be recognized, the method of calculating amounts receivable, and the way in which impairment of the receivable is assessed. The United Kingdom *Government Financial Reporting Manual* (HM Treasury, 2009) is an example of the detailed accounting policies used by an entity.

4.6 The initial accounting policies developed by an entity should also include an explanation of the valuation methods used to obtain opening balances for certain assets and liabilities, details of any transitional provisions applied, and the impact on those transitional provisions on the financial information. Further discussion of possible approaches to establishing opening balances of assets is found in Chapter 6.

Accounting Policies and Other Policies

4.7 Accounting policies and financial management policies are interrelated. Entities making the transition from cash to accrual accounting will need to establish a new set of accounting policies and review existing financial management policies in areas such as debt management, cash management, asset management, and financial authorities/delegations. For example, asset management guidelines under the cash basis of accounting may state who is responsible for the custody and maintenance of an asset, what steps they are required to take to safeguard the asset, and who is responsible for reporting loss or damage to the asset. At initial recognition of the asset for accrual accounting purposes, the basis for establishing cost will need to be determined in accordance with relevant IPSASs (e.g., inventories, investment property, property, plant and equipment and intangible assets). Following the introduction of accrual accounting, asset management policies may also state who has the authority to enter or amend data in the financial systems. In the case of assets, this may include policies related to recording depreciation/amortization on a regular basis, subsequent fair value measurement and policies and procedures relating to identification and measurement of impairment.

The Development and Approval of Accounting Policies

4.8 The development and approval of accounting policies includes both process tasks and technical specification of policies. The tasks identified in this section have been written from the perspective of a government intending to produce whole-of-government financial statements which are consistent with IPSASs. Many of the tasks are also relevant for individual public sector reporting entities. In the case of an individual reporting entity, one of the first steps would be to establish the extent of the entity's authority to develop its own accounting policies.

4.9 The development of accounting policies includes the following steps:

(a) Identify who has the authority to approve the policies. Where consolidated financial statements will be prepared, it is desirable to have consistent accounting policies across the group reporting entity. In the absence of consistent accounting policies, adjustments are required at the time of consolidation. For this reason, a central body commonly retains the right to determine significant accounting policies. However, this does not preclude individual entities from being given the authority to develop more detailed accounting policies or policies for transactions and balances that are specific to their entity.

(b) Identify those responsible for developing and reviewing the policies prior to final approval. Appropriate representatives may include the chief financial accountant, internal auditors, and financial officers from a range of entities (in terms of both size and functions).

(c) Establish time frames for development, consultation and approval.

(d) Decide whether legislative backing for the accounting standards is desired, and if so, initiate legislative changes.

(e) Identify authoritative accounting standards. Where there is no IPSAS on a particular topic, consider the applicability of other requirements in IPSASs and identify other sources of authoritative guidance in accordance with IPSAS 3. Where there are no authoritative accounting standards applicable to the public sector within a jurisdiction, it will be necessary to identify and/or develop a procedure for the development and approval of such accounting standards.

(f) Identify conflicts between accounting standards and legislation (if at all), and develop approaches to address these.[12]

(g) Identify any specific statutory disclosures that would require accounting policies.

(h) Develop a full set of accounting policies for internal use, as follows:

(i) Identify the transactions and balances for which accounting policies will be required (both the controlling entity and the consolidated entity if relevant).

(ii) Determine the style of guidance that will be required in the policies. Minimal guidance is appropriate when employees are familiar with accrual accounting and the accounting standards being applied. Detailed guidance may be required when employees are not familiar with accrual accounting or with accounting standards. Such detailed guidance could include a summary of the key requirements of an accounting standard and examples of the application of that standard to particular transactions and balances of the entity.

[12] For example, legislation may prescribe specific interest rates, restrict an entity from entering into financing arrangements or restrict the circumstances in which property may be sold.

(iii) Review existing accounting policies. Ensure that existing practices are documented so that the financial impact of changes in policies can be assessed.

(iv) Apply relevant accounting standards and other sources of authoritative guidance in accordance with IPSAS 3 to determine which accounting policies are appropriate to the entity's circumstances under the accrual basis of accounting.

(v) Determine which, if any, of the existing accounting policies are appropriate under the accrual basis of accounting.

(vi) Draft new accounting policies under the accrual basis of accounting in consultation with relevant individuals and groups (including employees with responsibility for managing transactions and balances).

(vii) Review and approve accounting policies internally. Ensure the new policies are documented.

(i) Consult with affected groups as part of due process and as part of the communications strategy. Consultation with the following groups may be appropriate:

(i) Auditors;

(ii) Heads of government entities;

(iii) Finance staff from individual entities within the wider reporting entity;

(iv) The local accounting profession;

(v) Elected or appointed representatives including legislative committees; and

(vi) Academics.

(j) Identify the information system requirements of the accounting policies (and the implications of this for existing systems). Note that it is important to allow sufficient lead time for changes to existing information systems to accommodate accrual accounting and any resulting new accounting policies.

(k) Prepare a statement of significant accounting policies for disclosure in general purpose financial statements.

(l) Develop guidance on the application of policies.

(m) Determine the expected impact of the policies on reported surplus or deficit and net assets/equity and develop an education and communications strategy to manage expectations around the first set of financial statements.

Materiality

4.10 The application of the requirements of all IPSASs is subject to the concept of materiality. An item is material if its omission from, or misstatement in, the financial statements could influence a user's judgments made on the basis of the statements (refer to IPSAS 1 for a definition of materiality). Materiality is discussed in the IASB *Framework for the Presentation of Financial Statements* and will be addressed in the forthcoming IPSASB framework.

4.11 The concept of materiality is used in a number of ways including deciding whether certain items need to be recognized, the amount of effort that should be directed towards measurement of certain items and whether certain items should be disclosed in the financial statements. IPSAS 1 states that an entity does not need to make disclosures specified by a standard if the information is not material (IPSAS 1 paragraphs 45–47). In addition, the concept of materiality can be used to decide whether the application of a particular financial reporting treatment to a transaction or balance, as opposed to an alternative treatment, has a material impact on the financial statements.

4.12 Judgment is required in deciding whether an item is material. In general, the larger the item the more material it is likely to be. However, some items are likely to be material because of their nature, such as amounts paid to related parties (for example, remuneration of auditors or trustees). The concept of materiality does not apply to legislative disclosure requirements—an entity must disclose information required by legislation regardless of the amount of the item.

4.13 There is no IPSAS that deals specifically with the assessment of materiality. Guidance on determining the materiality of items may be found in publications of individual jurisdictions. AASB 1031 *Materiality* is an example of such guidance (AASB, 2010). AASB 1031 states that significant professional judgement is required when determining the materiality of items. In the case of entities applying IPSASs, such judgment could be influenced by:

(a) The nature of the entity's operations;

(b) The size of the entity;

(c) Any materiality requirements outlined in applicable IPSASs;

(d) The type of the transaction classes of the entity;

(e) Any legislative requirements; and

(f) The users of the financial statements.

4.14 Generally, transactions and items need to be considered in context of an appropriate measurement base. An appropriate measurement base could be all items in the financial statements, relative items, or classes of items. For example:

(a) Assets and liabilities could be assessed relative to the appropriate asset or liability base;

(b) Cash flow items could be assessed against the net cash flow for operating, investing or financing activities; and

(c) Revenue and expense items could be assessed against relative to net surplus or deficit figures.

4.15 An entity will need to determine its own materiality thresholds for classes of items and consider how it will manage materiality for the entity as a whole. Assessments of materiality and the risks of misstatement in the financial statements are often reviewed by internal audit committees.

4.16 When an entity's financial statements are audited, the auditors will determine their own level of materiality in accordance with the auditing standards under which they are operating. For example, International Auditing Standard 320 *Materiality in Planning and Performing an Audit* provides guidance to auditors on assessing materiality, and includes consideration of the public sector environment (IAASB, 2008).

Accounting Policies and the Transition to Accrual Accounting

4.17 As part of the transition to accounting on the accrual basis, an entity needs to:

(a) Consider the impact of its transition path on its accounting policies;

(b) Determine the point at which it intends to assert full compliance with IPSASs;

(c) Decide whether to take advantage of any of the transitional provisions in IPSASs; and

(d) Decide how to deal with adjustments to opening balances and comparative information at the first application of IPSASs.

Transition Path

4.18 An entity may decide to defer the application of the accrual basis of accounting to the recognition of certain transactions or balances for a set period of time. If it does so, it needs to decide how to:

(a) Communicate this process to readers of financial statements so that they can make best use of the reported information; and

(b) Present changes in amounts reported due to changes in accounting policies.

Asserting Compliance with IPSASs

4.19 IPSAS 1, paragraph 28, states that "An entity whose financial statements comply with IPSASs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IPSASs unless they comply with all the requirements of IPSASs." An entity therefore needs to decide at what point it intends to assert full compliance with IPSASs and the impact of this date upon the timing of the various tasks outlined in this Study.

4.20 Although it is possible to adopt accrual accounting without asserting compliance with IPSASs, there are benefits to be obtained from developing IPSASs compliant policies:

(a) Use of existing IPSASs saves time and requires fewer resources. This allows more energy to be directed to the resolution of complex issues and implementation issues.

(b) External bodies such as rating agencies may find it easier to analyze financial statements prepared in accordance with independently-established accounting standards.

First-Time Adoption of IPSASs

4.21 An entity can claim full compliance with accrual basis IPSASs only when it has complied with the requirements of all applicable IPSASs currently in force. The point at which this happens depends upon the approach taken to adoption of accrual accounting in a jurisdiction.

4.22 There is no single IPSAS that addresses issues arising from first-time adoption of IPSASs. Some IPSASs contain transitional provisions which provide temporary relief from certain requirements in the IPSASs and some provide guidance on how to deal with any changes in reported figures, such as accumulated balances and comparative amounts, resulting from the first-time application of that IPSAS. In the absence of such provisions in an IPSAS, entities adopting IPSAS for the first time must refer to the requirements of IPSAS 3 regarding changes in accounting policies. IPSAS 3 requires retrospective application of accounting policies unless this is impracticable.

4.23 The period of time for which a transitional provision is available is stated in the relevant IPSAS. The transitional provision may be used from the date of first adoption of accrual accounting in accordance with IPSASs. For example, IPSAS 6, *Consolidated and Separate Financial Statements* provides relief, for three years, from the requirement to eliminate all balances and transactions between entities within the economic entity. IPSAS 17, *Property, Plant and Equipment* provides relief, for five years, from the requirement to recognize property, plant and equipment. Both IPSAS 6 and 17 require that an entity making use of these transitional provisions disclose that fact. Entities choosing to use transitional provisions will need to have a plan to comply fully with the relevant IPSAS within the required time frame.

4.24 The first-time adoption issues faced by entities transitioning from cash accounting to the accrual basis IPSASs may differ from the issues facing entities transitioning from another accrual based set of accounting standards to IPSASs. Where entities are transitioning from another accrual based set of accounting standards to IPSASs, disclosure of reconciliations between information previously reported and information currently reported can be useful in explaining the impact of the change in accounting policies. These types of reconciliations are explained in IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

Accounting Policies and Disclosures

4.25 Accounting policies do not include disclosure requirements. Where there is no IPSAS on a topic entities may refer to other authoritative guidance in deciding which disclosures are appropriate and how to gather the information required for these disclosures. Some disclosure requirements may require the development of accounting policies.

Accounting Policies and Accrual Budgeting

4.26 If an entity also adopts accrual accounting for budgeting purposes, it would be helpful for users if any differences between the accounting policies used in preparing the budget and the accounting policies are documented.

Relevance to the Cash Basis of Accounting

4.27 An entity reporting in accordance with the Cash Basis IPSAS will disclose the accounting policies used in the preparation of its financial statement(s) as required in that Standard.

4.28 Accounting policies are defined in the Cash Basis IPSAS. The Standard also provides guidance on the selection of accounting policies and requires the disclosure of significant accounting policies in the notes to the financial statements.

References

Australian Accounting Standards Board, AASB 1031 *Materiality*—Compiled, 2010
http://www.aasb.gov.au

Australian National Audit Office, Better Practice Guide: Preparation of Financial Statements by Public Sector Entities, June 2009
http://www.anao.gov.au

Commonwealth of Australia, Department of Finance and Administration, Finance Minister´s Orders for reporting periods ending on or after 1 July 2008
http://www.finance.gov.au

HM Treasury, *Financial Reporting Manual 2009–10*
http://www.hm-treasury.gov.uk

International Accounting Standards Board (IASB), International Financial Reporting Standards, IFRS 1, *First-time Adoption of International Financial Reporting Standards*, November 2008
http://www.ifrs.org

International Auditing and Assurance Standards Board (IAASB), International Standard on Auditing 320 *Materiality in Planning and Performing an Audit*, June 2008
http://web.ifac.org

International Federation of Accountants (IFAC)
http://web.ifac.org

IPSAS 1, *Presentation of Financial Statements*, December 2006

IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors,* December 2006

IPSAS 6, *Consolidated and Separate Financial Statements*, December 2006

IPSAS 17, *Property, Plant and Equipment*, December 2006

Cash Basis IPSAS, *Financial Reporting Under the Cash Basis of Accounting*, January 2003

New Zealand Treasury, *Treasury Instructions 2009*
http://www.treasury.govt.nz

Appendix A

Examples of Issues Requiring Accounting Policies: The Accrual Basis[13]

This Appendix illustrates topics on which it may be necessary for an entity to develop accounting policies or disclosure statements regarding assumptions used in the preparation of its financial statements. The list of topics shown is not necessarily comprehensive. The specific policies developed by an entity will be based on IPSASs or, in the absence of a relevant IPSAS, on other authoritative sources of guidance in accordance with IPSAS 3. The types of policies required will vary depending upon the type of entity. For example, a national government may require a number of policies on various types of non-exchange revenue. By contrast, an individual public sector entity within that government may have only one form of non-exchange revenue. Application of the accounting policies specified in IPSASs will deal with a number of the accounting policy issues identified in this Appendix. In addition, illustrative accounting policies are provided in relevant Chapters of this Study. An entity's established accounting policies need to be subject to periodic review in order to ensure that they continue to be consistent with IPSASs or other authoritative accounting standards, and generally accepted accounting practice.

General

- Entities to which the policies apply
- Reporting entity
    - Consolidation of controlled entities
    - Combination of associates
    - Joint ventures
- Reporting period
- Accrual basis used
- Going concern assumption
- Measurement basis
- Application of materiality
- Explanation of changes in accounting policies

Assets

- Definition and recognition of assets
- Classifications to be used within the financial statements (e.g., current, non-current)
- Cash and cash equivalents

[13] Note: Some policies will be applicable at the whole-of-government level only. These policies are indicative only. Each entity would develop a policy for each relevant transaction and balance.

- Accounts receivable and accrued revenue (by type, including transfers/grants receivable)
- Impairment
- Inventories (by type)
- Prepayments
- Investments (by type)
- Investment property
- Property, plant and equipment (by type)
- Leased assets/sale and leaseback transactions
- Information technology assets (hardware and software)
- Intangible assets
- Biological assets and agricultural produce
- Heritage assets
- Finance lease receivables

Liabilities

- Definition and recognition of liabilities
- Classifications to be used within the financial statements
- Accounts payable and accrued expenses (by type including transfers/grants payable)
- Finance lease liabilities
- Provisions for employee benefits
- Other provisions
- Pension liability
- Borrowings
- Bonds/stock
- Unearned revenue
- Currency issued
- Social policy obligations (by type)

Revenue

- Definition and recognition of revenues
- Classifications to be used within the financial statements
- Application of classification system to all revenues
- Recognition of investment revenue (by type, for example interest and dividend/distribution revenue)

- Recognition of revenue from the provision of goods and services (by type, examples listed)
    - Output revenue (under a purchaser/provider model)
    - User charges (exchange only)
    - Trading revenue
    - Certain government grants
    - Property rental
- Recognition of types of non-exchange revenue (by type, examples listed)
    - Taxes
    - Levies
    - Fines
    - Certain government grants
- Donations
- Other revenue
- Surplus or loss on construction contracts
- Operating lease revenue
- Finance lease revenue

Expenses

- Definition and recognition of expenses
- Classifications to be used within the financial statements
- Application of classification system to all expenses
- Employee expenses (including contributions to superannuation schemes)
- Supplies and consumables
- Depreciation of property, plant and equipment
- Amortization of intangible assets
- Impairment
- Transfer payments, grants, and donations (by type)
- Interest and financing costs
- Income tax/income tax equivalents (where appropriate)

Equity/Net Assets

- Composition of equity/net assets
- Contributed capital

- Accumulated surplus/deficit
- Asset revaluation reserve
- Foreign currency reserve

Other Policies

- General presentation and disclosure
- Prior period errors
- Gains and losses on disposal of non-current assets
- Assets and liabilities transferred
- Commitments
- Contingent liabilities
- Contingent assets
- Events after the reporting date
- Determination of cost for financial reporting purposes
- Comparatives
- Related party disclosures
- Foreign currency
- Accounting for hyperinflation
- Administered/entity transactions
- Budget reporting
- Non-financial reporting

Appendix B

Examples of Issues Requiring Accounting Policies: The Cash Basis

This Appendix illustrates topics on which accounting policies or disclosure statements may be required under the cash basis of accounting. Appropriate accounting policies for many of these topics are specified in the Cash Basis IPSAS.

General Accounting Policies

- Entities to whom the policies apply
- Basis of accounting policies
- Reporting entity
  - Consolidation of controlled entities
  - Joint ventures
- Reporting period
- Application of materiality
- Explanation of changes in accounting policies
- Payments by third parties
- Reporting currency

Cash Receipts

- Definition and Recognition of Receipts
- Classification of Receipts
  - Whole-of-Government level
  - Individual entity level

Cash Payments

- Definition and Recognition of Payments
- Classification of Payments
  - Whole-of-government level
  - Individual entity level

Cash

- Definition of cash

Other Policies

- General presentation and disclosure

- Going concern assumption
- Extraordinary items
- Administered transactions (if applicable)
- Prior period errors (if applicable)
- Additional asset and liability disclosures (if applicable)
- Commitments (if applicable)
- Contingent liabilities (if applicable)
- Contingent assets (if applicable)
- Cost accounting policies (if applicable)
- Comparatives
- Foreign currency
- Accounting for hyperinflation (if applicable)
- Budget reporting
- Non-financial reporting
    - Related party disclosures
    - Segment reporting

Appendix C

Examples of Financial Statements (including accounting policies)

This Appendix lists links to financial statements of governments or public sector entities. Care should be exercised when using these statements as some policies in these statements may not be IPSASs compliant and some entities are still in the process of transitioning to full adoption of IPSASs. Some of these financial statements are prepared in accordance with IFRSs or domestic equivalents to IFRSs.

International Organizations

Annual Accounts of the European Communities Financial Year 2008
http://eur-lex.europa.eu

IFAC Financial Statements for the year ended December 31, 2008
http://www.ifac.org/

IFAD Consolidated Financial Statements 2008 (in accordance with IFRSs)
http://www.ifad.org

Financial Statements of the Organisation for Economic Co-operation and Development as at 31 December 2008
http://www.oecd.org

World Food Programme Financial Statements 2008
http://fb.unsystemceb.org

Australia

Commonwealth of Australia Consolidated Financial Statements for the year ended 30 June 2009
http://www.finance.gov.au

Canada

Public Accounts of Canada 2010
http://www.tpsgc-pwgsc.gc.ca

France

Les comptes de l'Etat 2008
http://www.performance-publique.gouv.fr

Israel

Government of Israel, Essence of Financial Statements, December 31st 2008 (Unaudited)
http://www.ag.mof.gov.il

Japan

Financial Statements of Tokyo Metropolitan Government for fiscal year 2008
http://www.kaikeikanri.metro.tokyo.jp/kessan2008(english).html

Netherlands

National Financial Annual Report 2008
http://www.minfin.nl

New Zealand

Financial Statements of the Government of New Zealand for the year ended 30 June 2009
http://www.treasury.govt.nz

South Africa

Republic of South Africa, National Treasury, Consolidated Financial Information for the year ended 31 March 2008
http://www.treasury.gov.za

Human Sciences Research Council, Annual financial statements for the year ended 31 March 2009
http://www.hsrc.ac.za

Switzerland

Staatsrechnung, Bericht zur Bundesrechnung, 2008
http://www.efv.admin.ch

United States of America

Fiscal Year 2008 Financial Report of the United States Government
http://www.gao.gov

United Kingdom

HM Treasury Annual Report and Accounts 2008–09
http://www.hm-treasury.gov.uk

Model Financial Statements

Australia

Australian Capital Territory (ACT) Government Department 2008–09 Model Financial Report (in accordance with Australian Accounting Standards)
http://www.treasury.act.gov.au

Australian Capital Territory (ACT) Territory Authority 2008–09 Model Financial Report (in accordance with Australian Accounting Standards)
http://www.treasury.act.gov.au

South Australian Local Government 2009 Model Financial Statements (in accordance with Australian Accounting Standards)
http://www.lga.sa.gov.au

2008–2009 PRIMA Illustrative Financial Statements designed to assist Commonwealth Entities in the preparation of their financial statements (in accordance with Australian Accounting Standards)
http://www.finance.gov.au

2009–10 Model Report for Victorian Government Departments (in accordance with Australian Accounting Standards and statistical framework reporting)
http://www.dtf.vic.gov.au

New Zealand

Model financial statements: Ministry of Public Accountability 2007/08 (in accordance with New Zealand equivalents to IFRSs, as applicable to public benefit entities)

Model financial statements: **Te Motu** District Council 2007/08 (in accordance with New Zealand equivalents to IFRSs, as applicable to public benefit entities)

Model financial statements: Te Motu Regional Economic Development Trust 2008/ 09 (in accordance with New Zealand equivalents to IFRSs, as applicable to public benefit entities)
http://www.auditnz.govt.nz

United Kingdom

IFRS Based Proformas
http://www.hm-treasury.gov.uk

Appendix D

Links to Entities Specifying Government Accounting Policies

This Appendix provides links to accounting policy guidance for governments or public sector entities that report under the accrual basis of accounting. Care should be exercised when referring to these policies as some may not be IPSASs compliant. Some policies will have been developed in accordance with IFRSs or domestic equivalents to IFRSs.

Commonwealth of Australia, Department of Finance and Administration, Finance Minister´s Orders for reporting periods ending on or after 1 July 2008
http://www.finance.gov.au

HM Treasury, *Financial Reporting Manual 2009–10*
http://www.hm-treasury.gov.uk

New Zealand Treasury, *Treasury Instructions 2009*
http://www.treasury.govt.nz

Tokyo Metropolitan Government, *Tokyo Metropolitan Government Accounting Standard*
http://www.kaikeikanri.metro.tokyo.jp/kaikeikijunn_english.htm

Chapter 5: Reporting Entity Issues

Key Points

- The accrual basis IPSASs dealing with the determination of the boundaries of the reporting entity and the preparation of consolidated financial statements are:
    - IPSAS 6, *Consolidated and Separate Financial Statements*;
    - IPSAS 7, *Investments in Associates*; and
    - IPSAS 8, *Interests in Joint Ventures*.
- The IPSASB conceptual framework project is expected to provide guidance on the identification of group reporting entities and individual reporting entities.
- This Chapter considers the requirements of IPSAS 6 and discusses issues associated with identifying controlled entities for the purpose of preparing consolidated financial statements.
- This Chapter also considers the requirements of IPSAS 7 and IPSAS 8 in relation to determining which entities should be included in the consolidated financial statements and how they should be reported.

Introduction

5.1 This Chapter looks at the question of how to decide which individual entities and groups of entities should prepare general purpose financial statements as reporting entities. In the case of groups of entities, it discusses which entities should be included in the group reporting entity. For example, which entities should be included in the financial statements prepared for a whole-of-government reporting entity, a department, a state or a province?

5.2 A reporting entity is any entity that prepares general purpose financial statements for external users dependent on information in those financial statements. A reporting entity may therefore be:

(a) An individual entity such as a department, ministry, or other government entity; or

(b) An entity group such as the whole-of-government.

5.3 The term "economic entity" is used to refer to a reporting entity which comprises a number of individual entities. Therefore the whole-of-government reporting entity is an economic entity. However, a department, ministry, or other government entity may also control other entities and therefore be an economic entity. Existing reporting entities within a jurisdiction may be specified in legislation or they may have developed over time without any legislative or theoretical underpinning.

The Individual Reporting Entity

5.4 The International Public Sector Accounting Standards Board (IPSASB) has not issued any authoritative guidance on the definition of an individual reporting entity.[14] This issue will

[14] Study 8, *The Government Financial Reporting Entity* considered issues associated with determining the reporting entity (IFAC, July 1996). IPSAS 6 *Consolidated and Separate Financial Statements* establishes

be considered in the context of its conceptual framework project, currently under way. Individual reporting entities may be defined by reference to the existence of users who are dependent on general purpose financial statements for information for accountability or decision-making purposes, and who do not have the authority to demand special purpose statements.[15] For most entities, it will be readily apparent whether there are users who are dependent on financial reports for accountability and decision-making purposes. For other entities, it will be necessary to consider factors such as:

(a) The separation of management from those with an economic interest in the entity;

(b) Whether the entity receives public funds; and

(c) Whether users are likely to depend on financial reports for information for accountability or decision-making purposes.

5.5 Consideration of factors such as the economic and political importance of an entity and its financial characteristics (the extent of its resources and obligations) may also be relevant in determining whether it is likely that there are users dependent on an entity's financial report.

The Group Reporting Entity

5.6 Guidance on identifying group reporting entities is contained in IPSAS 6. Most IPSASs apply equally to the financial statements of an individual entity and to the consolidated financial statements for an economic entity, such as whole-of-government financial statements. IPSAS 6 applies to consolidated and separate financial statements. This Chapter outlines the key requirements in IPSAS 6 and identifies a number of steps that are required in order to apply IPSAS 6. IPSAS 7 specifies requirements for accounting for ownership interests in associates. IPSAS 7 does not specify how an investment in an associate should be accounted for in the investor's separate financial statements – this is addressed in IPSAS 6. IPSAS 8 includes requirements for reporting of joint ventures such as jointly controlled operations, jointly controlled assets, and jointly controlled entities. IPSAS 8 is discussed later in this Chapter.

Accounting for the Acquisition of Controlled Entities

5.7 This Chapter discusses the requirements of IPSAS 6 for determining the boundaries of the existing reporting entity. It does not consider the method of accounting for the acquisition of entities. At the time of writing the IPSASB had an active project to prescribe the accounting treatment for entity combinations undertaken by public sector entities.

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requirements for the presentation of separate financial statements but does not require that separate financial statements be presented.

15 The IPSASB has sought feedback from constituents on a range of issues including the users of financial statements of public sector entities and the objectives of public sector financial reporting in its Consultation Paper—*Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: The Objectives of Financial Reporting; The Scope of Financial Reporting; The Qualitative Characteristics of Information Included in General Purpose Financial Reports; The Reporting Entity* (September 2008).

Boundaries of the Reporting Entity

The Concept of Control

5.8 IPSAS 6 adopts the concept of control to determine the boundaries of the reporting entity. Under this approach the government financial reporting entity includes all those entities and transactions which the government controls. That is, it includes all resources controlled by, and all obligations of, the reporting entity regardless of the administrative or legal entities created to manage those resources and obligations. IPSAS 6 defines control within a public sector context and provides guidance on determining whether control exists. It defines control as "the power to govern the financial and operating policies of another entity so as to benefit from its activities." Both the power aspect and the benefit aspect are required to be present for control to exist. For example, if an entity has the power to appoint or remove a majority of the members of the governing body of another entity and the power to dissolve the other entity and obtain a significant level of the residual economic benefits, it would control the other entity in accordance with IPSAS 6.

5.9 IPSAS 6 requires that controlling entities prepare consolidated financial statements incorporating all controlled entities. There is an exception for entities under temporary control when the controlled entity is acquired and held exclusively with a view to its subsequent disposal within twelve months and management is actively seeking a buyer.

5.10 IPSAS 6 specifies the limited circumstances in which a controlling entity may choose not to prepare consolidated financial statements. One instance is where the controlling entity is itself a wholly-owned controlled entity and users of such financial statements are unlikely to exist or their information needs are met by its controlling entity's consolidated financial statements. Although IPSAS 6 exempts entities from preparing consolidated financial statements in certain circumstances, legislation may still require the preparation of consolidated financial statements.

Implementation: Determining the Boundaries of the Reporting Entity

5.11 Determining the boundaries of the reporting entity involves a review of the existing reporting entity or entities and identification of controlled entities in accordance with the criteria in IPSAS 6. This process includes consideration of the substance of the relationship between entities, not just the legal form. In this context the following steps are necessary:

(a) Identify and document the existing reporting entity/entities and the legislative requirements or decisions that have created the reporting entity/entities.

(b) Consider whether all entities that are currently required to report are in fact entities for which it is reasonable to expect the production and publication[16] of general purpose financial statements. The test for this is generally whether there are external users dependent upon these financial statements for information for accountability or decision-making purposes. In many jurisdictions this will include each individual department or government entity and may include the whole-of-government entity. However, the appropriate decision on whether individual government entities should be separate reporting entities may vary between and within jurisdictions.

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[16] The term "publication" as used here includes "public access" in any form.

(c) Consider whether there are other entities that should produce and publish general purpose financial statements.

(d) Identify potential controlled entities. Examples of such entities include entities receiving regular or substantial amounts of government funding, entities established by legislation (such as regulatory bodies), committees or groups established under the oversight of a government department or entity, and entities to which the government has provided financial assistance or guarantees to prevent financial collapse. Although it is suggested that such entities should be reviewed, they may not all be controlled entities. .

(e) Apply the control criteria in IPSAS 6 to all potential controlled entities to determine whether they are controlled entities or jointly controlled entities. Note that clarification of the legal status of some entities may be required during this process; however, the legal form alone will not determine control.

(f) Identify both the overall economic reporting entity and all individual reporting entities within that entity. As part of this process it is necessary to determine whether there is a need to prepare separate financial statements for the ultimate controlling entity as an individual reporting entity. For example, should a national government preparing consolidated financial statements also report separately on transactions and balances which belong to the government itself, as opposed to any of its controlled entities? In the private sector the controlling entity is referred to as the "parent" and may be a separate reporting entity in its own right. However, in the public sector, despite the fact that some transactions relate to the controlling entity only, this does not necessarily mean that the controlling entity is a separate reporting entity. It is necessary to consider any legal reporting requirements and also whether there are users dependent upon such information, but who are unable to demand financial information to meet their specific information needs.

(g) Review existing legal reporting requirements to see if they need to be aligned with the proposed reporting entities (determined using IPSAS 6).

(h) Identify any minority interests.

5.12 Although IPSAS 6 contains detailed guidance on the types of tests which should be applied to determine whether an entity is a controlled entity, judgments may be required when applying these tests. Loughlan gives examples of entities which may be considered to be on the boundaries of the United States federal reporting entity (Loughlan, 2010).

Consolidation

5.13 Consolidation is the process of presenting the financial statements of all entities that make up the reporting entity as if they were the financial statements of a single entity. It involves adding together all items on a line-by-line basis and eliminating any transactions or balances between members of the reporting entity.

5.14 In order to consolidate the financial statements of various entities it is necessary to have a documented and well-understood process for compiling and verifying the completeness and accuracy of the information at each stage of the consolidation process, including:

(a) A system for collecting financial statements of all the entities within the reporting entity. Some of the entities are autonomous entities with their own accounting policies and systems. Regardless of the manner in which they recognize and classify transactions and balances in their own financial statements, these entities will need to conform to the standard policies and classifications when providing financial information for consolidation. Information for consolidation purposes may be provided in a variety of ways. Where the various entities use a centralized accounting system or a common reporting system it may be obtained directly, or the information may be summarized on a spreadsheet which is then entered into a consolidation package;

(b) Ensuring that the accounting policies used by the individual entities within the reporting entity are consistent to the extent practicable. If they are not consistent it will be necessary to make adjustments at the time of consolidation to align the policies (for example, where a controlled entity accounts in accordance with a standard that is relevant for its activities but that is not relevant to the controlling entity accounts). Some differences between policies for immaterial items may be acceptable but this will need to be considered in the context of other factors affecting materiality. IPSAS 6, paragraph 49, requires that "Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.";

(c) Collecting information on the nature and amount of inter-entity transactions and balances. Inter-entity transactions and balances are eliminated on consolidation. Where entities within the wider economic entity regularly transact with each other it may be appropriate to establish additional codes for inter-entity transactions so that such transactions can be recorded directly within the accounting system. Consideration of materiality is also appropriate in determining the level of effort which goes into identifying inter-entity transactions and balances. The view of external auditors on the desirability of various methods of identifying inter-entity transactions can assist at this point. Entities preparing group financial statements under the cash basis may already have identified a number of inter-entity transactions;

(d) Selecting the method of performing the consolidation. Where a new accounting system is being established, or where an existing accounting system is being substantially overhauled, it is generally possible to incorporate a consolidation module. Alternatively it may be possible to use or adapt a standard consolidation software package. Where there are a relatively small number of entities, it may be possible to use a spreadsheet to perform the consolidation. It is also necessary to decide whether the consolidation is going to be done as one exercise or whether there will be a series of sub-consolidations within the group. For example, individual government entities may consolidate the financial statements of all their controlled entities and then all the government entities may be consolidated;

(e) Ensuring that the IPSAS 6 requirement for entities to have uniform reporting dates can be met. This involves identifying instances where the reporting dates differ establishing a process to obtain the necessary information for consolidation purposes; and

(f) Capturing information required to meet the disclosure requirements in various IPSASs, including the disclosure of amounts owed to other entities within the economic entity. The process used in one jurisdiction is explained below.

> *Example of Consolidation Process Adopted in One Jurisdiction*
>
> In the preparation of the consolidated financial statements for the whole-of-government in one jurisdiction, controlled entities are required to provide information by completing a consolidation pack. Consolidation packs are provided through the Internet to the entity responsible for compilation of consolidated financial statements. Consolidation packs are consolidated in a database. The consolidation packs have a number of validation rules to ensure that basic checks on the entry of financial information are satisfied before being consolidated. Entities can link these consolidation packs to their general ledgers, which allows their consolidation packs to be automated from their internal reporting processes. Once an entity has the process running smoothly it takes around three hours to complete a consolidation pack.
>
> Entities are required to have internal procedures to ensure that the information provided in the returns is accurate and complete. Information submitted for consolidation must be checked for accuracy and completeness before it is signed off. The information provided for use in the consolidated financial statements must agree with and be reconciled to the entity's financial management information system and audited financial statements, if any.

Disclosures Required

5.15 IPSAS 1, *Presentation of Financial Statements* and IPSAS 6 require a number of disclosures to be made regarding the nature of the reporting entity. The disclosures required include:

(a) The name of the reporting entity;

(b) Whether the financial statements cover the individual entity or the economic entity (with the economic entity being a group of entities comprising the controlling entity and any controlled entities);

(c) A list of significant controlled entities;

(d) The fact that a controlled entity is not consolidated in accordance with IPSAS 6;

(e) Summarized financial information of controlled entities that are not consolidated;

(f) The name of any controlled entity in which the controlling entity holds an ownership interest and/or voting rights of 50% or less, together with an explanation of how control exists;

(g) The reasons why an ownership interest of more than 50% of the voting or potential voting power of an investee does not constitute control; and

(h) In the controlling entity's separate financial statements, a description of the method used to account for controlled entities.

5.16 Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs, are included in the references to this Chapter.

National Accounts

5.17 Whole-of-government financial reports may be restricted to one level of government or may include more than one level of government depending upon the way in which levels of government have been established and are operated within a particular jurisdiction. By contrast, statistical systems such as Government Finance Statistics (GFS) and the System of National Accounts (SNA) (or regional equivalents) adopt a standard approach to the definition of the government sector. However, GFS excludes public financial and non-financial corporations, (that is, commercial public sector entities) from the general government sector, even if they are controlled. An entity may wish to consider providing, as additional information, an explanation of any differences in the whole-of-government reporting entity in financial statements prepared for financial reporting purposes and the government sector in statistical reports.

5.18 Chapter 20 of this Study discusses the requirements of IPSAS 22, *Disclosure of Financial Information about the General Government Sector*. IPSAS 22 applies only where a government chooses to present information about the general government sector in its consolidated financial statements.

Joint Ventures and Joint Control

5.19 In some circumstances, an entity may have joint control, rather than individual or full control, over another entity. IPSAS 8 defines a joint venture as "a binding arrangement whereby two or more parties are committed to undertake an activity that is subject to joint control" and joint control as "the agreed sharing of control over an activity by a binding arrangement."

5.20 The steps outlined in this Chapter for the identification of controlled entities may also be applied to the identification of jointly controlled entities. In order to determine the appropriate accounting treatment for a joint venture, an entity will also need to classify the joint ventures as jointly controlled operations, jointly controlled assets, or jointly controlled entities. IPSAS 8 establishes the accounting treatment for jointly controlled operations, jointly controlled assets, and jointly controlled entities in a venturer's separate financial statements and a venturer's consolidated financial statements.

5.21 IPSAS 8 specifies the requirements for accounting for jointly controlled entities in the consolidated financial statements of the venture. It allows either the proportionate consolidation method or the equity method of accounting to be used. IPSAS 6 specifies the requirements for accounting for jointly controlled entities in the investor's separate financial statements. The discussion in this Chapter of implementation issues associated with consolidation is also relevant to the proportionate consolidation of jointly controlled entities.

Significant Influence

5.22 In some cases a government may have significant influence but not control or joint control over an entity. IPSAS 7 refers to such entities as associates and specifies requirements for accounting for associates in the consolidated financial statements of the investor.

5.23 IPSAS 6 specifies the requirements for accounting for associates in the investor's separate financial statements.

Relevance to the Cash Basis of Accounting

5.24 For those preparing consolidated cash basis financial statements, the preparation of a consolidated statement of cash receipts and payments involves substantially the same process as for the preparation of consolidated financial statements under the accrual basis of accounting. The consolidation requirements for the cash basis of accounting are addressed in the Cash Basis IPSAS *Financial Reporting Under The Cash Basis of Accounting*.

5.25 Where an economic entity consists of reporting entities using different bases of accounting it may be useful to prepare a consolidated statement of cash receipts and payments may be useful.

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Appendix

Accounting Policies

This Appendix illustrates the accounting policies which are to be used for the economic entity. The policies are the internal accounting policies developed by a central entity for application in the preparation of whole-of-government financial statements for a hypothetical national government. They could also be used by individual government entities that control other entities. In some jurisdictions, the entities required to prepare financial statements for external users will be defined in legislation. In such cases, if the reporting entity wishes to assert compliance with IPSAS 6, it will need to assess whether the legal reporting entity is consistent with the application of IPSAS 6.

Reporting Entity

The financial statements are to disclose the entities controlled or jointly controlled by the entity and forming part of the consolidated financial statements.

Consolidation of Controlled Entities

The consolidated financial statements are to include all controlled entities required to be included by IPSAS 6. If a controlled entity is acquired and held exclusively with a view to its disposal in the near future, it should be excluded from consolidation and accounted for as an investment.

Controlled entities are to be consolidated in accordance with IPSAS 6. All material transactions and balances between sub-entities are to be eliminated on combination.

Uniform accounting policies are to be applied in the preparation of consolidated financial statements.

The entity needs to ensure that details of material transactions (and any resulting balances) between the reporting entity and any other reporting entities within the whole-of-government reporting entity are recorded.

Associates

Entities over which the reporting entity has significant influence are to be accounted for as associates using the equity method of accounting in accordance with IPSAS 7.

If an investment is acquired and held exclusively with a view to its disposal in the near future, it is to be classified as held for trading and accounted for in accordance with IPSAS 29, *Financial Instruments: Recognition and Measurement*.

Joint Ventures

The reporting entity's interest in joint ventures (jointly controlled operations, jointly controlled assets, and jointly controlled entities) is to be recognized and accounted for in accordance with IPSAS 8.

PART III—ELEMENTS

Part III of this Study outlines the main types of assets, liabilities, revenues, and expenses that occur in public sector entities. It identifies the IPSASs dealing with the definition, recognition, measurement, and disclosure of these items. The Study outlines the requirements of key IPSASs (or, in the absence of an IPSAS, other sources of authoritative guidance in accordance with IPSAS 3) and the types of implementation tasks associated with recognizing these items and complying with IPSASs or other accounting standards.

The Chapters in this Part of the Study focus on selected assets, liabilities, revenues, and expenses. The implementation tasks and issues that are illustrated in these Chapters may also be able to be applied more generally to other assets, liabilities, revenues, and expenses.

Chapter 6: Assets

Key Points

- This Chapter considers issues associated with the recognition of property, plant and equipment, and, to a lesser extent, inventories, construction contracts, and investment property.
- Asset topics covered in other Chapters include:
  - Intangible assets (refer to Chapter 10);
  - Biological assets and agricultural produce (refer to Chapter 11);
  - Impairment of assets (refer to Chapter 12); and
  - Financial assets (refer to Chapter 13).
- International Public Sector Accounting Standards (IPSASs) that deal with the definition, recognition, measurement, and disclosure of assets are listed in the references to this Chapter.
- Because entities adopt accrual accounting for both financial reporting and financial management, this Chapter contains a brief description of some policies and procedures and system requirements for good asset management.

Introduction

6.1 Examples of assets held by governments and government entities include:

(a) Financial assets (monetary assets):

(i) Cash and cash equivalents;

(ii) Revenues receivable;

(iii) Loans and advances to other governments;

(iv) Other loans and advances;

(v) Investments; and

(vi) Derivatives.

(b) Physical assets (non-monetary assets):

(i) Inventories;

(ii) Heritage assets and property, plant and equipment, including infrastructure assets and defense or military assets;

(iii) Investment properties;

(iv) Biological assets and agricultural produce; and

(c) Intangible assets.

6.2 This Chapter discusses the tasks and issues associated with the initial identification, recognition, and measurement of assets, and the systems and procedures required to support the ongoing preparation of accrual financial statements.

6.3 The Chapter focuses on issues associated with accounting for property, plant and equipment. The reasons for this focus are:

(a) Most entities have some property, plant and equipment;

(b) Property, plant and equipment is usually a significant proportion of an entity's total assets; and

(c) Many of the issues covered in relation to property, plant and equipment are also relevant to other assets.

6.4 The Chapter also includes a discussion of issues associated with accounting for inventories, construction contracts, and investment properties.

Assets—Definition and Recognition

6.5 IPSAS 1, *Presentation of Financial Statements* defines an asset as follows.

Assets are resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to the entity.

6.6 Assets are recognized for financial reporting purposes only when they meet all elements of this definition and the recognition criteria for assets. An asset will be included in the amounts shown in the statement of financial position when it is probable that benefits embodied in the asset will be realized or flow to the entity and the asset has a cost or other value that can be measured reliably.

6.7 Assets meeting the definition but not the recognition criteria cannot be recognized within the financial statement totals. However, such items may meet the definition of contingent assets. A contingent asset is "a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity" (IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 18). A contingent asset is disclosed where an inflow of economic benefits or service potential is probable.

6.8 A key aspect of the definition of an asset is that the asset is controlled by the entity. The existence of control may be obvious (for example, an entity may have documents demonstrating ownership of the asset). In other cases, particularly where an asset is the subject of a lease arrangement or a service concession arrangement, more judgment may be required.

General Asset Issues

6.9 In order to prepare an implementation plan for the recognition of assets, an entity needs to have some idea of the scope of the tasks involved and the likely amount of resources that these tasks will take. The amount of work required to recognize assets depends on the extent to which an entity already has information available on those assets. General steps in the recognition of assets include:

(a) Documenting all types of assets held by the entity (the compilation of asset registers is discussed later in this Chapter);

(b) Assessing the accuracy and completeness of existing information;

(c) Determining the categories of assets that will be used in the chart of accounts and the financial statements;

(d) Establishing accounting policies for each category in accordance with relevant IPSASs;

(e) Determining accurate opening balances for each category (identification, application of definition of asset, and measurement); and

(f) Establishing systems to support the ongoing requirements of accrual accounting.

6.10 Depending upon the basis of accounting previously used by an entity and the nature of supplementary information held, the amount of work required may vary considerably between entities and jurisdictions. For example, in jurisdictions where no records had previously been made of assets, considerable effort will be required to document the assets held and to determine accurate opening balances in accordance with relevant IPSASs. In jurisdictions where assets have previously been recorded, even if only for internal accounting purposes, the focus may be on measurement of the asset subsequent to its initial cost in accordance with the accounting policies for such assets.

6.11 In order to establish accounting policies for each category of assets, an entity will need to identify the relevant IPSASs. Examples of IPSASs which specify the initial and subsequent measurement of specific types of assets are:

(a) IPSAS 11, *Construction Contracts*;

(b) IPSAS 12, *Inventories*;

(c) IPSAS 13, *Leases*;

(d) IPSAS 16, *Investment Property*;

(e) IPSAS 17, *Property, Plant and Equipment*;

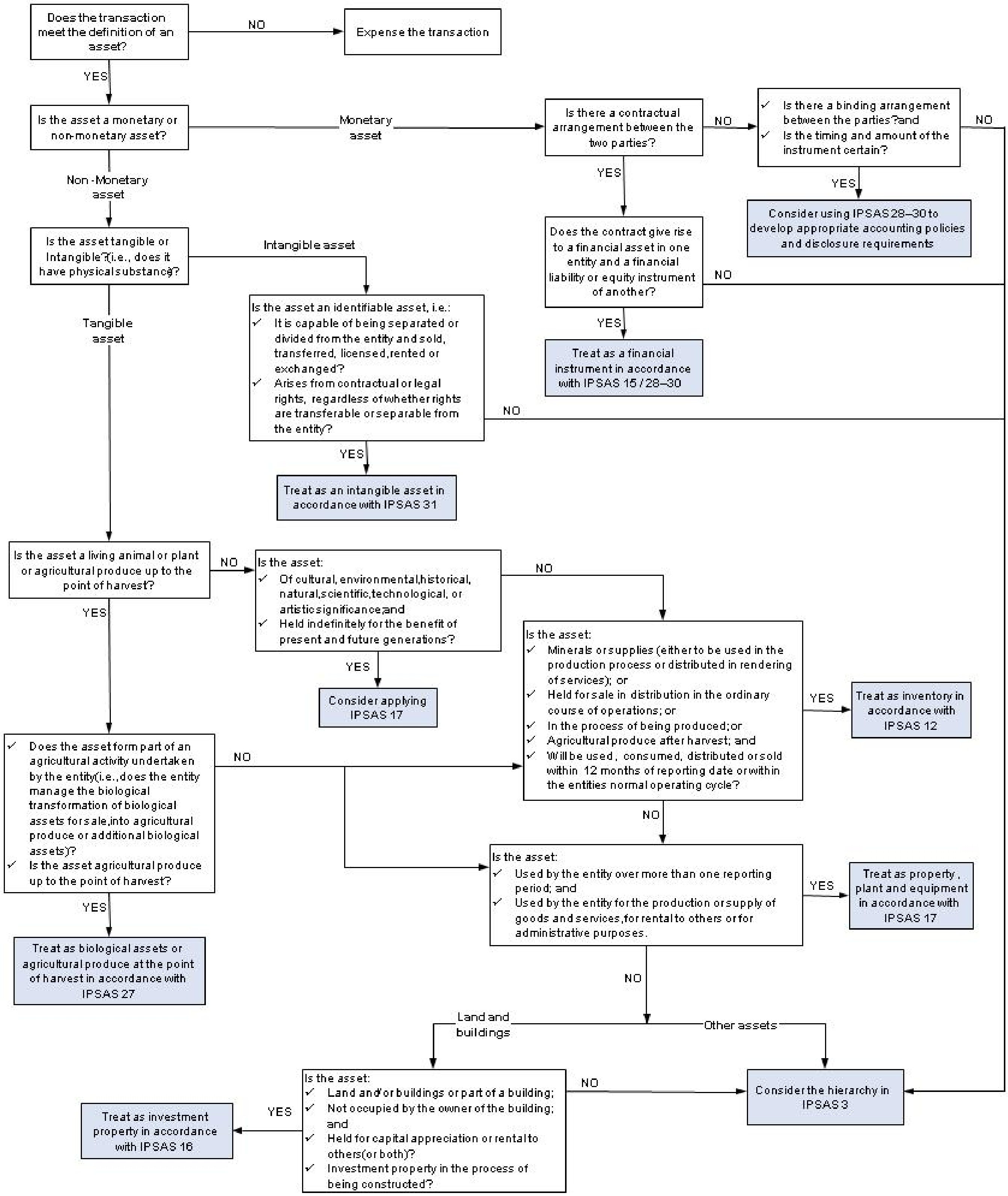
(f) IPSAS 29, *Financial Instruments: Recognition and Measurement*; and

(g) IPSAS 31, *Intangible Assets*.

6.12 IPSAS 21, *Impairment of Non-Cash Generating Assets* and IPSAS 26, *Impairment of Cash-Generating Assets* establish requirements regarding when and how certain assets must be reviewed for impairment. Other IPSASs such IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* and IPSAS 5, *Borrowing Costs* may affect the measurement of an asset.

6.13 The following decision tree on asset classification illustrates the issues that an entity may need to consider in deciding which IPSAS to apply. However, the scope exceptions in an IPSAS should always be checked before applying a Standard. The IPSAS measurement requirements for major classes of assets are summarized in Appendix B to this Chapter.

Figure 6.1 Asset Classification



Property, Plant and Equipment

6.14 This Chapter discusses the following topics in relation to property, plant and equipment:

(a) Definition and recognition;

(b) Recognition thresholds;

(c) Identifying classes and components;

(d) Assessment of useful lives;

(e) Impairment of assets;

(f) Asset registers;

(g) Valuation issues;

(h) External audits;

(i) Transitional provisions; and

(j) Lessons learned.

Property, Plant and Equipment—Definition and Recognition

6.15 IPSAS 17 defines property, plant and equipment as "tangible assets that: (a) are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one reporting period."

6.16 Before an item is recognized as property, plant and equipment for financial reporting purposes, it must satisfy the definition of property, plant and equipment and meet the recognition criteria for assets.

6.17 The first step in the identification and recognition of property, plant and equipment is the preparation of an implementation plan. The implementation plan for initial recognition of assets and the development of systems to support ongoing accrual accounting for those assets may be a subset of the main implementation plan or a separate plan. The plan needs to identify:

(a) All the required tasks including development of policies, identification, and valuation of assets and development of asset management policies and procedures. The identification and valuation of assets is more difficult when no records of existing property, plant and equipment exist;

(b) The person/position responsible for each task;

(c) The person/position responsible for management of this aspect of the plan;

(d) Project milestones and deadlines;

(e) Dependent items within the asset recognition plan and between asset recognition and other parts of the wider project; and

(f) The process and timeframe for resolution of issues.

6.18 The tasks likely to flow on from the implementation plan are set out in the diagram below. The steps outlined in this diagram can be applied to most types of non-current assets. Although the steps are shown sequentially, some of the steps could, and may need to, occur concurrently.

Figure 6.2 Recognition of Property, Plant and Equipment

Step 1	*Develop policies:* Identify authoritative standards and regulations in accordance with IPSAS 3, including definitions and recognition criteria; Identify asset classes and components of assets; Develop policies for componentization of assets; Develop capitalization thresholds for each class of asset; Identify measurement policies (including revaluation policy if applicable) for each class of asset; Develop policies for expensing or capitalizing subsequent expenditure on upgrades, improvements, and repairs and maintenance; Develop depreciation policies and select depreciation method for each class of asset; and Develop impairment policies.

Step 2	Identify information requirements associated with these policies and other related information desired for internal management purposes. Plan timeframes for collection and verification of data and development/ implementation of systems. This may require external expertise and assistance.

Step 3	*Develop asset register and determine opening balances:* Identify assets; Develop methods of obtaining historic cost information or valuations; Obtain historic cost information or valuations as required; and Validate data/resolve issues.

Ongoing	*Ongoing matters:* Maintain systems including a record of all asset movements (e.g., purchases, sales, revaluation changes, impairment, write-offs) and information required for additional disclosures; Develop processes to assess residual values, useful lives and depreciation methods; Calculate depreciation in each reporting period; Perform regular revaluations (if applicable); and Perform regular impairment reviews.

6.19 The development of an asset register (part of Step 3 in the above diagram) will also involve a review of current systems and asset management practices. If the entity has not previously established such systems or practices, it is unlikely that accounting systems will exist. Nevertheless, there may be data available in the entity (e.g., engineering or public works departments) to use as a starting point. An entity will need to:

(a) Decide whether to retain/modify existing asset records/systems or develop new systems. This could include consideration of whether information about some assets should be managed on separate databases and how these databases will link with the financial reporting system;

(b) Decide whether an asset register is to be integrated with the general ledger;

(c) Design and implement systems;

(d) Decide which managers within the entity have responsibility for asset management; and

(e) Review/develop asset management practices.

6.20 The development of the asset register also involves:

(a) Complete identification of all potential assets;

(b) Determination of asset classes and components;

(c) Collection of data on assets, including age, condition, remaining useful life, level of use, nature and extent of ongoing maintenance, and upgrades;

(d) Application of definitions of assets and property, plant and equipment;

(e) Application of recognition criteria;

(f) Application of capitalization thresholds;

(g) Verification of ownership where necessary;

(h) Identification of restrictions/covenants over ownership;

(i) Determining useful lives to be used in the calculation of depreciation; and

(j) Validation of data (ongoing).

6.21 Some entities may use outside expertise and assistance in performing these activities. Where an entity uses external parties it will still need to make sure that it has appropriate documentation of the process and methodology used and the qualifications of the external parties.

6.22 The determination of opening balances (part of Step 3) includes the collation of historic cost data and the valuation of any assets if they are to be measured at other than historic cost, as required by valuation policies. Collation of historic cost data includes the identification of all costs to make an asset operational and the estimation of historic cost where such actual historic cost is not available. The valuation of assets includes:

(a) Deciding whether to value all assets or whether to use a sampling approach;

(b) The identification of appropriate valuers for each class of asset;

(c) The preparation of instructions for valuers;

(d) The collection of information required by valuers; and

(e) A management review of valuations.

6.23 The identification of opening balances for property, plant and equipment is merely the first step in the process of preparing accrual-based financial statements. Other steps are to:

(a) Identify closing balances;

(b) Identify all movements during the period;

(c) Calculate depreciation;

(d) Identify audit issues and the development of plans to resolve these issues;

(e) Develop and test interfaces between the asset register and general ledger; and

(f) Identify and collect other asset information required to be disclosed in the financial statements.

Property, Plant and Equipment—Recognition Thresholds

6.24 Each entity needs to determine the value above which assets are capitalized and reported in the financial statements. When an entity establishes a capitalization threshold, assets below the relevant threshold are expensed in the period of purchase and assets above the threshold are recognized as assets in the statement of financial position. The use of capitalization thresholds reduces the cost of gathering data because it decreases the total number of fixed assets that have to be recorded and tracked. This saving to the entity must be considered in relation to the significance of the data to users of the financial statements.[17] One method sometimes used by entities to set an initial capitalization threshold (sometimes referred to as the de minimis level) is to require that a certain percentage (for example, at least 95%) of estimated total assets by value are reported in the financial statements. This method requires that the entity is able to make a reasonable estimate of total assets. Different thresholds will be appropriate for different entities—although, for consolidation purposes the controlling entity will establish a level above which assets must be capitalized. Different thresholds may be established for different classes of assets.

6.25 Despite the use of capitalization thresholds for most classes of assets, an entity may still recognize and report all assets within a class if it considers that this is appropriate. For example, an entity may choose to record and report all land, regardless of whether its recorded value is below the capitalization threshold.

6.26 In some instances, the use of procurement systems facilitates recognition of assets. If procurement is channeled through procurement systems on a mandatory basis, updating such procurement systems may be a feasible approach for the gathering of the information.

[17] The extent to which an entity is permitted to use capitalization thresholds may be limited by controlling entities and may vary between jurisdictions. In addition, an entity may be required to keep sufficient records of assets that have not been capitalized to permit an annual assessment of their materiality.

6.27 Some assets may have a lower value, per unit, than the capitalization threshold. However, such assets may be material as a group.[18] In this case, the assets may be reported as a single asset, with one combined value. Such assets are commonly referred to as group assets. An entity will need to use judgment in deciding how to apply its reporting threshold.

6.28 Despite the fact that certain items may be recorded as a single asset in the financial systems, an entity is still able to monitor or control the use and maintenance of these assets via a subsidiary system. For example, if a computer network is recognized as a single asset, each personal computer could still be recorded as an element of the network.

6.29 An entity may choose to record certain items that fall below the capitalization/reporting threshold. In accordance with the capitalization policy, these items would be expensed when purchased. However, a description of the items and their location may be recorded. For example, these items may be bar-coded and recorded in a separate asset register. This type of recording is appropriate for items such as video recorders, scanners, fax machines, mobile telephones, and certain tools. These items are sometimes referred to as "portable" items. Regular checks of such items, as part of the annual asset verification,[19] can assist in better management of the items and reduce the risk of theft.

Capitalizing Upgrades and Improvements

6.30 In accordance with IPSAS 17, subsequent disbursements on property, plant and equipment are only recognized as an addition to an asset when the disbursement improves the condition of the asset, measured over its total life, beyond its most recently assessed standard of performance. A monetary (or other) threshold may also be applied to upgrades and improvements (note: this threshold does not have to be the same as the one used for the initial capitalization of the relevant asset). As noted earlier in this Chapter, some entities may not be permitted to use this approach. Any such policies should be documented.

6.31 Any assets or components of assets which are replaced as part of an upgrade or improvement program need to be removed from the asset register and any other relevant records. Any residual carrying value for such assets or components would need to be written off at that point.

6.32 The entity may need to develop guidelines and examples (and provide training) for managers with asset responsibility, illustrating the types of transactions that would normally be capitalized or expensed.

6.33 The following two diagrams summarize the application of capitalization thresholds to asset purchases and to spending subsequent to purchase.

[18] The extent to which an entity is permitted to capitalize assets which do not individually meet the capitalization threshold may be limited by controlling entities and may vary between jurisdictions.

[19] The asset verification process is sometimes referred to as an inventory count or a stocktake, despite the fact that assets other than inventory may be involved.

Figure 6.3 Recording Threshold

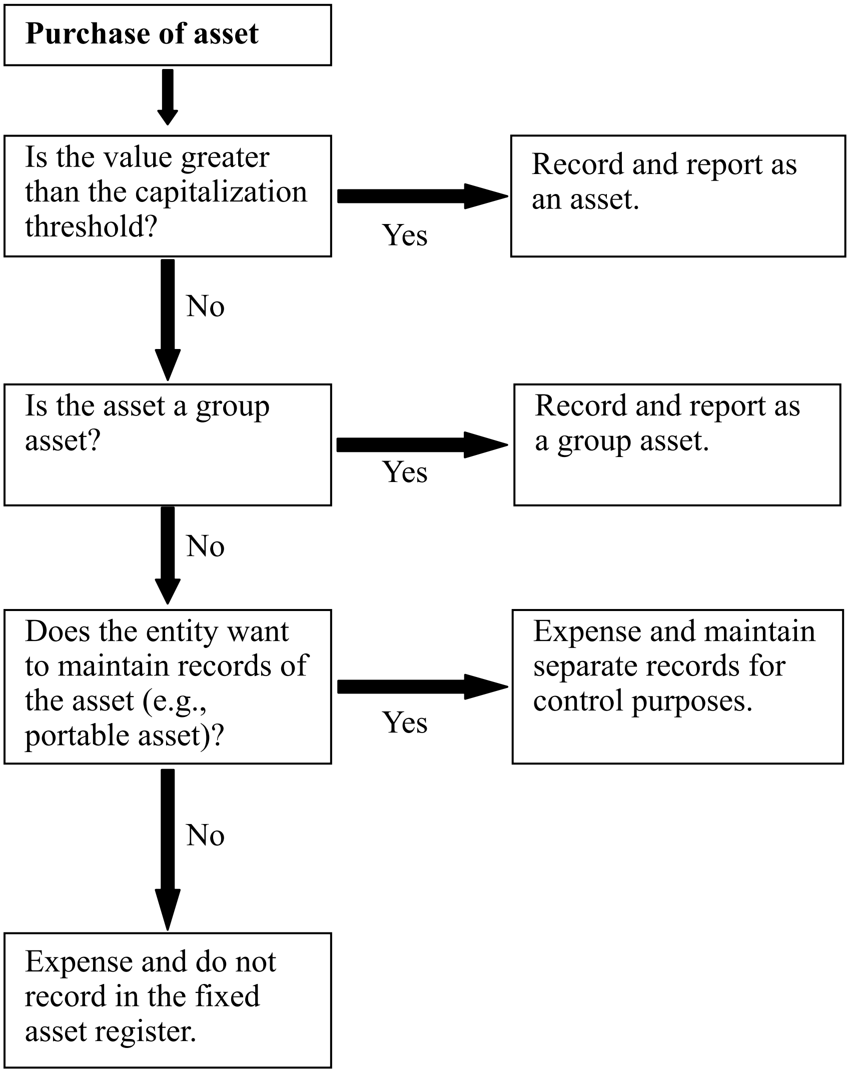
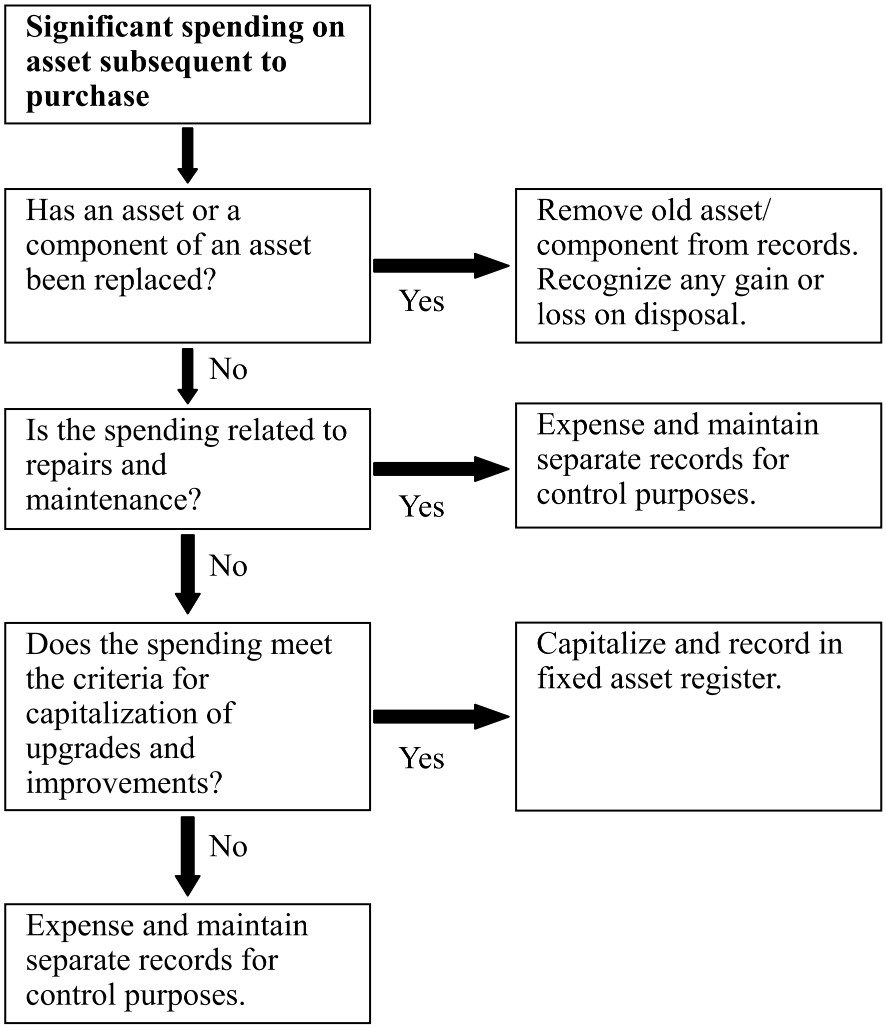


Figure 6.4 Capitalizing Upgrades and Improvements



Borrowing Costs

6.34 In accordance with IPSAS 5, borrowing costs that are incurred either can be recognized as an expense (benchmark treatment) or, where they have been incurred on a qualifying asset, can be capitalized (allowed alternative treatment). Qualifying assets are considered to be assets that because of their nature take a long period to get ready for their intended use or sale, for example, office buildings, hospitals and roads.

6.35 When the allowed alternative treatment is adopted by an entity, it should be applied consistently to all borrowing costs that are directly attributable to the acquisition, construction or production of all qualifying assets.

Property, Plant and Equipment—Identifying Classes and Components

6.36 A class of property, plant and equipment is a grouping of assets of a similar nature or function in an entity's operations that is shown as a single item for the purpose of disclosure in the financial statements. The following list from IPSAS 17 is a useful starting point in the identification of classes of property, plant and equipment:

(a) Land;

(b) Operational buildings;

(c) Roads;

(d) Machinery;

(e) Electricity transmission networks;

(f) Ships;

(g) Aircraft;

(h) Specialist military equipment;

(i) Motor vehicles;

(j) Furniture and fixtures;

(k) Office equipment; and

(l) Oil rigs.

6.37 Other common assets for public sector entities include roads, bridges, sewer systems, water and power supply systems, and communication networks.

6.38 IPSAS 17 does not require that an entity recognize heritage assets. If an entity chooses to recognize heritage assets it may, but is not required to, apply the measurement requirements of the Standard. However, an entity recognizing heritage assets must apply the disclosure requirements of that Standard. Some jurisdictions distinguish between operational (for example, historic buildings used as office accommodation) and non-operational heritage assets (for example non functional bridges and buildings that have only historical significance).[20] The specific classes of property, plant and equipment will vary between entities, depending upon the type of assets held and the materiality of particular types of assets. Each class of assets may also have sub-classes.

6.39 Some components of assets may be recognized as separate assets when they are significant and have useful lives that are different from those of the items of property, plant and equipment to which they relate. For example, the components of a water system may include the pipes, reservoirs, pumping station, and service connections. An entity needs to decide whether it is appropriate to recognize the components as separate assets or collectively as part of the larger asset (componentization). Provided the recognition criteria in IPSAS 17 are satisfied, replacement or renewal of a component is accounted

[20] For guidance on the identification of heritage assets by entities in South Africa refer ASB, 2001.

for as the acquisition of a separate asset and the replaced asset is derecognised. The recognition of components will be influenced by factors such as:

(a) Whether the component is a significant part of the asset;

(b) The reporting threshold;

(c) Materiality (for example, whether the separate recognition of a component will have a material impact on depreciation);

(d) Whether the component performs a separate function; and

(e) Whether the component's useful life differs from that of other components.

6.40 As part of accounting for network or system assets an entity may need to:

(a) Construct an asset management database;

(b) Identify appropriate components of the system or network;

(c) Ascertain the age and condition of the components;

(d) Assess the remaining useful life of existing asset components;

(e) Identify features of the component, for example type of surface or method of construction for a road;

(f) Identify the level of use that particular parts of the system or network are subject to;

(g) Establish a method for distinguishing between maintenance and upgrades or improvements for that component;

(h) Determine the valuation of assets for inclusion in the financial records;

(i) Calculate the amount of decline in service potential (depreciation) for the financial period;

(j) Plan for a cycle of inspection to check accuracy of records against actual conditions; and

(k) Link the underlying data to asset management plans, and link asset management plan information to the financial records and financial statements (that is, reconcile to general ledger information).

Property, Plant and Equipment—Assessment of Useful Lives

6.41 The useful life of an asset will vary depending upon the purpose for which the asset is used, the level of use, the nature and amount of maintenance and the climatic conditions. For example, the useful life of buildings is often shorter in tropical areas, due to the impact of high humidity, than in temperate climates. Sources of information for determining asset lives include:

(a) Discussions with the people responsible for the use and maintenance of assets;

(b) The useful lives of similar assets used by other entities and jurisdictions (the useful lives of major classes of assets are disclosed in annual reports); and

(c) Past records of asset acquisition and disposal.

6.42 The following considerations may be helpful in deciding how much time and effort to spend assessing the useful lives of assets:

(a) Initial assessments of useful lives could be used for a set period and then reviewed; and

(b) To what extent the uncertainty regarding the useful life of an asset will impact on depreciation expense and, if relevant, a charge for the use of capital.

6.43 Useful lives and depreciation methods need to be reviewed at every reporting date. For example, the existence of a large number of completely written-down assets still in use by an entity would indicate that the estimates of useful life are too short.

Property, Plant and Equipment—Assessment of Residual Values

6.44 The residual value of an item of property plant and equipment is defined in IPSAS 17.

6.45 The *residual value* of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

6.46 An entity needs to determine the residual value of a depreciable asset in order to know the amount that must be allocated across the asset's useful life. The sources of information for determining asset lives (discussed above) may also be useful for determining residual values.

6.47 Unless an entity has a prior agreement to dispose of an asset for a set amount the determination of the residual value will involve some judgment. The more specialized an asset is, the more judgment is likely to be required. Some assets in the public sector, particularly infrastructure assets, may not have a residual value (or the residual value may be negligible) because they are inalienable. The estimated residual value of an asset may change over time. IPSAS 17 and the two impairment standards, IPSAS 21 and IPSAS 26, all require that an entity periodically review the residual value of an asset.

Property, Plant and Equipment—Impairment of Assets

6.48 An asset is impaired when its carrying amount exceeds its recoverable amount or recoverable service amount. The recoverable amount or recoverable service amount is determined as the higher of its net selling price and its value in use. IPSAS 21 and IPSAS 26 provide guidance on impairment of assets within their scope. Chapter 12 discusses the requirements of these standards.

Property, Plant and Equipment—Asset Management Practices

6.49 A key factor in the development of asset management policies and procedures is "who will be responsible for the condition, use, and performance of assets?" For example, some classes of assets may be centrally managed and individual operational managers may require little information about those assets. In other cases, responsibility for assets may be devolved to operational managers. Where responsibility is devolved, each person with responsibility for asset management needs to know exactly what the responsibility entails and who has the authority to make changes to the accounting records.

6.50 Ideally, an entity will have asset policies and procedures that cover all aspects of asset management, including:

(a) General accounting procedures (refer below for examples);

(b) Planning (for example, the development of policies on the provision of operational facilities and other staff amenities such as canteens and gyms); and

(c) Operation (refer below for examples).

6.51 General accounting procedures for property, plant and equipment include:

(a) Recording assets in fixed asset registers with an identifiable audit trail (for example a bar-coded sticker on each asset and unique reference numbers);

(b) Regular reconciliation of the asset register to general ledger balances;

(c) Annual management checks for existence, continuing use, remaining life, obsolescence;

(d) Annual reviews for impairment;

(e) Annual reviews of useful lives, depreciation methods and residual values;

(f) Purchasing procedures to ensure that all additions are authorized and accurately recorded; and

(g) Sales or write-off procedures to ensure all disposals are authorized and properly recorded.

6.52 Operating procedures for assets could include:

(a) Establishing performance indicators (for example, levels of under-used space);

(b) Developing operation and maintenance plans (including cost maintenance priorities highlighting essential and urgent work);

(c) Procedures for monitoring the condition and use of assets;

(d) Developing maintenance plans;

(e) Tracking assets that are off-site, for example, transfers, loans and off-site repairs; and

(f) Safeguarding and protection of assets, particularly high value moveable assets.

6.53 Not all of these policies and procedures need to be in place at the beginning of the transition to accrual accounting, although some, such as monitoring the condition of assets are important in complying with the measurement aspects of the Standards. Some of them will evolve as managers become more familiar with the impact of assets on financial reporting, and asset management issues. However, these policies and procedures have an impact on the type of asset management systems that are required and in particular, the structure and content of the asset register (refer to next section). It is therefore helpful if they are considered (even if not developed) at an early stage of the transition.

6.54 The type of operating policies required also depends upon the extent of an entity's responsibility for asset management. Where procurement, maintenance and disposal functions are centrally managed, an entity will be responsible for following the procedures established by central entities rather than developing its own procedures.

6.55 In order to comply with IPSAS 17, adequate asset management plans or other appropriate information systems are necessary to reliably estimate the decline in future economic benefits and service potential (depreciation), and to ensure reliable reporting of the carrying value of those assets.

6.56 In the absence of an asset management plan, the following problems can occur:

(a) Sub-optimal use of assets;

(b) Failure to rationalize surplus assets;

(c) Significant variation in running costs between locations;

(d) Inadequate management information;

(e) Deteriorating physical condition of stock; and/or

(f) Continuing maintenance of uneconomic assets.

Property, Plant and Equipment—Asset Registers

6.57 An asset register is a complete and accurate list of assets owned by an entity that is regularly updated and validated. It records the opening and closing balances of classes of property, plant and equipment, and is used to support the reported figures in the financial statements. The compilation of an asset register for property, plant and equipment is one of the major steps in the adoption of the accrual basis of accounting. It is a critical part of an asset management information system and will normally contain information beyond that required for financial reporting.

6.58 The size and complexity of an asset register will depend on:

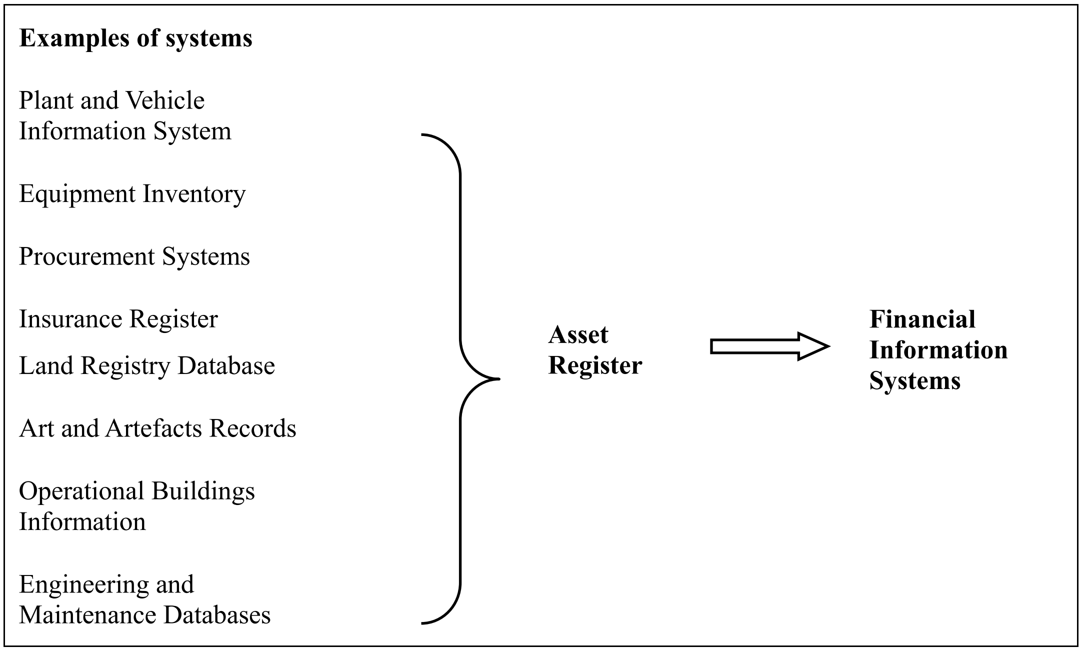
(a) The number and type of assets held by the organization; and

(b) The volume of purchases, transfers and disposals.

6.59 In its simplest form, an asset register may be a manual document or a spreadsheet. Alternatively, it can be a computerized system that interfaces directly with the general ledger (most computerized accounting systems have this facility). However, an asset register does not have to be a single computerized system or document. It can be a series of sub-systems with linkages and a common directory. The design of an asset register will to a large extent be influenced by the content of existing asset management systems and databases.

6.60 The following diagram illustrates how a number of systems can link to form an asset register.

Figure 6.5 Asset Register



6.61 Key issues in the design and development of an asset register are:

(a) The information it needs to contain; and

(b) Whether it should be integrated with the general ledger/other systems.

6.62 For each asset, an effective asset register needs to contain the following details (where applicable):

(a) Name of asset;

(b) Physical description;

(c) Serial number;

(d) Date of acquisition (purchase, creation, donation, forfeiture);

(e) Location;

(f) Person/position responsible for custody and maintenance of asset;

(g) Due date for replacement;

(h) Expected useful life;

(i) Original life;

(j) Expired life;

(k) Remaining life;

(l) Date asset life last reviewed;

(m) Date of last impairment test and any evidence of impairment;

(n) Historic cost or valuation (initially if known and subsequently as valuations are completed);

(o) Depreciation method and rate (once determined);

(p) Book value; and

(q) Date of disposal.

6.63 As shown in Figure 6.5, an asset register could also contain (or be linked to) other relevant information such as insurance details and planned maintenance.

6.64 Features of a good asset register include:

(a) Asset data is updated as transactions and events occur;

(b) The data is regularly reconciled with acquisition data, any subsidiary systems, and the general ledger;

(c) The data is readily available to asset managers, at the level of detail they require, preferably "on-line;" and

(d) The data is structured to allow different classifications of assets to be distinguished.

6.65 Possible sources of data for asset registers include:

(a) Existing asset lists and systems (details of vehicles and computer equipment are often available);

(b) Insurance lists;

(c) Lists of properties where the entity pays property taxes, electricity, water, or other utilities; and

(d) Information on land and buildings held by government entities responsible for cleaning or maintenance.

6.66 These records can often be the starting point for the compilation of an asset register. These sources of data may be used as the primary data or used to reconcile information held on assets within different systems. Such records will not generally have been an integral part of the accounting system, and they may have been updated periodically rather than as transactions occurred. As such, they may contain inaccurate or incomplete information. It is essential, therefore, that these records are checked regularly for accuracy and completeness if they are used to determine accounting figures.

6.67 In compiling the initial list of assets, the information in various systems will need to be reconciled with each other and with financial records. This information is likely to be required by an external auditor. Where the information in a fixed asset register is drawn from a number of different systems, it is essential that the underlying records for all items are reliable. In order to be able to rely on the information in existing systems, details of additions and disposals must have been correctly recorded in preceding years. Errors identified in existing systems need to be resolved and corrected. If the accuracy and completeness of existing systems is in doubt, complete or partial verification of assets will be required. Poorly performed asset verifications do not provide reliable information.

It is important to get this step right, or, in order to get reliable information and an unmodified clean audit opinion, it will need to be done again.

6.68 Once accrual accounting has been adopted, assets need to be verified regularly. Cyclical coverage of assets can vary between types of assets depending upon their risk profiles and degree of physical security. Not all assets will be verified by physical inspection. It is possible to purchase or design software that performs automated verification of information technology equipment attached to a local area or other network. The following illustrates how a department developed verification instructions which were clear and thoroughly explained to those involved.

> *Illustration Clarifying and Communicating Asset Verification Instructions*
>
> Department A had established a computerized asset register. However, the data in the asset register was not very accurate and resulted in an audit qualification. To resolve the problem the department conducted a complete verification of all fixed assets and re-entered all the asset data. In order to ensure that this process resulted in the collection of complete and accurate data, the department created teams of experienced staff, led by an accountant. The instructions were re-drafted so that they were clearly understood by all people participating in the verification process. As part of the process, the department made a video showing people how to conduct the verification process. The video showed all types of equipment held by the department, described the name and function of each piece of equipment and showed the location of the serial number.

6.69 Ownership of assets, especially land, needs to be checked and resolved. Items that may need special attention include:

(a) Land requisitioned for a particular purpose but never returned to the original owners;

(b) Forfeited assets (which may or may not belong to the entity);

(c) Donated assets and assets held in trust (which may include assets owned by the entity but required to be used for a particular purpose as well as assets held in a custodial capacity); and

(d) Land that has not been surveyed.

6.70 Where there are problems with the accuracy of data (e.g., quantity, location, age), or ownership cannot be immediately resolved, options include:

(a) Loading the data into the asset register (together with information on the issues to be resolved) and clearly flagging the issue; and

(b) Noting the discrepancies and referring the issue to more specialized staff (for example, legal advisers) for resolution.

6.71 At the stage that the entity begins to collect information for the asset register, the software and systems to be used to account for fixed assets may not have been selected or designed. Ideally, information would be collected in a form compatible with existing software, and new systems would take into account the existing record format. Even in the absence of such decisions, it is still possible to compile the basic data required for the asset register. At some point, asset register information may need to be transferred from one format to another. The benefits of making early progress on the asset register need to be compared to the likely time and cost of transferring information into a different system.

6.72 An asset register may be compiled in stages. The first stage may consist of compiling a list of all property, plant and equipment controlled by the reporting entity. This information can be collected prior to the finalization of accounting policies, as valuation and measurement issues can be resolved at the second stage. In addition, where information on particular classes of assets is difficult to obtain or determining control will be difficult, the collection of information on such assets can be treated as a separate exercise. Alternatively, identification and valuation can proceed on a class-by-class basis.

Integration of Asset Registers with the General Ledger

6.73 Asset registers may be separate systems or they may be integrated with the general ledger and other systems. If they are separate, then information from the asset register needs to be periodically transferred (using a manual or computerized interface) into the general ledger for the preparation of the financial statements. If the asset register is integrated with the general ledger, then the opening and closing balance information can automatically flow through into the general ledger, and automatic journal entries for depreciation can be created.

6.74 Integration of the asset register with other systems has clear advantages. For example, integration of the asset register with the purchasing, capital planning, preventative maintenance, accounts payable (to capture acquisitions) and general ledger systems:

(a) Minimizes manual intervention;

(b) Reduces the possibility of corruption of data, or error;

(c) Reduces the number of reconciliations required;

(d) Prevents duplicate data entry and processing; and

(e) Allows journals for depreciation and asset revaluations to be automatically generated.

6.75 An asset register may also be integrated with the human resource management information system. This allows the tracking of employee possession of attractive and portable items.

6.76 However, during the initial stages of implementation, an entity may be constrained by the nature of existing systems and the time and cost to re-design or replace these systems. In such circumstances, manual or computer interfaces between existing systems and the general ledger will be required. Such interfaces are a potential source of errors, not least the possibility that not all data on assets may be transferred. In order to avoid problems arising from interfaces, careful design, training and testing are required.

Validation of Asset Registers

6.77 Validation of asset registers involves conducting checks to show that the information in the register is complete and accurate as at a certain date. Compilation of a register can take some time, and during that time assets will have been acquired, enhanced, and disposed of. Validation of figures to be used for opening balances is therefore required. Lists of additions, enhancements, and disposals should be generated and reviewed. Validation is also required on an ongoing basis.

6.78 In most cases, there will be some asset movements (additions, enhancements and disposals) between the original valuation and loading of information into the asset register and the reporting date.

6.79 Methods of validating figures to be used for opening balances include:

(a) For land and buildings—documenting the source of information and procedures followed to establish the completeness of the records; and

(b) For other fixed assets—circulating information held on the asset register to employees responsible for physical custody of assets asking for confirmation of the accuracy and completeness of the records.

6.80 Good validation procedures include:

(a) Assigning responsibility for validation of information on each class of assets to one person/position;

(b) Ensuring that physical existence checks are conducted by staff independent of those responsible for custody of the assets;

(c) Requiring written approval of any amendments to information held by appropriate personnel;

(d) Requiring written statements confirming the accuracy of asset register information (subject to any amendments provided);

(e) Retaining records of any adjustments made to the asset register following receipt of proposed amendments; and

(f) Keeping records of which parts of the register have been validated and the dates on which the data was validated.

6.81 If it is not possible to conduct all verifications at the reporting date, it would be prudent to discuss the acceptability of a phased program of verification with auditors.

6.82 Due to time constraints, an entity may initially omit some immaterial categories of assets from the asset register. Subsequently, these assets will need to be identified (by component), valued, entered into the asset register, and recognized in the financial statements. The subsequent recognition of such assets will generally lead to both an increase in assets and net assets/equity.

Asset Registers—Summary

6.83 The following key points will be useful for entities developing an asset register:

(a) If preparing for converting to accrual accounting, start collecting basic information on assets immediately, even if this information is simply collected on a spreadsheet.

(b) Make sure asset verification instructions are clear and thoroughly explained.

(c) Start small—it is better to create a simple but workable asset register which has the minimum data required for all assets than to attempt and never finish a more complex register.

(d) Communicate with users to make sure registers are usable and used.

(e) Provide training for users of the asset management systems and asset register—a slow take up by users requires follow up action.

(f) Allow sufficient time for researching proof of ownership, including reconciling historical documents of ownership to more recent records—this task can be very time consuming.

(g) Establish a process for dealing with assets where ownership is disputed or cannot be resolved prior to reporting date.

(h) Remember to develop systems to track items (such as major components/spare parts) that are owned by the entity but are held by contractors for the repair, overhaul or modification of assets.

(i) Establish a process for identifying surplus property. Properties identified for disposal must then be valued in accordance with the policy on valuation of properties for disposal.

(j) Do not spend more to obtain information than the information is worth.

Property, Plant and Equipment—Measurement

6.84 IPSAS 17 specifies the initial and subsequent measurement of property, plant and equipment.

6.85 Entities that also compile data for statistical systems such as the Government Finance Statistics Manual 2001 (GFSM 2001) should be aware that the measurement of assets under those systems may differ from the requirements of IPSASs. Examples of differences between the GFS approach and IPSAS 17 are shown in the table below.

GFSM requirements	IPSAS 17
The GFS requires all assets to be valued at their current market value, which is defined as the amount that would have to be paid to acquire the asset on the valuation date taking into account its age, condition, and other relevant factors. This amount depends on the	Measurement on initial recognition is generally at cost[21]. Assets acquired through a non-exchange transaction are initially measured at fair value. Subsequent measurement is under the cost model or the revaluation model. Assets measured using the cost model must be reviewed for impairment. Assets measured using the revaluation model are not

[21] IPSAS 17 describes those costs that comprise the cost of an item of property, plant and equipment.

GFSM requirements	IPSAS 17
economic benefits that the owner of the asset can derive by holding or using it.	required to be reviewed for impairment. In testing an asset for impairment, the asset's recoverable amount or recoverable service amount must be determined. An asset's recoverable amount or recoverable service amount is not necessarily the asset's current market value.

Property, Plant and Equipment—Valuation Issues

6.86 Valuations may be required at the time of initial recognition if the item's cost cannot be determined reliably, or if the item has been donated. IPSAS 17 requires items of property, plant and equipment to be valued at cost (as at the date the assets are acquired). Where an asset is acquired at no or nominal cost, its cost is its fair value. Fair value is defined as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction" (IPSAS 17 paragraph 12). The relevant method will depend upon the circumstances. For example, different valuation methods are usually applied to items that will continue to be used and items that have been identified as surplus or otherwise intended for disposal. Valuation methods that may be relevant in assessing fair value include:

(a) Open market value;

(b) Market-based value; and

(c) Depreciated replacement cost.

6.87 The International Valuation Standards Board (IVSB) of the International Valuation Standards Council (IVSC) develops international standards for the valuation of assets and liabilities. The IVSB standards are intended to assist valuers providing valuations in accordance with IFRSs and IPSASs. The valuation profession in some countries requires that valuers apply these international standards. Other countries have national valuation bodies which issue similar standards.

6.88 Steps in valuing assets include:

(a) Develop appropriate valuation policies, including the valuation method, for each class of asset;

(b) Decide whether assets within those classes are to be valued;

(c) Prepare instructions for valuers;

(d) Collate information required by valuers;

(e) Select valuers; and

(f) Perform management review of valuations.

Opening Balance Policies

6.89 The following example of an accounting policy illustrates the use of valuations in the determination of opening balances.

> *Example: Accounting Policy—Initial Recognition of Property, Plant and Equipment*
>
> Items purchased or acquired before [date] or whose cost cannot be determined or is not reliable, are to be recorded at depreciated replacement cost (adjusted to take into account any major differences between the actual asset and the replacement asset). That is, the depreciated replacement cost is to be based on the estimated present cost of constructing the existing component of the asset by the same or (similar method) of construction.

6.90 In some cases, the original cost of the item may be available but significant development work may have been carried out since that date. For example, aircraft may have significant capitalized development costs. If original contract details for this work are not available, valuations of parts and estimations of development costs can be used to determine opening balances.

Full Population or Sample

6.91 It is possible to use stratified sampling when establishing the value of assets (New Zealand Treasury, 2002). The use of sampling techniques should be discussed with auditors.

Instructions for Valuers

6.92 Valuers require detailed instructions as to the valuation policies and specific details of assets to be valued. An example of the considerations which should be taken into account when compiling detailed instructions for valuers is contained in the United Kingdom National Audit Office's *IPSASs: Preparing for Audit* (United Kingdom National Audit Office, 2007). In particular, it is important to be aware that the effectiveness of a valuation exercise will be largely dependent upon the quality of the instructions.

6.93 Suggestions for developing instructions for valuers include:

(a) Requiring valuers to establish the completeness of the list of assets at a given site;

(b) Requiring valuers to provide a value and an estimated useful life for each asset;

(c) Using a relatively low capitalization threshold for valuations and applying this threshold to gross values (as opposed to net values). The threshold used in the asset register can be higher than this, but sufficient data is required to make an informed judgment;

(d) Being explicit about whether valuations are to include or exclude relevant taxes or duties; and

(e) Stating which set of professional valuation guidelines is applicable.

Information Required by Valuers

6.94 The data required by valuers for land is likely to include:

(a) Area;

(b) Ownership and title;

(c) Planning consents and agreements;

(d) Restrictive covenants, easements and rights of way;

(e) Use(s); and

(f) Who the valuer should contact to access the land.

6.95 Further information required by valuers for buildings is likely to include:

(a) Type of building, roof and heating system;

(b) Year of construction;

(c) Gross external area;

(d) Net internal area;

(e) Number of stories;

(f) Estimated replacement cost for insurance purposes;

(g) Condition surveys; and

(h) Maintenance records and expenditure.

Selection of Valuers

6.96 Qualified external valuers are generally used to obtain reliable and independent valuations. However, the cost of obtaining valuations may mean that internal staff may be used to value some assets. The use of internal staff may be more appropriate where computer-based models, price indices and catalogues are being used to obtain approximations of historic cost or current value. Where internal staff are used to perform valuations, it is important that the valuations are in full accordance with the best practice followed by firms of professional valuers and that sound audit trails are established (including references to price indices and catalogues used).

Management Review of Valuations

6.97 Management is still responsible for the accuracy of valuations, even when performed by external valuers. Before valuations are entered into asset registers, management therefore needs to review them for completeness and reasonableness. Management should document that this review has occurred, any issues identified, and subsequent action taken. Some of the problems that can arise include:

(a) Assets not owned by the entity being included in the entity's records;

(b) Assets owned by the entity not being included; and

(c) Assets identified as being held for disposal being valued on a continuing use basis.

6.98 Reconciliation between management records, the asset register, and valuations is a useful check to ensure that all assets owned have been valued and that all assets valued are indeed owned. Evidence of such reconciliations is important evidence for the external auditor.

6.99 After the valuation data has been inserted in the asset register, only those transactions that took place after the valuation date should be reflected in the asset register. Subsequent valuations should be reviewed for consistency. Copies of valuation reports form supporting documentation for opening balances.

Examples of Approximations

6.100 Where historic cost is the valuation method adopted, but such information is not available for each asset, valuations are normally required to determine opening balances. The transitional provisions of IPSAS 17 allow entities to recognize property, plant and equipment at cost or fair value at the date of acquisition. Some jurisdictions have adopted such methods of estimating historic cost, for example, one jurisdiction has developed a computer-based model that will provide an estimate of historic cost for property and infrastructure assets.

6.101 Where valuations are used to establish opening balances of assets, depreciated replacement cost of an asset may be established by reference to the buying price of a similar asset in an active and liquid market. Depreciated replacement cost may be approximated by using historic cost updated by price indices (and depreciated to reflect remaining useful life), or by using prices in current catalogues.

6.102 Another method of reducing the time and effort required in obtaining opening balances is to extrapolate values obtained from external valuers to assets not included in the valuation exercise. It would be prudent to obtain the views of the external auditors on the use of this method beforehand.

Property, Plant and Equipment—External Audits

6.103 This section considers how an entity can ensure that it is well prepared for an external audit. The main objective of this Study is to provide practical guidance to entities intending to report on an accrual basis, and intending to adopt IPSASs as part of that process. Many of the entities using this guidance will also have the objective of preparing external financial statements that receive an unqualified audit opinion. In order to help entities reap the benefits of the work they have put into the transition, this section discusses a selection of audit issues associated with property, plant and equipment. Although the focus is on property, plant and equipment, some of the discussion is also applicable to other areas. This section is not comprehensive. It is intended to provide examples of the types of planning and preparation that may be required to attain the goal of an unqualified audit opinion.

6.104 There are a number of steps that management and staff can take to help the audit go smoothly and to minimize the risk of a qualified audit report. They include:

(a) Understanding the auditor's objectives;

(b) Maintaining audit trails;

(c) Having supporting information and schedules ready; and

(d) Being aware of common audit issues and taking steps to avoid their occurrence.

6.105 An auditor is interested in assessing whether the entity's systems, controls, validations, and management reviews provide assurance regarding the following general audit assertions related to assets.[22]

(a) Existence—the asset exists;

(b) Rights and obligations—the entity holds or controls the rights to the asset;

(c) Completeness—all assets that should have been recorded have been recorded;

(d) Valuation and allocation—the asset is recorded at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded; and

(e) Presentation and disclosure—an item is disclosed, classified, and described in accordance with the IPSASs.

6.106 An audit trail consists of a positive set of links for each transaction or balance from source to account, and back. It is the ability to track from the financial statements back through the prime accounting records to the underlying transactions and events (and back again) so that management and the auditor may substantiate the individual account figures. Audit trails include the use of control totals and trail data when obtaining information from other computerized systems, and the use of documentation to support all decisions and assumptions. Examples of audit trails and system controls can be found in auditing textbooks and in-house system manuals. See for example United States Defense Finance and Accounting Service (2005).

6.107 Supporting schedules required for the preparation and audit of the financial statements include:

(a) A copy of the asset register by asset category;

(b) A reconciliation of opening and closing balances of each class of asset;

(c) A copy of the asset verification procedures and the final report;

(d) A reconciliation of the asset verification report to the asset register;

(e) A list of write-offs/write-downs;

(f) A schedule of spending subsequent to purchase showing which spending has been capitalized in accordance with the policy on capitalization;

(g) A schedule of any revenue or expense to be recognized in the statement of financial performance resulting from the sale of assets; and

(h) Valuation reports, where applicable, including the basis, date and name, and qualifications of the valuer.

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[22] IFAC's International Standard on Auditing (ISA) 500, *Audit Evidence*, paragraph 17, also describes assertions for other aspects of the financial statements.

6.108 An entity can expect an auditor to verify:

(a) The appropriateness of the entity's accounting policies in light of the IPSASs;

(b) Selected opening balances:

(i) Historic costs or other appropriate cost base (including residual values if any);

(ii) Useful life and depreciation or amortization policy;

(c) Selected acquisitions, disposals, repairs and maintenance expenses, write-downs and write-offs during the period; and

(d) The depreciation or amortization charge for selected assets.

6.109 In addition, the auditor will require a discussion of the methodology used, by asset class, to identify and value opening balances, and will be checking that regular reconciliations between the asset register and general ledger are performed.

Opening Balances

6.110 Evidence to support opening balances of assets can be provided by way of the following documents and procedures:

(a) A reconciliation of the initial asset register totals to valuation reports;

(b) Copies of confirmations from asset holders that asset registers are accurate and complete;

(c) A record of adjustments made to the asset register following review by asset holders;

(d) Lists of fixed asset additions, enhancements and disposals, with documentation of validation procedures performed on them; and

(e) Reasonableness checks on depreciation and revaluation (to include comparisons with any prior period figures available).

6.111 Opening balances need to:

(a) Be recognized and valued according to the chosen accounting policies;

(b) Be accurately entered into the accounting system;

(c) Be consistent with any figures brought forward from the cash-based accounts, for example, suspense accounts;

(d) Have clearly identifiable, documented sources;

(e) Have evidence of management review for ownership, accuracy and completeness; and

(f) Have evidence of physical verification, where appropriate.

Financial Statement Disclosures

6.112 An entity will need to ensure that its financial systems and records can provide the information required in order to meet the disclosure requirements of IPSASs, to monitor and assess potential financial risks associated with assets (for example, environmental cleanup costs), and to provide data for voluntary disclosures.

6.113 Examples of disclosures required by accounting standards include:

(a) Any class of property, plant and equipment not recognized under the transitional provisions in IPSAS 17;

(b) The existence and amounts of restrictions on title for property, plant and equipment pledged as securities for liabilities (IPSAS 1);

(c) The amount of expenditures recognized in the carrying amount of an item of property, plant and equipment in the course of its construction (IPSAS 17); and

(d) The amount of commitments for the acquisition of property, plant and equipment (IPSAS 1).

6.114 Additional asset disclosures could include:

(a) Any properties where dangerous/toxic substances are associated with the land or the buildings (refer to Chapter 7 for a discussion of contaminated land and landfill sites); and

(b) Any rights or obligations that attach to ownership or occupation and will transfer with the properties.

6.115 In addition to those disclosures required by accounting standards, an entity may choose to disclose:

(a) Physical descriptions of certain assets (for example state highways, national forests, recognized and unrecognized mineral deposits); and

(b) Descriptions of heritage assets (refer also to the discussion of heritage assets earlier in this Chapter).

6.116 Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Problems Identified During Audit

6.117 Issues that have been identified by auditors, across a range of jurisdictions, include:

(a) Physical asset verification procedures not being performed according to instructions (including breach of internal control by using staff with responsibility for assets to perform the verification);

(b) Deficiencies in verification procedures and unresolved discrepancies;

(c) Difficulties obtaining assurance about transactions that have occurred between the time of the asset verification and period end (where the asset verification occurs prior to period end);

(d) Verification of opening balances occurring at a later date, for example period end. This can lead to the accuracy of opening balance being questioned;

(e) Items that form part of a larger asset (e.g., a building) being recorded as single assets rather than as a series of components. This can lead to the age and condition of components being misstated as the components may have been upgraded or replaced since initial recognition of the assets;

(f) Poor implementation of asset identification;

(g) Stickers used for recording asset register references on assets such as furniture and equipment being incorrect or not visible;

(h) Policies, procedures, and training not being in place to ensure the sustainability of the asset register (or components of it);

(i) Assets being recorded at incorrect locations;

(j) Depreciation rates and useful lives not reviewed regularly (leading to large numbers of assets fully depreciated despite having future value);

(k) Acquisitions and disposals not recorded in a timely manner in asset registers or not processed in the general ledger;

(l) Missing disposal documentation;

(m) Lack of documentation to support the figures in the asset register;

(n) Figures presented for audit not subjected to any prior management review;

(o) Incomplete data on dates of acquisition (required for depreciation calculations);

(p) Asset registers not regularly reconciled to subsidiary records; and

(q) Asset registers not regularly reconciled to the general ledger.

6.118 This list shows that, although difficulties in valuation may be perceived as the major audit issue, poor implementation of asset verification procedures, incomplete documentation and a lack of regular reconciliations are just as likely to lead to an audit qualification.

Property, Plant and Equipment—Transitional Provisions

6.119 IPSAS 17 recognizes that due to the amount of work involved in identifying and obtaining the cost or valuation of all categories of property, plant and equipment, some entities may wish to recognize categories of assets progressively. It therefore provides a temporary provision for an entity to recognize some, but not all classes of property, plant and equipment. The provision is available for a maximum of five years from the date of adoption of accrual accounting in accordance with IPSASs.

6.120 Entities making use of the transitional provisions in IPSAS 17 are required to disclose that fact. Once an entity ceases to use the transitional provisions it must comply with IPSAS 17 in full, including being able to apply the standard retrospectively in accordance with IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*.

Property, Plant and Equipment—Lessons Learned

6.121 General lessons learned regarding the recognition of assets include the following:

(a) Start early—sufficient lead-time is critical.

(b) Obtain support from all concerned.

(c) Work very closely with auditors.

(d) Be prepared to make some mistakes.

(e) Be pragmatic.

(f) The process is evolutionary.

(g) Phased recognition of classes of assets has both advantages and disadvantages.

(h) Integrated systems avoid a number of audit issues arising from interfaces.

(i) Ensure there is a good audit trail including documentation for estimates and assumptions.

Inventories

6.122 This section highlights some issues that need to be addressed as part of the planning for the identification and measurement of inventories, and explains the application of IPSAS 12 and IPSAS 23 *Revenue from Exchange Transactions (Taxes and Transfers)* in relation to donated inventories. IPSAS 12 defines inventories as assets:

(a) In the form of materials or supplies to be consumed in the production process;

(b) In the form of materials or supplies to be consumed or distributed in the rendering of services;

(c) Held for sale or distribution in the ordinary course of operations; or

(d) In the process of production for sale or distribution.

6.123 Within the public sector, inventories are often held for use in service delivery or the production and sale of goods. Examples of inventories include:

(a) Ammunition;

(b) Consumable stores;

(c) Maintenance materials;

(d) Spare parts for plant and equipment other than those dealt with under IPSAS 17;

(e) Strategic stockpiles (e.g., energy reserves);

(f) Stocks of unissued currency;

(g) Work in progress, including:

(i) Educational/training course materials;

(ii) Client services (e.g., auditing services) where those services are provided at arm's length prices; and

(h) Land/property held for sale.

6.124 For the purpose of external reporting, entities can choose to classify inventories by type or by stage of completion (e.g., raw materials, work in progress and finished goods). IPSAS 1 requires the classification of assets (including inventories) as either current/non-current unless a presentation based on liquidity provides information that is reliable and is more relevant. A distinction between inventories held for sale or not intended for sale may also be made.

6.125 Entities will need to identify all inventories that meet the definition of inventories in IPSAS 12 and decide what categories of inventories will be used in the chart of accounts and in the financial statements.

Inventories—Recognition

6.126 Tasks associated with the recognition of inventories include:

(a) The establishment of recognition thresholds;

(b) Identification of the point at which title to various types of inventories passes, or is relinquished or transferred to or by the entity; and

(c) The establishment of systems and procedures to track costs associated with inventories in order to recognize inventory on hand at the end of the period.

6.127 Goods or services purchased by the entity are usually recognized when title to the goods has passed to the entity or the services have been rendered, and there is a legal obligation to pay for the goods or services. The recognition of goods in transit will depend upon the terms of the agreement under which the inventories were purchased.

6.128 The recognition of inventories acquired through a non-exchange transaction is governed by the requirements of IPSAS 23. The key elements required for recognition of an inflow of resources under IPSAS 23 are that the entity has control of the inflow, the inflow is probable, and the fair value of the asset can be measured reliably. All three aspects are required by IPSAS 23 paragraph 31.

6.129 The recognition of consumable items (for example, stationery) as inventories will depend upon the materiality of the items (both in terms of purchases and the amounts on hand at period end). Inventory items that fall below the established threshold level for the recognition of inventories (both individually and collectively) would be expensed on acquisition.

6.130 Recognition of work in progress is outlined in Appendix A to this Chapter. Systems for tracking costs and stocktaking procedures are discussed below.

Inventories—Systems

6.131 In order to meet the objectives of inventory control, an entity needs to establish systems for ordering, storing, using or selling inventories and accounting for these activities. The objectives of inventory management are to ensure that inventories are:

(a) Adequate to meet the needs of ongoing activities without disruption;

(b) Managed to reduce funds tied up in inventories and storage costs; and

(c) Subject to a good system of internal controls to minimize loss through damage, deterioration, unauthorized use, or theft.

6.132 In developing an accounting system for inventories, an entity will need to decide whether to operate a perpetual or periodic system (the comparison of the two systems set out below may be of assistance in making this decision). Under a perpetual system, inventory records are updated each time goods are received, used or sold. Under a periodic system, information on the levels of goods held is obtained by way of periodic asset verification. Where an entity is tracking the cost of particular processes or activities, the accounting system will also need to record the area or activity to which inventory is to be charged. Where inventories are significant, computer-based inventory management systems, purchasing systems, and accounts payable systems may be required. Inventory management systems need to be linked with, or regularly reconciled to, the general ledger.

Periodic Inventory System	Perpetual Inventory System
Inventory account and cost of goods sold are non-existent until the physical count at the end of the year.	Inventory account and the balance of costs of goods sold exist all the time.
Purchases account is used to record purchases.	No individual purchases account—purchases are recorded in the inventory account.
Purchase return account is used to record returns.	No individual purchase returns account –returns are recorded in the inventory account.
Cost of goods sold or cost of sale is computed from the ending inventory figure.	Cost of goods sold or cost of sale is available each time there is a sale.
For goods returned by customers there are no inventory entries.	Returns from customers are recorded by reducing the cost of goods sold and adding back into inventory.

Inventories—Verification

6.133 Periodic verification is required to provide evidence of the existence and condition of inventories.[23] Inventory verification is often referred to as a stock take. External auditors will want evidence that they can rely on the information collected by the entity. They may therefore want to review stock take procedures, observe the stocktaking process, and verify count and valuation amounts determined by the entity. All discrepancies identified, together with the action taken (such as writing off items) are documented. A regular review of issues identified and the action taken may assist the entity in improving its inventory management procedures. For example, a stock take can help identify obsolete items.

6.134 Stock takes generally involve a comprehensive stock take of all inventory items, as at a point in time. An alternative approach is the cycle count, in which only a percentage of items is assessed each time, with the entire inventory being verified over the course of the year. If cycle counting is reliable, an annual stock for those items may not be required.

[23] This Study does not provide guidance on asset verification procedures. However, examples of guidance on asset verification are included in the references to this Chapter.

Inventories—Assignment of Cost

6.135 IPSAS 12 states that the cost of inventories shall comprise all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition. It provides guidance on the identification and allocation of such costs. Inventories acquired through non-exchange transactions are measured at their fair value as at the date of acquisition.

6.136 IPSAS 12 allows cost to be assigned to inventories sold, or removed from inventories for use, by one or more of the following methods:

(a) Specific identification (for items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects); or

(b) First-in first-out (FIFO) or weighted average cost for other inventories.

6.137 Although IPSAS 12 permits a choice of method for the assignment of cost, it requires that an entity use the same cost formula for all inventories having a similar nature and use to the entity.

Inventories—Obsolescence and Damage

6.138 IPSAS 12 requires inventories to be carried at the lower of cost or net realizable value. Inventories shall be measured at the lower of cost and current replacement cost where they are held for:

(a) Distribution at no charge or for a nominal charge; or

(b) Consumption in the production process of goods to be distributed at no charge or for a nominal charge.

6.139 This means that regular (at least annual) checks for damage and obsolescence are required. This is ordinarily done as part of the periodic asset verification. Where items are written down to net realizable value, it is necessary to keep a record of the information on which the assessment of net realizable value has been based.

Construction Contracts

6.140 Where an entity holds assets as inventories for sale, distribution, or use as defined in IPSAS 12, it will account for work-in-progress of these assets in accordance with IPSAS 12. However, in some cases an entity such as a works and services department may enter a contract to construct an asset for another entity. Where work in progress relates to a construction contract as defined in IPSAS 11, the work in progress should be accounted for in accordance with IPSAS 11. The cost of construction work in progress includes:

(a) Costs that relate directly to the specific contract;

(b) Costs that are attributable to contract activity in general and can be allocated to the contract on a systematic and rational basis; and

(c) Such other costs as are specifically chargeable to the customer under the terms of the contract.

6.141 Where the outcome of a construction contract can be reliably estimated, IPSAS 11 requires contract revenue and contract costs to be recognized as revenue and expenses by reference to the percentage of completion (p.o.c) of the contract activity at the reporting date. The gross amount due from customers for contract work is recognized as an asset and the gross amount due to customers for contract work is recognized as a liability.

Investment Property

6.142 IPSAS 16 prescribes the accounting treatment for investment property and specifies related disclosures.

Investment Property—Scope

6.143 There are a number of exceptions to the scope of IPSAS 16. For example, it does not apply to:

(a) Property held for sale in the ordinary course of operations or in the process of construction or development for such sale;

(b) Owner-occupied property; and

(c) Property held to deliver a social service that also generates cash inflows. Such property is accounted for in accordance with IPSAS 17.

6.144 A property interest held by a lessee under an operating lease can qualify as investment property provided that the lessee uses the fair value model of IPSAS 16. In this case, the lessee accounts for the lease as if it were a finance lease.

Investment Property—Definitions

6.145 The following key terms are used in IPSAS 16:

Investment property is property (land or a building—or part of a building—or both) held to earn rentals or for capital appreciation, or both, rather than for:

(a) Use in the production or supply of goods or services, or for administrative purposes; or

(b) Sale in the ordinary course of operations.

Owner-occupied property is property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services, or for administrative purposes.

Investment Property—Recognition and Measurement

6.146 The recognition and measurement requirements of IPSAS 16 are summarized, and contrasted with the equivalent requirements in IPSAS 17, in the following table.

<table>
<tr><th></th><th colspan="2">IPSAS 16, Investment Property</th><th colspan="2">IPSAS 17, Property, Plant and Equipment</th></tr>
<tr><td>Types of assets included in the scope of the standard</td><td colspan="2">Land and buildings qualifying as investment property
and
Property interests held by a lessee under an operating lease</td><td colspan="2">All non-monetary assets (including land and buildings) qualifying as property, plant and equipment</td></tr>
<tr><td>Includes assets under construction</td><td colspan="2">Yes</td><td colspan="2">Yes</td></tr>
<tr><td>Measurement at initial recognition</td><td colspan="2">Cost
or
Fair value if acquired in an non-exchange transaction</td><td colspan="2">Cost
or
Fair value if acquired in an non-exchange transaction</td></tr>
<tr><td>Measurement after recognition</td><td colspan="2">Cost model
or
Fair value model</td><td colspan="2">Cost model
or
Revaluation model</td></tr>
<tr><td>Application of model</td><td colspan="2">To all investment property
(Where fair value model is used and fair value presumption is rebutted, an individual asset may be valued using the cost model while the rest continues to apply the fair value model)</td><td colspan="2">Model is applied on a class by class basis
(an individual asset within a class may not be valued using a different model)</td></tr>
<tr><td>Treatment of gains/losses on change in fair value</td><td colspan="2">Recognize in surplus or deficit in period in which it arises</td><td colspan="2">Increase is credited directly to revaluation surplus. However, the increase is recognized in surplus/deficit to the extent that it reverses a revaluation decrease of the same class of assets previously recognized in surplus or deficit
or
Decrease is recognized in surplus or deficit. However, the decrease is debited directly to revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that class of assets</td></tr>
<tr><td>Frequency of revaluations</td><td colspan="2">Annually</td><td colspan="2">Need not be annually provided that the carrying amount does not differ materially from that which would be determined at the reporting date</td></tr>
<tr><td rowspan="2">Annual depreciation</td><td>Cost model</td><td>Yes</td><td>Cost model</td><td>Yes</td></tr>
<tr><td>Fair value model</td><td>No</td><td>Revaluation model</td><td>Yes</td></tr>
<tr><td rowspan="2">Annual impairment testing</td><td>Cost model</td><td>Yes</td><td>Cost model</td><td>Yes</td></tr>
<tr><td>Fair value model</td><td>No</td><td>Revaluation model</td><td>No</td></tr>
</table>

Relevance to the Cash Basis of Accounting

6.147 The issues identified in this Chapter are relevant for entities intending to provide additional note disclosures on the nature and amount of assets as encouraged by the Cash Basis IPSAS, *Financial Reporting Under The Cash Basis of Accounting*. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown in the statement of cash receipts and payments. Where an entity discloses details of assets it would be helpful for users to highlight the cash receipts and payments associated with the additional disclosures.

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Appendix A

Accounting Policies

This Appendix illustrates examples of accounting policies for assets based on relevant IPSASs including property, plant and equipment and inventories.

These policies are examples of policies that might be developed by a central entity for application by all individual entities forming part of a whole-of-government reporting entity. The policies are consistent with the requirements of IPSAS 12 and IPSAS 17. However, it is possible that other policies that are consistent with these standards could also be developed. For example, entities applying IPSAS 17 may elect to measure items at depreciated historic cost or at fair value. The policy illustrated uses initial cost, with subsequent revaluations to fair value for certain assets. The illustrative policy for property, plant and equipment does not take advantage of any of the transitional provisions in IPSAS 17. Impairment of property, plant and equipment is addressed in Chapter 12.

Property, Plant and Equipment—Recognition

Items of property, plant and equipment that meet the recognition criteria for assets and that have a value greater than [*each entity to select an appropriate amount having regard to materiality*] are recognized in accordance with IPSAS 17 or IPSAS 23, as appropriate.

Property, Plant and Equipment—Cost

On initial application of IPSAS 17, assets not previously recognized are to be recognized at cost, or in the case of property, plant and equipment acquired at no or nominal cost, at fair value as at the date of acquisition.

Following initial application of IPSAS 17, assets recognized in accordance with IPSAS 17 are to be initially measured at cost.

The cost of an item of property, plant and equipment includes:

(a) The purchase price (including relevant taxes and duties, less trade discounts and rebates); and

(b) The directly attributable costs of bringing the asset to working condition for its intended use (including the cost of site preparation, initial delivery and handling costs, installation costs, professional fees such as for architects and engineers, and the estimated cost of dismantling the asset and restoring the site if required).

Self-constructed plant and equipment is accounted for in accordance with IPSAS 17 as follows:

(a) The cost of materials, labor and other inputs used during the construction process is obtained from transactions with parties external to the entity;

(b) The cost of abnormal amounts of wasted material, labor or other resources is not included in the cost of the asset; and

(c) Administration and other general overhead costs are not included unless they can be directly attributed to the construction of the asset or bringing it to its working condition.

Property, plant and equipment recognized in accordance with IPSAS 23 is initially measured at fair value as at the date of acquisition. Directly attributable costs of bring the asset to working condition for its intended use, are included in the amount recognized.

Property, Plant and Equipment—Following Acquisition

Following acquisition, property, plant and equipment is accounted for in accordance with IPSAS 17 as follows:

(a) It is measured at cost (less any accumulated depreciation and any accumulated impairment loss) or revalued amount (fair value at date of revaluation less any subsequent accumulated depreciation and any accumulated impairment loss).

(b) It is reviewed regularly for evidence of impairment in accordance with IPSAS 21and IPSAS 26.

(c) Subsequent expenditure is capitalized only when it is probable that the future economic benefits or service potential over the total life of the asset (in excess of the most recently assessed standard of performance of the existing asset), will flow to the entity. All other subsequent disbursements are recognized as expenses in the period in which they are incurred.

(d) Gains or losses arising from the retirement or disposal of an item are accounted for as gains and losses on disposal of non-current assets.

Property, Plant and Equipment—Revaluation

Land, buildings, leasehold improvements, and infrastructure are to be revalued every five years except where more frequent valuations are necessary to comply with IPSAS 17. Other assets are not to be revalued.

Revaluations are to be accounted for in accordance with IPSAS 17 as follows:

(a) Entire classes of assets, not individual assets, are to be revalued;

(b) Revaluations are to be made with sufficient regularity that the carrying amount does not differ from that which would be determined using fair value at the reporting date;

(c) Valuations are to be undertaken in accordance with the entity's policy on revaluations, including the use of registered valuers for certain classes of property, plant and equipment [*reporting entities will list whether internal or external valuers are required for each class*];

(d) Where no market value exists, value is to be assessed in relation to other similar assets or depreciated replacement cost;

(e) Any accumulated depreciation in respect of the class of assets is first credited to the assets to which it relates;

(f) A revaluation increase for a class of assets is directly credited to an asset revaluation reserve (except that a revaluation increase is recognized as revenue to the extent that it reverses a revaluation decrease of the same class of assets previously recognized as an expense);

(g) A revaluation decrease for a class of assets is recognized as an expense (although a decrease should be charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation surplus in respect of that same class of assets); and

(h) Revaluation increases and decreases relating to individual assets *within a class* of property, plant and equipment are offset against one another within that class (but are not offset in respect of assets in different classes).

The initial recognition of an item of property, plant and equipment at its fair value, in the absence of a determinable or reliable cost, does not constitute a revaluation.

Property, Plant and Equipment—Infrastructure Assets

Each component of an infrastructure asset with a materially different useful life from other components is accounted for as a separate asset and depreciated over its useful life.

Where the initial cost of construction is not known, a proxy such as depreciated replacement cost is to be used.

In common with other classes of property, plant and equipment, infrastructure assets are revalued in accordance with IPSAS 17.

Property, Plant and Equipment—Leased Assets

Assets acquired under finance leases are recognized as assets in accordance with IPSAS 13. The associated lease obligations are recognized as liabilities. Leased assets are depreciated in the same manner as other similar assets owned by the entity. The assets (and liabilities) are recognized at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments.

Assets leased by way of an operating lease are not recognized as assets. The associated expenses are accounted for in accordance with IPSAS 13.

Property, Plant and Equipment—Heritage Assets

Heritage assets are not required to be recognized under the provisions of IPSAS 17. Where an entity does recognize heritage assets it is not required to apply the measurement requirements of IPSAS 17. However, where an entity recognizes and measures heritage assets, it is required to make disclosures in accordance with IPSAS 17.

Inventory

In accordance with IPSAS 12, *Inventories*, inventories held for sale are to be measured at the lower of cost and net realizable value (NRV) on an item-by-item or group basis[25]. Inventories held for distribution at no charge, or for a nominal charge, are to be measured at the lower of cost and current replacement cost.

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[25] IPSAS 12 does not deal with work in progress of services which are to be distributed for no or nominal consideration directly in return from the recipients. The entity is not expected to have any such services. However, if such services do occur, the costs of producing the service are to be expensed as they occur.

The cost of inventories is to include purchase cost, or fair value if donated in-kind, and all other costs, including conversion costs, incurred in bringing inventories to their present location and condition. The cost of inventories comprising agricultural produce (harvested from the entity's own biological assets) is fair value less costs to sell at the point of harvest.

When inventories are sold or consumed, the carrying amount of those inventories is to be recognized as an expense in the period in which the related revenue is recognized.

The amount of any write-down of inventories to NRV (due to obsolescence, damage, or other reasons) and all losses of inventories are to be recognized as an expense in the period the write-down or loss occurs.

Costs are to be assigned to inventories using specific identification or first-in-first-out (FIFO) as appropriate.

Work in progress inventory is to be measured at the lower of cost and NRV.

Where work in progress of an entity relates to the provision of non-capital items or services, work in progress is to be determined on the basis of costs to date based on the stage of completion. Accurate records of work in progress will therefore require an auditable costing system to track costs, including records of labor input, overhead absorption rates, and additional direct costs.

Receivables

Refer to Chapter 13.

Appendix B

Measurement of Assets

This Appendix summarizes the measurement requirements in IPSASs dealing with major classes of assets. The discussion in other chapters and the detailed requirements of relevant IPSASs should be considered when developing accounting policies.

Asset category	**Initial measurement**		**Subsequent measurement**
	First time adoption	**Subsequent periods**	
Property, plant and equipment	Deemed cost – actual cost where historical records are available or Estimated fair value *(applied retrospectively apart from impairment of non-cash generating assets)*	Cost or Fair value if acquired in a non-exchange transaction	Cost less accumulated depreciation and impairment losses or Fair value at date of revaluation less subsequent accumulated depreciation and impairment losses
Investment property	Deemed cost – actual cost where historical records are available or Estimated fair value *(applied retrospectively apart from impairment of non-cash generating assets)*	Cost or Fair value if acquired in a non-exchange transaction	Cost less accumulated depreciation and impairment losses or Fair value
Inventories	Deemed cost – actual cost where historical records are available or estimated fair value (net realizable value / current replacement cost) *(applied retrospectively)*	Cost or Fair value if acquired in a non-exchange transaction	Lower of cost or net realizable value / current replacement cost.
Intangible assets	Deemed cost – actual cost where historical records are available or estimated fair value *(applied retrospectively apart from impairment of non-cash generating assets)*	Cost or Fair value if acquired in a non-exchange transaction	Cost less accumulated amortization and impairment losses or Fair value at date of revaluation less subsequent accumulated amortization and impairment losses

Asset category	Initial measurement		Subsequent measurement
	First time adoption	**Subsequent periods**	
Biological assets	Fair value less costs to sell If fair value cannot be measured reliably, cost *(applied prospectively)*	Fair value less costs to sell If fair value cannot be measured reliably, cost	Fair value less costs to sell. If cost is used at initial recognition, and the fair value is still not reliably measurable, measure at cost less any accumulated depreciation and impairment losses.
Agricultural produce	Fair value less cost to sell, at the point of harvest. *(applied prospectively)*	Fair value less cost to sell, at the point of harvest.	Generally accounted for as inventory—refer to IPSAS 12.

Chapter 7: Liabilities

Key Points

- This Chapter discusses implementation issues associated with the adoption of accrual accounting for a range of liabilities commonly recognized by governments and public sector entities including accounts payable and accrued expenses, debt, accrued interest, currency issued, and provisions.[26]
- International Public Sector Accounting Standards (IPSASs) that deal with the definition, recognition, measurement, and disclosure of liabilities are listed in the references to this Chapter.
- This Chapter does not address:
  - o Financial instruments within the scope of IPSASs 28-30 (refer to Chapter 13);
  - o Liabilities for employee-related expenses, including salary and wages, vacation leave, and pension obligations (refer to Chapter 14); and
  - o Social policy obligations arising from non-exchange transactions (refer to Chapter 15).
- The nature of existing systems and the assessment of the completeness and accuracy of information within those systems will affect the amount of work required to determine opening balances and establish systems that support reporting on an accrual basis.

Introduction

7.1 A national government is likely to have the following types of liabilities:

(a) Accounts payable arising from the purchases of goods and services;

(b) Accrued interest payable;

(c) Accrued salaries and wages;

(d) Accrued vested vacation pay or other accrued compensated absences;

(e) Employee pension obligations and other accrued employee benefits, including any accrued termination benefits;

(f) Amounts payable under guarantees and indemnities (where sufficient evidence is available to indicate that it is more likely than not that the amounts will be payable);

(g) Liabilities relating to unearned revenues;

(h) Transfer payments payable;

(i) Lease obligations related to finance leases;

(j) Bank loans and other short-term borrowings;

[26] Illustrative accounting policies that might be adopted for certain classes of liabilities are included in the Chapters of this Study that deal with specific types of liabilities.

(k) Long-term debt (both to the private sector and to other government entities);

(l) Environmental liabilities; and

(m) Obligations under accident compensation schemes.

7.2 At a whole-of-government level, debt and borrowings, and unfunded pension liabilities are likely to be the most significant non-current liabilities.

7.3 Within individual public sector entities, employee-related liabilities and provisions may be the most significant non-current liabilities. Some public sector entities may also have liabilities under finance leases, but many public sector entities do not have the authority to enter into finance leases.

7.4 The liability classifications required by an entity will depend on the types of liabilities that the entity incurs. In some cases, central organizations or the controlling entity may assume responsibility for certain liabilities. The disclosures required by IPSAS 1 *Presentation of Financial Statements* may be used as a starting point when thinking about the classification of liabilities. IPSAS 1 requires the disclosure of:

(a) Taxes and transfers payable;

(b) Payables under exchange transactions;

(c) Provisions;

(d) Financial liabilities (excluding amounts shown under taxes and transfers payable, payables under exchange transactions and provisions); and

(e) Further sub-classification of line items presented on the face of the financial statements.

7.5 IPSAS 1 also requires the classification of liabilities as current or non-current unless a presentation based on liquidity provides information that is reliable and is more relevant.

7.6 The amount of work required to recognize liabilities depends on the extent to which an entity already has information available on those liabilities. General steps in the recognition of liabilities include:

(a) Compiling a list of all types of liabilities incurred by the entity;

(b) Determining the categories of liabilities that will be used in the chart of accounts and the financial statements;

(c) Preparing accounting policies for each category;

(d) Assessing the accuracy and completeness of existing information on each category;

(e) Compiling accurate opening balances for each category (identification, application of the definition of a liability, and measurement); and

(f) Establishing systems to support the ongoing requirements of accrual accounting.

7.7 This Chapter discusses implementation issues associated with the adoption of accrual accounting for:

(a) Accounts payable and accrued expenses;

(b) Debt and accrued interest; and

(c) Provisions, including environmental liabilities.

7.8 Liabilities are also discussed in other Chapters as follows:

(a) Financial liabilities (Chapter 13);

(b) Liabilities for employee-related expenses, including salary and wages, vacation leave, and pension obligations (Chapter 14); and

(c) Transfers payable and other social policy obligations (Chapter 15).

Definition

7.9 IPSAS 1 defines liabilities as "present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential."

7.10 Various types of liabilities are defined in other IPSASs. For example, IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* defines provisions (liabilities of uncertain timing or amount) and IPSAS 28, *Financial Instruments: Presentation* defines financial liabilities.

Initial Recognition

7.11 An item is recognized as a liability in an entity's financial statements if:

(a) The obligation meets the definition of a liability in IPSASs; and

(b) The obligation meets the recognition criteria. These criteria are that it is probable that an outflow of resources embodying economic benefits or service potential will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

7.12 The more specific requirements of IPSAS 19 in relation to the recognition and measurement of provisions are discussed later in this Chapter.

Accounts Payable and Accrued Expenses

7.13 Accounts payable (also referred to as creditors) consist of amounts owed by the entity to others, including other government entities and the public. Types of accounts payables include:

(a) Those which occur when goods and services have been purchased on credit, and an invoice has been received (or the amount is payable under the terms of an ongoing contract or agreement) but not paid as at the end of the period;

(b) Amounts due to individuals in relation to non-exchange transfers such as welfare benefits; and

(c) Amounts due to other government entities or different levels of government in relation to non-exchange transfers such as grants.

7.14 Accrued expenses arise when goods and services have been purchased on credit from other parties during the period, and an invoice has not been received as at the end of the period or the amount is not yet due to be paid under the terms of a contract or agreement. Although accrued expenses are not financial instruments, as defined, they are discussed in conjunction with accounts payable in this Chapter. Accrued expenses often have separate codes in the chart of accounts, but for purposes of disclosure in the financial statements they are often aggregated with accounts payable.

7.15 Determination of opening balances of accounts payable and accrued expenses involves a thorough examination of all ongoing expenses. The entity needs to:

(a) Compile a list of all recorded amounts payable;

(b) Check that the amounts recorded for specific transactions are correct;

(c) Check that the recorded amounts are complete—this may involve seeking confirmation from regular suppliers; and

(d) Review all expenses to see if there are likely to be accrued expenses at period end.

7.16 The process followed needs to be documented to enable opening balances to be established and to provide an audit trail.

Debt and Accrued Interest

7.17 This section provides an introduction to issues in accounting for debt and debt servicing costs on an accrual basis. More detailed information on financial liabilities is found in Chapter 13. The section includes a brief discussion of issues to be considered in classifying items as debt or equity instruments (for a more detailed discussion of this issue refer to Chapter 13). Some of the issues discussed in this section are not directly linked to the adoption of accrual accounting. However, the adoption of accrual accounting is often linked to a review of debt management policies and procedures and other changes designed to improve the management of public debt.

7.18 Debt is a form of liability that represents money borrowed from individuals, banks, or other institutions. The terms used to describe debt securities and other forms of borrowing vary across jurisdictions. Some of the terms used are shown in the table below.

Term	**Description**
Interest bearing/non-interest bearing	Indicates whether the security bears interest.
Marketable/non-marketable securities	Indicates whether the securities may be traded in financial markets or whether the holder has to keep the security until maturity.
Bills	Short-term obligations. Depending upon the jurisdiction the term may be up to one year or up to 90 days.
Notes	Medium-term obligations. Depending upon the jurisdiction the term may be between one year and ten years. In some jurisdictions notes may be used to describe securities with a term of less than one year.

Term	Description
Bonds/debentures	Long-term obligations. Depending upon the jurisdiction, the term may be more than 10 years. In some jurisdictions bonds/debentures may be any security over one year. They give the holder the unconditional right to a fixed or contractually determined variable money income in the form of coupon payments and/or a stated fixed sum on a specified date or dates when the security is redeemed.
Loans and advances	These may include loans and advances from other levels of government, other governments, multi-lateral and bi-lateral agencies, and bank loans.

7.19 Bonds or debentures may have regular interest or coupon payments, they may be "zero-coupon" or they may have an inflation-adjusted premium payable on maturity. They may be issued at a premium or a discount.

Debt and Equity Instruments

7.20 IPSAS 28 establishes principles for presenting financial instruments as liabilities or equity instruments and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

7.21 The principles in IPSAS 28 complement the principles for recognizing and measuring financial assets and financial liabilities in IPSAS 29, *Financial Instruments: Recognition and Measurement*, and for disclosing information about them in IPSAS 30, *Financial Instruments: Disclosures*.

7.22 IPSAS 28 requires that the issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset, and an equity instrument. The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets, or equity instruments.

7.23 The classification of instruments as debt or equity is unlikely to be a major issue for most public sector entities adopting accrual basis IPSASs, but some entities will hold instruments where this guidance will be required.

Information Available Prior to the Transition

7.24 The amount of work required to recognize debt and debt servicing costs on an accrual basis will depend on an entity's existing basis of accounting used for financial reporting and existing systems and the extent to which records have been retained (i.e. the completeness of information). For example, governments reporting on the modified accrual basis may already account for debt and interest expense in accordance with the accrual basis. Governments reporting on the cash basis will not recognize debt as a liability, but they normally have some system to record debt transactions and manage debt. The nature and reliability of these systems can vary immensely. Types or aspects of systems which may be used to record and manage debt transactions and balances include:

(a) Manual records. These may include details of the initial debt, scheduled repayments, the current balance outstanding, dates interest is due, currencies, terms and conditions. Manual records may suffice where debt consists solely of loans and advances and there are a limited number of such obligations;

(b) Spreadsheets incorporating the details listed in the above bullet point. The spreadsheets may also perform interest calculations and be used to generate cash flow budgets;

(c) The general ledger of an accounting system. This may be used to record some debt transactions (refer also to the section on systems below);

(d) Specific software developed to maintain and forecast debt service requirements under the cash basis. These packages may link to other software applications that assist jurisdictions to monitor the sustainability of their debt (for example, the World Bank's Debt Sustainability Model). Such systems may or may not have the capability to integrate borrowing and investments to obtain consolidated cash flows; and

(e) Treasury and cash management systems that can be used to manage both the debt and all the cash flows of a government. Such systems may also be able to generate the accounting entries required under cash accounting or accrual accounting (both modified historic cost and mark-to-market). Governments using such systems could be managing their debt portfolio on a mark-to-market basis while reporting on a cash basis.

7.25 Entities therefore need to identify:

(a) The requirements associated with reporting on the accrual basis;

(b) The information available from and the capabilities of their existing systems;

(c) The differences between the information required and the information available; and

(d) Possible solutions, which may involve modifying existing systems or developing new systems.

7.26 The adoption of accrual accounting has a number of implications for the calculation of debt servicing costs, including the following:

(a) The calculation of interest expense (including accrued interest) becomes more complex. For example, the accrued interest on bonds is generally calculated on a yield-to-maturity basis.

(b) The discount is usually amortized over the term of the instrument and is recognized as an additional debt servicing expense. By contrast, under cash accounting the discount on issue of debt securities may be excluded from debt servicing costs and shown as a below the line adjustment to the recorded level of gross debt, or recognized in the accounts on the day of issue.

(c) Premiums payable on redemption of index-linked bonds are recognized as a debt servicing expense over the life of the instrument. Under the cash basis, such premiums are not generally treated as debt servicing costs.

(d) The date of issue of debt has a much greater impact on the calculation of interest. This has implications for preparing and monitoring accrual budgets.

(e) Where a government has foreign currency debt, the gains and losses arising as a result of currency movements on that debt will impact directly upon the statement of financial performance. A risky portfolio will lead to increased volatility in the statement of financial performance.

7.27 Entities adopting accrual accounting need to assess the completeness and accuracy of existing information. The purpose of the evaluation is to determine whether existing information is sufficiently accurate to provide information on opening balances. In addition, the evaluation should provide an indication of the extent to which systems operating under the existing basis of accounting correctly record transactions and events during the period. As a starting point, the accuracy and completeness of the following will need to be assessed:

(a) Amount borrowed (including premium or discount on issue), repaid and still outstanding;

(b) Dates for repayment of principal or redemption of instruments;

(c) Interest rates and dates/coupon rates and dates;

(d) The existence of index-adjusted instruments and the likely impact of such changes on the final amount to be repaid; and

(e) The currency in which debt is repayable.

7.28 This step is more important where manual systems or a number of systems have been used to record information, particularly where controlled entities have the authority to borrow. A review of existing systems and the specification of functionality requirements for future systems (as discussed below) is also required.

Review of Systems

7.29 In preparing for the adoption of accrual accounting, entities using the cash basis should review all existing systems to determine the extent to which existing systems can be adapted to meet the needs of accrual accounting. If this is not possible, new systems will be required. Entities using the cash basis may have, or be considering purchasing, an entity management system with some of the standard accounting modules such as purchasing, order entry, payables, receivables, payroll, and general ledger. Such systems may also offer a “treasury” module. If such modules meet all the functionality requirements, they have the advantages of fully integrated systems. However, to the extent that they do not provide this functionality (for example risk management) or capture all the relevant transaction flows, interfaces with other systems would need to be developed.

7.30 The other alternative is to purchase a separate treasury/debt management system. Most treasury/debt management systems can generate accounting entries and then use an interface to incorporate those entries into the general ledger.

7.31 The costs and balances (assets and liabilities) associated with running the debt management activity itself may be recorded in a separate system.

Premiums and Discounts on Issue

7.32 Discounts and premiums arising on the issue of a debt instrument are generally treated as an increase or decrease in the cost of borrowing. Discounts and premiums are recognized in the statement of financial position on issue (government securities are measured at their nominal value adjusted for the unamortized portion of the premium or discount on issue). Unamortized premiums are added to the reported amount and unamortized discounts are subtracted from the reported amount.

7.33 Discounts/premiums are generally amortized over the period of the instrument on a yield-to-maturity basis (for floating rate debt instruments the amortization may be over the first interest period).

Accrued Interest

7.34 For the purpose of financial reporting under the accrual basis, interest is calculated as it is incurred. This includes interest which is due and payable, as well as the amount of interest which would be payable if interest were required to be settled at the reporting date. A brief summary of the relevant method of calculation is provided below.

Financial Instrument	**Method of Calculation**
Interest on short-term deposits	Multiply the rate of interest by the principal outstanding for the reporting period.
Interest on bills and similar short-term instruments	The difference between the face value and the price paid at the time of issue (i.e. the discount) measures the interest payable over the life of the bill. Interest is measured using the effective interest method.
Interest on bonds and debentures	For ordinary bonds interest expense is the accrued portion of the coupon payment due. For zero-coupon bonds interest expense is the difference between the redemption price and the issue price. Interest is calculated using the effective interest method. For index-linked bonds the change in the value of the principal outstanding between the beginning and the end of a particular reporting period due to the movement in the relevant index is treated as interest accruing in that period, in addition to any interest due.

7.35 Entities reviewing their accounting policies and systems as part of the move to accrual accounting may also wish to review the method of compiling data for statistical systems such as the System of National Accounts, 2008 (2008 SNA), the European System of Accounts 1995 (ESA 95) and the Government Finance Statistics Manual 2001 (GFSM 2001). Both GFSM 2001 and the 2008 SNA require the use of the debtor's approach in calculating interest. The 2008 SNA also includes guidance on index linked securities.

Derivatives

7.36 Financial derivatives used by debt managers include interest rate swaps and cross-currency swaps. Interest rate swaps allow debt managers to adjust the debt portfolio's exposure to interest rates; for example, by synthetically converting a fixed rate obligation into a floating rate one. Similarly, a cross-currency swap can be used to synthetically change the currency exposure of a debt obligation. Accounting for derivatives is discussed in Chapter 13.

Traded Debt

7.37 Where debt instruments are traded, they are frequently recorded at fair (market) value. Entities with traded debt may need to identify the portfolio of debt instruments that are traded to enable the correct accounting policy to be applied.

Debt Management Objectives

7.38 Although the adoption of accrual accounting is not required in order to initiate a review of debt management objectives and practices, it is often a catalyst for such a review. The establishment or review of debt management objectives is appropriate prior to the introduction of accrual accounting as it may have implications for systems and accounting policies. For example, the debt management objectives may mean that the debt portfolio is to be managed on a mark-to-market basis. If the debt is to be formally reported on a modified historic cost basis, the systems chosen should be able to cope with both bases of accounting.

7.39 Debt management objectives are influenced by a government's public policy framework (that is, the government's monetary, fiscal and exchange rate policies) and the government's risk management framework. Examples of risks associated with debt portfolios include market risk, funding risk, credit risk, liquidity risk, portfolio concentration risk, and operational risk. Debt management objectives and the risk management framework may have implications for the most appropriate organizational structure and systems.

7.40 The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. Other examples of objectives include developing a domestic debt market and maintaining certain percentages of foreign currency debt in specified currencies.

7.41 In order to assist countries in their efforts to reduce financial vulnerability, the International Monetary Fund and the World Bank, in cooperation with national debt managers, have developed a set of guidelines on public debt management. *The Guidelines for Public Debt Management* (IMF and World Bank, 2001 and 2003) are designed to assist policy makers in considering reforms to strengthen the quality of their public debt management and reduce their country's vulnerability to international financial shocks. They seek to identify areas in which there is broad agreement on what generally constitutes sound practices in public debt management. They focus on principles applicable to a wide range of countries at different stages of development and with various institutional structures of national debt management. The Guidelines should assist policy advisers and decision-makers involved in designing debt management reforms. They include discussion of risk management frameworks. Additional guidelines dealing with issues of public debt sustainability and legal features were published in 2003.

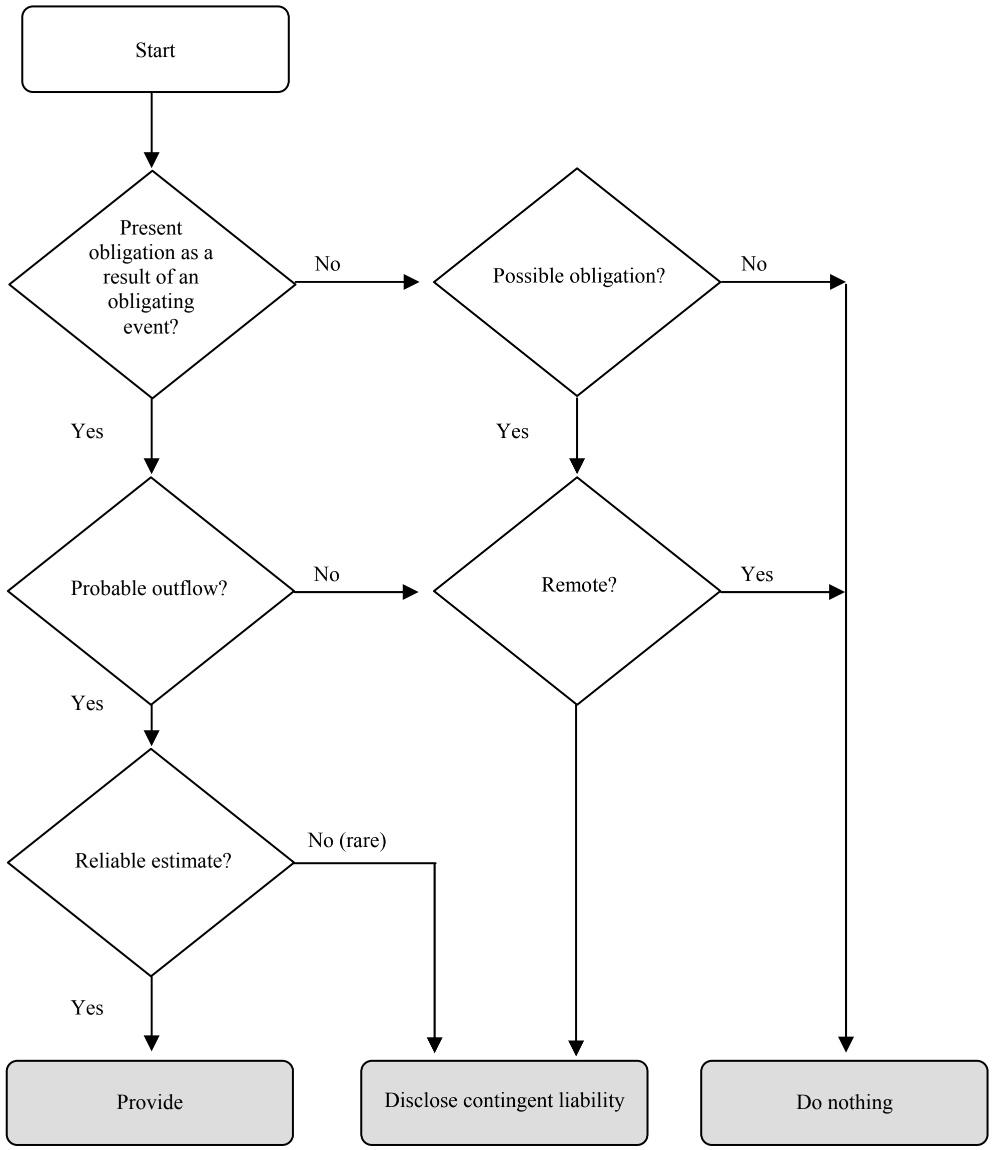
Provisions and Contingent Liabilities

7.42 The objective of IPSAS 19 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities, and contingent assets, and that sufficient information is disclosed in the notes to enable users to understand their nature, timing, and amount. A provision is a liability of uncertain timing or amount. If provisions meet the recognition criteria in IPSASs they are recognized in the financial statements.

7.43 Contingent liabilities are defined in IPSAS 19. They may be potential liabilities where the existence of the present obligation is currently uncertain, or they may be items that meet the definition of a liability but not the recognition criteria.

7.44 Figure 7.1 below is from Appendix B of IPSAS 19. It summarizes the main recognition requirements of IPSAS 19 in relation to provisions and contingent liabilities. The decision tree in Figure 7.1 does not form part of the standards and should be read in the context of the full text of the standards.

Figure 7.1 Decision Tree—Recognition of Provisions



7.45 Provisions should be recognized when:

(a) The obligation meets the definition of a liability;

(b) It is probable that an outflow of benefits will be required; and

(c) The outflow is capable of reliable measurement.

7.46 It is not always clear whether a present obligation exists. In these cases, IPSAS 19 explains that a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date. Examples of items for which provisions may be recognized are restructuring costs, environmental clean-up obligations, and refunds to donors.

7.47 A contingent liability, as defined by IPSAS 19, is not recognized in the statement of financial position. Instead it is disclosed in the notes to the financial statements (unless the possibility of an outflow is remote in which case it need not be disclosed). Contingent liabilities can include liabilities arising from legal actions and claims. Cebotari discusses a range of issues associated with contingent liabilities in the public sector including mitigating risk associated with contingent liabilities, and managing and disclosing contingent liabilities (Cebotari 2008).

Measurement of Provisions

7.48 The amount that a provision is recognised at should be the best estimate of the expenditure that will be needed to settle the liability (the present obligation) at the reporting date.

7.49 It may be difficult to reach a best estimate of a provision due to the risks and uncertainties surrounding the events and circumstances that have caused the provision to arise.

7.50 In some cases the provision may not become payable for a significant length of time. The amount of the provision recorded in the statement of financial position should be the present value of the expenditures expected to be required to settle the obligation. IPSAS 19 paragraph 53 provides some guidance on the selection of a discount rate. The choice of the discount rate can have a significant impact on the amount of the reported provision.

7.51 Expected future events that may impact the amount expected to settle the obligation should be taken in account when determining the amount of a provision. However, it is necessary that there is sufficient objective evidence that the future events will occur.

7.52 In situations where the expected disposal of an asset may give rise to gains, the gains should not be taken into account when measuring the provision. Rather, they should be recognised at the time of disposal of the asset concerned and in accordance with the IPSAS pertinent to the asset.

7.53 IPSAS 19 also provides guidance on reimbursements, changes in provisions, and the use of provisions. These issues are briefly discussed below.

Reimbursements

7.54 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognized only when it is virtually certain it will be received on settlement of the asset. The reimbursement is a separate asset and should not be greater than the provision.

Use of Provisions

7.55 Provisions must be reassessed at each reporting date and adjustments made when necessary to reflect the current best estimate. They should be used only for the purpose for which they were originally established. Provisions for future losses should not be recognized.

Onerous Contracts

7.56 A provision for an onerous contract may be raised if the contract is clearly onerous, and falls within the scope of IPSAS 19. A contract is onerous when the unavoidable costs of meeting the contract obligations are greater than the economic benefits or service potential received by the entity from the contract.

Restructuring

7.57 A provision for restructuring costs may only be recognized when the basic criterion for the recognition of provisions are met. The entity must have a detailed and formal plan as to the restructuring envisaged, including the activity or operating unit concerned (of part thereof), the principal locations impacted, the location, function, and approximate number of employees who will be compensated for their loss of employment, the expenditures incurred and the date the planned restructuring will take place. A provision can also be recognized only when the entity has raised a valid expectation in those affected that the planned restructuring will take place.

7.58 Examples of events that may meet the definition of restructuring include:

(a) Termination or disposal of an activity or service;

(b) Closure of a branch office or termination of activities of a government agency in a specific location, or the relocation of activities from region to another;

(c) Changes in management structure, for example, eliminating a layer of management or executive service; and

(d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.

7.59 A restructuring provision cannot be raised as a consequence of a sale or transfer until there is a binding agreement in place, and the entity is irrevocably committed to the sale or transfer.

7.60 A restructuring provision can only include direct expenditures which arise from the restructuring and are both necessary due to the restructuring and not associated with the ongoing activities of the entity.

Disclosure

7.61 The disclosure requirements of IPSAS 19 are set out in paragraphs 97 to 109 of the Standard. Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Lease Liabilities

7.62 IPSAS 13, *Leases* establishes accounting requirements for most leases. Leases are classified as either finance leases or operating leases. IPSAS 13 provides guidance on the classification of leases into these two categories.

Finance Leases

7.63 A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not be eventually transferred. Examples of leases that transfer substantially all the risks and rewards incidental to ownership of an asset include:

(a) A lease that covers substantially all of the asset's life; and/or

(b) A lease under which the present value of lease payments is substantially equal to the asset's fair value.

7.64 Public sector entities may be prohibited from entering into financing leases because they give rise to long-term obligations.

7.65 A lessee is required to recognise an asset and liability in respect of the leased asset. The asset and liability are measured at the lower of the present value of minimum lease payments and the fair value of the asset, determined at the inception of the lease. The lease liability gradually reduces over time as the finance lease payments are apportioned between interest and the lease liability.

Operating Leases

7.66 All other leases are operating leases. Although operating leases do not give rise to liabilities, the lessee has a commitment to make lease payments in accordance with the lease agreement. IPSAS 13 requires that a lessee disclose details of minimum lease payments for various time periods (up to one year, between one and five years, and later than five years).

Disclosure

7.67 The disclosure requirements of IPSAS 13 in relation to lessors' obligations are set out in paragraphs 60 and 69. Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Transition Issues

7.68 Many of the transition issues identified in relation to debt would also apply to lease liabilities. Identification and classification of leases are critical steps. As part of the adoption of accrual accounting an entity may develop guidelines on matters to be considered before entering into a lease and approvals required to enter into lease arrangements. Such guidelines could also exist under a cash accounting system but the adoption of accrual accounting highlights the liabilities arising from leases.

Environmental Liabilities

7.69 This section addresses accounting issues associated with certain types of environmental obligations. Depending upon the nature of the obligation and the legislative environment within which a jurisdiction operates, these obligations may meet the definition of a provision in IPSAS 19. Environmental risks or obligations include:

(a) Landfills;

(b) Other contaminated sites; and

(c) Other environmental obligations.

7.70 Each of these is discussed below.

7.71 Under accrual accounting, all environmental obligations that meet the definition and recognition criteria for liabilities should be recognized. This involves:

(a) Identification of the nature of any possible obligation or risk;

(b) Identification by the entity of possible obligations and the source of those obligations; and

(c) Identification of possible/probable future cash flows and the factors influencing the size and timing of those cash flows. For example, clean up costs will be influenced by the possible types of action to address a problem (removal, containment, or redemption) and the current technology available.

7.72 Determination of the obligating event can be a difficult issue for some environmental obligations. Obligations may be legal or constructive. Legal obligations can be evidenced by legislative requirements and legally enforceable contracts. A constructive obligation is defined in IPSAS 19 as:

> *an obligation that derives from an entity's actions where:*
>
> (a) *by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and*
>
> (b) *as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.*

7.73 In the absence of a legal obligation, an entity needs determine whether there is sufficient evidence to indicate the existence of a constructive obligation.

Landfills

7.74 Entities may have a constructive or legal obligation under statute to avoid, remedy, or mitigate the environmental effects of landfills. There may be requirements regarding standards for the day-to-day operation of landfills and for closure and post-closure care. The cost of post-closure care can require monitoring the site for up to 30 years after closure, the costs of which can be significant.

7.75 Recognition of landfill obligations would involve measuring the liability based on the expenditure required to settle the obligation at reporting date (taking into account the time value of money).

7.76 An entity will need to maintain data on landfills in order to assess the likely timing and amount of future obligations. Relevant data includes:

(a) Adequate identification to permit the site to be located;

(b) A description of the landfill closure and post-closure care requirements;

(c) The basis of recognition and measurement of the liability;

(d) The reported liability for closure and post-closure care at the reporting date, the estimated total cost of closure and post-closure care, and the amount remaining to be recognized;

(e) The remaining capacity of the site and the estimated remaining landfill life in years;

(f) The estimated length of time needed for post-closure care;

(g) Costs incurred to date, by year; and

(h) Estimated revenue post-closure, for example, from gas production.

Other Contaminated Sites

7.77 Entities may be responsible for managing contaminated sites. Contamination may be caused by the following:

(a) Asbestos remediation;

(b) Old gasworks sites;

(c) Meat processing sites;

(d) Timber treatment plants;

(e) Quarries;

(f) Sawmills;

(g) Garbage disposal sites (other than landfills);

(h) Pesticide and poison storage sites;

(i) Effluent treatment and disposal; and

(j) Fuel storage and retail sites.

7.78 Depending upon the nature of the obligation to clean up and manage a contaminated site, the actual or probable costs may be accounted for as a liability or a contingent liability.

Other Environmental Obligations

7.79 Other types of possible environmental obligations include storm water drainage and treatment, sewage treatment, contaminated water supply, erosion protection, and coastal hazards. Each of these issues needs to be researched to determine whether it is appropriate to:

(a) Recognize the costs when incurred;

(b) Recognize a liability; or

(c) Disclose a contingent liability.

Register of Contaminated Sites

7.80 An entity will need to maintain a record of contaminated land in order to manage the sites and to assure auditors that it is monitoring any liabilities (actual and potential) arising from such contamination. This information (often referred to as a register) is an important tool in managing the clean-up of sites.

7.81 Information that may be required in relation to land that is contaminated or has associated liabilities includes:

(a) Adequate identification to permit the site to be located;

(b) Description of contamination or suspected contamination;

(c) Action plan for site restoration or monitoring;

(d) Estimated cost for further monitoring or restoration (including dates of estimates and assumptions underlying the estimates);

(e) Classification as liability or contingent liability (and assumptions or facts supporting the classification); and

(f) Costs incurred to date, by year.

Review of Organizational Structure and Internal Controls

7.82 Although a review of organizational structure and internal controls is not strictly required in order to adopt accrual accounting, both of these factors can have an impact on the efficiency of operations, the reliability of information produced and the potential for fraud. On a broad level the entity must determine who has responsibility for the management and reporting of all types of liabilities. The issues associated with management of internal operations are outlined in the following extract from *The Guidelines for Public Debt Management* (IMF and World Bank, 2003, page, 17).

> 67. *Risks of government losses from inadequate operational controls should be managed according to sound business practices, including well-articulated responsibilities for staff, and clear monitoring and control policies and reporting arrangements. Operational risk, due to inadequate controls and policy breaches, can entail large losses to the government and tarnish the reputation of debt managers. Sound risk monitoring and control practices are essential to reduce operational risk.*
>
> 68. *Operational responsibility for debt management is generally separated into front and back offices with distinct functions and accountabilities, and separate reporting lines. The front office is typically responsible for executing transactions in financial markets, including the management of auctions and other forms of borrowing, and all other funding operations. It is important to ensure that the individual executing a market transaction and the one responsible for entering the transaction into the accounting system are different people. The back office handles the settlement of transactions and the maintenance of the financial records. In a number of cases, a separate middle or risk management office has also been established to undertake risk analysis and monitor and report on portfolio-related risks, and to assess the performance of debt managers against any strategic benchmarks. This separation helps to promote the independence of those setting and monitoring the risk management framework and assessing performance from those responsible for executing market transactions. Where debt management services are provided by the central bank (e.g., registry and auction services) on behalf of the government's debt managers, the responsibilities and accountabilities of each party and agreement on service standards can be formalized through an agency agreement between the central bank and the government debt managers.*

Transitional Provisions

7.83 Because a number of IPSASs establish requirement in respect of leases, entities should check the availability of transitional provisions in each applicable IPSAS. This section gives examples of transitional provisions in some IPSASs.

7.84 IPSAS 13 establishes transitional provisions for lease liabilities in respect of assets that have not been recognized as a result of a transitional provision in another IPSAS. Retrospective application of IPSAS 13 by entities that have already adopted the accrual basis of accounting is not required.

7.85 IPSAS 19 requires retrospective application of its requirements but the effect of adopting the Standard is treated as an adjustment to the opening balance of accumulated surpluses (deficits) for the period in which it is first adopted. Retrospective application to the earliest period presented is not required.

Relevance for the Cash Basis of Accounting

7.86 The issues identified in this Chapter are relevant for entities intending to provide additional note disclosure on the nature and amount of various categories of liabilities encouraged by the Cash Basis IPSAS. Although an entity may provide additional disclosures within the financial statements or as supplementary information, non-cash amounts cannot be included in the amounts shown on the face of the statement of cash receipts and payments. Although borrowings are not recognized as liabilities under the cash basis, separate schedules of borrowings and details of securities over assets are often disclosed. Any cash inflow from borrowings will also appear as cash receipts in the statement of cash receipts and payments.

7.87 Although the use of cash accounting does not preclude the use of additional records and systems, entities using the cash basis may not have developed systems that provide the full range of information useful for debt management purposes. For example, an entity may have manual records showing the currency of specific borrowings but may not have readily accessible data on the currency exposure associated with its debt. A preliminary assessment of some of the exposures an entity wishes to manage may assist an entity in determining the importance of certain functions within the debt management system.

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[27] IPSAS 15 is superseded by IPSAS 28 and IPSAS 30. IPSAS 15 remains applicable until IPSAS 28 and IPSAS 30 are applied or become effective, whichever is earlier. The new IPSASs dealing with financial instruments are discussed in Chapter 13.

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Appendix

Accounting Policies

This Appendix illustrates examples of accounting policies for accounts payable, provisions, contingent liabilities, and commitments. The policies are examples of policies that might be developed by a central entity for application by all individual entities forming part of a whole-of-government reporting entity. The policies are consistent with the requirements of IPSAS 19.

Creditors and other payables

Creditors and other payables are measured at cost.

Other liabilities and provisions

Other liabilities and provisions are recorded at the best estimate of the expenditure required to settle the obligation. Liabilities and provisions to be settled beyond 12 months are recorded at the present value of their estimated future cash outflows.

Contingent liabilities and contingent assets

Contingent liabilities and contingent assets are reported at the point at which the contingency is evident. Contingent liabilities are disclosed if the possibility that they will crystallize is not remote. Contingent assets are disclosed if it is probable that the benefits will be realized.

Commitments

Commitments are future expenses and liabilities to be incurred on contracts that have been entered into at balance date.

Cancellable commitments that have penalty or exit costs explicit in the agreement on exercising the option to cancel are reported at the value of that penalty or exit cost (i.e., the minimum future payments).

Commitments are classified as:

(a) Capital commitments: aggregate amount of capital expenditure contracted for but not recognized as paid or provided for at period end

(b) Non-cancellable operating leases with a lease term of more than one year, and

(c) Other non-cancellable commitments: these may include consulting contracts, cleaning contracts, and ship charters.

Interest commitments on debts and commitments relating to employment contracts are not included in the statement of commitments.

Chapter 8: Revenues and Expenses

Key Points

- International Public Sector Accounting Standards (IPSASs) that deal with the definition, recognition, measurement, and disclosure of revenues and expenses are listed in the references to this Chapter.
- This Chapter provides an overview of common types of revenue and expenses and discusses classification, accounting policies required, and recognition points. The Chapter also discusses purchasing and payment systems and costing/allocation systems.
- Revenue and expense topics which are discussed in more detail in other chapters include:
  - Non-exchange revenue addressed by IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* (refer to Chapter 16);
  - Employee expenses addressed by IPSAS 25, *Employee Benefits* (refer to Chapter 14);
  - Expenses arising from social policy obligations (refer to Chapter 15);
  - Revenues and expenses arising from financial instruments (refer to Chapters 7 and 13);
  - Depreciation of property, plant and equipment addressed by IPSAS 17, *Property, Plant and Equipment* (refer to Chapter 6);
  - Impairment of assets addressed by IPSAS 21, *Impairment of Non-Cash-Generating Assets* and IPSAS 26, *Impairment of Cash-Generating Assets* (refer to Chapters 6 and 12)*;* and
  - Amortization of intangible assets (refer to Chapter 10).

Introduction

8.1 IPSAS 1, *Presentation of Financial Statements* paragraph 7, defines revenue as "the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners." IPSAS 1, paragraph 7, defines expenses as "decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrence of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners." Revenue and expenses are recognized for financial reporting purposes when all elements of the definitions and the recognition criteria, as specified in IPSAS 1, for revenue and expenses are satisfied.

8.2 Common types of revenue for national governments include:

(a) Non-exchange revenues:

(i) Direct and indirect taxes;

(ii) Duties;

(iii) Fees and fines;

(iv) Other non-reciprocal transfers;

(v) Exchange revenues:

(vi) Sales of goods or services;

(vii) Dividends;

(viii) Interest;

(ix) Net gains arising from the sale of assets;

(b) Gains:

(i) Increases in market value;

(ii) Foreign exchange gains; and

(iii) Other gains.

8.3 Common types of expenses for national governments include:

(a) Personnel (employee-related) expenses;

(b) Cost of goods sold/services provided;

(c) Physical asset use (depreciation and loss of service potential);

(d) Rental and leasing costs;

(e) Maintenance;

(f) Interest;

(g) Expenses relating to financial assets;

(h) Transfers (including grants and donations) to other governments, organizations, and individuals;

(i) Losses:

(i) Decreases in market value;

(ii) Foreign exchange losses; and

(iii) Other losses.

8.4 The amount of work required to recognize revenues and expenses on an accrual basis depends on the extent to which an entity already has information available on those items. General steps in the recognition of revenues and expenses include:

(a) Compiling a list of all types of revenue and expense relevant to the entity;

(b) Determining the categories of revenue and expense to be used in the chart of accounts and the financial statements;

(c) Preparing accounting policies for each category of revenue and expense;

(d) Assessing the accuracy and completeness of existing information on each category; and

(e) Establishing systems to support the recognition of revenue and expense items or developing interim measures to provide reasonable estimates of revenue and expense items. The establishment of systems may be evolutionary. An entity may gradually adapt its recording systems to improve the accuracy and reliability of information concerning revenue and expense items.

8.5 Topics covered in this Chapter include:

(a) Classification of revenues and expenses;

(b) Development of accounting policies;

(c) Recognition point for revenues and expenses;

(d) Purchasing and payment systems; and

(e) Allocation/costing systems.

8.6 Appendix A to this Chapter includes examples of accounting policies for a range of revenue and expense items.

8.7 There are two approaches to revenue recognition in IPSASs: the earnings approach in IPSAS 9, *Revenue from Exchange Transactions* and the performance obligation approach in IPSAS 23. Under the earnings approach in IPSAS 9 revenue is recognized when it is earned. Under IPSAS 23 revenue is recognized when the entity has satisfied the performance obligation associated with the non-exchange revenue. The recognition of accounts receivable and accrued revenue has been briefly discussed in Chapter 6. Assets associated with the recognition of taxation receivable and accrued taxation revenue are discussed in Chapter 16.

Classification

8.8 Each entity needs to develop a classification system for revenues and expenses for use in the chart of accounts, the face of the financial statements, the notes to the financial statements, and internal reports. The chart of accounts is often developed by a central entity, although individual entities may have flexibility to add items. The development of a chart of accounts is discussed in Chapter 2.

8.9 Useful sources of information in establishing revenue and expense classifications include:

(a) The disclosures required by IPSASs and, in the absence of a specific IPSAS, any other authoritative accounting standards that apply in accordance with IPSAS 3 *Accounting Policies, Changes in Accounting Estimates and Errors;*[28]

(b) Existing classification systems used under the current basis of accounting;

(c) The classifications required for statistical reporting (for example, refer to the Government Finance Statistics Manual 2001 (GFSM 2001)); and

(d) The classifications required by a relevant external agency (e.g., a funder or legislative body).

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[28] Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

8.10 Where an entity has been using a basis of accounting other than the accrual basis, it will need to ensure that the classification system takes account of accrued revenue and expenses.

8.11 Classifications specifically required in order to meet the requirements of IPSASs include:

(a) Within the consolidated reporting entity there will need to be provision for identification of revenues and expenses by each entity and by each program, area of activity or other component required by legislation or government directive;

(b) Significant categories of revenue (IPSAS 1), including separate identification of revenue arising from:

(i) The rendering of services;

(ii) The sale of goods;

(iii) Interest, royalties and dividends or their equivalents;

(iv) Exchanges of goods (IPSAS 9);

(c) Significant categories of non-exchange revenue (IPSAS 23);

(d) Separate identification of exchange and non-exchange transactions and the associated receivables and payables (IPSAS 1);

(e) Separate identification of expenses by the nature of the expense (input type) or by function (IPSAS 1). Operating costs applicable to revenues, recognized as expenses during the period are to be classified by nature (IPSAS 12, *Inventories*);

(f) Separate identification of:

(i) Depreciation, amortization, and impairment (IPSAS 17, IPSAS 31, *Intangible Assets*, IPSAS 21, and IPSAS 26);

(ii) Salaries and employee benefits (IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*);

(iii) Finance costs (IPSAS 1);

(g) Separate identification of borrowing costs so that they may be reviewed to see whether they meet the conditions for capitalization to qualifying assets (IPSAS 5 *Borrowing Costs*);

(h) The amount of revenue recognized in relation to inventories sold, exchanged, or distributed during the period (IPSAS 12);

(i) The carrying amount of inventories sold, exchanged, or distributed during the period, or operating costs (raw materials, consumables, labor costs, other operating costs and the net change in inventories) applicable to revenue (IPSAS 12);

(j) Separate identification of write-downs or losses associated with inventories occurring during the period and any reversals of write-downs during the period (IPSAS 12); and

(k) Gain or loss on sale of property, plant and equipment (IPSAS 17).

8.12 If an entity conducts transactions on behalf of others, as an agent, it will need to ensure that revenues and expenses arising from those transactions are appropriately classified. The collection of cash on behalf of other entities is discussed in Chapter 9.[29]

Accounting Policies

8.13 An entity will require policies on:

(a) Classification of inflows as revenue of the entity or revenue of another entity such as the government as a whole;

(b) Recognition and measurement of each type of exchange revenue (for example, sale/distribution of goods and services, interest, gains and losses on investment properties);

(c) The treatment of various types of appropriations or funding provided by way of other legislative authority in the financial statements;

(d) Recognition and disclosure of non-exchange revenue, including revenue derived from coercive powers, resources provided and received free of charge, including grants and donations, and liabilities assumed by another entity (refer to Chapter 16);

(e) Methods adopted to determine the stage of completion of transactions involving the rendering of services;

(f) The measurement of assets, including the method(s) used to allocate costs to those assets;

(g) Recognition of inventory expense and the treatment of supplies and consumables;

(h) Identification, measurement, and disclosure of asset impairments (refer to Chapter 6);

(i) Recognition and measurement of depreciation or amortisation (refer to Chapters 6 and 10);

(j) Recognition and measurement of interest (refer to Chapter 7) and the method of accounting for borrowing costs;

(k) Recognition and measurement of employee-related expenses (refer to Chapter 14);

(l) Identification and recognition of bad and doubtful debts;

(m) Recognition and disclosure of grants, donations, and transfers made or received (refer to Chapter 16);

(n) The treatment of gains and losses on disposal or revaluation of assets (refer to Chapter 6); and

(o) The treatment of foreign currency gains and losses (refer to Chapter 17).

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29 The non-mandatory Appendix to IAS 18 *Revenue* provides guidance on determining whether an entity is acting as a principal or as an agent. This guidance was added by the IASB in April 2009, as part of the *Improvements to IFRSs* 2009.

8.14 The above list of accounting policies required is not necessarily complete. A complete list of policies required can be determined by working through applicable accounting standards and identifying where an accounting standard addresses recognition, measurement, or disclosure of a financial element relevant to the entity. A potential list of policies is included in IPSAS 1. Another way of identifying accounting policies required is to review the accounting policies of other jurisdictions which have adopted accrual accounting—both the published statement of accounting policies, which is usually in summary form, and the more detailed accounting policy manuals.

Recognition Points for Revenues and Expenses

8.15 The general recognition criteria of measurability and probability underlie the recognition of all revenues and expenses. However, the application of these general principles to specific types of revenue and expenses means that an entity needs systems to identify the appropriate recognition point for such revenues and expenses. Examples of the type of information required include:

(a) Rendering of services—reliable measurement of stage of completion, costs associated with that stage of completion and costs to complete the transaction;

(b) Sale of goods—identification of the point at which significant risks and rewards of ownership of the goods have passed to the purchaser and reliable measurement of costs incurred or to be incurred in relation to the transaction;

(c) Interest revenue—the effective yield on assets, due dates, the proportion of time elapsed during the reporting period compared to the proportion of time until the next due date;

(d) Dividends/distributions receivable—the point at which the right to receive payment is established;

(e) Rental revenue—due dates and a method of calculation; a method of allocating both direct and indirect expenses associated with investment properties to specific properties; and

(f) Inventories sold, exchanged or distributed—a system for recognizing the cost of inventories consumed in relation to transactions; systems for billing for chargeable services.

8.16 Entities need to identify which types of revenues and expenses will require accruals, and develop or review systems that allow for the systematic and accurate identification and processing of such accruals.

8.17 In developing systems an entity needs to consider:

(a) Whether to record payables (also referred to as creditors) at the time of actual delivery or at time the invoice is received and certified. The purchasing entity needs to identify the point at which it is obliged to make payment. Generally, an entity will receive an invoice for goods and services it receives from third parties. However, some entities within a group may not formally invoice other entities within that group;

(b) Whether all receivables (also referred to as debtors) should be recorded in the accounting system throughout the reporting period or whether some should be recorded at the end of the reporting period. An entity has the option of keeping separate records during the period and entering details of receivables in the accounting system at the end of the period; and

(c) Whether funding from a central government body or another level of government is required to be matched against particular services, or whether it is recognized as one lump sum. This will be influenced by the entity's revenue recognition policies determined in accordance with IPSAS 9 and IPSAS 23 and the nature of any obligations associated with that revenue.

8.18 Entities need to develop methods to identify irrecoverable amounts and amounts that are impaired. IPSAS 29, *Financial Instruments: Recognition and Measurement* specifies requirements for recognizing the impairment of receivables.

Purchasing and Payment Systems

8.19 Prior to the introduction of accrual accounting, purchasing and payment systems and procedures need to be reviewed. Key requirements are that:

(a) The entity has good controls over the authorization of spending (refer to ACT, April 2003);

(b) Money is spent for the purpose intended and in accordance with budgetary and/or legislative authorities;

(c) Payments are made in accordance with the entity's payment policy; and

(d) Systems provide comprehensive, accurate and timely information.

8.20 Purchasing and payment systems may be centralized across the whole-of-government or decentralized to the extent that each reporting entity has the authority to determine its own arrangements. Where entities have delegated authority to determine their own systems and procedures they may decide to have one centralized system for the entity as a whole or to allow individual geographic locations or sub-units to operate their own systems. Decisions regarding the appropriate degree of centralization will be influenced by how well existing arrangements work in terms of efficiency, effective control, and meeting user requirements.

8.21 Some of the advantages of operating well-structured, centralized purchasing and payment systems which interface to the general ledger are that:

(a) Greater control can be exercised over the use of suppliers (e.g., the system may allow for a list of preferred suppliers with set items at set prices);

(b) It is easier to implement policies regarding controls over certain types of spending (e.g., travel and accommodation);

(c) They result in fewer bank account transactions;

(d) Most accounting entries (e.g., creditors) for goods and services purchased using the system can be automatically generated;

(e) Manual entries are required only for goods and services purchased outside the system;

(f) Employees purchasing items require less training on accruals; and

(g) Coding systems can be used to automatically allocate the cost of purchases to budgets. Where individuals with budget responsibilities have on-line access to their financial information they can then track actual spending against budgets during the reporting period.

8.22 These advantages would need to be considered against the need within the entity for flexibility in selecting and changing suppliers.

Allocation/Costing Systems

8.23 Where an entity is required to report revenue and expenses for particular locations, branches, programs, outputs etc, it will require systems to allocate revenues and expenses. This topic is not specifically addressed within this Study. Guidance on allocation issues facing public sector entities from various jurisdictions is noted in the references to this Chapter.

8.24 Because employee-related costs are one of the key expenses for many public sector entities, time recording is often required to support such systems. In some cases, this can involve significant cultural change. Where new time recording systems are introduced, care should be taken in trying to keep requirements simple (at least at first) so that information can be collected in a timely manner. Complex requirements can result in non-compliance, delays in processing (and preparation of financial statements) and inaccurate information.

Internal Controls

8.25 Examples of internal controls required to support the accruing of revenues and expenses include:

(a) Clear identification of authorities for setting charges and fees;

(b) Clear identification of the authority to charge other government organizations;

(c) Regular reviews of charges and fees;

(d) The establishment of guidelines for providing credit;

(e) Regular reconciliations between subsidiary and control ledgers;

(f) Active management of amounts owed to the entity;

(g) Regular review of debtors to identify bad debts and other indicators of impairment;

(h) Accurate and complete records of debtors;

(i) Periodic reviews of costs (against charges where relevant);

(j) Active management of creditors to ensure payments are made in accordance with the policy on payment (for example, on or by due date);

(k) Consistent application of accounting policies and regular review of the application of accounting policies (for example, the review of whether costs associated with the construction of assets or creation of inventories have been appropriately capitalized or expensed);

(l) Establishment of policies and procedures for purchasing;

(m) The establishment of tendering policies and procedures;

(n) The establishment of policies for contracting out of services (if appropriate);

(o) Regular review of suppliers to ensure suppliers are meeting the needs of the entity and are acting in accordance with any supply agreement; and

(p) The establishment of procedures to verify the receipt of goods and services against purchase orders, authorize invoices for payment, and pay for goods and services.

8.26 The International Organization of Supreme Audit Institutions (INTOSAI) produces guidance on establishing and maintaining effective internal controls in the public sector (INTOSAI, 2001).

Relevance to the Cash Basis of Accounting

8.27 The issues identified in this Chapter are relevant for entities intending to provide additional disclosures on the nature and amount of accrued revenues and expenses as encouraged by the Cash Basis IPSAS. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the financial statements.

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Appendix

Accounting Policies

This Appendix illustrates examples of accounting policies for a selection of revenue and expense items. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. Because of the wide variation in types of revenue and expense items which exist between various types of entities and jurisdictions, some potential policies (for example, revenue classifications) have not been illustrated.

These policies comply with relevant IPSASs such as IPSAS 9, IPSAS 11, and IPSAS 12.

However, it is possible that other policies that are consistent with these standards could also be developed—the appropriateness of a particular policy for a revenue or expense item depends on the exact conditions under which the revenue is earned or the expense is incurred. Recognition points for revenue and expense items may therefore vary between entities within a jurisdiction and between jurisdictions.

Other Chapters also discuss accounting policy issues relating to revenue and expenses (for example, Chapter 12 *Impairment of Assets* and Chapter 13 *Financial Instruments*.

Revenue

The definition of revenue in IPSAS 9 is to be applied.

Exchange revenue is to be recognized when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably in accordance with IPSAS 9.

Revenue received but not yet earned at the end of the reporting period is to be recognized as a liability (unearned revenue).

Revenue that has been recognized and that is subsequently written off or waived is to be recognized as an expense.

Classification of Revenue

[The central agency will identify the categories of revenue to be used on the face of the financial statements. Each reporting entity will identify the types of revenue included within each category.]

Interest Revenue

Interest revenue is accrued using the effective interest rate method. The effective interest rate exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount. The method applies this rate to the principal outstanding to determine interest revenue each period.

Royalty Revenue

Royalties are to be recognized when the royalty payment is due.

Dividend Revenue

Dividend revenue from investments is recognized when the right to receive payment has been established.

Sale of Goods or Rendering of Services

Revenue from the sale of goods and services and the rendering of services is to be recognized in the statement of financial performance as it is earned. The raising of an invoice, assessment or any other obligation to pay usually evidences the recognition of revenue.

Revenue from partially completed services is to be recognized by reference to the stage of completion of contracts or in accordance with the underlying agreement or contract. The stage of completion is determined according to the proportion that costs incurred to date bear to the estimated total costs of completion.

Surplus or Loss on Construction Contracts

Revenue from construction contracts is to be accounted for in accordance with IPSAS 11, *Construction Contracts*.

Contract revenue is to include:

(a) The initial amount of revenue agreed in the contract;

(b) Variations in contract work, claims and incentive payments to the extent that:

    (i) It is probable that they will result in revenue; and

    (ii) They are capable of being reliably measured.

Contract costs are to include:

(a) Costs that relate directly to the specific contract;

(b) Costs that are attributable to contract activity in general and can be allocated to the contract on a systematic and rational basis; and

(c) Such other costs as are specifically chargeable to the customer under the terms of the contract.

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with a construction contract are to be recognized as revenue and expenses respectively, by reference to the stage of completion of the contract activity at the reporting date.

When the outcome of a construction contract cannot be estimated reliably:

(a) Revenue is to be recognized only to the extent of contract costs incurred that it is probable will be recoverable; and

(b) Contract costs are to be recognized as an expense in the period in which they are incurred.

When it is intended at the inception of a construction contract that contract costs are to be fully recovered from the parties to the construction contract, any expected deficit on the construction contract is to be recognized as an expense immediately.

Rent

Rent revenue is to be recognized as it is earned.

Finance Leases

Finance lease revenue is to be accounted for in accordance with IPSAS 13, *Leases*. The recognition of finance lease revenue is to be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease.

Assets acquired by way of finance lease are to be amortized over the period of the lease. Lease payments are allocated between the principal component and the interest expense.

Expenses

The definition of expenses in IPSAS 1 is to be applied.

Expenses are to be recognized when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that is probable and can be measured reliably.

Expenses are to be recognized in the period to which they relate.

Classification of Expenses

[The central agency will identify the categories to be used on the face of the financial statements. Each reporting entity will identify the types of expense included within each category.]

Inventories

In accordance with IPSAS 12, *Inventories*, the carrying amount of inventories sold, exchanged or distributed is to be recognized as an expense in the period in which the related revenue is recognized. If there is no related revenue, the expense is to be recognized when the goods are distributed or related service is rendered. IPSAS 12 does not apply to work in progress of services which are to be distributed for no or nominal consideration directly in return from the recipients. The entity is not expected to have any such services. However, if such services do occur, the costs of producing the service are to be expensed as they occur.

The amount of any write-down of inventories and all losses of inventories are to be recognized as an expense in the period the write-down or loss occurs.

The amount of any reversal of any write-down of inventories is to be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

Inventories allocated to other asset accounts, (for example, to other forms of inventory or to self-constructed property, plant or equipment are to be accounted for in accordance with the policy on those assets).

Supplies and Consumables

Supplies and consumables (including other office costs) are to be recognized as expenses when incurred.

Impairment of receivables

Refer to Chapter 12.

Operating Leases

Operating lease payments are to be accounted for in accordance with IPSAS 13. Operating lease payments are to be recognized as an expense in the statement of financial performance on a straight-line basis over the lease term, where this is representative of the pattern of benefits to be derived from the leased property.

Depreciation

All depreciable property, plant and equipment (including revalued assets where appropriate) is to be depreciated.

The depreciation charge for each period is to be recognized as an expense unless it is included in the carrying amount of another asset.

Assets are to be depreciated in accordance with the methods and rates shown below: [*Each reporting entity will identify the methods and rates for categories of assets—these may vary between entities and jurisdictions depending upon the type of use, extent of maintenance, and climatic conditions.*]

Leasehold improvements are to be depreciated either over the unexpired period of the lease or the useful lives of the improvements, whichever is the shorter.

Borrowing costs

Borrowing costs include: [*Each reporting entity will list relevant types of borrowing costs, for example, interest on bank overdrafts and borrowings*].

Borrowing costs meeting the criteria for capitalization as part of the cost of a qualifying asset are to be capitalized in accordance with IPSAS 5, *Borrowing Costs*.

All other borrowing costs are to be recognized as an expense in the reporting period in which they are incurred.

Impairment of Assets

Refer to Chapter 12.

PART IV—SPECIFIC TOPICS

Part IV of this Study discusses implementation issues arising from the recognition of certain assets, liabilities, revenues, and expenses that are not covered in Part III. These topics have been dealt with separately in order to allow the reader to focus on the issues associated with them in more depth than would have occurred in Part III. It also considers implementation issues for segment reporting (in Chapter 18) and related parties (Chapter 19).

The Chapters focusing on specific asset topics are:

- Chapter 9, *Cash*;
- Chapter 10, *Intangible Assets*;
- Chapter 11, *Agricultural Produce and Biological Assets*; and
- Chapter 12, *Impairment of Assets.*

Chapter 13, *Financial Instruments* deals with issues in financial reporting of financial assets and liabilities.

The Chapters focusing on specific liability topics are:

- Chapter 14, *Employee-Related Liabilities*; and
- Chapter 15, *Liabilities Arising From Social Policy Obligations*.

The issues discussed in these two Chapters also relate to the recognition of the associated expenses.

The remaining chapters discuss the requirements of specific standards and issues that may be associated with the adoption of those standards.

- Chapter 16, *Non-Exchange Revenue* focuses on the major source of revenue for many public sector entities and the requirements of IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*.
- Chapter 17, *Foreign Currency* explains the implications of adopting IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* to account for foreign currency gains and losses.
- Chapter 18, *Segment Reporting* outlines the requirements of IPSAS 18, *Segment Reporting* and explains the steps that an entity would need to complete if it is to comply with that Standard.
- Chapter 19, *Related Party Disclosures* discusses the requirements of IPSAS 20, *Related Party Disclosures*.
- Chapter 20, *Disclosure of Financial Information about the General Government Sector* discusses the application of IPSAS 22, *Disclosure of Financial Information about the General Government Sector*. This Standard applies only where a government chooses to present financial information about the general government sector in its consolidated financial statements.
- Chapter 21, *Presentation of Budget Information in Financial Statements* identifies a number of documents that discuss issues relating to the adoption of accrual budgeting and

discusses the requirements of IPSAS 24, *Presentation of Budget Information in Financial Statements.*

- Chapter 22, *Entity Combinations* discusses the requirements of IFRS 3, *Business Combinations.*

The International Public Sector Accounting Standards Board (IPSASB) intends to revise this Study periodically to include explanations of the requirements of recently issued IPSASs. This revision process will occur periodically and this Study will not necessarily include discussion of all new or amended IPSASs. Consequently, readers will need to check the latest effective versions of IPSASs on the IFAC website (www.ifac.org). As part of the revision process the IPSASB may develop further Chapters for inclusion in this Part or amend these Chapters.

Chapter 9: Cash

Key Points

- The adoption of IPSASs, particularly IPSAS 2, *Cash Flow Statements*, means that an entity would have to report on both cash and cash equivalents in its cash flow statement.
- This Chapter discusses the requirements of IPSAS 2, in particular the definition and recognition of cash, the information requirements for completion of a cash flow statement, and the determination of control of cash.
- This Chapter also explains the definition of cash and control of cash in the Cash Basis IPSAS, *Financial Reporting Under The Cash Basis.*
- Existing administrative arrangements which involve the use of special types of bank accounts such as deposit accounts, trust accounts, advance accounts, and imprest accounts, would need to be reviewed to determine whether the balances in these accounts are controlled by the entity.

Introduction

9.1 Most governments and government entities will already have good records of most of their cash payments, cash receipts, and cash balances. Because most cash balances are readily identifiable, cash may be regarded as an "easy" asset to account for. However, there are still a number of issues that need to be considered when planning a transition to accrual accounting and the adoption of IPSASs. Some of these issues are explained below.

9.2 IPSAS 2 requires a cash flow statement to include both cash and cash equivalents. Some cash equivalents may not have previously been reported as part of opening and closing cash balances.

9.3 IPSAS 1 defines assets as "resources controlled by an entity." As cash is an asset, all cash reported as part of the entity's opening and closing cash balances should meet this test. This raises two issues:

(a) Whether all cash balances that are currently reported by the entity are controlled by the entity. In some cases an entity may currently be reporting cash balances which are held in trust or which are administered rather than controlled; and

(b) Whether there are any cash balances controlled by the entity which are not currently included in the entity's reported cash balances.

9.4 IPSAS 6, *Consolidated and Separate Financial Statements*, paragraph 43, notes that "In preparing consolidated financial statements, an entity combines the financial statements of the controlling entity and its controlled entities line-by-line by adding together like items of assets, liabilities, net assets/equity, revenue, and expenses." Entities required to produce consolidated financial statements will therefore need to identify any inter-entity cash flows and cash balances.

9.5 Cash is a financial asset and is therefore subject to the disclosure requirements in IPSAS 15, *Financial Instruments: Disclosure and Presentation* and IPSAS 30, *Financial Instruments: Disclosures*.[30]

9.6 Some items currently recognized as cash balances may not meet the definition of cash or cash equivalents in IPSAS 2. For example, entities using a modified form of the cash basis may have been accustomed to recognize certain receivables and payables as cash balances. Such items do not meet the definition of cash in IPSAS 2.

9.7 Unless the context suggests otherwise, references to "cash" in this Chapter should be read as including "cash equivalents."

Definitions

9.8 IPSAS 2 defines cash as "cash on hand and demand deposits." Cash on hand is not a defined term. Examples of cash on hand are:

(a) Bank account balances (both domestic and foreign);

(b) Cash awaiting deposit (if internal controls require same day deposit of cash receipts there may be no cash in this category);

(c) Petty cash floats or imprest accounts; and

(d) Cash in transit.

9.9 Cash held in bank account balances may refer to specific accounts in a named bank. However, where a reporting entity has a number of controlled entities and operates a centralized cash management system, the bank accounts of controlled entities may be real or notional. The term "notional bank accounts" refers to a system where there is one central bank account, but the cash flows of each entity are separately identified and each entity knows its notional cash balances. The entity operating the central bank account becomes, in effect, a banker for the other entities.

9.10 The cash on hand of a government department may include its ledger balance of funds "drawn down" from the government and available for use. It would consist only of the amount actually drawn down or otherwise available for immediate use—not the total annual amount appropriated or authorized.

9.11 IPSAS 1 defines cash equivalents as "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value." Cash equivalents therefore include:

(a) Short-term deposits;

(b) Deposits at call; and

(c) Other highly liquid investments that are readily convertible to cash on hand at the entity's option.

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30 IPSAS 15 is superseded by IPSAS 28, *Financial Instruments: Presentation* and IPSAS 30. IPSAS 15 remains applicable until IPSAS 28 and IPSAS 30 are applied or become effective, whichever is earlier. IPSAS 28 and IPSAS 30 are discussed in Chapter 13.

9.12 Cash equivalents are items that are immediately available or repayable on demand. They differ from debtors/accounts receivable in that although debtors/accounts receivable are payable to the entity, they are not payable on demand.

Recognition

9.13 In common with the recognition of other assets, cash and cash equivalents are recognized when they are measurable and probable. There are generally no difficulties in establishing the measurability and probability of cash and cash equivalents.

Information Requirements

9.14 IPSAS 2 requires that an entity:

(a) Report consolidated cash flows and cash balances;

(b) Separately disclose cash and cash equivalents;

(c) Include an explanation, in the accounting policies, of the items which make up cash and cash equivalents; and

(d) Disclose any cash balances not available for use by the entity.

9.15 An entity complying with IPSAS 2 would need to:

(a) Identify all bank accounts and other forms of cash or cash equivalents;

(b) Identify any cash balances with restricted use;

(c) Establish who has control (the ability to use cash for their own purposes) of the cash; and

(d) Establish a system for collecting cash flow and cash balance information from all entities within the reporting entity.

9.16 The implications of complying with IPSAS 6 have been previously considered in Chapter 5, *Reporting Entity Issues*.

9.17 Some of the issues that can arise in identifying the cash and cash equivalent balances of an entity are discussed in the following sections.

Control of Cash

9.18 Only those cash balances controlled by the entity meet the definition of cash for that entity. The concept of control is applied to determine whether receipts collected and payments made by the entity are in fact controlled by the entity and therefore represent cash. Frameworks for governing the collection of receipts and making of payments will vary between jurisdictions but the following discussion may be useful in this exercise.

9.19 Two possible scenarios (illustrated using receipts only) are described below.

(a) Receipts that are controlled by the entity are generally considered to be either revenue or a receivable of the entity. They are available to be used by the entity and the bank account in which they are held represents cash of the entity.

(b) Receipts that are not controlled by the entity are not cash of the individual entity collecting the funds for example, a government department collecting taxes on behalf of the government, which it is not entitled to spend, or receipts collected on behalf of another government controlled entity in an agency or administering capacity.

9.20 The above two scenarios illustrate two relatively clear instances where cash is controlled or not controlled. However, in the latter scenario arrangements and controls over such funds may vary. In some cases the amounts will be required to be held in a separate bank account and may clearly belong to the other entity. In other cases the funds may be intermingled with the funds of the collecting entity and available for use by the reporting entity, with the amounts collected being remitted at regular intervals. If the reporting entity controls the funds, the funds form part of its cash balances, but a liability to the other party may also exist. Where funds held on behalf of others are intermingled with, and reported as part of the entity's own cash balances, an entity is required to disclose the existence of significant cash balances not available for its use.

9.21 IPSAS 2 allows cash flows to be reported on a net basis when the cash receipts collected and payments made on behalf of customers, taxpayers, or beneficiaries reflect the activities of the other parties rather than those of the entity.

9.22 Money held in trust is discussed separately below.

Deposit Accounts/Holding Accounts

9.23 An entity preparing for transition to the accrual basis may have a range of specific accounts that it has used as a means of separately identifying funds of a specific nature or purpose that are not available for its general use. These accounts need to be reviewed to see if they should form part of the reported cash balances of the entity.

9.24 Examples of the types of cash that may be held in such accounts include:

(a) Bonds or deposits, for example, tenancy bonds or Customs bonds; and

(b) Funds held for a specific purpose.

Each of these examples is discussed further below.

Bonds or Deposits

9.25 A Government may require people entering the country with disposable consumer goods (that would be subject to duty if sold within the country) to pay a refundable bond or deposit. If the goods are subsequently taken out of the country, the Government would refund the deposit. If the goods are not taken out of the country within a specified time, the Government may take the bond or deposit in lieu of customs duty. The issue here is at what point the bond or deposit is controlled by, and should therefore be recognized as cash of, the individual entity responsible for collection of customs duty and/or the government as a whole. Identification of this point will depend on the circumstances in each case. Prior to the point at which such amounts are controlled, they may be more appropriately accounted for as trust money.

Funds Held for a Specific Purpose

9.26 Funds held for a specific purpose may have come from a higher level of government or private individuals or organizations. The main issue is whether such funds were a grant, donation, or other form of revenue that is now controlled by the entity or whether the funds are still controlled by the "donor." If the funds are controlled by the entity, they should be treated as part of the entity's cash balances. In the case of funds subject to restrictions and conditions, separate note disclosure of the amount of the restricted cash balance may be appropriate, and in some cases a liability may exist. The accounting treatment of such transactions is addressed in IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers*). IPSAS 23 is discussed in Chapter 16. If the funds are still controlled by the donor then they belong to the donor.

Trust Accounts

9.27 Cash that is held in trust for another party is not controlled by the entity and therefore does not meet the definition of an asset of the entity. An example of cash held in trust is the cash held by a government entity on behalf of prisoners detained by the government.

9.28 To identify the cash balances that it controls, an entity will need to:

(a) Review all trust accounts that are believed to hold trust money to determine who controls the cash; and

(b) Review all bank accounts controlled by the entity to identify whether such accounts include any cash that should be accounted for as trust money.

9.29 Because the controls over trust accounts may be different from those over other centralized bank accounts, entities using the cash basis sometimes use trust accounts for other purposes. For example, some jurisdictions using the cash basis have treated trust accounts as a mechanism to allow government-owned trading activities to operate and spend trading receipts without requiring an appropriation. Others have used trust accounts as a means of separating funds intended to be used for a specific purpose and to allow the funds to be spent over a period of time without requiring a separate annual appropriation each year. In neither case is the cash in the bank account held in trust for another individual or organization.

9.30 As part of the transition to accrual accounting, many entities find it appropriate to review the treatment of trust money. This may include creating a legislative definition of trust money, and establishing who has authority to manage trust money, the banking arrangements for trust money, and the type of reporting that is required for trust money. For example, the definition of trust money may be limited to situations where there is a trustee/beneficiary relationship. In addition to reviewing the management of trust money, entities will also need to consider whether they manage any assets or liabilities on a trust basis and the most appropriate form of control and reporting with respect to those assets and liabilities.

Advance Accounts

9.31 Some jurisdictions may operate advance accounts whereby amounts paid from the bank account are deemed not to be cash payments because they are immediately repayable.

Advance accounts may be used to forward money to individual controlled entities or individual employees for specified purposes, for example, staff travel. Advance accounts may operate through a separate bank account or a separate ledger. When an entity adopts the accrual basis of accounting, such arrangements may need to be reviewed. Under the accrual basis, any cash payment needs to be recognized as a reduction in the cash balance. The entity then needs to decide if the outflow of cash represents an expense or a receivable/loan.

9.32 The review of advance account arrangements may result in the collection of amounts currently outstanding, the write-off of amounts unlikely to be recovered, or the formal recognition of amounts receivable.

Imprest Accounts

9.33 Where a government or other controlling entity has a centralized bank account and operates a system of cash appropriations, it may take some time for requests for payment to be authorized and processed through the system by the central processing entity. Individual entities can find this type of system restrictive and so may be granted limited access to cash, subject to retrospective approval of the spending. Such access to cash is often granted by way of imprest accounts or suspense accounts. These operate in a similar way to a petty cash float. They have a limited balance available for certain purposes and all items must be retrospectively approved with appropriate supporting documentation, before any further funds are advanced to the account.

9.34 Cash balances held in imprest accounts form part of the cash of the consolidated reporting entity and would therefore be included in any consolidated financial statements. Where the individual entity with access to the imprest account also prepares financial statements, it needs to decide if the cash in the imprest account meets the definition of an asset—that is, does it control the cash? If the answer is "yes," then the cash in the imprest account would be reported as part of its cash balances. If the answer is "no," then the imprest account would be accounted for by the entity that has control.

9.35 The need for imprest accounts disappears if individual entities have access to their own bank accounts (either real or nominal) and are able to write their own checks or otherwise make their own payments. However, most entities retain the use of a petty cash system for inconsequential cash spending.

9.36 The proposed adoption of IPSASs (either cash or accrual) provides an opportunity to require that reconciliations of all imprest accounts have been completed and to review the need for all such accounts.

Foreign Currency Bank Accounts

9.37 Under the accrual basis, differences between opening and closing balances due to the movement in rates are separately disclosed within the cash flow statement. The method of translating foreign currency bank accounts under the accrual basis of accounting is set out in IPSAS 4. The reconciliation of the effect of exchange rate changes on the cash balances held by an entity should be presented separately in the financial statements.[31]

[31] Chapter 15 in this Study provides guidance on accounting for foreign currency transactions and foreign operations.

Stamps and Postal Orders

9.38 Where an entity other than the entity responsible for the production of such items (e.g., a government department), holds material balances of items that are readily convertible to cash such as stamps and postal orders, these may be classified as cash equivalents. However, where an entity is responsible for the production of stamps (e.g., a national postal service), these would be recognized as inventory at cost.

Unissued Currency

9.39 Where an entity is responsible for the production of currency, unissued currency (notes and coins for circulation) should be recognized as inventory at cost and not cash.

Non-Cash Transactions

9.40 Non-cash transactions are excluded from the cash flow statement. However, IPSAS 2 states that such transactions should be disclosed elsewhere in the financial statements. Where a transaction has both a cash and non-cash component, knowledge of both aspects of the transaction may be relevant for users. An example of a combined transaction is where assets are exchanged with only the net difference in the agreed price being paid in cash. The two elements of the transaction should therefore be cross-referenced in the accounting system or an additional memorandum account of such transactions should be maintained. The notes to the cash flow statement can be used to disclose details of such transactions.

Relevance to the Cash Basis of Accounting

9.41 Many of the issues identified in this Chapter are relevant for entities intending to comply with the requirements of the Cash Basis IPSAS. For example, the use of advance accounts, imprest accounts, and foreign currency bank accounts are similarly treated for both the cash basis of accounting and accrual basis of accounting.

9.42 The Cash Basis IPSAS also defines cash and control of cash and requires that only the cash controlled by the entity be recognized. "Control of cash" is defined as when the entity can use or otherwise benefit from the cash in pursuit of its objectives and can exclude or regulate the access of others to that benefit. The Standard notes that amounts deposited in the bank account of an entity are controlled by the entity. This means that cash collected on behalf of another entity and deposited in its own bank account before transfer to an account controlled by another government account is controlled by the entity for the period during which the cash resides in the bank account prior being transferred. However, the Standard allows the collecting entity to report the cash received and paid on a net basis.

9.43 The Cash Basis IPSAS encourages an entity intending to migrate to the accrual basis of accounting to present its statement of cash receipts and payments in accordance with IPSAS 2.

References

International Federation of Accountants (IFAC)

http://www.ifac.org

IPSAS 2, *Cash Flow Statements*, May 2000

IPSAS 4, *The Effects of Changes in Foreign Exchange Rates*, April 2008

IPSAS 6, *Consolidated and Separate Financial Statements*, December 2006

IPSAS 15, *Financial Instruments: Disclosure and Presentation*, December 2001

Glossary of Defined Terms, December 2008

Cash Basis IPSAS, *Financial Reporting Under The Cash Basis of Accounting*, Updated 2006 and 2007

Study 11, *Governmental Financial Reporting, Accounting Issues and Practices*, May 2000

Appendix

Accounting Policies

This Appendix illustrates an example of accounting policies for cash that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity.

Cash and Cash Flows

Cash is to include all cash balances on hand which are controlled by the reporting entity. This will include amounts awaiting banking, petty cash, imprest floats, and cash in transit. Cash will also include demand deposits of the reporting entity which are held with banks or other financial institutions including foreign currency accounts of the entity. Cash equivalents will comprise all short-term highly liquid investments that are readily convertible to cash within a maximum period of three months, and are subject to an insignificant risk of changes in value.

Where a reporting entity controls other entities, a consolidated financial statement prepared in respect of the economic entity comprising the entity and its controlled entities is to include all the cash and cash equivalents controlled by the entities within the economic entity. Inter-entity cash flows and cash balances are to be eliminated on consolidation.

Disclosures

A cash flow statement is to be prepared in accordance with IPSAS 2, *Cash Flow Statements*. Cash flows are to be reported on a gross basis except where reporting on a net basis is allowed by IPSAS 2. When, in accordance with IPSAS 2, certain types of cash flows are reported on a net basis, the notes to the financial statements are to acknowledge that this has occurred.

Trust Accounts and Third Party Settlements

Cash which is collected and/or held on behalf of another party and is deposited in a trust account which is not available for use of the reporting entity, is not to be included in amounts reported as cash or cash flows of the reporting entity. The total amount held in trust for other parties may be reported in the notes to the financial statements by major class.

Cash payments may be made by third parties such as multilateral development banks or donors directly to the entity’s creditors. Where the entity does not receive cash or cash equivalents from the multilateral development bank or donor entity, or gain control of a bank account or similar facility established for its benefit by the multilateral development bank or donor, the payments are not to be included as a cash flow of the entity. However, these amounts are to be disclosed separately in notes to the financial statements by major class of lender or donor and/or major class of activity.

Chapter 10: Intangible Assets

Key Points

- IPSAS 31, *Intangible Assets* is effective for periods beginning on or after April 1, 2011. IPSAS 31 is based on the requirements of IAS 38 *Intangible Assets* and SIC-32 *Intangible Assets—Web Site Costs*.
- IPSAS 31 limits the types of intangible assets that may be recognized by an entity. The definition of an intangible asset includes a requirement that the asset be identifiable (that is, the asset must be separable from the entity, or arise from contractual or legal rights). In addition, the Standard specifically prohibits the recognition of certain internally generated intangible assets and internally generated goodwill.
- The initial measurement of an intangible asset in accordance with IPSAS 31 depends on how the asset is acquired. Separately acquired intangible assets and internally generated intangible asset meeting the recognition criteria in the Standard are initially measured at cost. There are specific requirements for intangible assets acquired in other ways.
- Under IPSAS 31, intangible assets may be subsequently measured using either the cost model or the revaluation model. However, the circumstances in which the revaluation model may be used are limited.
- IPSAS 31 also specifies requirements regarding amortization, derecognition, and disclosure of intangible assets.
- This Chapter includes examples of intangible assets that may be held by governments and public sector entities. It also outlines some implementation issues associated with identifying intangible assets and developing accounting policies for intangible assets.
- Much of the discussion in Chapter 6 of this Study, particularly the material on identifying and recording property, plant and equipment, is also applicable to intangible assets.

Introduction

10.1 The discussion in this Chapter is based on the requirements of IPSAS 31. Prior to the development of IPSAS 31 entities applying IPSASs may have sought guidance from IAS 38 and SIC-32.

10.2 Certain intangible assets are excluded from the scope of IPSAS 31 because they are addressed in other IPSASs or have not yet been considered by the IPSASB. Two exclusions from the scope of IPSAS 31 are worthy of special mention.

Powers and Rights

10.3 Powers and rights conferred by legislation, a constitution, or by equivalent means are excluded from the scope of IPSAS 31. The IPSASB proposes to consider the accounting for such powers and rights following the development of a conceptual framework for the public sector. This Chapter therefore focuses on acquired intangible assets.

Goodwill Arising from an Entity Combination

10.4 Goodwill recognized as an intangible asset in the event of an entity combination and intangible assets acquired in an entity combination are also excluded from the scope of IPSAS 31. Although the IPSASB has signaled its intention to develop one or more IPSASs dealing with entity combinations, currently there is no IPSAS on this topic. The discussion of goodwill in this Chapter is therefore based on the requirements of IFRS 3, *Business Combinations* (as at January 2010, the date of issue of IPSAS 31).

Definitions

10.5 IPSAS 31 includes a number of definitions including the following key terms:

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

An *intangible asset* is an identifiable non-monetary asset without physical substance.

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

10.6 In addition, the following defined terms from IFRS 3 are referred to in this Chapter.

Goodwill—An asset representing the future economic benefits or service potential arising from other assets acquired in a business combination that are not individually identified and separately recognized.

Business—An integrated set of activities and assets that is conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members or participants.

Business combination—A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as "true mergers" or "mergers of equals" are also business combinations as that term is used in IFRS 3.

Acquirer—The entity that obtains control of the acquiree.

Acquiree—The business or businesses that the acquirer obtains control of in a business combination.

Control—The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Non-controlling interest—The equity in a subsidiary not attributable, directly or indirectly, to a parent.[32]

Intangible Assets—Characteristics and Examples

10.7 In broad terms, intangible assets represent recognizable rights to future economic benefits and service potential. In keeping with other non-current assets, an intangible asset must have a useful life greater than one year. Not all intangible assets of a public sector entity

[32] IPSASs use the term "minority interest" instead of "non-controlling interest."

will fall within the scope of IPSAS 31, meet the definition of an intangible asset in IPSAS 31 or satisfy the recognition criteria in IPSAS 31.

10.8 Under IPSAS 31, an intangible asset must meet both the general definition of an asset (as discussed in Chapter 6) and the additional requirement of being identifiable. Identifiable intangible assets can be sold or acquired separately from other assets, for example patents, databases, and concessions. Non-identifiable intangible assets cannot be sold separately, for example, human resources and good labor relations. If an item within the scope of IPSAS 31 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognized as an expense when it is incurred.

10.9 Examples of intangible assets that may be recognized by public sector entities in accordance with IPSAS 31 include:[33]

(a) Acquired software (although some software may meet the definition of property, plant and equipment);

(b) Databases and database management software created and maintained by government entities, such as those containing information on the demographic statistics of the population, land ownership, private sector entity ownership, and registers of securities and charges;

(c) Acquired rights under licensing agreements for films, videos, plays, and manuscripts, in entities such as broadcasting, tourism, arts, and culture;

(d) Capitalized research and development costs;

(e) Acquired operating rights or rights of use, such as rights/licenses to extract mineral resources, access rights, rights to operate a radio spectrum, import/export licenses, airport landing rights, fishing quotas;

(f) Acquired patents and copyrights held by government entities in areas such as tourism, research, education, health, agriculture, and archives;

(g) Agreements with other entities which give those other entities a right to provide utilities. Some intangible assets may also be service concessions assets. Proposals for accounting for service concession assets are set out in Exposure Draft 43 *Service Concession Arrangements: Grantor* (IFAC, 2010);

(h) Trademarks, intellectual property and brand names; and

(i) Goodwill arising from an entity combination (IPSAS 31 prohibits the recognition of internally generated goodwill).

10.10 A description of the ways in which a government unit may create certain intangible assets (for example, "intangible fixed assets" and "intangible non-produced assets") is found in the International Monetary Fund (IMF) *Government Finance Statistics Manual 2001*,

[33] This list sets out examples of intangible assets that may meet the definition of an intangible asset and the recognition criteria for intangible assets in IPSAS 31. An entity will need to assess each potential intangible asset against the requirements of IPSAS 31. Due to differing environments, some items, such as databases, may not meet the definition and recognition criteria in certain jurisdictions.

Chapter 7 (IMF, 2001). However, not all of these assets will fall within the scope of IPSAS 31 or meet the requirements for recognition under IPSAS 31.

Computer Software

10.11 Some assets, such as computers, may have both tangible and intangible elements. For example, a computer consists of both the hardware and the software, the hardware being a tangible asset and the software potentially being an intangible asset if it meets the recognition criteria in IPSAS 31. Depending on the relative materiality of the components and the extent to which the components operate together, the computer software may or may not be recognized as an intangible asset with the hardware being recognized as a tangible asset. For example, a piece of electronic equipment may have software installed in order for it to operate. However, if the software is not separable from the equipment, is not purchased or developed separately and is necessary for the equipment to operate it may not be accounted for separately from the equipment. On the other hand, computer operating systems purchased and licensed separately from the computer hardware would be accounted for separately from the computer hardware.

Intangible Heritage Assets

10.12 Some intangible assets may be regarded as heritage assets because of their cultural, environmental, or historical significance. IPSAS 31 does not require the recognition of intangible heritage assets. Nor does it prohibit the recognition of such assets. If an entity chooses to recognize intangible heritage assets it must comply with the disclosure requirements of IPSAS 31 in respect of those assets that have been recognized. Measurement of recognized heritage assets is optional. This approach to heritage assets is consistent with the approach taken by the IPSASB with respect to heritage assets falling within the scope of IPSAS 17, *Property, Plant and Equipment*. If an entity chooses not to recognize certain intangible heritage assets it may make disclosures about those assets in accordance with IPSAS 31 but is not required to do so.

Accounting requirements

Recognition

10.13 An entity is required to recognize an intangible asset if, and only if, specified criteria are met. To recognize an item as an intangible asset, an entity must demonstrate that the item meets both:

(a) The definition of an intangible asset; and

(b) The recognition criteria.

10.14 These requirements apply to both (i) costs incurred initially to acquire an intangible asset, to develop an internally generated intangible asset, or the fair value of an intangible asset acquired through a non-exchange transaction; and (ii) costs incurred subsequently to add to, replace part of, or service an intangible asset.

10.15 The definition of an intangible asset requires that it be identifiable. An intangible asset is identifiable if it either:

(a) Is separable, that is, is capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liabilities, regardless of whether the entity intends to do so; or

(b) Arises from binding arrangements (including rights from contracts or other legal rights), regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

10.16 An intangible asset is recognized if, and only if:

(a) It is probable that the expected future economic benefits or service potential that are attributable to the asset will flow to the entity; and

(b) The cost of the asset can be measured reliably.

10.17 In the case of an intangible asset acquired in an entity combination, an entity applying IFRS 3 would consider it probable that expected future economic benefits or service potential attributable to that intangible asset will flow to the entity.

10.18 Where an entity accounts for the acquisition of another entity in accordance with the requirements of IFRS 3, it would recognize an intangible asset of the acquiree at the acquisition date separately from goodwill, irrespective of whether or not the asset had been recognized by the acquiree before the business combination.[34] This means that the acquirer recognizes as an asset, separately from goodwill, an in-process research and development project of the acquiree if the project meets the definition of an intangible asset.

10.19 Under IFRS 3 goodwill arising on a business combination is measured as the difference between:

(a) The aggregate of (a) the acquisition-date fair value of the consideration transferred, (b) the amount of any non-controlling-interest, and (c) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously-held net assets/equity interest in the acquiree; and

(b) The net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed (measured in accordance with IFRS 3).

10.20 If the difference above is negative, the resulting gain is recognized as a bargain purchase in surplus or deficit.

10.21 Cost expended on the development (or on the development phase of an internal project) shall be recognized as an intangible asset if, and only if, an entity can demonstrate all of the following:

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) Its intention and ability to complete the intangible asset and use or sell it;

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[34] When referring to the requirements of IFRS 3, this Chapter uses the term "business combination" rather than the more generic term "entity combination."

(c) How the intangible asset will generate probable future economic benefits or service potential. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(d) The availability of adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset; and

(e) The entity's ability to measure reliably the expenditure attributable to the intangible asset during its development.

10.22 An entity's own web site that arises from development and is for internal or external access is an internally generated intangible asset that is subject to the requirements of IPSAS 31. A website arising from development shall be recognized as an intangible asset if, and only if, an entity can satisfy all the requirements for the recognition of an internally generated intangible asset. In particular, an entity may be able to satisfy the requirement to demonstrate how its web site will generated probable future economic benefit when, for example, the web site is capable of generating revenue or income, including direct revenue or income from enabling orders to be placed. An entity is not able to demonstrate how a web site developed solely or primarily for promoting and advertising its own products and services will generate probable future economic benefits, and consequently all expenditure on developing such a web site shall be recognized as an expense in surplus or deficit when incurred.

10.23 IPSAS 31 prohibits recognition of the following as intangible assets:

(a) Cost expended on research or the research phase of an internal project: expenditure on research or the research phase of an internal project is required to be recognized as an expense when it is incurred (paragraph 52);

(b) Internally generated goodwill (paragraph 46); and

(c) Internally generated brands, mastheads, publishing titles, lists of users of as service, and items similar in substance (paragraph 61).

Initial Measurement

10.24 An entity is required to measure an intangible asset initially at cost. The cost of a separately acquired intangible asset comprises:

(a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

(b) Any directly attributable cost of preparing the asset for its intended use.

10.25 IPSAS 31 provides more detailed guidance on determining the initial cost of certain assets such as intangible assets acquired through a non-exchange transaction and intangible assets acquired through an exchange of assets and internally generated intangible assets. Each of these is discussed below.

10.26 If an entity acquires an intangible asset through a non-exchange transaction an entity applies the requirements of IPSAS 23 in conjunction with IPSAS 31. Consistent with

IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*, the cost of the asset is its fair value at the date it is acquired. In addition, for initial measurement of such intangible assets, an entity considers directly the attributable costs specified in IPSAS 31. For the purposes of IPSAS 31, the use of fair value in the context of initial measurement of an intangible asset acquired through a non-exchange transaction does not constitute a revaluation.

10.27 If an entity acquires an intangible asset through an exchange of assets (which is itself an exchange transaction), the cost of the intangible asset acquired is measured at fair value unless the fair value of neither the asset received nor the asset given up is reliably measurable. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

10.28 The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in the Standard. Expenditure on an intangible asset shall be recognized as an expense (i.e., not capitalized) unless:

(a) It forms part of the cost of an intangible asset that meets the recognition criteria; or

(b) The item is acquired in an entity combination and cannot be recognized as a separate intangible asset in which case, it forms part of the amount recognized as goodwill.

10.29 Costs expended that have previously been recognized as an expense are prohibited from being reinstated as an asset or part of an asset. For example, if an entity has expensed costs associated with the development of a database and subsequently decides that the database meets the criteria for recognition of an intangible asset in accordance with IPSAS 31, it cannot recognize as part of the cost of the database those costs that have already been expensed.

10.30 IFRS 3 provides guidance on the cost of intangible assets acquired through a business combination. The cost of an intangible asset acquired through a business combination is its fair value at the acquisition date. If an asset acquired in an entity combination is separable or arises from contractual or other legal rights, it is considered that sufficient information exists to measure reliably the fair value of the asset.

Subsequent Measurement

10.31 Subsequent to initial recognition an entity must choose either the cost model or the revaluation model as its accounting policy.

10.32 Under the cost model, subsequent measurement of an intangible asset is at cost less accumulated amortization and any accumulated impairment losses. An intangible asset with a finite useful life is amortized and and intangible asset with an indefinite useful life is not. There is a rebuttable presumption in IPSAS 31 that the residual value of an intangible asset with a finite useful life is zero. If the residual value is zero, the entire cost of the asset is allocated over its useful life. If the asset is expected to have a residual value then the depreciable amount is allocated over the asset's useful life.

10.33 The use of the revaluation model is subject to the requirements that (i) the fair value of the asset can be determined by reference to an active market and (ii) all the other assets in that asset's class are also be accounted for using the revaluation model (unless there is no active market for those assets). An active market is a market in which all of the following conditions exist:

(a) The items traded in the market are homogenous;

(b) Willing buyers and sellers can normally be found at any time; and

(c) Prices are available to the public.

10.34 Under the revaluation model, subsequent measurement of an intangible asset is at the asset's fair value at the date of revaluation less any subsequent accumulated amortization and any subsequent accumulated impairment losses. Revaluations must be made regularly enough to ensure that, at the end of each reporting period, the carrying amount of the asset does not differ materially from its fair value. Unlike IPSAS 17, IPSAS 31 requires that revalued intangible assets be accounted for on an asset-by-asset basis, rather than a class basis.

10.35 If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be recognized in net asset/equity under the heading "revaluation surplus." However, the increase shall be recognized in surplus or deficit to the extent that it reverses a revaluation decrease of the same asset previously recognized in surplus or deficit. If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognized in surplus or deficit. However, the decrease shall be recognized in net assets/equity to the extent of any credit balance in the revaluation surplus in respect of that asset.

10.36 An entity is required to assess whether the useful life of an intangible asset is finite or indefinite and whether the asset is expected to have any residual value. IPSAS 31 assumes that the residual value of an intangible asset with a finite useful life is zero unless certain conditions are met. If the useful life is considered by be finite, the entity must then assess the length of, or number of production or similar units constituting, that useful life. An intangible asset is regarded by the entity as having an indefinite useful life when, based on an analysis of all the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate cash inflows for the entity. The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset must include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.

10.37 The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life. Amortization shall begin when the asset is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Amortization shall cease at the earlier of the date that the asset is classified as held for sale and the date that the asset is derecognized. The amortization method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. The amortization charge for each period shall be recognized in surplus or deficit unless this or another standard permits or requires it to be included in the carrying amount of another asset.

10.38 The amortization period, the amortization method and the residual value, if any, for an intangible asset with a finite useful life shall be reviewed at least at each reporting date. If the expected useful life of the asset is different from previous estimates, the amortization period shall be changed accordingly. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortization method shall be changed to reflect the changed pattern. Such changes shall be accounted for as changes in accounting estimates in terms of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*.

10.39 An intangible asset with an indefinite useful life shall not be amortized. In accordance with the accounting standards on impairment of assets an entity is required to test an intangible asset with an indefinite useful life for impairment annually and whenever there is an indication that the intangible asset may be impaired. Refer to Chapter 12 for guidance on impairment testing of assets.

10.40 Further, the useful life of an intangible asset that is not being amortized shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as a change in an accounting estimate.

Steps Required to Account for Intangible Assets on an Accrual Basis

Main Steps Required

10.41 The main steps required in order to account for intangible assets on an accrual basis and in accordance with IPSASs are:

(a) Develop accounting policies;

(b) Identify all potential intangible assets;

(c) Apply the recognition principles in the accounting policies to potential intangible assets to determine which intangible assets should be recognized. If an entity has previously recognized some intangible assets it will also need to consider whether any intangible assets which have previously been recognized should be derecognized in accordance with the new accounting policies;

(d) Measure those intangible assets that are to be recognized in the financial statements;

(e) Identify useful lives and residual values;

(f) Collect information needed to make appropriate and required disclosures in the financial statements;

(g) Consider the significance of intangible assets which will not be recognized in the financial statements and whether disclosure of such assets would be appropriate;

(h) Confirm that appropriate systems are in place to enable recording of ongoing transactions; facilitate the regular review of intangibles for potential impairment and the accounting for impairment losses (if any); and record the information required to be disclosed in the financial statements; and

(i) Regularly review recognized intangible assets for impairment.

Development of Accounting Policies

10.42 The accounting policies developed will need to address:

(a) Initial recognition of expenditures on intangible items;

(b) Recognition of subsequent expenditure;

(c) Initial measurement (including intangible assets acquired for no or nominal consideration);

(d) Measurement subsequent to initial recognition;

(e) Amortization;

(f) Impairment; and

(g) Sale or disposal.

10.43 Appendix A to this Chapter contains illustrative accounting policies.

Identification of Intangible Assets

10.44 An entity will need to compile a list of all potential intangible assets and apply the definition and recognition criteria for intangible assets to each item on the list. Potential intangible assets include a government's acquired rights or agreements with other parties. The financial statements of other entities that currently recognize intangible assets may be useful for comparative purposes, but care should be taken that similar accounting policies have been applied by that entity and that the intangible assets recognized by those entities fall within the scope of IPSAS 31. For example, the scope of IPSAS 31 excludes powers and rights conferred by legislation, a constitution, or by equivalent means.

10.45 Entities may have rights which have been granted to them, by a property owner, to use land for certain purposes (e.g., to construct assets on or over a specific property or the right to access to a property). In the public sector, these types of rights, sometimes referred to as servitudes, are usually acquired in connection with infrastructure such as roads and water reticulation systems. Entities will need to assess whether such rights meet the definition and recognition criteria in IPSAS 31. Issues associated with accounting for such rights have been considered by the Accounting Standards Board in South Africa (ASB, 2009).

10.46 Once a list of potential intangible assets has been established, an entity would then apply the definition of an intangible asset and the criteria for recognition to all potential intangible assets. This stage of the process should be carefully documented so that the information collected and conclusions reached can be used to support reported balances during an external audit.

Measurement of Recognized Intangible Assets

10.47 IPSAS 31 permits the recognition of intangible assets only if the cost of the asset can be measured reliably. An entity will therefore need to review the adequacy of its systems and records to assess whether this requirement can be satisfied.

10.48 The availability of reliable cost data for intangible assets on transition to the accrual basis will depend upon the type of accounting records previously maintained. Options for measurement in the case of first-time recognition of assets have been discussed in Chapter 6. These options include the re-creation of cost data and the use of fair values as at the date of initial recognition.

10.49 The transitional provisions in IPSAS 31 will limit the amount of work required by entities adopting the Standard. Only those entities that have previously recognized intangible assets are required to apply the Standard retrospectively.

Review of Intangible Assets for Potential Impairment

10.50 An entity is required to regularly test intangible assets for impairment and/or conduct regular reviews of recognized intangible assets to determine whether or not such assets need to be tested for impairment. As such, the accounting policies for impairment; the methods to be used to collect the required data; and responsibility for conducting the impairment review should be established as well as the necessary systems need to be established at the same time the entity determines the intangible assets to be recognized.

10.51 Intangible assets that are measured at revalued amounts are not subject to the impairment requirements relating to intangible assets in IPSAS 21 and IPSAS 26. These two standards specifically exclude intangible assets measured at revalued amounts from their scope. This is because the IPSASB considers that such intangible assets will be revalued with sufficient regularity to ensure that they are carried at an amount that is not materially different from their fair value as at the reporting date and any impairment will be taken into account in the valuation.

Information Required to be Disclosed in Respect of Intangible Assets

10.52 For each class of intangible asset, the disclosures required include:

(a) Details of the nature of and useful lives of intangible assets;

(b) For intangible assets considered to have indefinite useful lives, details of the asset; the reasons supporting the assessment of an indefinite useful life, and the factors considering in making the assessment;

(c) The amortization rates and methods used;

(d) A detailed reconciliation of the carrying amount at the beginning and end of the reporting period as well as the gross carrying amount and any accumulate amortization and impairment losses at the beginning and end of the reporting period;

(e) Details of intangible assets acquired through non-exchange transactions including their fair values and carrying amounts; and

(f) Details of revaluations of intangible assets.

10.53 Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Disclosure of Information about Unrecognized Intangible Assets

10.54 In common with IPSAS 31, many accounting standards restrict the types of intangible assets that may be recognized and the circumstances in which they may be recognized. This can lead to situations where entities have significant intangible items that are not recognized in the financial statements. Additional disclosure of intangible assets that have not been recognized in the financial statements is not required by IPSAS 31 but would provide more complete information about the nature of the resources under an entity's control.

Transitional Provisions

10.55 The transitional provisions in IPSAS 31 distinguish between entities that have previously recognized intangible assets and those that have not.

10.56 Entities that have previously recognized intangible assets are required to apply the Standard retrospectively in accordance with IPSAS 3.

10.57 Entities that have not previously recognized intangible assets and that use the accrual basis of accounting are required to apply the Standard prospectively. Retrospective application by such entities is permitted.

Relevance to the Cash Basis of Accounting

10.58 The issues identified in this Chapter are relevant for entities intending to provide additional disclosures on the nature and amount of intangible assets as encouraged by the Cash Basis IPSAS. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the statement of cash receipts and payments.

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Appendix

Accounting Policies

This Appendix illustrates an example of accounting policies for intangible assets that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The illustrative policy is based largely upon IPSAS 31. The policy illustrated requires intangible assets to be measured initially at cost, with subsequent revaluations to fair value where fair values are available.

(a) Computer software

Costs associated with maintaining computer software programs are recognized as an expense as incurred. Staff training costs are recognized as an expense when incurred.

Development costs that are directly attributable to the design and testing of identifiable and unique software products controlled by the group are recognized as intangible assets when the following criteria are met:

(a) It is technically feasible to complete the software product so that it will be available for use;

(b) Management intends to complete the software product and use or sell it;

(c) There is an ability to use or sell the software product;

(d) It can be demonstrated how the software product will generate probable future economic benefits or service potential;

(e) Adequate technical, financial, and other resources to complete the development and to use or sell the software product are available; and

(f) The expenditure attributable to the software product during its development can be reliably measured.

Directly attributable costs that are capitalized as part of the software product include the software development employee costs and an appropriate portion of relevant overheads.

Other development expenditures that do not meet these criteria are recognized as an expense as incurred. Development costs previously recognized as an expense are not recognized as an asset in a subsequent period.

Computer software development costs recognized as assets are amortized over their estimated useful lives, which does not exceed three years.

(b) Trademarks and licenses

Separately acquired trademarks and licenses are shown at historical cost. Trademarks and licenses acquired in an entity combination are recognized at fair value at the acquisition date. Trademarks and licenses have a finite useful life and are carried at cost less accumulated amortization. Amortization is calculated using the straight-line method to allocate the cost of trademarks and licenses over their estimated useful lives of 15 to 20 years.

Acquired computer software licenses are capitalized on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortized over their estimated useful lives of 3 to 5 years.

(c) **Goodwill**

Refer to Chapter 22 for illustrative accounting policies for goodwill arising from an entity combination.

(d) **Intangible assets acquired in an entity combination**

Refer to Chapter 22 for illustrative accounting policies for intangible assets arising from an entity combination.

(e) **Impairment**

Refer to Chapter 12 for illustrative accounting policies for impairment of intangible assets.

(f) **Disposals**

Gains and losses on disposals are determined by comparing the proceeds with the carrying amount of the asset. Gains and losses on disposals are reported in the statement of financial performance.

When revalued assets are sold, the amounts included in revaluation reserves in respect of those assets are transferred to accumulated surpluses.

Chapter 11:Agricultural Produce and Biological Assets

Agriculture

- IPSAS 27, *Agriculture* applies to biological assets and agricultural produce at the point of harvest when they relate to agricultural activity. The requirement to be engaged in agricultural activity is a key aspect of the scope of the Standard.
- IPSAS 27 does not apply to land related to agricultural activity, intangible assets related to agricultural activity, or biological assets held for the provision or supply of services.
- In most cases the initial and subsequent measurement of biological assets is at fair value less costs to sell.
- The initial measurement of agricultural produce is fair value less costs to sell at the point of harvest. Subsequent measurement of agricultural produce is generally in accordance with IPSAS 2 *Inventories*.
- Changes in the fair value of biological assets during a period are reported in surplus or deficit.
- On initial adoption of IPSAS 27 an entity needs to identify the assets that fall within the scope of that Standard, develop appropriate policies and procedures and apply those policies and procedures.

Introduction

11.1 Agricultural activity can be significant for the public sector in certain parts of the world, including many developing countries. Examples of agricultural activities include livestock farming, dairy farming, forestry, rubber and tea plantations, viticulture, fish farming, and crop farming.

11.2 IPSAS 27 was issued in December 2009. It is based on IAS 41 and incorporates limited changes to the requirements of that standard to address public sector-specific issues. For example, IPSAS 27 addresses biological assets—such as livestock--held for transfer or distribution at no charge or for a nominal charge to other public sector bodies or to not-for-profit organizations. It also includes disclosure requirements that are aimed at enhancing consistency with the statistical basis of accounting that governs the Government Finance Statistics Manual (GFSM 2001).

11.3 Not all biological assets or agricultural produce will fall within the scope of IPSAS 27. The definition of agricultural activity, discussed in more detail below, focuses on the management of biological assets for various purposes. The focus on management means that the harvesting of biological assets from unmanaged sources, such as ocean fishing, and agricultural activities that are incidental to other activities, such as the natural increase in zoo animals do not fall within the scope of the Standard.

11.4 The emphasis on fair value measurement in IPSAS 27 may be a challenge for entities that have previously measured biological assets and agricultural produce at cost.

11.5 Agricultural activity is defined as the management by an entity of the biological transformation of biological assets for sale, into agricultural produce, or into additional biological assets. The biological transformation of a biological asset comprises the process of growth, genetic transformation, production, and procreation. Agricultural produce refers to the harvested product of biological assets, such as milk, wool, meat, fruits, or cereals. IPSAS 27 applies to agricultural produce only at the point of harvest.

11.6 Because many of the requirements of IPSAS 27 are identical to those in IAS 41, public sector entities may find guidance on IAS 41 useful.

Summary of IPSAS 27

Scope

11.7 IPSAS 27 applies to biological assets and agricultural produce at the point of harvest when they relate to agricultural activity. It does not deal with the processing of agricultural produce after harvest—IPSAS 12 should be applied to such inventories. The reference to agricultural activity in the scope of the standard means that the definition of agriculture activity is critical when determining which assets fall within the scope of the Standard. Examples of activities which do not meet the definition of agricultural activity are found in PricewaterhouseCoopers (2009).

11.8 The Standard does not apply to land related to agricultural activity (refer to IPSAS 17 or, if it is investment property, IPSAS 16), intangible assets related to agricultural activity (refer to IPSAS 31) or biological assets held for the provision or supply of services.

11.9 The exclusion for biological assets held for the provision or supply of services is intended to assist public sector entities by clarifying that such biological assets are not dealt with in IPSAS 27. In developing IPSAS 27 the IPSASB acknowledged that in the public sector biological assets are often held for the provision or supply of services. Examples of such biological assets include horses and dogs used for policing purposes. The IPSASB concluded that such biological assets are not held for use in an agricultural activity because they are not routinely managed for the purpose of measuring and monitoring the change in quality or quantity brought about by biological transformation or harvest.

Definitions

11.10 IPSAS 27 includes a number of definitions including the following key terms::

Agricultural activity is the management by an entity of the biological transformation and harvest of biological assets for:

- Sale;
- Distribution at no charge or for a nominal charge; or
- Conversion into agricultural produce or into additional biological assets for sale or for distribution at no charge or for a nominal charge.

Agricultural produce is the harvested product of the entity's biological assets.

A *biological asset* is a living animal or plant.

Biological transformation comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset.

Costs to sell are the incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes. Disposal may occur through sale or through distribution at no charge or for a nominal charge.

Harvest is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

11.11 In considering common features of agricultural activity IPSAS 27 highlights that management of biological transformation distinguishes agricultural activity from other activities. Management facilitates biological transformation by enhancing, or at least stabilizing, conditions necessary for the process to take place.

11.12 In developing IPSAS 27 the IPSASB decided that the definition of agricultural activity should encompass biological assets held for distribution at no charge or for a nominal charge. This may occur where a public sector entity raises livestock which is then distributed free of charge or transfers ownership of other assets such as plantations or farms at no charge.

Recognition and Measurement

11.13 IPSAS 27 requires that an entity recognize a biological asset or agricultural produce when and only when:

(a) The entity controls the asset as a result of past events;

(b) It is probable that future economic benefits or service potential associated with the asset will flow to the entity; and

(c) The fair value or cost of the asset can be measured reliably.

11.14 These requirements are effectively identical to the recognition requirements for property, plant and equipment in IPSAS 17. Although IPSAS 27 explicitly states that the entity must control the asset as a result of past events this is one of the components of the definition of an asset.

11.15 IPSAS 27 establishes initial and subsequent measurement requirements for biological assets and agricultural produce at the point of harvest. These requirements are summarised in the following table. Generally the quoted market price in an active market represents the best measure of the fair value of a biological asset or agricultural produce. If an active market does not exist, IPSAS 27 provides guidance for choosing another measurement basis.

11.16 The requirements for biological assets apply to assets acquired through both exchange and non-exchange transactions.

	Biological Assets	**Agricultural Produce**
Initial measurement	Fair value less costs to sell. If fair value cannot be measured reliably, cost.	Fair value less costs to sell, at the point of harvest.
Subsequent measurement	Fair value less costs to sell. If cost was used at initial recognition, and fair value is still not reliably measurable, measure at cost less any accumulated depreciation and any accumulated impairment losses.	Generally accounted for as inventory—refer to IPSAS 12.

11.17 In certain situations a loss may arise on initial recognition because costs to sell must be deducted from fair value.

11.18 The following table summarizes the requirements of IPSAS 27 in relation to determining the fair value of biological assets and agricultural produce.

Scenario	**Determining Fair Value**
Active market exists	If one market, use the market quoted price. If more than one market, use the most relevant market quoted price (i.e., the price from the market expected to be used).
No active market exists	Use one or more of the following: (a) the most recent market transaction price; (b) the market price for similar asset; or (c) a sector benchmark.
No market determined price available	Use present value of expected net cash flows from the assets discounted at a current market determined rate.
Cost approximates fair value	Cost.

11.19 IPSAS 27, paragraph 19, permits the grouping of biological assets or agricultural produce for the determination of fair value. The grouping has to be made depending on the significant attributes of the biological assets and of other agricultural produce, such as: age, consumable character, reproduction capacity, or quality. The attributes selected must reflect the attributes used in the market as a basis for pricing.

Gains and Losses

11.20 IPSAS 27 requires that gains and losses on biological assets be recognized as revenue. Such gains are therefore excluded from the scope of IPSAS 9, *Revenue from Exchange Transactions*.

Disclosure

11.21 IPSAS 27 requires extensive disclosures. These include:

(a) The impact on the statement of financial performance of initial recognition of biological assets and agricultural produce and changes in the reported values of biological assets. Separate disclosure of changes in fair values due to physical changes and price changes are encouraged;

(b) A description of biological assets. This must distinguish between:

   (i) Consumable and bearer biological assets. This requirement was prompted by a desire for consistency with the Government Finance Statistics Manual 2001 (GFSM 2001);

   (ii) Biological assets held for sale and those held for distribution at no charge or for a nominal charge;

(c) A description of the nature of the entity's activities involving each group of biological assets and non-financial measures or estimates of the physical quantities (if not disclosed elsewhere);

(d) The methods and significant assumptions applied in determining fair values of biological assets and agricultural produce;

(e) The fair value less costs to sell of agricultural produce harvested during the period, determined at the point of harvest;

(f) Details of various restrictions on biological assets, commitments to purchase biological assets, and financial management risk strategies; and

(g) A reconciliation of changes in the carrying amount of biological assets between the beginning and the end of the current period. This reconciliation must separately disclose increases due to biological assets acquired through non-exchange transactions and decreases due to biological assets held for distribution at no charge or for a nominal charge.

11.22 Additional disclosures are required in respect of biological assets where fair value cannot be measured reliably. Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

11.23 Application of IPSAS 27 leads to the recognition of gains and losses arising from fair value measurement being reported in the statement of financial performance. Although such reporting provides useful accountability information during the biological transformation process it may also lead to greater volatility in reported surpluses/deficits. Entities may decide to make additional disclosures to explain the impact of these reported fair value changes.

Considerations when Implementing IPSAS 27

Initial Identification and Verification

11.24 An entity will need to identify all biological assets, and associated agricultural produce. It will then need to consider whether the related activities meet the definition of agricultural activity. If the transformation or growth of biological assets is incidental to another purpose or is not actively managed by the entity then the activities are unlikely to meet the definition of agricultural activity. Biological assets which are unlikely to fall within the definition of agricultural activity in IPSAS 27 include trees planted in public reserves or alongside rivers to prevent erosion, and the natural breeding of animals in a zoo. In such cases an entity should then consider whether the items meet the definition of property, plant and equipment, the definition of inventory or whether they should be expensed.

11.25 Once biological assets and agricultural produce within the scope of IPSAS 27 have been identified they will need to be formally recorded so that they can be managed and reported. They may be recorded in the entity's main asset register or in a separate asset register.

Determining Fair Value

11.26 An entity will also need to identify which of the approaches to determining fair value in IPSAS 27 are appropriate for various assets. If an entity concludes that fair value cannot be reliably measured for certain biological assets it should document its reasons for reaching this conclusion. IPSAS 27 states that the presumption that fair value can be measured reliably for a biological asset can be rebutted only on initial recognition for a biological asset for which market-determined prices or values are not available, and for which alternative estimates of fair value are determined to be clearly unreliable.

11.27 If an entity proposes to group assets for the purposes of determining fair value it will need to decide which groupings reflect market attributes. In some cases grouping biological assets by region may be acceptable. This may be the case when the biological assets have different characteristics in different regions or when the cost structure is different.

11.28 If an entity decides that professional valuers are required for certain types of biological assets it should develop policies to ensure that this occurs.

11.29 Some biological assets are attached to the land. Land is not within the scope of IPSAS 27. Guidance on the valuation of agricultural land is provided by the International Valuation Standards Board (IVSC, 2007). It may be necessary to value the land (and possibly the entire operation), including the biological assets, and then deduct the valuation of the land (and other assets if applicable) to obtain the value of the biological assets.

11.30 In some cases there may be no active market for biological assets in their current state and condition. Forests are a good example of this. Although there may be markets for the harvested products of forests, there may not be markets for standing timber, or they may be limited in comparison with the total volume of standing forest. In such cases discounted cash flow approaches are used. There have been ongoing concerns raised about the valuation of forests and some have raised concerns that there may be diversity in practice.

11.31 In February 2010 the International Valuation Standards Board convened an expert group to consider whether there is diversity of practice regarding valuation of forestry assets in accordance with IAS 41. This review also proposed to consider the extent to which these issues are common to other agricultural or biological assets. The project may lead to a revision of Guidance Note No 10, *Valuation of Agricultural Properties* or separate guidance on the valuation of forestry assets.

11.32 There have also been issues raised regarding the fair value of immature fish and whether it is possible to estimate fair values for immature fish by reference to markets for mature fish. Because of the uncertainty surrounding the valuation of immature fish the policy for valuing such fish and the composition of immature fish (by type and weight) may be separately disclosed.

Ongoing Compliance

11.33 Following initial implementation of IPSAS 27 the entity needs to determine fair values of biological assets and agricultural produce at each reporting period.

Areas of Approximation and Uncertainty

11.34 Areas that may require the exercise of significant judgment include:

(a) Determining the fair value of biological assets for which there is no active market;

(b) Determining the fair value of bearer assets; and

(c) The assumptions required in performing a discounted cash flow analysis when this method is applied to determine fair value.

11.35 IPSAS 27 tries to provide users with information about areas of uncertainty by requiring disclosure of the methods and significant assumptions applied in determining fair values. In addition to the disclosure requirements in IPSAS 27, an entity is required by IPSAS 1, *Presentation of Financial Statements*, paragraph 140, to disclose information about (a) the key assumptions concerning the future, and (b) other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

11.36 The importance of these disclosures in the context of private sector forests has been examined by PricewaterhouseCoopers (2009). They conducted a study on the application of the fair value requirements of IAS 41 to standing timber, and related disclosure practices. They noted that often the reasons for the fair valuation approach selected are not explicitly discussed in the financial statements, meaning that users may not appreciate the judgments and related uncertainties that are inherent in the valuation of forest assets. The report concluded that there is room for further improvement with regard to the level of the transparency of critical valuation assumptions especially given that the overwhelming majority of standing timber valuations are site specific.

Transitional Provisions

11.37 Entities applying IPSAS 27 for the first time are given relief from the usual retrospective application requirements in IPSAS 3. IPSAS 27 requires that the effect of the initial recognition of biological asset or agricultural produce be treated as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which IPSAS 27 is first adopted.

Relevance to the Cash Basis of Accounting

11.38 The issues identified in this Chapter are relevant for entities intending to provide additional disclosures on the nature and amount of biological assets as encouraged by the Cash Basis IPSAS. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the statement of cash receipts and payments.

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Appendix

Accounting Policies

This Appendix illustrates accounting policies for selected biological assets that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The policies are not comprehensive.

Inventories

Wool on hand is valued at fair value less estimated costs to sell at time of harvest.

For policies on other types of inventory refer to Chapter 6.

Livestock

Livestock are measured at their fair value less costs to sell. The fair value of livestock is based on market prices of livestock of similar age, breed, sex, and generic merit. Where meaningful market-determined prices do not exist to assess the fair value of the group’s other biological assets, the fair value is determined based on the net present value of expected cash flows, discounted at appropriate current market-determined pre-tax rates Changes in the value of existing productive livestock and the numbers and/or composition of the livestock are treated as revenue items.

Milk

Milk is initially measured at its fair value less costs to sell at the time of milking. The fair value of milk is determined based on market prices in the local area.

Forestry Assets

Forestry assets are valued on the basis of fair value less estimated costs to sell. Fair value is determined based on the present value of expected net cash flows discounted at a current market determined pre-tax rate. Forestry Assets are revalued annually by an independent valuer. Valuation movements pass through the statement of financial performance. The costs to maintain the forestry assets are included in the statement of financial performance.

Fish

The valuation of biomass is carried out for each operating region. Estimated biomass (kg) is multiplied by estimated prices; prices which would be received by the farms assuming that all fish were sold at market index prices less cost to point of sale at the end of the period. Market index prices are published market statistics on prices achieved on actual sales in the key markets in which the entity operates. In valuing immature fish, index prices for mature fish are used with a weight adjustment to reflect differences to mature, harvestable fish. It is assumed in the calculations that all fish in inventory could be sold without affecting market prices.

Chapter 12:Impairment of Assets

Key Points

- The purpose of reviewing and testing assets for impairment is to ensure that the carrying amount of an asset reported in the statement of financial position does not exceed the asset's recoverable amount or recoverable service amount.
- IPSAS 21, *Impairment of Non-Cash-Generating Assets* and IPSAS 26, *Impairment of Cash-Generating Assets* prescribe requirements for the identification of assets that may be impaired, the impairment testing of assets, and the accounting for impairment losses and the reversal of those losses.
- On initial adoption of IPSAS 21 and IPSAS 26 an entity needs to identify the assets that are subject to those standards, develop appropriate policies and procedures, and apply those policies and procedures.
- The ongoing monitoring of asset impairment depends on the type of asset. Some assets are subject to annual review for indicators of impairment. Others are subject to annual impairment testing.
- Other IPSASs such as IPSAS 31 also establish requirements in relation to the frequency of impairment testing for specific assets.

Introduction

12.1 With the adoption of accrual accounting, financial reports will include a statement of financial position. With the carrying value of assets reported on the statement of financial position, more attention may be paid to whether or not the carrying amounts reported are recoverable.

12.2 This Chapter discusses the process required to be followed in reviewing and testing assets for impairment. The purpose of reviewing and testing assets for impairment is to ensure that the carrying amount of an asset reported in the statement of financial position does not exceed the asset's recoverable amount or recoverable service amount.

12.3 IPSAS 21 and IPSAS 26 prescribe the procedures that an entity applies to determine whether an asset is impaired and to ensure that impairment losses are recognized. IPSAS 21 and IPSAS 26 also specify when an entity should reverse impairment losses and prescribe disclosures.

Definitions

12.4 IPSAS 21 and IPSAS 26 establish a number of definitions including the following key terms:

An *impairment* is a loss in the future economic benefits or service potential of an asset, over and above the systematic recognition of the loss of the asset's future economic benefits or service potential through depreciation or amortization.

Cash-generating assets are defined as assets held with the primary objective of generating a commercial return.

A *cash-generating-unit* is defined as the smallest identifiable group of assets held with the primary objective of generating a commercial return that generates cash inflows from continuing use that are largely independent of the cash inflows from other assets or groups of assets.

Non-cash-generating-assets are defined as assets other than cash-generating assets.

The *carrying amount* of an asset is defined as the amount at which an asset is recognized in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses thereon.

Depreciation (amortization) is the systematic allocation of the depreciable amount of an asset over its useful life.

An *impairment loss of a cash-generating asset* is defined as the amount by which the carrying amount of an asset exceeds its recoverable amount.

The *recoverable amount* of an asset or a cash-generating unit is defined as the higher of its fair value less costs to sell and its value in use.

Fair value less costs to sell is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.

Value in use of a cash-generating asset is defined as the present value of the estimated future cash flows expected to be derived from the continuing use of an asset and from its disposal at the end of its useful life.

An *impairment loss of a non-cash-generating asset* is defined as the amount by which the carrying amount of an asset exceeds its recoverable service amount.

The *recoverable service amount* of a non-cash-generating asset is defined as the higher of the asset's fair value less costs to sell and its value in use.

Value in use of a non-cash-generating asset is defined as the present value of the asset's remaining service potential.

Summary of IPSAS 21 and IPSAS 26

12.5 IPSAS 21 and IPSAS 26 provide requirements for the identification of assets that may be impaired, the impairment testing of assets and the accounting for impairment losses and the reversal of those losses.

12.6 There are a number of assets that are excluded from the scope of IPSAS 21 and/or IPSAS 26. Assets that do not need to be reviewed and/or tested for impairment in accordance with IPSAS 21 or IPSAS 26 include:

(a) Property, plant and equipment and intangible assets that are regularly revalued in accordance with the revaluation models in IPSAS 17 and IPSAS 31;

(b) Investment property that is measured using the fair value model; and

(c) Assets arising from construction contracts (see IPSAS 11), inventories within the scope of IPSAS 12 and financial assets within the scope of IPSAS 29.

12.7 Despite these exclusions there are still a number of assets that need to be reviewed for possible indication of impairment and/or tested for impairment in accordance with IPSAS 21 or IPSAS 26. Impairment requirements for some assets are covered partly in the IPSAS dealing with such assets and partly in the impairment standards. For example, IPSAS 21 and IPSAS 26 contain specific requirements for testing intangible assets for impairment, and for recognizing and measuring impairment losses related to intangible assets. The requirements in IPSAS 21 and IPSAS 26 complement the requirements of IPSAS 31. Intangible assets measured at cost are included in the scope of IPSAS 21 or IPSAS 26 as appropriate and should be tested for impairment according to the requirements of those standards.

12.8 With the exception of intangible assets with an indefinite useful life or intangible assets that are not yet available for use, an entity is required to assess at each reporting date whether there is any indication that an asset may be impaired (or whether an impairment loss recognized in a prior reporting period may have reversed or reduced). In assessing whether there is any indication of impairment (or that an previous impairment might have reversed) an entity is required to consider, as a minimum, indications such as:

(a) Significant changes in the demand or need for services provided by the asset;

(b) Significant changes taking place or expected to take place in the technological, legal, or government policy environment in which the entity operates;

(c) Evidence of physical damage of an asset;

(d) Significant changes in the extent to which, or manner in which, an asset is used or is expected to be used;

(e) A decision to halt the construction of an asset before it is complete or in a usable condition or a decision to resume construction of an asset that was previously halted; and

(f) Evidence from internal reporting indicating that service performance of an asset is, or will be, significantly different from that previously expected.

12.9 This list of indications is not exhaustive—there may be other indications of impairment or indicators that impairments should be reversed.

12.10 Where there is an indication that an asset may be impaired, or that a previous impairment loss may have reversed or been reduced, an entity is required to determine the recoverable amount of the asset. Intangible assets with an indefinite useful life or intangible assets that are not yet available for use must be tested for impairment annually As such, their recoverable amount must be estimated annually regardless of whether or not there are any indications of impairment.

12.11 The recoverable amount of a cash-generating asset or the recoverable service amount of a non-cash generating asset is the higher of an asset’s fair value less costs to sell and its value in use. Where there is no reason to believe that an asset’s value in use materially exceeds its fair value less costs to sell, the asset’s fair value less costs to sell may be used as its recoverable amount.

12.12 The estimation of value in use of a cash-generating asset involves the estimation of the future cash flows derived from continuing use of the asset and from its ultimate disposal and the application of an appropriate discount rate to those cash flows. The estimation of value in use of a non-cash-generating asset involves estimating the present value of the asset's remaining service potential. The present value of the remaining service potential of the asset is determined using any one of the following approaches as appropriate:

(a) **Depreciated Replacement Cost Approach**: Under this approach, the present value of the remaining service potential of an asset is determined as the depreciated replacement cost of the asset.

(b) **Restoration Cost Approach**: Restoration cost is the cost of restoring the service potential of an asset to its pre-impaired level. Under this approach, the present value of the remaining service potential of the asset is determined by subtracting the estimated restoration cost of the asset from the current cost of replacing the remaining service potential of the asset before impairment.

(c) **Service Units Approach**: Under this approach, the present value of the remaining service potential of the asset is determined by reducing the current cost of the remaining service potential of the asset before impairment to conform with the reduced number of service units expected from the asset in its impaired state.

12.13 Where the recoverable amount of a cash-generating asset or the recoverable service amount of a non-cash-generating asset is less than its carrying amount, the carrying amount of the asset is reduced to its recoverable amount or recoverable service amount. The amount of that reduction is recognized as an impairment loss in the statement of financial performance.

12.14 In respect of cash-generating assets there are occasions when the recoverable amount of an individual asset cannot be determined for the asset on its own. In such cases, the recoverable amount can be determined only for the asset's cash-generating unit being the smallest group of assets (including the asset being considered for impairment) that generates cash inflows that are largely independent of the cash flows from other assets or cash-generating units. An impairment loss is recognized for a cash-generating unit where its recoverable amount is less than the carrying amount of that unit. The impairment loss is allocated to reduce the carrying amount of the assets of the unit on a pro rata basis.

12.15 Non-cash-generating assets may contribute service potential to cash-generating units. In such cases, a proportion of the carrying amount of that non-cash-generating asset is allocated to the carrying amount of the cash-generating unit prior to estimation of the recoverable amount of that cash-generating unit.

12.16 Where an asset's recoverable amount has increased since the last impairment loss was recognized, and certain conditions are met, there is a reversal of that impairment loss and the carrying amount of the asset is increased to its recoverable amount. However, the carrying amount cannot be increased above the carrying amount that would have been determined (net of amortization or depreciation) had no impairment loss been recognized in prior reporting periods. The amount of the reversal is recognized immediately in the statement of financial performance.

12.17 Subsequent to recognizing an impairment loss or reversing an impairment loss, an entity must also recognize the depreciation or amortization period and method used.

12.18 A redesignation of an asset from a cash-generating asset to a non-cash-generating asset, or from a non-cash-generating asset to a cash-generating asset, is only made when there is clear evidence that such a redesignation is appropriate. At the subsequent reporting date after a redesignation, an entity reviews, as a minimum, the listed indications appropriate to the asset after redesignation.

12.19 Disclosures are required in respect of the following:

(a) Criteria developed by the entity to distinguish cash-generating assets from non-cash-generating assets;

(b) Details of events or circumstances that led to the recognition or reversal of impairment losses;

(c) For each class of asset, details of impairment losses recognized, and reversals of impairment losses recognized in surplus or deficit;

(d) If an entity reports segment information in accordance with IPSAS 18, *Segment Reporting*, details regarding impairment losses recognized or reversed by segment;

(e) Details of material impairment losses recognized or reversed for cash-generating assets or cash-generating units including detailed information in respect of those assets and cash-generating units; and

(f) Detailed information regarding estimates used to measure recoverable amounts of cash-generating units containing intangible assets with indefinite useful lives including assumptions, approaches to determining recoverable amounts, and sensitivity analyses of certain estimates.

12.20 Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Considerations when Implementing IPSAS 21 and IPSAS 26

Initial Implementation

12.21 Some entities may change from cash accounting to accrual accounting in one step. Others may adopt accrual accounting in phases.

12.22 If an entity adopts accrual accounting in one step, the carrying amounts at which it first recognizes its assets may already reflect the fact that the asset has been impaired in the past. If this is the case, the entity may not need to review and or test its assets for impairment initially. However the entity will still need to be prepared for ongoing review and/or testing of assets for impairment at the end of the initial reporting period following adoption of accrual accounting and for each subsequent reporting period. Therefore, the entity will need to:

(a) Identify the classes of assets that fall within the scope of IPSAS 21 or IPSAS 26;

(b) Classify assets falling within the scope of IPSAS 21 or IPSAS 26 – assets need to be classified as cash-generating or non-cash-generating;

(c) Determine the cash-generating units to which the cash-generating assets belong and, if necessary, determine the cash-generating units to which non-cash-generating assets need to be allocated;

(d) Gather the information required to disclose the required information; and

(e) Record the process followed to begin implementation of IPSAS 21 and IPSAS 26 as well as the outcome of the process followed. This information will be included in the working papers for the entity's financial statements for review by the entity's auditors.

12.23 If an entity is adopting IPSAS 21 and IPSAS 26 for the first time; or if an entity adopts accrual accounting in phases, and has recognized assets in one phase but adopts IPSAS 21 and IPSAS 26 in a subsequent phase, the entity will need will need to:

(a) Identify the classes of assets that fall within the scope of IPSAS 21 or IPSAS 26;

(b) Classify assets falling within the scope of IPSAS 21 or IPSAS 26 – assets need to be classified as cash-generating or non-cash-generating;

(c) Determine the cash-generating units to which the cash-generating assets belong and, if necessary, determine the cash-generating units to which non-cash-generating assets need to be allocated;

(d) Carry out an initial review of assets for indications of impairment;

(e) If there are any indications of impairment identified, carry out initial impairment testing and consider whether the remaining useful life, the depreciation (amortization) method, or the residual value for the asset needs to be reviewed and adjusted;

(f) Carry out impairment testing of intangible assets that have indefinite useful lives or intangible assets that are not yet available for use;

(g) Gather the information required to disclosure the required information; and

(h) Record the process followed to implement IPSAS 21 and IPSAS 26 and the outcome of that initial implementation as part of the working papers supporting initial adoption of accrual accounting or supporting the financial statements for review by the entity's auditors.

Ongoing Compliance

12.24 Following initial implementation of IPSAS 21 or IPSAS 26 the entity needs to establish a process for complying with the requirements of IPSAS 21 and IPSAS 26 over the life of assets. These requirements are generally annual, but may be required more frequently An entity will need to:

(a) Review assets for indications of impairment at least annually;

(b) If there are indications that assets may be impaired, test assets for impairment by determining their recoverable amounts or recoverable service amounts to determine whether or not an impairment loss should be recognized (or whether or not an impairment loss recognized in a prior reporting period should be reversed). Also, consider whether the remaining useful life, the depreciation (amortization) method, or the residual value for the asset needs to be reviewed and adjusted;

(c) Test for impairment intangible assets that have indefinite useful lives or intangible assets that are not yet available for use at least annually by determining their recoverable amounts or recoverable services amounts;

(d) Where an impairment losses is recognized or reversed, reconsider whether or not the asset's depreciation or amortization method or period remain appropriate;

(e) Gather information required to comply with the disclosure requirements; and

(f) Document the review of assets for indications of impairment, impairment testing carried out, and information gathered in support of the disclosure requirements as part of the working papers supporting the annual financial statements for review by the entity's auditors.

Decision Tree

12.25 Included in Appendix A to this Chapter is a Decision Tree that summarises the process to be followed and the decisions to be made in complying with IPSAS 21 and IPSAS 26.

System Requirements

12.26 An entity may need to:

(a) Establish a system for ongoing review for possible indications of impairment. Depending on the size and structure of the reporting entity, this could entail individuals completing a checklist of possible indications of impairment, considering any other possible indications of impairment, and documenting their assessment and conclusion;

(b) Establish an approach to determining the recoverable amount or recoverable service amount of assets required to be tested for impairment. This may require a significant amount of approximation and estimation;

(c) Maintain records of the amount of impairment losses recognized (or reversed) separate from the usual depreciation or amortization and accumulated depreciation or amortization accounts. This is because the reversal of an impairment loss recognized in a prior reporting period is restricted. The reversal of an impairment loss cannot increase an asset's carrying amount above that which would have been determined (net of depreciation or amortization) had no impairment occurred;

(d) Modify its existing asset system to allow for possible changes in the depreciation or amortization method, or review period, of assets for which impairments are recognized or reversed;

(e) Maintain records of review of assets for indications of impairment and impairment tests carried out; and

(f) Maintain records of information required to be disclosed in the financial statements.

Areas of Approximation and Uncertainty

12.27 Areas that may require the exercise of significant judgment include:

(a) Determining an asset's value in use: For cash-generating assets, the estimation of value in use involves the estimation of the future cash flows derived from continuing use of the asset and from its ultimate disposal and the application of an appropriate discount rate to those cash flows. The discount rate is a pre-tax rate that reflects current market assessments of the time value time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.

(b) For non-cash-generating assets, the estimation of value in use involves the estimation of the present value of the future service potential derived from continuing use of the asset and from its ultimate disposal. The present value of an asset's remaining service potential is determined using any one of the approaches identified above namely: the Depreciated Replacement Cost Approach; the Restoration Cost Approach; or the Service Units Approach.

(c) Determining an asset's fair value less costs to sell: The best evidence of an asset's fair value less costs to sell is its price in a binding sale agreement in an arm's length transaction. If there is no binding sale agreement but the asset is traded in an active market, fair value less cost to sell is estimated based on the market price of the asset. If there is no binding sale agreement and no active market for the asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain from the disposal of the asset in an arm's length transaction.

Transitional Provisions

12.28 IPSAS 21 may be applied prospectively. Impairment losses (reversals of impairment losses) that result from adoption of IPSAS 21 are recognized in net surplus or deficit.

12.29 IPSAS 26 is applied retrospectively in accordance with IPSAS 3.

Relevance to the Cash Basis of Accounting

12.30 The issues identified in this Chapter are not generally relevant for entities using the cash basis of accounting unless an entity intends to provide additional note disclosures of certain assets measured in accordance with IPSASs.

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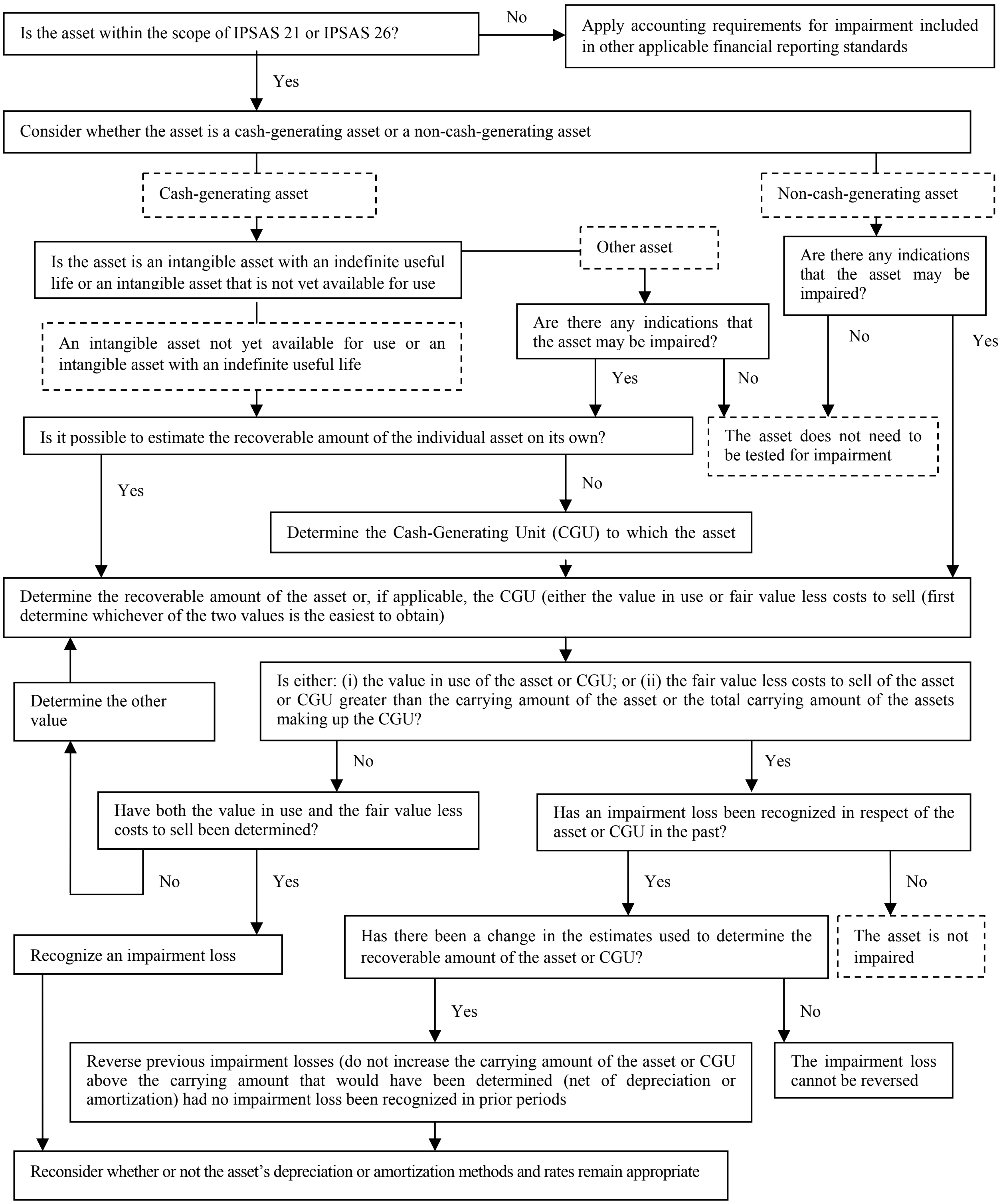
Appendix A

Decision Tree—Impairment of Assets

The Decision Tree below summarizes the process required to be followed and the decisions required to be made in complying with IPSAS 21 and IPSAS 26.



Appendix B

Accounting Policies

This Appendix illustrates an example of accounting policies for impairment that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity.

Chapter 13 *Financial Instruments* discusses accounting policy issues relating to impairment of financial instruments.

Impairment of Assets

Assets that have a finite useful life are reviewed for indicators of impairment at each reporting date. When there is an indication that an asset may be impaired, the asset is tested for impairment. Assets carried at revalued amounts are not reviewed or tested for impairment. Other than goodwill, intangible assets that have an indefinite useful life, or are not yet available for use, are not subject to amortization and are tested annually for impairment.

For purposes of impairment testing, assets are classified as either cash-generating or non-cash-generating. Assets held with the primary objective of generating a commercial return are classified as cash-generating assets. All other assets are classified as non-cash-generating assets.

For the purposes of assessing impairment, cash-generating assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). To test a cash-generating asset or cash-generating unit for impairment, its recoverable amount is estimated and compared with its carrying amount. The recoverable amount is the higher of its fair value less costs to sell and its value in use. The value in use is determined as the present value of expected future cash flows.

To test a non-cash-generating asset for impairment its recoverable service amount is estimated and compared with its carrying amount. The recoverable service amount is the higher of its fair value less costs to sell and its value in use. The value in use is the present value of remaining service potential of the asset.

An impairment loss is recognized for the amount by which the carrying amount of the asset or cash-generating unit exceeds its recoverable amount. Any impairment loss is recognized in the statement of financial performance.

Assets that have suffered an impairment loss in prior reporting periods are reviewed for possible reversal of the impairment at each reporting date. Any reversal of an impairment loss is recognized in the statement of financial performance.

Chapter 13: Financial Instruments

Key Points

- In January 2010 the IPSASB issued three new standards dealing with the presentation, recognition and measurement, and disclosure of financial instruments. These standards are IPSAS 28, *Financial Instruments: Presentation,* IPSAS 29, *Financial Instruments: Recognition and Measurement* and IPSAS 30, *Financial Instruments: Disclosures.* The effective date for all three standards is January 1, 2013. The standards are closely based on the equivalent IFRSs, being IAS 32, IAS 39 and IFRS 7.
- IPSAS 15, *Financial Instruments: Disclosure and Presentation*, the first IPSAS dealing with financial instruments, remains applicable until IPSAS 28 and IPSAS 30 are applied or become effective, whichever is earlier. The requirements of IPSAS 15 are discussed in an Appendix to this Chapter.
- This Chapter focuses on the requirements of IPSASs 28-30 and the implications for entities proposing to adopt these standards.
- IPSAS 28 prescribes principles for classifying and presenting financial instruments as liabilities or net assets/equity, and for offsetting financial assets and liabilities. It addresses financial guarantee contracts, contractual and non-contractual arrangements, issuer classification of financial instruments, puttable instruments, treasury shares, and members' shares in co-operative entities.
- IPSAS 29 has been written to establish principles for recognizing, derecognizing, and measuring financial assets and financial liabilities. The standard covers recognition in the statement of financial position, initial and subsequent measurement, concessionary loans, financial guarantee contracts, derecognition, and hedge accounting.
- IPSAS 30 prescribes disclosures that enable financial statement users to evaluation the significance of financial instruments to an entity, the nature and extent of the risks of those financial instruments, and how the entity manages the risks. Disclosure requirements include:
  - Information about financial assets and financial liabilities addressing by category, special disclosures when the fair value option is used, reclassifications, derecognitions, pledges of assets, embedded derivatives, and breaches of terms of agreements;
  - Disclosing addressing the performance of the entity during the period, including information about recognized revenue, expenses, gains and losses; interest revenue and expense; fee revenue, and impairment losses;
  - Disclosures around concessionary loans;
  - Information and accounting policies, hedge accounting, and the fair values of each class of financial assets and financial liabilities; and
  - Qualitative and quantitative disclosures about exposures to risks and the management of those risks.
- The International Accounting Standards Board (IASB) is developing new financial reporting requirements for financial instruments. The IPSASB is monitoring this work.

Introduction

13.1 The development of IPSASs 28–30 was a key component of IPSASB's convergence program. In developing these standards the IPSASB made relatively few changes to the requirements of the underlying IASB standards. Some of the key areas where public sector modifications were considered appropriate are noted in the relevant section on each standard. Prior to the development of these standards IPSAS 15 provided only limited guidance on accounting for financial instruments and entities applying IPSASs were required to use hierarchy of guidance in IPSAS 3 when developing accounting policies on the recognition and measurement of financial instruments.

13.2 This Chapter outlines the requirements in IPSAS 28–30 and explains the steps that an entity choosing to comply with these standards would need to work through. It is unlikely that most government departments or individual public sector entities will have to account for and make disclosure of the more complex instruments that IPSASs 28–30, were written to cater for. Generally, only central agencies responsible for an entity's treasury functions will need to apply the more challenging aspects of IPSAS 29. The implications of these requirements are outlined in the implementation section below.

13.3 The IASB has an active project to revise the requirements of IAS 39. The IPSASB is monitoring the IASB's work on financial instruments and, once the IASB's project is complete, will consider the appropriateness of these new requirements for public sector entities. The effective dates of IPSASs 28–30 are for annual financial statements covering periods beginning on or after January 1, 2013. This date is intended to give entities time to consider alternative adoption strategies. A brief discussion of the IASB's project is included in this Chapter.

Islamic Financial Services

13.4 IPSASs do not specifically address issues associated with Islamic financial services. For example, although the presentation requirements of IPSAS 28 may apply to a range of contracts or components of contracts that arise within Islamic law, the requirements of IPSAS 30 regarding disclosure of interest will not be relevant to such contracts. The Accounting and Auditing Organization for Islamic Financial Institutions prepares accounting standards for Islamic financial institutions. These standards are regarded as complementing other financial reporting standards.

Summary of IPSAS 28

13.5 This section outlines key requirements of IPSAS 28 in relation to the presentation and classification of financial instruments. It is not a comprehensive discussion of the requirements of the Standard.[35] In addition, the key public sector modifications made to the requirements of IAS 32 when developing IPSAS 28 are noted.

13.6 IPSAS 28 establishes principles for presenting financial instruments as liabilities or equity, and for offsetting financial assets and liabilities.

[35] Summaries of IPSASs requirements are also available in (Deloitte, 2010).

13.7 IPSAS 28 applies to all financial instruments except for those specifically excluded by the Standard. The definition of financial instruments is therefore critical in applying the Standard.

Definitions

13.8 IPSAS 28 establishes a number of definitions including the definitions of financial instruments, financial asset and financial liability which are set out below. The paragraph references in the definitions are to the body of the Standard.

A *financial instrument* is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

(a) Cash;

(b) An equity instrument of another entity;

(c) A contractual right:

(i) To receive cash or another financial asset from another entity; or

(ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

(d) A contract that will or may be settled in the entity's own equity instruments and is:

(i) A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that is:

A contractual obligation:

(iii) To deliver cash or another financial asset to another entity; or

(iv) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or

(e) A contract that will or may be settled in the entity's own equity instruments and is:

(i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 15 and 16, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 17 and 18, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraph 15 and 16 or paragraphs 17 and 18.

13.9 Although these definitions encompass complex instruments created by financial corporations, they also include very common items such as loans and receivables. Most public sector entities will therefore have some financial instruments.

Contractual and Non-Contractual Arrangements (and Non-Exchange Revenue Transactions)

13.10 The definitions of financial instruments, financial asset, and financial liability refer to contracts, contractual rights, and contractual obligations. In applying IPSAS 28 it is therefore important to decide whether assets and liabilities arise out of contractual or non-contractual arrangements as this affects whether they fall within the scope of the Standard. IPSAS 28 provides guidance on whether assets and liabilities (including non-exchange arrangements) arise out of contractual or non-contractual arrangements. Assets and liabilities arising out of non-contractual arrangements are outside the scope of IPSAS 28.

13.11 In developing IPSAS 28 the IPSASB considered whether non-exchange revenue transactions can give rise to financial assets and financial liabilities. In the Basis for Conclusions on IPSAS 28 the IPSASB concluded that:

(a) Assets arising from non-exchange revenue transactions could be financial assets; and

(b) Liabilities arising from non-exchange revenue transactions are not generally financial liabilities. However, the IPSASB acknowledged that there may be rare instances where such transactions may give rise to financial liabilities and suggested that consideration of such issues could be considered in a future project.

13.12 The IPSASB acknowledged one example where a non-exchange revenue transaction could give rise to a financial liability. This is where one entity transfers funds to another entity, with a condition that those funds are to be forwarded to particular groups of people.

Financial Guarantee Contracts

13.13 One of the scope exceptions in IPSAS 28 permits financial guarantee contracts to be accounted for as insurance contracts so long as the issuer elects to do so and uses accounting applicable to insurance contracts (IPSAS 28, paragraph AG8).[36] Financial

[36] This scope exception also occurs in IPSAS 29 and 30.

guarantee contracts are those contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. An entity uses the application guidance in IPSAS 28 to determine whether a financial guarantee is a contract or not. An entity may also apply IPSAS 28 to insurance contracts which involve the transfer of financial risk.

Classification as Liabilities or Net Assets/Equity

13.14 IPSAS 28 prescribes principles for classifying and presenting financial instruments as liabilities or net assets/equity. Although a considerable portion of the Standard is devoted to this issue, many public sector entities will have liabilities only and will not be required to make judgments on this classification issue.

Interest and Dividends

13.15 The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends or similar distributions, losses, and gains relating to that instrument are recognized as revenue or expense in surplus or deficit. IPSAS 28 requires that interest, dividends or similar distributions, losses, and gains relating to a financial instrument or a component that is a financial liability be recognized as revenue or expense in surplus or deficit. Distributions to holders of an equity instrument are recognized as a reduction in net assets/equity in the statement of financial position.

Offsetting

13.16 IPSAS 28 limits the circumstances in which financial assets and liabilities may be offset. A financial asset and a financial liability may be offset and reported as a net amount when, and only when, an entity has a legally enforceable right to set off the amounts, and intends either to settle on a net basis or simultaneously.

Summary of IPSAS 29

13.17 This section outlines key requirements of IPSAS 29 in relation to the recognition and measurement of financial instruments. It is not a comprehensive discussion of the requirements of the Standard. In addition, the key public sector modifications made to the requirements of IAS 39 when developing IPSAS 29 are noted.

13.18 IPSAS 29 establishes principles for recognizing and measuring financial assets, financial liabilities, and some contracts to buy or sell non-financial items.

13.19 The objective of IPSAS 29 is to establish principles for recognizing and measuring financial assets, financial liabilities, and some contracts to buy or sell non-financial items.

Initial Recognition

13.20 An entity shall recognize a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. All financial assets and financial liabilities, including all derivatives and certain embedded derivatives that meet this requirement, are recognized in the statement of financial position.

Derecognition of a Financial Liability

13.21 An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Initial Measurement of Financial Assets and Financial Liabilities

13.22 When a financial asset or financial liability is recognized initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss (surplus or deficit), transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

13.23 An entity has an option of recognizing normal purchases and sales of securities in the market place consistently either at trade date or settlement date. If settlement-date accounting is used, IPSAS 29 requires recognition of certain value changes between trade and settlement dates.

Derecognition of a Financial Asset

13.24 IPSAS 29 establishes conditions for determining when a financial asset must be removed from the statement of financial position. It requires that an entity shall derecognize a financial asset when the contractual rights to the cash flows from the financial asset expire, or when the asset is transferred. The requirements in IPSAS 29 relating to the transfer of a financial asset are very detailed and can be difficult to achieve.

Subsequent Measurement of Financial Assets

13.25 For the purpose of measuring a financial asset after initial recognition, IPSAS 29 classifies financial assets into the following four categories:

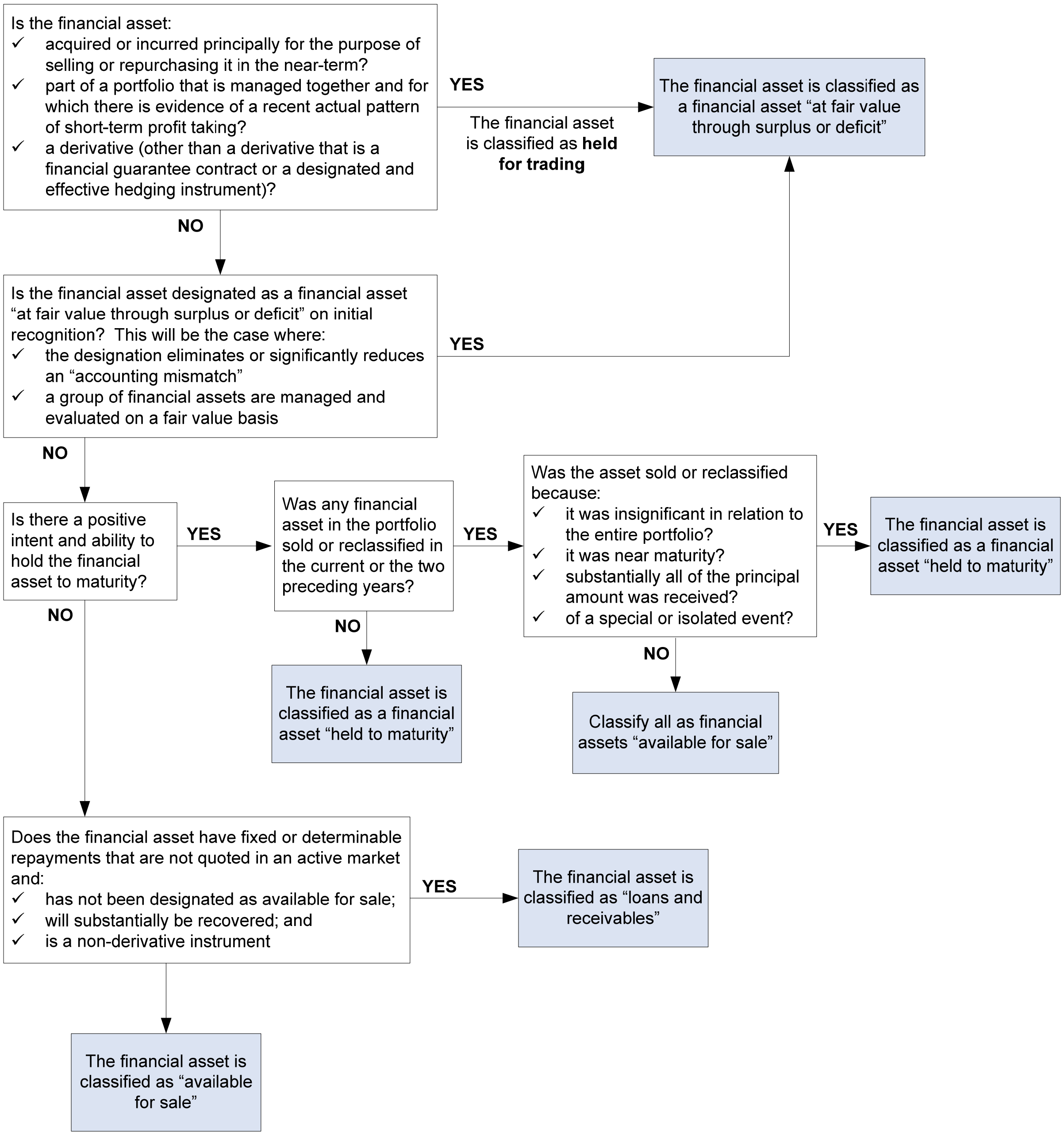
(a) Financial assets at fair value through surplus or deficit;

(b) Held-to-maturity investments;

(c) Loans and receivables; and

(d) Available-for-sale financial assets.

13.26 The decision tree below illustrates the classification of financial assets into the various categories in IPSAS 28.



13.27 An entity may designate a financial asset or financial liability (or a group of financial assets, financial liabilities, or both) on initial recognition as one(s) to be measured at fair value, with changes in fair value recognized in surplus/deficit. To impose discipline on this categorization, an entity is precluded from reclassifying financial instruments into or out of this category.

13.28 After initial recognition, an entity shall measure most financial assets (specific exceptions are discussed below), including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. IPSAS 29 establishes requirements on how to determine fair value. It states that the best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. A fair value hierarchy for determining fair value is set out in the Application Guidance forming part of IPSAS 29.

13.29 Financial assets for which there are specific measurement requirements in IPSAS 29 are:

(a) Loans and receivables, which shall be measured at amortized cost using the effective interest method;

(b) Held-to-maturity investments, which shall be measured at amortized cost using the effective interest method; and

(c) Investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which shall be measured at cost.

13.30 The table below sets out the measurement principles for the categories of financial assets.

Category	**Initial measurement**		**Subsequent measurement**
	First time adoption	**Subsequent periods**	
At fair value through surplus or deficit	Fair value (excluding transaction costs)	Fair value	Fair value
Loans and receivables	Fair value plus transaction costs	Fair value plus transaction costs	Amortized cost
Held-to-maturity	Fair value plus transaction costs	Fair value plus transaction costs	Amortized cost
Available for sale	Fair value plus transaction costs	Fair value plus transaction costs	Fair value

13.31 Financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements in IPSAS 29. All financial assets, except those measured at fair value through surplus or deficit, need to be regularly reviewed for impairment.

Subsequent Measurement of Financial Liabilities

13.32 After initial recognition, an entity shall measure all financial liabilities at amortized cost using the effective interest method, except for:

(a) Financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured, which shall be measured at cost;

(b) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Specific requirements apply to the measurement of such financial liabilities;

(c) Financial guarantee contracts. After initial recognition, an issuer of such a contract shall measure it at the higher of:

(i) The amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (the equivalent IPSAS is IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*);

(ii) The amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9, *Revenue from Exchange Transactions*); and

(d) Commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall measure it at the higher of (i) the amount determined in accordance with IPSAS 19; and (ii) the amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.

13.33 The table below sets out the measurement principles for the categories of financial liabilities.

Category	**Initial measurement**		**Subsequent measurement**
	First time adoption	**Subsequent periods**	
At fair value through surplus or deficit	Fair value (excluding transaction costs)	Fair value (excluding transaction costs)	Fair value
Other financial liabilities	Fair value less transaction costs	Fair value less transaction costs	Amortized cost

Measurement of Concessionary Loans

13.34 IPSAS 29 provides guidance on accounting for concessionary loans. Concessionary loans are loans granted to or received by an entity on below market terms. The requirement to initially measure financial assets and financial liabilities also applies to concessionary loans received by an entity (a liability) and concessionary loans granted by an entity (an asset). However, in the case of concessionary loans there is a difference between the fair value of the concessionary loan and the loan proceeds. The splitting of a transaction such as a concessionary loan into exchange and non-exchange components is critical. The exchange component is subject to the recognition and measurement requirements in IPSAS 29.

13.35 In the case of a concessionary loan received by an entity, any difference between the fair value of the loan and the transaction price (the loan proceeds) is accounted for in accordance with IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)*. The exchange component is recognized and initially measured in accordance with IPSAS 29.

13.36 In the case of a concessionary loan granted by an entity, IPSAS 29 requires that the difference between the fair value of the loan and the transaction price (the loan proceeds) be treated as an expense. The exception is where a concessionary loan granted is, in substance, a transaction with owners in their capacity as owners.

13.37 After initial recognition, concessionary loans received or granted are measured in accordance with the requirements in IPSAS 29.

Measurement of Financial Guarantees Issued Through a Non-Exchange Transaction

13.38 IPSAS 29 also provides guidance on the initial and subsequent measurement of contractual financial guarantees issued through a non-exchange transaction. At initial recognition, where no fee is charged or where the consideration is not fair value, an entity firstly considers whether there are quoted prices available in an active market for financial guarantee contracts directly equivalent to that entered into. Where there is no active market for a directly equivalent guarantee contract; the entity considers whether a valuation technique other than observation of an active market is available and provides a reliable measure of fair value.

13.39 Where a fair value is obtainable either by observation of an active market or through another valuation technique, the entity recognizes the financial guarantee at that fair value in the statement of financial position and recognizes an expense of an equivalent amount in the statement of financial performance. If no reliable measure of fair value can be determined, either by direct observation of an active market or through another valuation technique, an entity is required to apply the principles of IPSAS 19 to the financial guarantee contract at initial recognition.

13.40 Subsequent measurement should be at the higher of the amount determined in accordance with IPSAS 19 and the amount initially recognized, less, when appropriate, cumulative amortization recognized in accordance with IPSAS 9.

Gains and Losses

13.41 A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship shall be recognized, as follows.

(a) A gain or loss on a financial asset or financial liability classified as at fair value through surplus or deficit shall be recognized in surplus or deficit.

(b) A gain or loss on an available-for-sale financial asset shall be recognized in net assets/equity, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognized. At that time the cumulative gain or loss previously recognized in net assets/equity shall be reclassified from equity to surplus or deficit as a reclassification adjustment. However, interest calculated using the effective interest method is recognized in surplus or deficit. Dividends on an available-for-sale equity instrument are recognized in surplus or deficit when the entity’s right to receive payment is established.

13.42 For financial assets and financial liabilities carried at amortized cost a gain or loss is recognized in surplus or deficit when the financial asset or financial liability is derecognized or impaired, and through the amortization process. However, for financial assets or financial liabilities that are hedged items the accounting for the gain or loss shall follow the requirements summarized below.

Impairment and Uncollectability of Financial Assets

13.43 An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired.

Discount Rates

13.44 Financial assets are initially measured at fair value. To calculate fair value for non current financial assets such as long term loans or receivables with no stated interest, fair value is usually derived by using a discounted cash flow method. Fair value under this method is the present value of all future cash receipts discounted using the prevailing market rate of interest for a similar instrument with a similar credit rating, and issue at a similar time.

13.45 The subsequent measurement of financial assets may be at fair value or at amortized cost as discussed above. The discount rate for financial assets at fair value will not be amended unless impairment is suspected. This is covered below. Financial assets measured subsequently at amortized cost are measured using the effective interest rate, which is the rate that exactly discounts estimated future cash payments or receipts through the financial instrument's expected life (or if appropriate a shorter period), to the net carrying amount of the financial asset. To calculate the effective interest rate, an entity should estimate cash flows considering all the financial instrument's contractual terms, but should not consider future credit losses.

13.46 When a financial asset is considered to be impaired, it is evidenced by a fall in the cash flows expected to be generated, discounting at a rate of interest that reflects a current market rate of interest would impose fair value measurement on the financial asset. This is appropriate for financial assets measured at fair value, but not for those measured at amortized cost. The historical effective rate should be used as the discount rate even in instances where it is lower or higher than the rate on current loans originated by the entity. That is, loan impairments are based only on the reduction in the estimated cash flows, not on changes in interest rates. This means that financial assets carried at amortized cost that become impaired in value continue to be carried in the financial statements at a value that takes into account the present value of all the expected future cash flows, and in a manner that is consistent with the financial asset's measurement prior to the impairment.

13.47 However, there are three specific instances where the original discount rate is not used to measure impairment loss. They are:

(a) In the case of variable rate loans and variable rate held-to-maturity investments, the discount rate used for measuring impairment losses should be the current variable rate that was agreed under the contract.

(b) For financial assets that are reclassified out of the held for trading or available for sale categories, the effective interest rate should be recalculated using the fair value at the date of the reclassification. The new effective interest rate will then be used to calculate the interest income in future periods. It will be considered to be the original effective interest rate when measuring impairment.

(c) With regard to fixed rate loans designated as a hedged item in a fair value hedge of interest rate risk, the loan's carrying amount is adjusted for any changes in its fair value attributable to interest rate movements. Therefore the effective interest rate before the hedge becomes irrelevant and the effective interest rate is recalculated using the loan's adjusted amount. This adjusted effective rate will be used as the rate for discounting the estimated future cash flows for measuring the impairment loss on the hedged loan.

Hedging

13.48 Hedge accounting (recognizing the offsetting effects of both the hedging instrument and the hedged item in the same period's surplus or deficit) is permitted in certain circumstances, provided that the hedging relationship is clearly designated and documented, measurable, and actually effective. If there is a designated hedging relationship between a hedging instrument and a hedged item, accounting for the gain or loss on the hedging instrument and the hedged item is subject to specified requirements in IPSAS 29.

13.49 Hedging relationships are of three types:

(a) Fair value hedge: a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect surplus or deficit.

(b) Cash flow hedge: a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect surplus or deficit.

(c) Hedge of a net investment in a foreign operation as defined in IPSAS 4.

13.50 If a fair value hedge meets the conditions in IPSAS 29 during the period, it shall be accounted for as follows:

(a) The gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* (for a non-derivative hedging instrument) shall be recognized in surplus/deficit; and

(b) The gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized in surplus/deficit. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss (surplus/deficit) applies if the hedged item is an available-for-sale financial asset.

13.51 If a cash flow hedge meets the conditions in IPSAS 29 during the period, it shall be accounted for as follows:

(a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized directly in net assets/equity through the statement of changes in net assets/equity; and

(b) The ineffective portion of the gain or loss on the hedging instrument shall be recognized in surplus or deficit.

13.52 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see IPSAS 4, paragraphs 18 and 19), shall be accounted for similarly to cash flow hedges:

(a) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized directly in net assets/equity through the statement of changes in net assets/equity; and

(b) The ineffective portion shall be recognized in surplus or deficit.

Summary of IPSAS 30

13.53 This section outlines key requirements of IPSAS 30 in relation to financial instrument disclosures. It is not a comprehensive discussion of the requirements of the Standard. In addition, the key public sector modifications made to the requirements of IFRS 7 when developing IPSAS 30 are noted.

13.54 The objective of IPSAS 30 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) The significance of financial instruments for the entity's financial position and performance; and

(b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

13.55 The extent of disclosure required will depend on the extent of an entity's use of financial instruments and of its exposure to risk. For example, a government department whose only financial instruments are accounts receivable and accounts payable will find it easier to comply with IPSAS 30 than an entity responsible for treasury functions within a government or large organization.

13.56 IPSAS 30 requires disclosure of:

(a) The significance of financial instruments for an entity's financial position, financial performance, and cash flows.

(b) Qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk, and market risk. The qualitative disclosures describe management's objectives, policies, and processes for managing those risks. The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. Together, these disclosures are intended to provide an overview of the entity's use of financial instruments and the exposures to risks they create.

13.57 The three types of risks identified within IPSAS 30 are:

(a) **Credit risk**, being the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

(b) **Liquidity risk**, being the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

(c) **Market risk**, being the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk, and other price risk.

13.58 Examples of the disclosures required by IPSAS 30 include:

(a) Disclosures relating to the entity's financial position—including information about financial assets and financial liabilities by category, credit risk associated with financial instruments designated as at fair value through surplus or deficit, reclassification of financial assets, derecognition of financial assets, details of assets pledged as collateral, credit losses recognized in an account separate from the related asset, embedded derivatives, and breaches of terms of agreements;

(b) Disclosures relating to the entity's performance in the period—including information about recognized revenue, expenses, gains and losses; interest revenue and expense; fee revenue; and impairment losses;

(c) A reconciliation between the opening and closing carrying amounts of concessionary loans; and

(d) Other disclosures—including information about accounting policies, hedge accounting, and the fair values of each class of financial asset and financial liability.

13.59 Specific risk disclosures required by IPSAS 30 include:

(a) Credit risk: maximum exposure to credit risk, details of past due and impaired assets, details of assets held as collateral, and the credit quality of financial assets that are neither past due nor impaired;

(b) Liquidity risk: maturity analyses for both non-derivative and derivative liabilities and a description of how an entity manages liquidity risk; and

(c) Market risk: a sensitivity analysis for each type of market risk.

13.60 Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Transition to IPSASs 28, 29 and 30

13.61 Entities that are already using the accrual basis of accounting and transitioning to IPSASs 28, 29 and 30 may find private sector guidance on the equivalent IFRSs useful. Entities making use of such guidance should be aware of the differences between the two sets of standards. Important points to consider include:

(a) The impairment methodology is likely to be different from that used under an entity's previous GAAP. In particular, general provisions are not permitted, and all impairment of debt instruments is measured using a discounted cash flow methodology.

(b) An entity's estimates of loan impairments at the date of transition to IFRSs are consistent with estimates made for the same date under previous GAAP.

(c) Many financial instruments will need to be fair valued, with no adjustments for blockage or liquidity provisions if they are quoted in an active market.

(d) Identify all derivatives contracts, which are discussed in the Application Guidance in IPSAS 29. The amortized cost at the date of transition will need to be calculated, using effective interest rates.

13.62 The transition process for entities currently applying cash accounting will be significantly more involved. The following section identifies implementation issues of relevance to entities transitioning from the cash basis to IPSASs 28, 29, and 30.

Financial Instrument Implementation Issues

13.63 The following list of tasks and issues will assist entities in planning for the identification, disclosure, presentation, recognition, and measurement of financial instruments. Completion of these steps should enable an entity to meet the requirements in IPSASs 28-30. When developing criteria for recognition of financial instruments and determining the basis of measurement for each class of financial instrument, entities are encouraged to review the latest international and national developments in this area, and consider the impact of these developments on their future reporting requirements.

Identification

(a) Identify all potential financial instruments in all controlled reporting entities. This includes checking for financial instruments that do not meet the criteria for recognition.

(b) Identify all financial guarantees, noting that these may previously have been treated as contingent liabilities. Maintain the financial guarantees in a register and determine whether they should be treated in accordance with IPSAS 19, *Provisions, Contingent Liabilities, and Contingent Assets* or IPSAS 28.

(c) Identify all concessionary loans, with interest rates below market rates or at zero interest.

(d) Identify all derivatives contracts. Derivative contracts are discussed in the Application Guidance in IPSAS 29 and the illustrative examples that accompany IPSAS 29. Further guidance on common derivative contracts is provided in IAS 39 *Implementation Guidance – Questions and Answers* (IASB, 2002).

(e) Record details of where existing information on financial instruments is held.

(f) Allocate responsibility for the maintenance of information on such financial instruments and financial reporting of various categories of assets and liabilities.

(g) Identify all categories of revenue, expense, assets, and liabilities associated with financial instruments that are relevant for the reporting entities and the classifications that will be used in the chart of accounts and the financial statements.

(h) Identify existing accounting policies and update these as new accounting policies are developed.

(i) Identify all financial risks and financial risk management policies.

(j) Review/develop and implement internal controls for the issuance, collection, and safe custody of financial instruments, including:

  (i) Individual identification of instruments;

  (ii) The establishment of a register of instruments and their status;

  (iii) Retention of a copy of all instruments on issue;

  (iv) Appropriate cancellation procedures; and

  (v) Safe custody arrangements for stationery used to document financial instrument arrangements.

(k) Review/develop systems for providing details of significant terms and conditions of financial instruments.

(l) Determine which financial instruments will be designated as accounting hedges (as opposed to economic hedges) and develop systems for the documentation of the accounting hedges and the collection of relevant information to meet IPSAS 29 disclosure requirements.

Disclosure and Presentation

Classify all financial instruments in accordance with the required categories, for example, trading/non-trading. Identify how the entity will demonstrate its intention to hold certain loans and receivables to maturity.

(m) Classify all financial instruments issued by the entity as liabilities or net assets/equity.

(n) Identify all financial instruments held as specific hedges rather than as hedges against an overall position.

(o) Determine whether all shares meet the definition of equity instruments. If not, ensure that dividends relating to these shares are classified as expenses.

(p) Determine whether any financial assets and liabilities meet the criteria for set-off.

(q) Identify the extent to which financial risks, including price risk (currency risk, interest rate risk, and market risk), credit risk, liquidity risk, and cash flow risk, are relevant for the reporting entity.

(r) Develop and document financial risk management objectives and policies, including hedging policies (such objectives and policies may already be in existence for certain categories of financial instruments such as borrowings and government securities).

(s) Develop methods of monitoring and reporting on financial risks, including information on maturity dates, effective interest rates, and maximum credit risk exposure.

(t) Decide where to place disclosures on financial instruments in the financial statements. Options include the face of the financial statements (for recognized financial instruments only), the notes to the financial statements, and supplementary schedules or statements. The presentation of certain disclosures in the notes to the financial statements or on the face of the statements may be specified within standards.

(u) Develop the format for disclosures and identify how this information can be obtained each reporting period and who has responsibility for the provision of this information for external reporting.

(v) Prepare *pro forma* disclosures—examples are illustrated in the relevant standards.

Recognition and Measurement

Develop/review criteria for recognition and derecognition.

(w) Develop/review the basis of measurement for each class of financial asset and financial liability:

(i) Where historic cost or modified historic cost is used, identify the method used for initial and subsequent measurement, including the treatment of premiums and discounts on issue, indexed instruments, doubtful debts and impairment;

(ii) Where fair value is used, identify determination of carrying amounts, for example, quoted market prices and discounted cash flows;

(iii) Where discounted cash flows are used to obtain fair value, identify the appropriate discount rate; and

(iv) Identify any significant assumptions required for measurement.

(x) Develop/review policies for financial instruments used to hedge anticipated transactions.

(y) Develop/review basis on which revenue and expense arising from the financial assets and liabilities will be recognized.

(z) Develop policies for certain types of transactions involving financial instruments.

(aa) Apply recognition criteria.

(bb) Identify the relevant opening balance for all recognized financial instruments.

(cc) Identify fair value for all financial assets and liabilities or identify where this is not practicable. Note that fair values are required for disclosure purposes even where another measurement base is used.

(dd) Develop or review systems for obtaining fair values at reporting dates.

13.64 The following sections in this Chapter describe some common issues which may be encountered when implementing the requirements of IPSASs 28–30.

Transaction Costs

13.65 Transaction costs are costs that can be directly attributed to the acquisition, issue or disposal of a financial asset or financial liability. Such costs would not have occurred if the entity had not acquired, issued, or disposed of the financial instrument. They do not include debt premiums or discounts, financing costs, or internal administrative or holding costs. Examples include:

(a) Transfer taxes;

(b) Fees and commissions paid to agents, advisors, dealers, or brokers;

(c) Regulatory agency levies; and

(d) Security exchange levies.

Financial Guarantees

13.66 Financial guarantee contracts require the issuer to make specified payments to recompense the holder of the contract for a loss it incurs if a specific debtor does not make payment when it becomes due under the debt instrument. The terms of the debt instrument may be the original terms or they may have been modified. Such contracts may be written in the form of insurance contracts and may have previously been accounted for as insurance contracts.

13.67 IPSAS 29 allows entities to elect to account for such contracts as financial instruments in accordance with IPSAS 29 or as insurance contracts in accordance with the relevant national or international standard. The requirements governing this election are actually specified in IPSAS 28 paragraph AG8. It states that an entity may make this election in the following instances:

(a) If an entity previously applied accounting applicable to insurance contracts and adopted an accounting policy that treated financial guarantee contracts as insurance contracts, it may continue to treat such contracts either as insurance contracts or as financial instruments in accordance with IPSAS 28.

(b) If an entity previously did not apply accounting applicable to insurance contracts, it may elect to treat financial guarantee contracts either as insurance contracts or as financial instruments when an entity adopts IPSAS 28.

13.68 In both (a) and (b) above, the election is made on a contract by contract basis, and the choice is irrevocable.

13.69 Assertions that the contract is an insurance contract may be found in documentation such as contracts, accounting policies, financial statements, and records of communications between customers and regulators.

Amortized Cost

13.70 Amortized cost is the amount at which a financial asset or financial liability is measured at initial recognition, less principal repayments, and plus or minus any unamortized original premium or discount. IPSAS 29 requires the amortized cost to be calculated using the effective interest method. The effective interest rate in a financial instrument is the rate that exactly discounts the cash flows associated with the financial instrument through maturity or the next repricing date to the net carrying amount at initial recognition, i.e., a constant rate on the carrying amount. The effective interest rate is sometimes termed the level yield to maturity or the next repricing date, and is the internal rate of return of the financial asset or financial liability for that period. Implementation Guidance that accompanies IPSAS 29 provides an example of an amortized cost calculation for a financial asset (refer to example B25 of the Implementation Guidance).

Investment Valuation Models

13.71 The basic investment model is the discounted cash flow model, measuring the value of an investment as the sum of the present value of its future cash flows.

13.72 The future cash-flow for a single year is written algebraically as Ci/(1+r) (where C equals the cash flow, i is the year and r is the discount rate). For example, if you receive $100 in one year's time, the present value of the cash flow is $90.91, if it was discounted back at a rate of 10%. That is, 100 = 90.91/(1.1).

13.73 A key issue is to identify an appropriate discount rate. IPSAS 29 (paragraph AG112) provides guidance on the determination of a discount rate for use in a valuation model. It requires that an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made.

Receivables

13.74 Because receivables are one of the most common financial assets held by public sector entities, this section focuses on implementation issues associated with receivables.

13.75 Receivables consist of amounts owed to the entity by others, including other government entities and the public. Types of receivables include:

(a) Interest receivable;

(b) Amounts due in relation to goods and services provided to others;

(c) Amounts due in relation to fines and penalties levied by the entity;

(d) Amounts due from another government entity or a different level of government in relation to non-reciprocal transfers to the entity; and

(e) Taxation receivables.

13.76 Prepayments occur when an entity pays for services in advance of receiving or using the services (for example, rent may be paid one month in advance) and there is still a prepayment remaining at the end of the reporting period. In checking for the existence of prepayments, entities would need to review the terms and conditions of agreements with suppliers. Prepayments are not receivables, nor do they meet the definition of financial instruments. Unless they are material, they are often presented together with receivables. In developing an accounting policy on prepayments various issues should be considered such as discounting (for example, where the prepayment will be settled over more than one reporting period) and impairment (ASB, 2010).

13.77 This Chapter provides a brief discussion of some implementation issues associated with the initial recognition of receivables and the ongoing identification and review of receivables. The recognition points for related revenues are discussed in Chapters 8 and 16.

Receivables—Opening Balances

13.78 Determination of opening balances of accounts receivable involves a thorough examination of all recorded amounts receivable.[37] The entity needs to:

(a) Compile an aggregate list of all recorded amounts receivable (the same process can be applied to short-term loans and advances and amounts receivable in relation to unpaid user fees and charges);

(b) Check that the amount recorded is correct and is not in dispute;

(c) Check that the item is legally enforceable. If it is not legally enforceable, this may reduce the likelihood of collecting the amount owed;

(d) Assess the likelihood of recovering the amount owed. Check that contact details for the individual or entity are correct and assess whether the individual or entity has sufficient funds to pay the amount owed;

(e) In the case of amounts in dispute or where the individual or entity is experiencing financial difficulties, the entity needs to consider the cost of taking legal or other action to recover the amount owed; and

(f) Where a write-off, write-down or waiver is proposed, the entity needs to carry out any procedures required before such action, document the recommended action, record details of any approval obtained, and update the financial records.

13.79 The entire process needs to be thoroughly documented to enable opening balances to be established and to provide an audit trail. Where opening balances are established after the event, subsequent receipts may a useful source of information.

Receivables—Write-offs, Write-downs and Waivers

13.80 An entity needs to develop or review its policy and procedures on write-offs of receivables and waivers of amounts receivable, including:

(a) The circumstances in which they may occur;

[37] Although accrued revenue is not a receivable, it is often presented with receivables in the financial statements.

(b) Who has the authority to recommend the write-off or waiver;

(c) Who has the authority to authorize the write-off or waiver;

(d) Any implications for the approved budget;

(e) The type of proof or documentation required to support the write-off, write-down or waiver;

(f) The documentation required to record the action; and

(g) Any disclosure required (e.g., there may be legislative disclosure requirements).

13.81 The type of proof or documentation required to support a recommendation for a write-off of a debt could include:

(a) Debtor's name and details;

(b) Details as to why the entity may need to write-off the debt; and

(c) Due date for payment and number of days overdue.

13.82 The policy and procedures may need to set out the process to be followed for the initial review of balances, which may occur at a central level, and the ongoing review of balances, which should occur periodically, but at a minimum, at the reporting date. Recorded amounts of balances owed can be significantly more than amounts likely to be collected. This is often the case under a cash accounting system where records of amounts owed have been kept but there has been no regular review of the collectability of those amounts. Writing-off large amounts can be a politically sensitive issue. In order to help this process go smoothly it is helpful to obtain early approval for these policies and procedures. It is also helpful to ensure that elected and appointed representatives understand this process and the implications for the cash flows of the entity.

13.83 Write-offs can occur in the following situations:

(a) An error in the original amount recorded;

(b) Proven insolvency of the debtor;

(c) An untraceable debtor;

(d) A change in government policy or a government directive; and

(e) Administrative write-offs of small amounts (e.g., amounts under a certain monetary threshold may not warrant further action).

13.84 Although an entity may have decided that an amount is not collectible and may have written it off in the financial statements, the entity has not forgone any legal rights to recover the amount. An entity may maintain memorandum records of amounts written off that it intends to continue trying to collect. Processes need to be established over which personnel have authority to update these records.

13.85 Any receivables that are financial instruments will be subject to the entity's policies on impairment of financial instruments and the requirements of IPSASs dealing with financial instruments.

Entities With Restricted Borrowing Abilities

13.86 It is common for public sector entities to have externally imposed restrictions on borrowing funds. For example, a national government may restrict the ability of local and regional governments to issue debt instruments. It is also common for a government to restrict borrowing by government departments although circumstances vary. For example, borrowings by individual entities may be (i) prohibited, (ii) made on behalf of entities by the central government, or (iii) the entity must first apply for permission from the central government body to enter into a contract to borrow funds. Although the disclosure of such borrowing restrictions is not required by IPSAS 30 it can provide useful context for readers of the financial statements.

13.87 When an entity is not allowed to borrow or to invest in financial instruments, it will hold a narrower range of financial instruments and require less detailed accounting policies. Typical financial instruments for such entities will be bank accounts, short-term deposits, accounts receivable (debtors) and accounts payable (creditors).

Relevance to the Cash Basis of Accounting

13.88 The issues identified in this Chapter are relevant for entities intending to provide additional note disclosures of the nature and amount of the various financial assets, liabilities, revenues and expenses as encouraged in the Cash Basis IPSAS. Entities using the cash basis of accounting will have recognized most of their cash assets (refer to Chapter 9, Cash for additional discussion of issues associated with the recognition of cash under the accrual basis). It is also likely that entities using the cash basis of accounting will maintain additional records of some investments and formal debt. However, they are unlikely to have comprehensive records of all financial assets and liabilities.

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Victorian Government Financial Reports
http://www.dtf.vic.gov.au

Appendix A

Accounting Policies

The accounting policies below illustrate the internal accounting policies used to identify, disclose, recognize, and measure a selection of financial instruments at a whole-of-government level. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The disclosure and presentation policies are based on the assumption that the entity has adopted IPSAS 29.

The recognition and measurement policies illustrated in this Appendix will not necessarily be those chosen by other entities, as the recognition and measurement of financial instruments varies across jurisdictions. Guidance and examples are also contained within IPSASs 28–30.

Other Chapters also discuss accounting policy issues relating to financial instruments (for example, Chapter 7 *Liabilities* and Chapter 9 *Cash)*.

Policies relating to the Statement of Financial Performance[38]

Interest Revenue

Interest revenue is accrued using the effective interest rate method. The effective interest rate exactly discounts estimated future cash receipts through the expected life of the financial asset to that asset's net carrying amount. The method applies this rate to the principal outstanding to determine interest revenue each period.

Dividend Revenue

Dividend revenue from investments is recognized when the right to receive payment has been established.

Interest Expense

Interest expense is accrued using the effective interest rate method. The effective interest rate exactly discounts estimated future cash payments through the expected life of the financial liability to that liability's net carrying amount. The method applies this rate to the principal outstanding to determine interest expense each period.

Policies Relating to the Statement of Financial Position

Financial Instruments

Financial Assets

Financial assets are designated into the following categories: loans and receivables, available-for-sale financial assets, held to maturity investments, and financial assets designated as fair value through surplus or deficit. This designation is made by reference to the purpose of

[38] To the extent that an entity has described its revenue and expense recognition policies elsewhere, they would not be presented with the financial instruments policies.

the financial instruments, policies and practices for their management, their relationship with other instruments, and the reporting costs and benefits associated with each designation.

Although they do not arise out of a contract, for ease of presentation, receivables from taxes, levies and fines (and any penalties associated with these activities), as well as social benefit receivables are included in these policies. These non-contract receivables, collectively referred to as sovereign receivables, are designated separately from other financial assets.

Sovereign receivables are initially assessed at nominal amount or face value; that is, the receivable reflects the amount of tax owed, levy, fine charged, or social benefit debt payable. These receivables are subsequently adjusted for penalties and interest as they are charged, and tested for impairment. Interest and penalties charged on tax receivables is presented as tax revenue in the statement of financial performance.

Loans and receivables are recognized initially at fair value plus transaction costs and subsequently measured at amortized cost using the effective interest rate method (refer to the interest revenue policy). Loans and receivables issued with a duration of less than 12 months are recognized at their nominal value, unless the effect of discounting is material. Allowances for estimated irrecoverable amounts are recognized when there is objective evidence that the asset is impaired. Interest, impairment losses, and foreign exchange gains and losses are recognized in the statement of financial performance.

In accordance with this general policy, student loans are recognized initially at fair value plus transaction costs, and subsequently measured at amortized cost using the effective interest rate method, less any impairment loss. Fair value on initial recognition of student loans is determined by projecting forward expected repayments required under the scheme and discounting them back at an appropriate discount rate. The difference between the amount lent and the fair value on initial recognition is expensed on initial recognition. The subsequent measurement at amortized cost is determined using the effective interest rate calculated at initial recognition. This rate is used to spread the interest revenue across the life of the loan and determines the loan's carrying value at each reporting date.

Financial assets held to maturity financial assets designated at fair value through surplus or deficit are recorded at fair value with any realized and unrealized gains or losses recognized in the statement of financial performance.

A financial asset is designated at fair value through surplus or deficit if acquired principally for the purpose of trading in the short term. It may also be designated into this category if the accounting treatment results in more relevant information because it either significantly reduces an accounting mismatch with related liabilities or is part of a group of financial assets that is managed and evaluated on a fair value basis. Gains or losses from interest, foreign exchange and other fair value movements are separately reported in the statement of financial performance. Transaction costs are expensed as they are incurred.

Available-for-sale financial assets are initially recorded at fair value plus transaction costs. They are subsequently recorded at fair value with any resultant fair value gains or losses recognized directly in net assets except for impairment losses, any interest calculated using the effective interest method and, in the case of monetary items (such as debt securities), foreign exchange gains and losses resulting from translation differences due to changes in amortized cost of the asset. These latter items are recognized in the statement of financial performance. For non-monetary available-for-sale financial assets (e.g., some unlisted equity instruments) the fair value movements recognized in net assets include any related foreign exchange component. At derecognition, the cumulative fair value gain or loss previously recognized directly in net assets is recognized in the statement of financial performance.

Cash and cash equivalents include cash on hand, cash in transit, bank accounts, and deposits with a maturity of no more than three months from date of acquisition.

Fair values of quoted investments are based on current bid prices. Regular way purchases and sales of all financial assets are accounted for at trade date. If the market for a financial asset is not active, fair values for initial recognition and, where appropriate, subsequent measurement are established by using valuation techniques, as set out in the following notes. At each reporting date an assessment is made whether there is objective evidence that a financial asset or group of financial assets is impaired.

Financial Liabilities

Financial liabilities held to maturity and financial liabilities designated at fair value through surplus or deficit are recorded at fair value with any realized and unrealized gains or losses recognized in the statement of financial performance. A financial liability is designated at fair value through surplus or deficit if acquired principally for the purpose of trading in the short term. It may also be designated into this category if the accounting treatment results in more relevant information because it either eliminates or significantly reduces an accounting mismatch with related assets or is part of a group of financial liabilities that is managed and evaluated on a fair value basis. Gains or losses from interest, foreign exchange and other fair value movements are separately reported in the statement of financial performance. Transaction costs are expensed as they are incurred.

Other financial liabilities are recognized initially at fair value less transaction costs and subsequently measured at amortized cost using the effective interest rate method. Financial liabilities entered into with a duration of less than 12 months are recognized at their nominal value. Amortization and, in the case of monetary items, foreign exchange gains and losses, are recognized in the statement of financial performance as is any gain or loss when the liability is derecognized.

Derivatives

Derivative financial instruments are recognized both initially and subsequently at fair value. They are reported as either assets or liabilities depending on whether the derivative is in a net gain or net loss position respectively. Recognition of the movements in the value of derivatives depends on whether the derivative is designated as a hedging instrument and, if so, the nature of the item being hedged (see Hedging section below).

Derivatives that are not designated for hedge accounting are classified as held-for-trading financial instruments with fair value gains or losses recognized in the statement of financial performance. Such derivatives may be entered into for risk management purposes, although not formally designated for hedge accounting, or for tactical trading.

Hedging

Individual entities consolidated within the reporting entity apply hedge accounting after considering the costs and benefits of adopting hedge accounting, including whether an economic hedge exists and the effectiveness of that hedge, whether the hedge accounting qualifications could be met, and the extent it would improve the relevance of reported results.

Transactions between entities within the reporting entity do not qualify for hedge accounting in the consolidated financial statements (although they may qualify for hedge accounting in the separate financial statements of the individual entities). Where a derivative is used to hedge the foreign exchange exposure of a monetary asset or liability, the effects of the hedge relationship are automatically reflected in the statement of financial performance so hedge accounting is not necessary.

(a) *Cash Flow Hedge*

Where a derivative qualifies as a hedge of variability in asset or liability cash flows (cash flow hedge), the effective part of any gain or loss on the derivative is recognized in net assets and the ineffective part is recognized in the statement of financial performance. Where the hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability (e.g., where the hedge relates to purchase of an asset in a foreign currency), the amount recognized directly in net assets is included in the initial cost of the asset or liability. Otherwise, gains or losses recognized in net assets transfer to the statement of financial performance in the same periods as when the hedged item affects the statement of financial performance (e.g., when the forecast sale occurs). Effective parts of the hedge are recognized in the same area of the statement of financial performance as the hedged item.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in net assets at that time remains in net assets and is recognized when the forecast transaction is ultimately recognized in the statement of financial performance. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in net assets is transferred to the statement of financial performance.

(b) *Fair Value Hedge*

Where a derivative qualifies as a hedge of the exposure to changes in fair value of an asset or liability (fair value hedge) any gain or loss on the derivative is recognized in the statement of financial performance together with any changes in the fair value of the hedged asset or liability.

The carrying amount of the hedged item is adjusted by the fair value gain or loss on the hedged item in respect of the risk being hedged. Effective parts of the hedge are recognized in the same area of the statement of financial performance as the hedged item.

Impairment of Receivables

Impairment of a loan or a receivable is established when there is objective evidence that amounts due will not be able to be collected according to the original terms. Significant financial difficulties of the debtor/issuer, the probability that the debtor/issuer will enter into bankruptcy, and default in payments are considered to be indicators that the asset is impaired.

The amount of the impairment is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted using the original effective interest rate. If a loan or receivable has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract.

The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognized in the statement of financial performance. When the receivable is uncollectible, it is written off against the allowance account. For term deposits, local authority stock, government stock and community loans, impairment losses are recognized directly against the instrument's carrying amount.

Overdue receivables that have been renegotiated are reclassified as current (i.e., not past due).

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the reversal of the previously recognized impairment loss is recognised in the statement of financial performance.

Appendix B

IPSAS 15

This Appendix gives an overview of the key presentation and disclosure requirements of IPSAS 15. IPSAS 15 remains applicable until IPSAS 28 and IPSAS 30 are applied or become effective, whichever is earlier. The effective date for IPSAS 28 and 30 is January 1, 2013.

The purpose of the disclosures required by this Standard is to provide information that will enhance understanding of the significance of on-balance- sheet and off-balance-sheet financial instruments to an entity's financial position, performance, and cash flows, and assist in assessing the amounts, timing, and certainty of future cash flows associated with those instruments. In addition to providing specific information about particular financial instrument balances and transactions, entities are encouraged to provide a discussion of the extent to which financial instruments are used, the associated risks, and the financial purposes served.

The following terms are used in IPSAS 15 with the meanings specified.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

A *financial asset* is any asset that is:

(a) Cash;

(b) A contractual right to receive cash or another financial asset from another entity;

(c) A contractual right to exchange financial instruments with another entity under conditions that are potentially favorable; or

(d) An equity instrument of another entity.

A *financial instrument* is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Commodity-based contracts that give either party the right to settle in cash or some other financial instrument should be accounted for as if they were financial instruments, with the exception of commodity contracts that (a) were entered into and continue to meet the entity's expected purchase, sale, or usage requirements, (b) were designated for that purpose at their inception, and (c) are expected to be settled by delivery.

A financial liability is any liability that is a contractual obligation:

(a) To deliver cash or another financial asset to another entity; or

(b) To exchange financial instruments with another entity under conditions that are potentially unfavorable.

An entity may have a contractual obligation that it can settle either by payment of financial assets or by payment in the form of its own equity securities. In such a case, if the number of equity securities required to settle the obligation varies with changes in their fair value so that the total fair value of the equity securities paid always equals the amount of the contractual obligation, the holder of the obligation is not exposed to gain or loss from fluctuations in the price of its equity securities. Such an obligation should be accounted for as a financial liability of the entity.

An insurance contract (for the purposes of this Standard) is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others, and interruption of operations.

Market value is the amount obtainable from the sale, or payable on the acquisition, of a financial instrument in an active market.

Monetary financial assets and financial liabilities (also referred to as monetary financial instruments) are financial assets and financial liabilities to be received or paid in fixed or determinable amounts of money.

The IPSAS 15 presentation and disclosure requirements relate to a wide range of financial instruments. It is unlikely that most government departments or individual public sector entities will have to account for, and make disclosure of, the more complex instruments that IPSAS 15 (and IPSASs 28–30), were written to cater for. Generally, only central agencies responsible for an entity's treasury functions will need to apply the more challenging aspects of IPSAS 15 and IPSAS 29. The implications of these requirements are outlined in the implementation section in the Chapter.

Financial instruments issued should be classified (as a whole or in component parts) with reference to the substance of the contractual arrangement on initial recognition and with reference to the definitions for financial liabilities and equity.

Interest and dividends stemming from the financial instrument (e.g., interest paid or received on loans, dividends received on investments in shares and, if relevant, dividends paid on own shares) should be shown in the statement of financial performance as expense or revenue. Distributions to holders of financial instruments classified as equity should be debited by the issuer directly to equity (net assets).

A financial asset and a financial liability should be offset and the net amount reported in the statement of financial position only when the entity has a legally enforceable right to set off the recognized amounts, and actually intends to either settle on a net basis, or to realize the asset and settle the liability simultaneously.

An entity should describe its financial risk management objectives and policies, including its policy for hedging each major type of forecasted transaction for which hedge accounting is used. A clear distinction should be made between economic hedging and hedge accounting in accordance with IPSAS 29.

A discussion of management's policies for controlling the risks associated with financial instruments, including policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risk, and requirements for collateral to mitigate credit risks, provides a valuable additional perspective that is independent of the specific instruments outstanding at a particular time. Some entities provide such information in a commentary that accompanies their financial statements rather than as part of the financial statements.

Entities must disclose the terms, conditions, and accounting policies for each class of financial asset, financial liability, and equity instrument, both recognized and unrecognized. Disclosures must include information about the extent and nature of financial instruments, including significant terms and conditions that may affect the amount, timing, and certainty of future cash flows. The accounting policies and methods adopted including the criteria for recognition and basis of measurement application should also be disclosed.

The risks that should be addressed in management's discussion include:

(a) Price risk, which can be broken into currency risk, interest rate risk, and market risk;

(b) Credit risk;

(c) Liquidity risk; and

(d) Cash flow risk.

IPSAS 15 requires specific disclosures about the following risks:

(a) Interest rate risk—for each class of financial asset and financial liability whether recognized or unrecognized, an entity should disclose information about its exposure to interest rate risk, including contractual repricing, or maturity dates (whichever dates are earlier), and effective interest rates (when applicable).

(b) Credit risk—for each class of financial asset and financial liability whether recognized or unrecognized, and entity should disclose information about its exposure to credit risk including the amount that best represents its maximum credit risk exposure at reporting date without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instrument and significant concentrations of credit risk.

Entities should disclose information about fair value for each class of financial asset and financial liability, both recognized and unrecognized. If this is not practicable due to constraints of timeliness or cost to determine the fair value with sufficient reliability, that fact should be disclosed. Entities should also disclose information about the principle characteristics of the underlying financial instrument that are pertinent to its fair value.

Financial assets that are carried at an amount in excess of fair value should be disclosed, giving the carrying amount and the fair value of either the individual asset or an appropriate group of individual assets, and the reasons for not reducing the carrying amount with the nature of evidence providing the basis for management's view that the carrying amount will be recovered.

On transition to IPSAS 15, entities are expected to present comparative information for prior periods. However, if such information is not available at the date of first adoption, entities need not present it.

Appendix C

Differences between IPSASs and IFRSs

This Appendix summarizes the differences between IPSASs 28, 29 and 30 and the IFRSs on which they are based.

Key Differences Between IPSAS 28 and IAS 32

The key differences between IPSAS 28 and IAS 32 (issued originally in 2003, including amendments up to December 31, 2008) are as follows:

(a) IAS 32 allows entities to treat financial guarantee contracts as insurance contracts where entities have previously asserted that such contracts are insurance contracts and not financial instruments. IPSAS 28 allows a similar election, except that entities need not have explicitly asserted that financial guarantees are insurance contracts.

(b) IPSAS 28 contains additional Application Guidance dealing with the identification of arrangements that are, in substance, contractual.

(c) IPSAS 28 contains additional Application Guidance on when assets and liabilities arising from non-exchange revenue transactions are a financial instrument.

(d) Principles from IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* have been included as an Appendix in IPSAS 28.

(e) The transitional provisions in IPSAS 28 differ from those in IAS 32. This is because IPSAS 28 provides transitional provisions for those entities applying the Standard for the first time or those applying accrual accounting for the first time.

Key Differences Between IPSAS 29 and IAS 39

The key differences between IPSAS 29 and IAS 39 (including amendments up to December 31, 2008 as well amendments made by the IASB to IAS 39 as part of its *Improvements to IFRSs* in April 2009) are as follows:

(a) IPSAS 29 contains additional application guidance to deal with concessionary loans and financial guarantee contracts entered into at nil or nominal consideration. IAS 39 does not deal with these areas.

(b) Principles from IFRIC 9 *Reassessment of Embedded Derivatives* and IFRIC 16 *Hedges of a Net Investment in a Foreign Operation* have been included as an appendix to IPSAS 29.

Key Difference Between IPSAS 30 and IFRS 7

The key difference between IPSAS 30 and IFRS 7 (originally issued in 2005, including amendments published to April 2009) is that IPSAS 30 contains requirements related to concessionary loans, which are more common in the public sector. IFRS 7 does not require such disclosures.

Chapter 14: Employee-Related Liabilities

Key Points

- IPSAS 25, *Employee Benefits* establishes requirements for all employee benefits, except share based transactions.
- IPSAS 25 states that an entity shall disclose information that enables the users of the financial statements to evaluate the nature of its employee obligations and the financial effect of the changes to those plans during the year.
- The Standard does not deal with accounting and reporting by retirement benefit plans or benefits that are not consideration in exchange for services rendered by employees or past employees.
- Accounting for short-term employee benefits is not generally difficult. The more difficult issues are pensions, and to a lesser extent, other long-term benefits such as long service leave.
- Certain policy decisions, such as the devolution or non-devolution of authority for personnel functions and the extent to which personnel functions are centralized can have a major impact on the design of information systems. Such decisions would ideally be made at an early stage of the reform process.

Introduction

14.1 Most salaries and wages earned during a reporting period are paid during that period and therefore only a small liability exists at the end of the period. However, in the case of other employee entitlements, particularly pension entitlements, end-of-period liabilities can be significant. This Chapter deals with issues associated with the recognition of such liabilities. It does not address issues associated with pensions provided to citizens as opposed to government employees. Issues associated with the recognition of such pension schemes are discussed in Chapter 14.

14.2 Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees, and are classified into four categories:

(a) Short-term employee benefits;

(b) Other long-term benefits;

(c) Termination benefits; and

(d) Post employment benefits.

14.3 IPSAS 25 distinguishes between short-term benefits and long-term benefits. In the case of long-term benefits it requires that an entity use an actuarial assessment to discount the value of the future amount. Although IPSAS 25 requires the use of actuarial techniques, it does not require that a qualified actuary be used. One of the decisions an entity makes in applying IPSAS 25 is whether to engage an actuary and if so, the terms of that engagement.

Definitions

14.4 IPSAS 25 establishes a number of definitions including the following key terms:

Short-term employee benefits are employee benefits (other than termination benefits) which fall due wholly within 12 months after the end of the period in which the employees render the related service.

Other long-term employee benefits are employee benefits (other than post-employment benefits and termination benefits) which do not fall due wholly within 12 months after the end of the period in which the employees render the related service.

Termination benefits are employee benefits payable as a result of either:

(a) An entity's decision to terminate an employee's employment before the normal retirement date; or

(b) An employee's decision to accept voluntary redundancy in exchange for those benefits.

Post-employment benefits are employee benefits (other than termination benefits) which are payable after the completion of employment.

14.5 IPSAS 25 goes on to clarify that short-term employee benefits include items such as:

(a) Wages, salaries, social security contributions;

(b) Short-term compensated absences (such as paid annual leave and paid sick leave)

(c) Performance related payments; and

(d) Non-monetary benefits provided to current employees (such as medical care, free or subsidized goods, low cost housing, and use of vehicles).

Review of Existing Systems and Structures

14.6 All entities, regardless of the basis of accounting used, will have existing systems for calculating and processing wage and salary payments and maintaining records on employee entitlements to benefits such as paid leave. An entity will need to assess whether these systems will be able to provide the information required by IPSAS 25, and other IPSASs. Issues to consider include:

(a) Whether existing systems capture the information required to account for the entity's employee benefits at each reporting period. If not, whether the system can be upgraded to capture the necessary information. Whether the information is in a form that can support the preparation of the entity's financial statements. Some entities may need to redesign the chart of accounts and create specific accounts for previously unrecorded items.

(b) Whether existing systems can capture the initial information needed to commence accounting for employee benefits. If not, how that information can be captured and integrated into existing information and reporting processes.

(c) Whether the required information is accessible at the level of the individual reporting entity. If not, the types of changes that will need to be made to the system.

Accessibility

14.7 Existing systems may accurately record details of each individual employee's remuneration and entitlements such as annual leave earned and taken. However, if this information is available only by consulting each individual's personnel records at the end of each reporting period (for example, monthly or quarterly) the task of aggregating the liability could be onerous.

The Reporting Entity and the Degree of Centralization

14.8 Many governments have centralized personnel or human resource departments or entities, which have responsibility for a wide range of personnel functions including recruitment, training, promotion, establishment of terms and conditions, administration of disciplinary processes, personnel records and wage, and salary systems. The introduction of accrual accounting may be accompanied by changes to centralized personnel functions such as the devolution of some of these functions. Such devolution is not a consequence of adopting accrual accounting.

14.9 The definition of the reporting entity has an impact on the level of aggregation required. If individual government entities are reporting entities and centralized systems are maintained, then it is necessary to either:

(a) Ensure that personnel systems can record employee expenses and accrued liabilities for each individual reporting entity. This may involve the use of internal allocations or actual payments by individual entities to reimburse the central entity; or

(b) Decide that individual entities will not be required to account for certain employee expenses and liabilities. This latter option is not consistent with accrual accounting to the extent that the financial statements should include all expenses, including the cost of goods and services provided free of charge. However, for practical reasons some jurisdictions may choose not to allocate certain costs to individual entities. The non-allocation of some costs and accrued liabilities may in some circumstances be justified on the grounds that they are the responsibility of the government as a whole rather than its individual entities.

14.10 As the devolution or non-devolution of authority for personnel functions can have a major impact on the design of systems, such policy decisions would ideally be made at an early stage of the reform process.

Implementation

14.11 The following list sets out some of the steps required for the recognition of employee-related liabilities. Where entities have been using a modified version of the cash or accrual basis for budgeting or financial reporting, some or most of the information referred to in these steps may already be readily available:

(a) Develop accounting policies.

(b) Determine appropriate classifications, including current and non-current.

(c) Identify all potential employee-related expenses and liabilities.

(d) Document the background to each entitlement, including the underlying authority, entitlement criteria, when entitlement occurs, payment dates, existing information on the likely amount of the associated liability, and contact details for people responsible for administering the entitlements.

(e) Distinguish between benefits that lead to an absolute entitlement and those taken on the basis of need, as the recognition point for the two will differ.

(f) Estimate the likely range for the amount of each liability at the end of each reporting period.

(g) Identify possible ways in which liabilities could be determined at the end of each reporting period and the information required in order to calculate relevant amounts (for example, system changes, actuarial valuations, estimation).

(h) Develop recommendations on proposed methods of obtaining information including system changes.

(i) Review internal controls to ensure that all leave taken is recorded and processed in a timely manner.

(j) Ensure that existing or newly implemented systems can generate the information needed to satisfy the disclosure requirements of IPSAS 25 (paragraphs 26, 140 to 146, and 163 to 165).[39]

14.12 Where there are a number of entities within the consolidated reporting entity it may be possible to develop centralized models to help entities estimate their obligations for long service leave and retirement benefits. For example, a centralized model may be appropriate where there are a number of entities with small to medium numbers of employees, where benefits are not complex or where the size of the liabilities does not warrant an independent actuary's valuation. Such guidance could reduce the overall cost of complying with IPSAS 25. In some jurisdictions a Government Actuary or other central agency may provide actuarial advice to public sector entities and develop life expectancy tables for public sector pension schemes.

Accounting Policies

14.13 IPSAS 25 requires an entity to disclose the accounting policies used in respect of employee benefits. The accounting policies will detail the entity's methodologies for the measurement and recognition of employee benefits. The reporting entity will be required to develop internal policies for all employee benefits it accounts for, and will also be required to report the accounting policies for material items in the entity's annual report.

Accrued Salaries and Wages

14.14 Monthly financial statements are often prepared for internal reporting purposes. Salaries and wages are commonly paid weekly, fortnightly, four weekly, or monthly. They may be paid in arrears, in advance, or a mixture of both. Accrued salaries and wages are

[39] Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

determined by multiplying the average daily salary and wage bill by the number of days between the last salary and wage payment and the end of the reporting period (less any days that were paid in advance). Entities need to decide whether the “days” used in this calculation are calendar days or working days.

14.15 Accruals for allowances that are regular in amount may be calculated in the same way as for salaries and wages. Where payment dates differ or the amounts fluctuate markedly between periods, a separate accrual may be required for some types of payment. Adjustments may need to be made for large one-off or unusual payments that should not form part of the average daily salary and wage bill.

14.16 Although some entities in the public sector may have a wide range of allowances that form part of an employee’s remuneration, the calculation of salary and wage accruals should be performed in the same manner as in the private sector. The reference manuals for accounting systems generally contain guidance on options within the system for such accruals.

14.17 In terms of implementation, the main issues are to identify payment dates, the extent to which payments are in arrears or advance, which salary and wage components should be included in the average daily salary bill and the definition of “days.” In addition, an entity needs to decide whether it will perform these accruals for the entity as a whole, or whether it will allocate these accruals to individual sub-units within the entity.

Annual Leave

14.18 Entities should be able to obtain details of opening and closing annual leave entitlements from their payroll system (changes to payroll systems to ensure that this information is available on a regular and timely basis is the major implementation issue for recognition of this liability).

14.19 An entity may have a policy limiting the number of days’ leave that may be carried forward. In such cases, the accrual for the annual leave liability may be calculated for the full amount of annual leave owing, even where some individuals have accumulated leave in excess of the permitted amount, with reductions in accordance with the policy being performed as a separate exercise.

14.20 Accrued annual leave is usually taken within the following period and there is therefore no need to discount the amount.

14.21 In practice, annual leave that employees take during a period is often classified as salary expense rather than as annual leave expense, because it would ordinarily be immaterial to show it as a separate line item.

Sick Leave

14.22 The arrangements in place for sick leave vary widely between jurisdictions and entities. In some cases employees may be allowed to accumulate sick leave up to a specified number of days. Such sick leave is referred as “vesting.” Vesting refers to leave which, once it has been granted, or has accrued, cannot be taken away. Where an entitlement is vesting, the entity would estimate the liability for sick leave in future periods using a process similar to that used for other vesting employee entitlements.

14.23 In other cases employees will have an entitlement to sick only in times of sickness. Such sick leave is "non-vesting."Where employees, on average, take fewer sick days than their annual entitlement, there is no need to recognize a liability for future sick leave.

14.24 Any liability recognized in respect of sick leave would need to be supported by evidence as to the amount of sick leave taken by employees.

Defined Contribution Plans / Defined Benefit Plans

14.25 The nature of an entity's obligations to employees under pension schemes (also referred to as superannuation schemes in some jurisdictions) will vary across jurisdictions. The two classifications used for financial reporting purposes are defined benefit plans and defined contribution plans.

14.26 Defined benefit plans are retirement benefit plans under which pensions are determined by reference to a formula based on employees' remuneration and length of service. Defined contribution plans are retirement benefit plans under which the employer and/or employee make specified contributions to the plan during a set period. The number of defined benefit plans has declined in some jurisdictions in recent years, mirroring similar trends in private sector plans. Defined benefit plans may be fully funded (plan assets are sufficient to offset plan liabilities), partially funded (plan assets partially offset plan liabilities), or are funded on a pay-as-you-go basis. On a pay-as-you-go basis, the employee may make a regular contribution to the scheme, but the government contributes only the amount required to pay the amounts currently owing to retired employees. Where plan assets are less than plan liabilities, the net amount is often referred to as the unfunded component.

14.27 In order to meet the requirements of reliable measurement, the amount of the unfunded liability for defined contribution plans and the total liability for defined benefit plans is usually estimated by actuaries. Although the detailed calculations are performed by actuaries, the entity still needs to work through the following steps to ensure that all potential liabilities are accounted for appropriately:

(a) Identify all pension plans/payments (including ex gratia payments to employees in lieu of pension payments).

(b) Document the contributors and recipients for each plan.

(c) Classify pensions to employees as either costs which should be allocated to individual reporting entities or costs which should be reported at the whole-of-government level (for example, ongoing obligations to previous government employees may be treated by some governments as a whole-of-government expense).

(d) Determine whether there is a legal obligation (supported by legislation or contract) to make payments. In the case of payments where there is no clear legal obligation, establish whether there is a constructive obligation.

(e) Determine whether schemes are defined benefit plans or defined contribution plans in terms of IPSAS 25.

(f) Determine whether schemes are fully funded, partially funded, or are funded on a pay-as-you-go basis. Fully funded schemes are those where annual contributions to the scheme cover the annual expense. The unfunded component of schemes occurs when annual payments are not sufficient to cover the annual expense. Where schemes are not fully funded, including on a pay-as-you-go basis, regular actuarial valuations are required to provide evidence of the amount of the unfunded liability.

(g) Research and assess the likelihood of the government changing employees' pension entitlements. This will impact upon the probability of future payments being made and the calculation of the pension liability.

(h) Clarify institutional arrangements for the recognition of the liability. Each individual reporting entity should recognize total employee-related expenses. However, if a central entity has assumed responsibility for the liability then an individual entity does not need to recognize the liability. Instead it would recognize both an expense and corresponding revenue to acknowledge that another entity has assumed one of its obligations. Where responsibility for pension liability is assumed at a central level, the central entity will need to devise a method of allocating the aggregate pension expense to individual entities. Such allocations may be based on actuarial assessments where these are available. In the absence of such assessments, pro rating the total pension expense by entity personnel expense/total government personnel expense may give an approximation.

(i) Select an appropriate discount rate for calculating the present value of liabilities. IPSAS 25 (paragraph 91) requires that the discount rate used to discount post-employment benefit obligations (both funded and unfunded) reflect the time value of money. It also requires that the currency and term of the financial instrument selected to reflect the time value of money shall be consistent with the currency and estimated term of the post-employment benefit obligations. The Government bond rate is often used as an indicator of the time value of money but this may not be appropriate in all cases. There may be no Government bonds with an appropriate term or corporate bonds may have a higher rating than Government bonds in some economies. If it is not possible to identify a financial instrument with a life-cycle consistent with the post-employment benefit obligation, the reporting entity may need to develop a financial model to estimate the time value of money.

Long Service Leave

14.28 Some jurisdictions provide extended or additional leave entitlements in recognition of periods of long service by employees. These entitlements usually vest after a specified period of service. A liability for long service leave (and other long service benefits such as overseas trips) should be accrued based upon an estimate of the number of employees likely to qualify for the leave, the amount of the entitlement and the estimated date of entitlement.

14.29 In order to assess the likely amount of the liability, the entity will need to research such matters as:

(a) The number of employees qualifying for the leave in recent years and any factors which are likely to lead to a higher or lower uptake rate in the future (for example, projected attrition rates);

(b) Their average rate of pay and projected pay of future recipients, taking account of pay increases due to promotion and inflation; and

(c) The likely cost of the long service leave to be paid to existing employees in future years and the present value of those amounts.

14.30 It may be argued that, technically the liability should be recognized from the first year of service. However, because of employee turnover, recognizing the liability only for those employees who have been employed for a certain time and are therefore more likely to qualify for the leave may provide a reasonable estimate. The approach adopted by an entity will depend upon the amount of work involved and the impact on the financial statements of calculating the liability for all employees from their first year of service or from some other date, such as from five or ten years from their date of employment. The latter approach results in the first five or ten years' obligation for an employee being recorded as an expense in one period. Where there are low numbers of employees qualifying for long service leave or the value of the benefit is minimal, there may be no material impact on the financial statements of recognizing the expense as the entitlement falls due. Actuarial estimates may be helpful in assessing the most appropriate time at which to begin recording long service leave.

14.31 Where similar conditions of service apply across a range of government entities, guidance on the appropriate time of recognition should be provided to all entities to ensure a consistent approach.

14.32 The long service leave expense is the change in the provision for long service leave entitlements between the beginning and end of the reporting period, plus any payments made during the period. Where long service leave payments are paid as normal salary amounts it is helpful if the personnel system also highlights the amount relating to long service leave. If payments during a period are not material, the change in the provision during the period may provide a reasonable estimate of the expense. However, to justify this approach an entity would need to provide evidence showing how it had estimated leave payments during the period.

Bonus Payments and Profit Sharing Arrangements

14.33 Bonus payments and profit sharing payments are usually classified as salaries and wages, although it may be paid only once or twice a year. The accounting requirements for bonus payments and profit sharing payments are set out in IPSAS 25 paragraphs 20 to 25.

14.34 Bonus payments and profit sharing payments are recognized only when a reliable estimate of the obligation can be made. IPSAS 25 specifies the conditions that must be satisfied before a liability can be recognized. Therefore an entity needs to decide if it has such arrangements and if they meet the requirements detailed in paragraph 23 for a reliable estimate. If the entity determines that it does have to recognize an obligation to pay bonus payments or profit sharing payments the entity records the amount of the payment as a liability in the period the payment is attributed to.

Practical Considerations

Requests for Proposals

14.35 Entities accounting for employee benefit obligations in accordance with IPSAS 25 may need to enlist the services of professional actuaries. The Government Finance Officers Association in the United States of America has developed a document to assist entities in developing a request for proposals (RFP) for the procurement of these services (Government Finance Officers Association, 2006). The document is not an RFP itself, nor should the items in the checklist be regarded as mandatory items for inclusion in a RFP. Rather, the checklist is a document that recommends items for *consideration* in an RFP. The document was developed to support entities implementing the relevant standards in that jurisdiction (being GASB Statements 43 and 45).

Purchasing Coalitions

14.36 Where a number of entities are required to obtain actuarial valuations they may consider forming a purchasing coalition to negotiate discounts from a single actuarial firm.

Developing Models

14.37 If there are a number of smaller entities with relatively small obligations or similar circumstances it may be possible for the entities, or a central agency, to develop a model that allows them to comply with the requirements of the standards at a lower cost than obtaining a full actuarial valuation. Such models generally streamline some of the elements of the calculations and use simplifying assumptions. Examples of models or simplifying assumptions developed by central agencies to assist certain entities in complying with financial reporting standards on employee benefits are noted in the references to this Chapter (refer to New Zealand Treasury, 2009; Government of South Australia, 2009; State Government of Victoria, 2008). These examples relate to the implementation of the relevant standards in those jurisdictions (being the domestic equivalents of IAS 19).

14.38 Although IPSAS 25 does not require the entity to use an actuary to measure post-employment benefit obligations some countries specifically require that an actuary be used in measuring post-employment benefit obligations and prescribe how often these actuarial valuations should be performed. An entity would need to ensure that any simplifying models still allowed the entity to comply with any jurisdiction specific requirements.

Implementation Planning and Monitoring

14.39 The United Nations Development Programme *UNDP's IPSAS Adoption Strategy* (UNDP, September 2009) provides an example of issues identified and being monitored by an entity regarding the adoption of IPSAS 25.

Transitional Provisions

14.40 IPSAS 25 sets out a number of requirements relating to first-time adoption. For example, comparative information and some disclosures are not required in the first year of adoption.

Relevance to the Cash Basis of Accounting

14.41 The issues identified in this Chapter are relevant for entities intending to provide additional disclosures on the nature and amount of employee-related liabilities as encouraged by the Cash Basis IPSAS. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the statement of cash receipts and payments.

14.42 Entities making additional disclosures need to be clear about the nature of those additional disclosures. For example, are they intended to be in accordance with the requirements of IPSAS 25 or some other jurisdiction-specific requirements?

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Appendix

Accounting Policies

This Appendix illustrates the internal accounting policies for the recognition of employee expenses and associated employee-related liabilities. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity.

General

The full cost of employees' services is to be recognized as an expense when the expense is incurred. Amounts incurred but not paid are to be accrued. Liabilities assumed by another entity are to be recognized as an expense of one entity and revenue of the other.

Salaries and Wages

A liability for salaries and wages incurred but not paid is to be accrued at the end of the reporting period.

Annual Leave

Annual leave due but not taken is to be recognized as a liability. It is to be calculated on the basis of leave owing to each employee (including any time in lieu), and is to be based on the individual employee's expected salary at the time the leave is likely to be taken. For example, if the leave is expected to be taken within the following period, the employee's expected salary during that period would be used.

Accrued annual leave that must be taken within the following year is to be classified as a current liability. Accrued annual leave that may be taken after the following year is to be classified as a non-current liability. The provision for annual leave is not discounted.

Long Service Leave

Provisions for long service leave entitlements are to be initially recognized once an employee has completed five years' service[40] and subsequently recognized each year following that time.

Long service leave liabilities are to be measured as the present value of estimated leave service entitlements. In measuring the present value of long service leave entitlement liabilities, the average interest rate attaching, as at the reporting date, to borrowings of the entity is to be used to discount estimated future cash outflows.

Provisions for long service leave are to be classified as current or non-current as appropriate.

Other long service benefits are to be recognized at the point that the employee becomes entitled to them.[41]

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40 The number of years' service required by an entity before it begins to account for long service leave will vary depending upon the entitlement criteria for the leave and the relationship between various lengths of service and the proportion of employees qualifying for the leave.

41 This policy assumes that the impact of recognizing such other long service benefits in this way is immaterial.

Sick Leave/Compassionate Leave

No liability or expense is to be recognized in relation to sick leave and compassionate leave until the time of absence.[42]

Pensions

Defined Benefit Plans

The liability arising in respect of the following defined benefit plans is to be accounted for in accordance with IPSAS 25, *Employee Benefits.*

[*The reporting entity is to list the pension plans*.]

The amount recognized as a defined benefit liability is to be the net of the following amounts:

(a) The present value of the defined benefit obligation as at the end of the reporting period (after taking account of any payments against the liability during the period);

(b) Plus any actuarial gains (less any actuarial losses) to the extent that they are recognized in accordance with IPSAS 25 (this refers to fluctuations which exceed the limits set out in IPSAS 25);

(c) Less any past service cost not yet recognized as an expense; and

(d) Less the fair value at the end of the reporting period of plan assets out of which the obligations are to be settled directly.

The liability is to be assessed annually by [*reporting entity to insert details of specified actuary*]. It is to be calculated based on the latest actuarial assessment [*reporting entity to specify frequency with which assessment occurs*] or more recent data if this is available.

Defined Contribution Plans

The contribution due to a defined contribution plan in exchange for service provided by employees during the year is to be recognized as an expense in accordance with IPSAS 25.

A liability for contributions payable to a defined contribution plan is to be recognized only if the contribution paid during the period is less than the contribution required.

Severance/Termination Benefits

A liability for severance/termination payments is to be recognized if there is a present obligation on the employer at the reporting date. There is an obligation to be met where there is an award or agreement that provides for payments to be made under specified conditions and these conditions are satisfied.

[42] This policy assumes that sick leave is non-vesting and that employees on average take sick leave equal to or less than the entitlements that accrue in the reporting period.

Chapter 15: Liabilities Arising From Social Policy Obligations

Key Points

- This Chapter addresses issues associated with the accounting treatment of liabilities or potential liabilities arising from certain social policy obligations of governments. Examples of circumstances in which a government may have a social policy obligation include:
  - Future obligations arising from social benefits such as state retirement benefits and unemployment benefits;
  - Moral or equitable obligations to provide relief to victims of natural disasters;
  - Obligations under accident compensation schemes;
  - The announcement of a new program or spending initiative; and
  - Future obligations under current policies.
- Currently, there is no IPSAS dealing with the recognition, measurement, or disclosure of liabilities arising from social benefits provided by an entity for which it receives no or nominal consideration directly in return from the recipients of those benefits. In the absence of an IPSAS, entities will need to develop accounting policies based on appropriate authoritative guidance.
- If social benefits give rise to financial assets or financial liabilities these should be accounted for in accordance with the IPSASs dealing with financial instruments.
- This Chapter outlines approaches adopted by some governments to the recognition of various obligations arising from these social benefits. The types of social benefits provided, eligibility criteria, timing of eligibility, and likelihood of future obligations vary between jurisdictions.
- This Chapter suggests that entities first identify all potential social policy obligations, and then attempt to find solutions to the accounting issues associated with those obligations by grouping them into categories with similar characteristics.
- Projects to develop requirements for the reporting of social benefit obligations have not yet led to a standard because of difficulties in determining the point at which a present obligation for different sorts of social benefits arises and the extent of those present obligations. The IPSASB continues to consider issues associated with social policy obligations in the context of current projects. The IPSASB released a Consultation Paper, *Reporting on the Long-term Sustainability of Public Finances* in November 2009. The IPSASB is also in the process of developing a conceptual framework for the public sector in which issues relevant to social benefit obligations will be considered.

Introduction

15.1 This Chapter addresses issues associated with the identification and recognition of liabilities arising from the social benefits provided by governments for which the government does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits.

Social benefits arising from exchange transactions are dealt with by IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* (refer to Chapter 7). Employee-related liabilities (refer to Chapter 14).

15.2 Obligations arising from social benefits or social policy obligations are the current and future financial obligations of a government to provide goods, services, and transfers to citizens under its existing social policies. Social policies encompass a government's policies in relation to the direct provision or funding of services such as health, education, housing, and social protection. The provision of services or various forms of social protection through transfers may be targeted (for example, recipients may be restricted to families and children, the elderly, the ill, the widowed, the unemployed, or those on low incomes). Alternatively they may be available to all citizens. Governments at all levels may provide financial assistance to individuals and groups in the community to access services to meet their particular needs, or to supplement their income.

15.3 Social policy obligations may be funded entirely by the government, or partially by the government and partially by way of contribution from the recipients. In such cases, the government's portion of the cost may be funded by way of tied taxes or general taxes. Both government contributions and individual contributions may be made over a period of years (often to a separate scheme or plan) or at the time of provision. In some jurisdictions social benefits may be provided in the form of an exchange transaction whereby recipients pay a government agency an amount approximately equal to the benefit received.

15.4 Governments are generally involved in a much wider range of activities than individual private sector entities, and face more issues in relation to the identification and measurement of liabilities. Accounting standard setters developing standards for the private sector generally do not consider the full range of issues that arise in the public sector. Governments which have adopted, or are adopting, accrual accounting have been forced to address these issues. Some of the approaches taken within various jurisdictions are discussed further below.

15.5 There is currently no IPSAS dealing specifically with the accounting treatment of liabilities arising from social policy obligations. However, if an entity elects to recognize provisions to provide social benefits through non-exchange transactions (i.e., the provision of those social benefits that are presently excluded from the scope of IPSAS 19), IPSAS 19 requires that certain disclosures be made in its general purpose financial statements.

Definitions

15.6 The definitions in IPSAS 19 are relevant to the discussion of social benefit obligations. Chapter 7 discusses some of the definitions in IPSAS 19. The definition of an obligating event is discussed later in this Chapter.

Possible Approaches

15.7 This section gives examples of approaches adopted by some governments to the recognition of various obligations arising from social benefits. The types of social benefits provided, eligibility criteria, timing of eligibility, and likelihood of future obligations vary between jurisdictions and all of these factors will influence the accounting policies adopted by an entity. The IPSASB is developing a conceptual framework for the public sector. The work on definition of a liability will be relevant for entities considering issues associated with the recognition of social benefit obligations.

Example 1

A government accrues unpaid amounts due to service providers in relation to free and subsidized medical care already provided by government-owned institutions at the end of the reporting period. Although it does not recognize the future costs of such medical care policies in the financial statements themselves, it provides disclosures.

Example 2

A government recognizes its obligation to third party recipients to deliver goods, services, or transfers once the intended third party recipient has met certain eligibility criteria as established in the contract or legislation. For example, in the case of welfare payments the government does not recognize a liability until it acknowledges an obligation to the recipient for the welfare payment. This happens when the government receives an application for a welfare payment and the application meets the eligibility criteria in legislation or regulations.

Example 3

A government has no legal obligation to make welfare payments. This government recognizes welfare payments as a liability and an expense when they are due to be paid, regardless of when payment actually occurs. If such liabilities have not been paid by the end of the reporting period, the liability is recognized in the statement of financial position. The obligation recognized includes any recipients who have been entered into the system for that payment period.

Example 4

A government operates a workers' injury compensation plan. It recognizes the future costs of past claims and the future costs of new claims in respect of which the injuries have occurred but claims have yet to be notified.

Example 5

Government entities use grants to reimburse external providers for payments made to entitled citizens in accordance with government policy. The government entities recognize an obligation to the external providers at the point at which the external providers make the payments to citizens. This is considered to be the "past event" which triggers the "present obligation."

Implementation Issues

15.8 The first step is to identify the obligations associated with the provision of social benefits that could lead to the recognition of a liability or provision. IPSAS 19 refers to two types of social benefits:

(a) The delivery of health, education, housing, transport, and other social services to the community.

(b) Payment of benefits to families, the aged, the disabled, the unemployed, veterans, and others.

15.9 The next step is to identify any obligations that fall within the scope of an existing IPSAS. If this occurs, the relevant IPSAS would provide the basis for the accounting policy.

15.10 For the remaining obligations, the next step is to consider whether the obligation could be accounted for in a manner similar to the obligations associated with exchange transactions. For example, some obligations which are at first classified as social policy obligations because they are related to grants made by a government, rather than consideration provided by the beneficiaries, may in fact have an element of exchange. Where there is an element of exchange, the entity could review the terms and conditions of the grant and re-establish the grant as an exchange transaction. As part of this process the government and public sector entities making the grants to individuals and entities would clarify what they expect in return for the grant, the point at which they expect this return, when the good or service is deemed to be delivered and when payment of the grant is due. This would then provide an appropriate point for the government to recognize the expense and any accrued liability. This approach is used in jurisdictions that adopt a purchaser-provider model. In such jurisdictions, all transactions by a government with entities or individuals are classified as the purchase of goods or services (outputs) or transfers (where the government receives no direct benefit in return). The fact that a jurisdiction has not formally adopted a purchaser-provider model would not preclude a government from exploring this approach. Social policy obligations arising from exchange transactions are dealt with by IPSAS 19.

15.11 The remaining social policy obligations may be sub-classified as those that are reasonably certain as to timing and amount or those that are uncertain as to timing or amount. Those that are reasonably certain as to timing and amount may be recognized in the same way as other liabilities (for example, the timing and amount of pensions for aged citizens may be known with sufficient certainty to justify a period-end accrual). In relation to those that are uncertain as to timing or amount, the entity needs to decide whether it would be appropriate to recognize a provision or disclose a contingent liability. Although IPSAS 19 excludes from its scope those obligations and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration equal to the value of goods and services provided, directly in return from the recipients of those benefits, the guidance in this IPSAS may nonetheless be useful in recognizing and measuring such provisions or disclosing such contingent liabilities.

15.12 Once an entity decides that a social policy obligation meets the conditions for recognition, it then needs to collect information on the amount of likely future cash flows and determine the method of calculation. For example, the entity will need to select an appropriate discount rate and determine the appropriate treatment of risk (for example, risk-free discount rates or risk-free cash flows and risk-adjusted discount rates or risk-adjusted cash flows).

15.13 Where an entity decides that a social policy obligation does not meet the conditions for recognition or for disclosure as a contingent liability, it then needs to consider whether it wishes to provide some form of supplemental disclosure in the financial statements or in some other document.

Background Information/Entitlement Criteria

15.14 For each type of potential obligation it is helpful to record details of:

(a) The relevant legislation, agreements, or examples of such payments;

(b) Entitlement criteria where applicable;

(c) Approval systems for applications and methods of notification;

(d) Payment mechanisms;

(e) Information available on current payments and the extent to which these relate to past or future obligations;

(f) Actuarial estimates of future obligations; and

(g) Current accounting treatment and disclosures.

15.15 This information can then be used to justify the classification of obligations into similar groups and the subsequent accounting treatment chosen. The information forms part of the audit trail.

Obligating Event

15.16 Determination of the obligating event can be a difficult issue for some obligations. Obligations may be legal or constructive. Legal obligations can be evidenced by legislative requirements and legally enforceable contracts. Constructive obligations are defined in IPSAS 19 as follows:

> *A constructive obligation is an obligation that derives from an entity's actions where:*
>
> (a) *By an established pattern of past practice, published policies, or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and*
>
> (b) *As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.*

15.17 In the absence of a legal obligation, an entity needs to determine whether there is sufficient evidence to indicate the existence of a constructive obligation.

15.18 For example, when a disaster has occurred, if a government has a policy of providing disaster relief assistance, its past practice, and public communication of its intention to provide such assistance for particular types of disasters, may be sufficient to provide evidence of a constructive obligation.

15.19 In the case of discretionary items such as donations, there is generally no legal obligation prior to the transfer of cash, assets, or loan forgiveness. Where there is a legally enforceable obligation prior to the transfer of cash then a liability would exist at the time the obligation becomes enforceable (for example, on the signing of an agreement).

15.20 The timing of entitlement in relation to benefits determines whether there is a liability for end-of-period accruals. For example, where entitlement does not occur until the date of payment, governments do not generally recognize a liability in relation to the benefit, apart from the amount due and payable at the reporting date.

15.21 The entity may need to develop policies for each benefit, specifying both the eligibility criteria and the policy to be followed in determining whether those eligibility criteria have been met. For example, are individuals seeking medical assistance from a government regarded as having met eligibility criteria when:

(a) They develop a condition and meet the criteria although they have not notified anyone that they intend to seek assistance from the government;

(b) They have completed an application seeking assistance;

(c) They have been assessed by a health care provider (employed by a non-government entity) who has recommended that their application be approved;

(d) The government entity responsible for approving assistance has received the application and has approved it;

(e) Their name and details have been entered into the system for payment; or

(f) The payment is due?

15.22 For some benefits there is no single obligating event creating a future liability. Rather, the individual or organization must meet the entitlement criteria at regular intervals. An example would be helpful to illustrate the distinction.

15.23 The point selected for recognition of the expense (and hence any related liability) is not solely dependent upon the existence of an obligating event. The obligation must also be able to be reliably measured. Reliable measurement depends on the nature of the information available.

Future Cash Flows

15.24 The identification of future cash flows associated with an obligation may require some research and estimation. For example, an entity may need to collect data on the conditions under which payments would be required, the number of instances of such payments being made in the past and the projected number of instances of such payments being required in the future. Actuarial estimates of the likelihood of certain events occurring may be required. In the case of period-end accruals however, an entity may know exactly how much it owes to another government entity or an individual for services delivered or to be delivered.

Classification

15.25 For those obligations that are recognized, an entity needs to develop a policy on the classification of various types of changes that will be recognized as expenses. For example, the unwinding of the discount rate would be classified as interest expense.

Financial Assets and Financial Liabilities

15.26 Some social policy obligations of governments may give rise to financial assets and liabilities. For example, student loans give rise to financial assets. Chapter 13 discusses issues associated with accounting for financial instruments. In deciding whether assets and liabilities arising from social policy obligations fall within the scope of the standards on financial instruments an entity will need to consider whether the arrangements are contractual or non-contractual. Only contractual arrangements give rise to financial assets and financial liabilities. IPSAS 28 provides guidance on assessing whether an arrangement is a contract for the purposes of that Standard.

Disclosure of Accounting Policies

15.27 An entity should develop, document, and disclose the accounting policies used for various obligations, including the point basis on which the provisions have been recognized and the measurement basis adopted.

Ongoing Review and Procedures

15.28 In order to ensure that the information provided each period is accurate, an entity will need to review all provisions regularly. Adjustments may be made to reflect the current best estimate or to reflect material changes in the assumptions underlying the calculations of the cash flows. An entity will therefore need to allocate responsibility for such reviews, provide guidance on issues to be considered in such reviews and the level of documentation required, and carry out regular checks to ensure that such reviews are occurring in accordance with these guidelines.

15.29 Only expenditures that relate to the purpose for which a provision was originally created may be offset against that provision. Generally, an entity establishes authorization procedures to ensure that any increases in provisions or use of provisions are approved by appropriate personnel. This may be done by specifying the individuals or positions with authority to create and/or amend provisions, and restricting access within the accounting system to those individuals.

Relevance to the Cash Basis of Accounting

15.30 The issues identified in this Chapter are relevant for entities intending to provide additional disclosure on the nature and amount of liabilities arising from certain social policy obligations as encouraged by the Cash Basis IPSAS. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the statement of cash receipts and payments.

IPSASB's Work on Social Policy Obligations—Past and Current

15.31 In 2004 a Steering Committee established by the Public Sector Committee (IPSASB's predecessor) issued an Invitation to Comment (ITC) *Accounting for Social Policies of Governments* (IFAC, 2004). This ITC sought feedback on recognition, measurement and disclosure proposals for social benefit obligations. The ITC distinguished between collective goods and services, individual goods and services, old age pension obligations, and other obligations involving cash transfers. In summary, the ITC proposed that in the case of collective and individual goods and services, no obligation arose until the goods and services were provided. In the case of obligations involving cash transfers (other than old age pensions) the ITC put forward the view that no present obligation for the payment of future cash transfers arises until an individual has satisfied all eligibility criteria, with the maximum amount of the obligation being limited to the amount that the individual is entitled to from one validation point until the next. This is essentially a due and payables approach. In the case of old age pensions the Steering Committee members did not have a unanimous view. The majority considered that obligations to provide old age pensions should be accounted for in the same way as other obligations to provide cash transfers. However some supported an earlier point of recognition, and recognition of a much greater liability. In putting forward these views the Steering Committee also acknowledged the need for comprehensive disclosures regarding the extent and timing of future cash flows.

15.32 The IPSASB did not consider that constituents had provided sufficient support to develop financial reporting requirements based on the proposals in the ITC. The IPSASB continued to consider these matters and in April 2008 it released three related documents for comment:

(a) Consultation Paper, Social Benefits: Issues in Recognition and Measurement;

(b) ED 34, Social Benefits: Disclosure of Cash Transfers to Individuals and Households; and

(c) Project brief, Long Term Fiscal Sustainability Reporting.

15.33 The purpose of the 2008 Consultation Paper was to solicit further comments from constituents regarding issues surrounding the recognition and measurement of social benefits. The 2008 Consultation Paper summarized many of the issues that had been addressed in the 2004 ITC.

15.34 ED 34 proposed disclosure, in financial statements, of amounts to be paid to beneficiaries as part of social benefits programs, as well as information about those programs. The amounts proposed to be disclosed included both amounts that were currently due and payable as well as amounts that would be payable to existing beneficiaries at some point in the future. It did not propose disclosure of amounts payable to beneficiaries that would become eligible in the future. Based on respondents' feedback, the IPSASB decided not to progress this ED. In addition, the IPSASB decided that proposals for recognition and measurement should now be closely linked to work on its Conceptual Framework project dealing with elements, particularly the definition of a liability.

15.35 Most constituents supported the IPSASB's proposal to initiate a project on Long-term Fiscal Sustainability. This project led to the publication of the Consultation Paper, *Reporting on the Long-Term Sustainability of Public Finances* (IFAC, 2009). The Consultation Paper expressed the view that many of the specialized reports produced by governments on long-term fiscal sustainability would not meet the information needs of users of general purpose financial reports. Amongst other things the Consultation Paper sought feedback on two possible approaches to making information on a government's long-term finances available to the public in the context of general purpose financial reporting. The two approaches were including additional statements in general purpose financial reports providing details of projects and the provision of summarized projections in narrative reporting.

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Study 11, *Governmental Financial Reporting: Accounting Issues and Practices*, May 2000

Appendix

Accounting Policies

This Appendix illustrates the internal accounting policies for the recognition of certain social policy obligations that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. There is currently no IPSAS dealing with the recognition, measurement, or disclosure of liabilities arising from social benefits provided by an entity for which it receives no or nominal consideration directly in return from the recipients of those benefits. In the absence of an IPSAS, entities will need to develop accounting policies based on appropriate authoritative guidance.

Generally accepted accounting practice with regard to such obligations can vary between countries and is determined by the nature of the arrangements underlying specific social policy obligations. These arrangements also vary significantly between jurisdictions. The following policies assume that a government provides a range of social benefits which impose financial obligations on the whole-of-government and individual public sector entities.

Individual Social Benefits

A liability for benefits is to be recognized in respect of benefits payable based on the estimated number of beneficiaries entitled to benefits at year end where claims either have been made or are expected to be made and which remain unpaid at the end of the year. The calculation of expected claims is to be based on population numbers and estimated drawing rates, having regard to the record of historical patterns of drawings. Outstanding claims likely to be settled within six months of the reporting date need not be discounted.

Each entity is to disclose an explanation of the policy adopted in relation to each main category of benefit, including the recognition criteria adopted and factors taken into account in estimating the number of beneficiaries and measuring the expected amount of claims (including the discount rate applied in any present value calculation).

Grants and Subsidies

Where grants and subsidies are discretionary until payment occurs, an expense is to be recognized when the payment is made. Where services are required to be performed by the grantee to establish eligibility for such grants or subsidies, the expense and any associated liability are to be recognized when the services have been performed.

Where specified criteria are required to be fulfilled in order for entitlement to occur, an expense and any associated liability is to be recognized when those criteria have been satisfied and the government has received notice that this has occurred.

Workers' Injury Compensation Scheme—Outstanding Claims

An estimate of the future costs of all outstanding claims arising from past events and for which the entity has a present obligation is to be recognized as a provision. Outstanding claims are to include all claims, regardless of whether they have been reported, as at balance date. The estimate is to be based on an assessment by an independent actuary. The total cost of new claims is therefore to be recognized in the year that claims occur.

Chapter 16: Non-Exchange Revenue

Key Points

- IPSAS 23, *Revenue from Non-Exchange Transactions (Taxes and Transfers)* prescribes requirements for the recognition and measurement of revenue arising from non-exchange transactions.
- IPSAS 9, *Revenue from Exchange Transactions* prescribe requirements for revenue arising from exchange transactions.
- Issues associated with accounting for non-exchange revenues include classification, determining recognition points, measurement at initial recognition, and determining the appropriate treatment of conditions attached to grants.
- Transactions which give rise to non-exchange revenue often also involve the recognition of assets. Initial recognition of such assets is in accordance with IPSAS 23, together with any specific requirements in the relevant standard for such assets.

Introduction

16.1 This Chapter discusses the requirements of IPSAS 23 and issues associated with accounting for revenue from non-exchange transactions. Non-exchange revenue is derived from transactions where the entity receives value from another entity without directly giving approximately equal value in exchange. Most public sector entities will have some form of non-exchange revenue, and for many, it will be their main source of revenue. Types of non-exchange revenue falling within the scope of IPSAS 23 are:

(a) Taxes (direct and indirect);

(b) Grants from national governments, other levels of government, and international agencies;

(c) Fines and other penalties imposed for breaches of the law;

(d) Certain fees and charges;

(e) Bequests;

(f) Gifts and donations, including goods in-kind and services in-kind; and

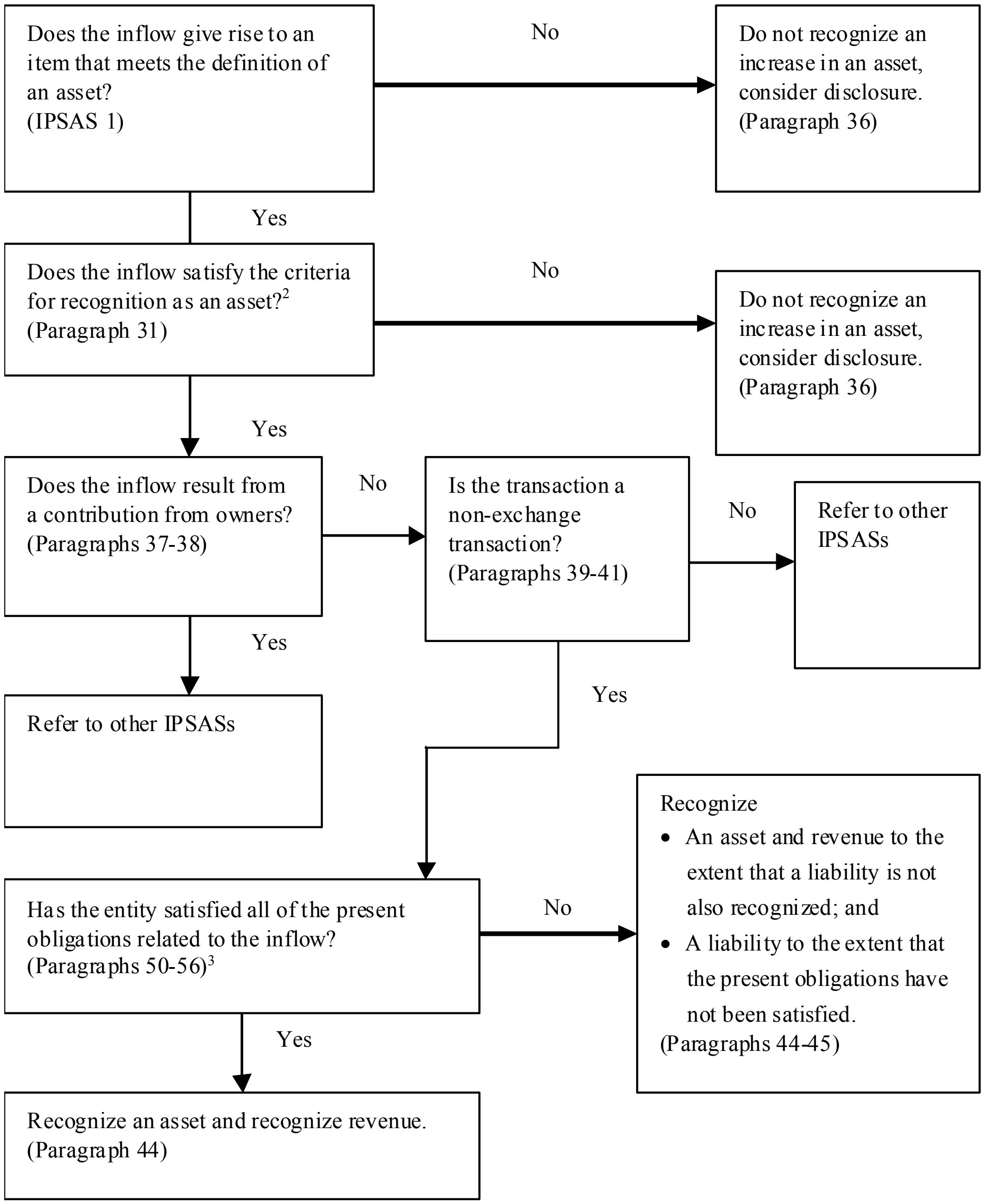
(g) The forgiveness of debt or assumption of the entity's liabilities by another entity.

Summary of IPSAS 23

16.2 The following flowchart, taken from IPSAS 23, summarizes the requirements of the Standard. This section highlights some of these requirements.

General Principles

Illustration of the Initial Analysis of Inflows of Resources[1]



1. The flowchart is illustrative only; it does not take the place of the Standards. It is provided as an aid to interpreting the IPSAS.
2. In certain circumstances, such as when a creditor forgives a liability, a decrease in the carrying amount of a previously recognized liability may arise. In these cases, instead of recognizing an asset the entity decreases the carrying amount of the liability.
3. In determining whether the entity has satisfied all of the present obligations, the application of the definition of conditions on a transferred asset, and the criteria for recognizing a liability are considered.

16.3 In order for an entity to recognize an asset from a non-exchange transaction the item must meet the definition of an asset and satisfy the recognition criteria set out in IPSAS 23. The two recognition criteria, both of which must be satisfied, are that (i) it is probable that the future economic benefits or service potential associated with the asset will flow to the entity and (ii) the fair value of the asset can be measured reliably. An asset acquired through a non-exchange transaction shall initially be measured at its fair value as at the date of acquisition.

16.4 IPSAS 23 acknowledges that some transactions may include two components: exchange and non-exchange. Where this occurs, the non-exchange component is recognized according to the requirements of IPSAS 23 and the exchange component is recognized in accordance with other relevant standards.

16.5 Under IPSAS 23 the recognition of an asset as a result of a non-exchange transaction does not necessarily give rise to revenue of an equivalent amount. If a liability is also recognized in respect of the inflow of resources from the same transaction then only the amount of the increase in net assets is recognized as revenue.

16.6 Present obligations may arise from the types of non-exchange transactions considered in IPSAS 23. IPSAS 23 acknowledges that assets transferred in a non-exchange transaction are often expected or required to be used in certain ways. It uses the terms stipulations, conditions, and restrictions to describe these expectations and requirements. The definitions of these terms, as used in IPSAS 23, are shown below.

(a) **Stipulations** on transferred assets are terms in laws or regulation, or a binding arrangement, imposed on the use of a transferred asset by parties external to the reporting entity.

(b) **Conditions** on transferred assets are stipulations that specify that the future economic benefits or service potential embodied in the asset is required to be consumed by the recipient as specified or future economic benefits or service potential must be returned to the transferor.

(c) **Restrictions** on transferred assets are stipulations that limit or direct the purposes for which a transferred asset may be used, but do not specify that future economic benefits or service potential is required to be returned to the transferor if not deployed as specified.

16.7 Under IPSAS 23 conditions on assets give rise to liabilities but stipulations do not. The Implementation Guidance accompanying IPSAS 23 includes examples of restrictions and conditions. An example of a condition is where a donor specifies that an entity must purchase specific drugs or vaccines or return the donated funds to the donor. An example of a restriction is where a donated building must be used for a specified purpose, but there is no requirement to return the building if its use changes.

16.8 In order for an entity to recognize a liability from a non-exchange revenue transaction the present obligation must meet the definition of a liability and satisfy the recognition criteria set out in IPSAS 23. The two recognition criteria, both of which must be satisfied, are that (i) it is probable that an outflow of resources embodying future economic benefits or service potential will be required to settle the obligation and (ii) a reliable estimate of the amount of the obligation can be made. The amount recognized as a liability is the best estimate of the amount required to settle the present obligation at the reporting date. As an entity subsequently satisfies the obligations giving rise to such liabilities it reduces the carrying amount of the liability and recognizes an amount of revenue equal to that reduction. The types of obligations that may give rise to the recognition of liabilities in accordance with IPSAS 23 are discussed in the next section of this Chapter.

16.9 IPSAS 23 also requires that an entity recognize an advance receipt liability in respect of advance receipt of taxes prior to the occurrence of the taxable event (paragraphs 53 and 66) and advance receipts of resources relating to a transfer arrangement before that transfer arrangement becomes binding (paragraphs 54 and 106). In the case of advance receipt of taxes, a liability of an amount equal to the amount of the advance receipt is recognized until the taxable event occurs.

Taxes

16.10 IPSAS 23 discusses the application of the general principles in the Standard to taxes and establishes specific requirements in respect of the recognition and measurement of taxes (paragraphs 59 to 75). The key requirements are:

(a) An entity recognizes an asset in respect of taxes when the taxable event occurs and the asset recognition criteria are met. The Standard gives examples of when the taxable event is likely to occur for certain types of taxes.

(b) Taxation revenue is determined at a gross amount. It is not reduced for expenses paid through the tax system (e.g. amounts that would otherwise be paid using another payment method and which may be payable regardless of whether or not the individual pays taxes).

(c) Taxation revenue shall not be grossed up for the amount of tax expenditures. Tax expenditures are foregone revenue affecting the amount of tax liability. Tax expenditures provide benefits to taxpayers by allowing special deductions from gross income.

(d) Transfers.

16.11 IPSAS 23 discusses the application of the general principles in the Standard to various types of transfers (paragraphs 59 to 75). Generally an entity recognizes an asset in respect of transfers when the transferred resources meet the definition of an asset and satisfy the criteria for recognition as an asset. Goods-in-kind are subject to these general requirements. However, there is an exception for services-in-kind. An entity may, but is not required to, recognize services in-kind as revenue and as an asset. This exception was included in the Standard because of the uncertainties surrounding services-in-kind including the ability to exercise control over the services, the difficulty of measuring the fair value of some services. Disclosure of services-in-kind is encouraged.

Contributions from Owners

16.12 IPSAS 23 notes that contributions from owners are defined in IPSAS 1. Inflows of resources relating to contributions from owners do not give rise to revenue. Any contributions from owners are accounted for separately. Paragraph 38 gives examples of documentation that may provide evidence that a transaction represents a contribution from owners. Paragraph 80 gives examples of agreements that are, in substance, agreements to make a contribution from owners. Examples are agreements that specify that the entity providing resources is entitled to distributions of future economic benefits or service potential during the recipient entity's life, or distribution of any excess of assets over liabilities in the event that the recipient entity is wound up, or that specify that the entity providing resources acquires a financial interest in the recipient entity that can be sold, exchanged, transferred or redeemed.

Disclosures

16.13 IPSAS 23 requires the following disclosures either on the face of, or in the notes to the financial statements:

(a) The amount of revenue from non-exchange transactions recognized during the period by major classes showing separately taxes and transfers.

(b) The amount of receivables recognized in respect of non-exchange revenue.

(c) The amount of liabilities recognized in respect of transferred assets subject to conditions.

(d) The amount of assets recognized that are subject to restrictions and the nature of those restrictions.

(e) The existence and amounts of any advance receipts in respect of non-exchange transactions.

(f) The amount of any liabilities forgiven.

16.14 Note disclosures include:

(a) The accounting policies adopted for the recognition of revenue from non-exchange transactions.

(b) For major classes of revenue from non-exchange transactions, the basis on which the fair value of inflowing resources was measured.

(c) For major classes of taxation revenue which the entity cannot measure reliably during the period in which the taxable event occurs, information about the nature of the tax.

(d) The nature and type of major classes of bequests, gifts, and donations showing separately major classes of goods in-kind received.

16.15 IPSAS 1 also includes similar, although less detailed, disclosure requirements.

(a) The statement of financial position must include, as separate line items on the face of the statement, recoverables from non-exchange transactions (taxes and transfers) and receivables from exchange transactions. Additional disclosure is required of categories of receivables, including amounts receivable from user charges, taxes, and other non-exchange revenues (paragraphs 88 and 94).

(b) Total revenue must be sub-classified, either on the face of the statement of financial performance or in the notes to the statement of financial performance, in a manner appropriate to the entity's operations (paragraph 108).

(c) In the summary of specific accounting policies applied an entity shall disclose the accounting policies used that are relevant to an understanding of the entity's financial statements. In the case of public sector entities this would be expected to include an accounting policy for recognition of taxes, donations, and other forms of non-exchange revenue (paragraphs 132 and 135).

16.16 Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Interaction Between IPSAS 23 and Other IPSASs

16.17 Non-exchange revenue transactions often involve the transfer of assets. The initial recognition and measurement of such assets is generally governed by IPSAS 23 and the subsequent measurement and accounting for such assets is government by the relevant IPSAS. Examples of specific IPSASs which interact with IPSAS 23 are listed below.

(a) IPSAS 12, IPSAS 16 and IPSAS 17 all require that the cost of assets acquired through a non-exchange transaction be measured at their fair value as at the date of acquisition. This replicates the requirements in IPSAS 23.

(b) IPSAS 27 requires that biological assets acquired through non-exchange transaction be measured on initial recognition and at each reporting date at fair value less costs to sell (except where the fair value cannot be measured reliably). This is almost identical to the requirements in IPSAS 23 except that entities are also required to consider costs to sell. IPSAS 27 also requires specific disclosures about biological assets acquired or to be disposed of via non-exchange transactions.

(c) IPSAS 28 contains additional Application Guidance on when assets and liabilities arising from non-exchange revenue transactions are financial assets or financial liabilities. One key requirement before they can be financial assets or liabilities is that they must be contractual. The Basis for Conclusions in IPSAS 27 notes the IPSASB's view that liabilities arising from non-exchange revenue transactions are not generally financial liabilities. Liabilities which arise after initial recognition of such transactions need to be separately assessed to determine whether they are financial liabilities. An entity uses the guidance in IPSAS 28 and IPSAS 23 in assessing whether a non-exchange transaction gives rise to a liability or an equity instrument (contribution from owners).

(d) IPSAS 29 states that the initial recognition and measurement of rights and obligations arising from non-exchange revenue transactions which fall within the scope of IPSAS 23 should be in accordance with IPSAS 23. Application guidance in IPSAS 23 clarifies that the initial measurement of financial assets arising from such transactions should be (i) at fair value using the principles in IPSAS 23 and (ii) taking account of transaction costs that are directly attributable to the acquisition of the financial asset (where the asset is subsequently measured other than at fair value through surplus or deficit).

(e) When an entity has its debt waived as part of a non-exchange transaction the entity applies IPSAS 23 revenue recognition requirements and IPSAS 29 derecognition requirements.

(f) Entities granting and receiving concessionary loans need to apply IPSAS 29 to the initial recognition of such loans. The portion of the loan that is expected to be repaid, along with any interest payments, is an exchange transaction and is accounted for in accordance with IPSAS 29. The difference between the transaction price (loan proceeds) and the fair value of the loan on initial recognition is likely to be a non-exchange expense or non-exchange revenue. Non-exchange revenue is accounted for in accordance with IPSAS 23.

16.18 At the time that IPSAS 23 was developed, the IPSASB reviewed the requirement of IPSAS 12, IPSAS 16 and IPSAS 17 to ensure that they were consistent with IPSAS 23 requirements.

16.19 More recently the IPSASB has developed standards on financial instruments and agriculture and has reexamined the interaction between IPSAS 23 and other standards, particularly the consistency of initial measurement of assets and liabilities and the nature of liabilities arising from non-exchange revenue transactions.

16.20 IPSAS 23 contemplates the initial recognition of a non-financial liability only. During the development of the standards on financial instruments the IPSASB noted that in some situations a non-exchange revenue transaction may give rise to a financial liability (for example, where an entity receives cash which is to be used to provide a cash transfer to other parties) but expressed the view that this would be rare. The IPSASB's Basis for Conclusions on IPSAS 27, IPSAS 28, and IPSAS 29 comment on this and other issues associated with the interaction of IPSAS 23 and the standards dealing with financial instruments.

Development of Accounting Policies

16.21 The main accounting policy issues associated with non-exchange revenues are:

(a) Classification of revenues, including classifications to be used on the face of the financial statements, in the notes to the financial statements and in the chart of accounts;

(b) Determining the point at which the criteria for recognition of revenue are satisfied for various categories of non-exchange revenues such as taxes and transfers; and

(c) Identifying whether conditions attached to grants meet the definition and criteria for recognition of a liability.

Classification

16.22 Useful sources of information or considerations in establishing a system of revenue classifications include the:

(a) Existing revenue classification system used under the current basis of accounting;

(b) Disclosures required by IPSASs;

(c) Statistical reporting systems, particularly for classification of taxation revenue; and

(d) Existence of any restrictions or conditions on the revenue and related assets.

16.23 Statistical reporting systems include:

(a) The System of National Accounts (SNA);

(b) The European System of Integrated Economic Accounts of EU member States (ESA), which is primarily an elaboration of SNA, though differing from it in certain respects; and

(c) The Government Finance Statistics Manual (GFSM, 2001).

16.24 Application of IPSAS 23 may result in the recognition of revenue from transactions that have not previously been regarded as giving rise to revenue (for example, non-cash grants or donations).

16.25 Because IPSAS 1 and IPSAS 23 require the separate disclosure of information on exchange and non-exchange revenues and associated assets and liabilities, each class of revenue item should be classified as exchange or non-exchange (exchange revenue is discussed in Chapter 8). Bergmann and Schuler consider the classification of the revenues of the European Patent Office under IPSASs (Bergmann and Schuler, 2009).

16.26 Individuals responsible for external financial reporting and those responsible for statistical reporting should be involved in the development of classifications. For example, the classification of items with revenues with exchange and non-exchange components may differ between these systems and IPSASs.

16.27 Appropriations or other forms of budgetary authorities represent an authorization by the legislature to expend funds. The legislative and administrative arrangements surrounding appropriations vary considerably from one jurisdiction to another with corresponding differences in the classification of the subsequent transactions in the financial statements (for example as revenue or assets). Each entity needs to determine whether the funds received by way of appropriation or other budgetary authority meet the definition of revenue, and if so, whether such revenue is exchange or non-exchange.

16.28 Another aspect of classification is determining whether all the revenue flows collected by an entity meet the requirements to be recognized as revenue of that entity. It is not uncommon for public sector entities to collect taxes or fees, in an agency capacity, on behalf of other public sector entities. Chapter 9 notes that an entity will need to carefully consider whether it controls cash flows associated with such transactions.

16.29 If an entity conducts transactions on behalf of others, as an agent, it will need to ensure that revenues and expenses arising from those transactions are appropriately classified. The collection of cash on behalf of other entities is discussed in Chapter 9.

Recognition

16.30 Although IPSAS 23 establishes recognition requirements for various types of non-exchange revenue, the application of these requirements can still be subject to considerable judgment. In some cases, there may be a range of possible recognition points with measurability and probability being different at each point. For each revenue item, an entity needs to identify the possible recognition points and identify, given existing or planned collection mechanisms and information systems, the point at which the entity obtains control over the asset and the revenue is both measurable and probable. This task could be performed in the following way:

(a) Obtain a complete list of relevant revenue items (for example, exclude all revenue items that are to be accounted for as exchange transactions in accordance with IPSAS 9).

(b) Document the nature of the item, the circumstances in which it arises, the periods for which the revenue is due, the payment dates and any evidence on the amount of revenue due that is actually collected (this information may already be available).

(c) Identify and talk to individuals with responsibility for developing existing recognition points and operating existing systems. Information sought should include how the revenue is collected and the extent to which the entity has information (or can generate information) on the likely amount of revenue due and to be collected. Relevant individuals could include those who are responsible for drafting relevant legislation and regulations, preparing financial statements, and operating collection systems.

(d) Draft both general and detailed proposed recognition points for each revenue item. The detailed policy could include reference to any particular document or procedure. For example, the presentation of a signed declaration to a Customs Officer, or the release of goods for home consumption could be the point of recognition.

(e) Identify any changes that would be required in order to move the existing recognition point closer to the point at which the revenue is recognized under IPSASs. Existing administrative processes may not provide the information necessary for accrual at the point the underlying event or transaction occurs. For material revenue items, it may be appropriate to consider whether administrative and system changes could be implemented in the near future.

(f) In relation to promises to make donations or grants, an entity needs to document the nature of existing donations and grants, identify those which are enforceable and identify material items that may require disclosure. On an ongoing basis, the entity will need to ensure that it has a system for recording and monitoring promises by others to donate resources to the entity.

16.31 Some entities have chosen to split the work required in relation to developing and applying IPSAS-compliant accounting policies for transfers into phases. For example, the United Nations Industrial Development Organization (UNIDO, 2009) chose to apply its new accounting policies to new transfers first. It then applied the new accounting policies to existing funding arrangements over a transitional period.

Transfers

16.32 In order to determine the appropriate recognition point for government transfers to be received by an entity, it is necessary to document:

(a) The process for authorization of the transfer by the donor/transferor;

(b) Any eligibility criteria;

(c) The way in which the donor/transferor confirms that criteria have been met;

(d) The likelihood of eligibility criteria not being met;

(e) In the event of eligibility criteria not being met, the likelihood of funds having to be returned to the transferor; and

(f) The point at which a reasonable estimate of the amount can be made.

16.33 An entity will need to record and monitor outstanding restrictions and conditions attached to all material non-exchange transfers to ensure that restrictions or conditions relating to cash transfers or donated assets are not breached and to ensure that revenue is recognized as performance of obligations relating to conditions occurs. As noted above, IPSAS 23 requires disclosure of both restrictions (on assets) and liabilities (as a result of conditions). IPSAS 2 also encourages entities to disclose the amount and nature of restricted cash balances.

Tax Revenue

16.34 IPSAS 23 requires that an entity recognize an asset in respect of taxes when the taxable event occurs and the asset recognition criteria are met. It suggests that the taxable event for income tax is likely to be the earning of assessable income during the period by the taxpayer. However, if taxation revenues are not reliably measurable at this time an entity will need to consider alternative recognition points. In the case of income tax, the following are alternative potential recognition points:

(a) At the end of the income year;

(b) When the tax returns are filed;

(c) When tax is assessed;

(d) When a tax liability is recognized by the taxpayer; or

(e) When payment is received.

16.35 Because the nature of taxes and other non-exchange revenues and the procedures and systems used to collect and record revenues vary greatly between jurisdictions, it is possible that the initial points of recognition will also vary. In considering alternative recognition points for items, it is helpful to:

(a) Investigate whether it is possible to reliably estimate revenues at an appropriate earlier recognition point; and

(b) Calculate the amount of revenue that would be recognized using different recognition points and see if there is any material difference.

16.36 In some jurisdictions, tax revenues may be recognized at the time when tax payments are due and payable according to legislation or when an assessment is issued by the relevant taxation authority. An alternative approach is to recognize tax revenue based upon the tax liabilities that will arise (in any period) with respect to the transactions and balances occurring during that reporting period, even where an assessment has not yet occurred. Under this method, current year revenue is also affected by variations between prior year estimates and the associated actual transactions during the current year. The first approach generally provides more certainty in the recording of revenue and less possibility of material misstatement.

Transitional Provisions

16.37 IPSAS 23 provides generous transitional provisions. Entities have five years from the date of adoption of IPSAS 23 to recognize all taxation revenue and three years to recognize all other non-exchange revenue. These transitional provisions reflect the fact that adoption of IPSAS 23 is likely to result in considerable change to an entity's accounting policies and that it may take some time to fully implement these changes.

16.38 The regular progress reports prepared by United Nations agencies, including the World Food Programme and the United Nations Industrial Development Organization (UNIDO) indicate the nature and extent of work required to implement IPSAS 23 in those organizations. The UNIDO elected to make use of the three year transitional provisions available in IPSAS 23 as it wished to develop a reliable model for measuring revenue from non-exchange transactions during the transition period (UNIDO, 2009).

Relevance to the Cash Basis of Accounting

16.39 This discussion of revenues from non-exchange transactions may be of interest to entities reporting in accordance with the Cash Basis IPSAS, *Financial Reporting Under The Cash Basis of Accounting* (Cash Basis IPSAS) for the following reasons.

(a) The Cash Basis IPSAS, paragraph 1.3.12 requires that total cash receipts be sub-classified using a classification appropriate to the entity's operations. Paragraph 2.1.30 outlines a possible classification. In deciding what sub-classification to use an entity may wish to consider whether separate classification of cash receipts from exchange and non-exchange transactions is appropriate. An entity which intends to move to accrual based IPSASs may also wish to ensure that its current chart of accounts can be used in the future support the disclosure requirements in IPSAS 23.

(b) The Cash Basis IPSAS, paragraphs 1.10.8 to 1.10.27, requires a number of disclosures regarding external assistance to an entity. These disclosures are intended to capture both assistance provided directly by way of cash and other forms of non-cash assistance such as the purchase of goods and services on behalf of an entity. Most, but not necessarily all, external assistance transactions will be non-exchange. An entity which intends to move to accrual based IPSASs may find it helpful to consider the requirements of IPSAS 23 in relation to different forms of external assistance (for example, cash received, assets provided directly to the entity, assets provided to others on behalf of the entity, donated services, loans provided on favorable terms, and the write off of amounts owing to others).

(c) The Cash Basis IPSAS, paragraphs 2.1.15 to 2.1.22, encourages disclosure of administered transactions. Because taxes and other non-exchange revenues are often collected by government departments or agencies on behalf of the government, a number of the cash flows associated with administered transactions will represent revenue from non-exchange transactions.

(d) The Cash Basis IPSAS, paragraph 2.1.33, encourages disclosure of information about the assets and liabilities of the entity. An entity electing to make these disclosures will need to decide whether to apply the requirements of IPSAS 23 in identifying such assets and liabilities. For example, IPSAS 23 provides guidance on the recognition of grants receivable and the recognition of liabilities in relation to conditions on grants.

(e) The Cash Basis IPSAS, paragraph 1.4.9, requires that an entity disclose, in commentary, the nature and amount of significant cash balances that are not available for use of the entity and subject to external restrictions. The discussion in IPSAS 23 of restrictions and conditions may be useful in making such disclosures.

16.40 The additional disclosures discussed above may be provided in the notes to the financial statements or as supplementary information, but the amounts relating to any non-cash items cannot be included in the amounts shown on the face of the statement of cash receipts and payments.

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Appendix

Accounting Policies

Part I

Part I of this Appendix illustrates the accounting policies for the initial recognition of taxes, duties, fines, and licenses. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities collecting such revenues either on behalf of a whole-of-government reporting entity or on their own behalf.[43] The examples may differ from the recognition points illustrated in IPSAS 23 due to assumptions about the point at which the revenue becomes reliably measureable.

Taxation Revenue

- Personal income tax on salaries and wages and interest, which is deducted at source, is to be recognized when the individual earns the income subject to the source deductions.
- Corporate income tax is to be recognized as installments are received and as assessments of final tax due are made.
- Taxes on international travel are to be recognized on the date of departure of the vessel or aircraft.
- Land tax is to be recognized at the time the assessment is issued.

Revenue from Taxes, Duties, Fines, and Licenses

- Customs and excise duties are to be recognized when goods subject to these taxes are distributed for consumption.
- Stamp duty is to be recognized when the duty is received by the collecting entity.
- Fines are to be recognized at the point the fine is imposed.
- Business and professional licenses are to be recognized at the time of initial application and upon renewal.

Part II

Part II of this Appendix contains policies from the financial statements of the World Food Programme (WFP) as at December 31, 2008 which illustrate the application of IPSAS 23 by that entity.

[43] The policies for the recognition of non-exchange revenue may vary considerably between jurisdictions and levels of government. This is because the characteristics of non-exchange revenue, such as manner of assessment, assessment dates, payment dates, payment systems, availability of information at various points and the likelihood of payment, vary widely between types of revenue and between jurisdictions. Recognition policies are heavily reliant on the accuracy and reliability of information prior to the receipt of revenue.

Basis of Preparation

In accordance with IPSAS requirements, and reflecting the nature of WFP's business, revenue from contributions confirmed in writing is recognized as non-exchange transactions as per IPSAS 23.

WFP considers that while there are restrictions on the use of contributions, these restrictions do not meet the definition of a condition as described under IPSAS 23. These contributions are recognized as revenue when confirmed in writing by donors.

Inventories

Food commodities and non-food items on hand at the end of the financial period are recorded as inventories and are valued at lower of cost or current replacement cost.

The cost of food commodities includes purchase cost or fair value[7] if donated in-kind and all other costs incurred in bringing the food commodities into WFP's custody at their point of first entry into a recipient country where they become distributable. In addition, any significant costs of conversion such as milling or bagging are included. Cost is determined on the weighted average basis.

Food commodities are expensed when distributed directly by WFP or once they are handed over to cooperating partners for distribution.

Contributions and Receivables

Contributions are recognized when confirmed in writing by donors.

Receivables are stated at nominal value less allowance for estimated irrecoverable amounts.

In-kind contributions of services that directly support approved operations and activities, which have budgetary impact, and can be reliably measured, are recognized and valued at fair value. These contributions include use of premises, utilities, transport, and personnel.

Donated Property, Plant and Equipment are valued at fair market value and recognized as fixed asset and revenue.

Chapter 17: Foreign Currency

Key Points

- IPSAS 4, *The Effects of Changes in Foreign Exchange Rates* contains guidance on accounting for foreign currency transactions and foreign operations.
- In order to apply IPSAS 4, entities will need to ensure they have systems for identifying the transactions and balances referred to in IPSAS 4 and have classified foreign operations as either foreign operations that are integral to the operations of the reporting entity or as foreign entities.
- The adoption of accrual accounting is often associated with an increased emphasis on the management of foreign exchange risk. This may involve the development of policies regarding exposures to individual currencies and financial institutions, and the types of instruments to be used to manage those exposures.

Introduction

17.1 IPSAS 4:

(a) Deals with accounting for foreign currency transactions and foreign operations;

(b) Sets out the requirements for determining which exchange rate to use for the recognition of certain transactions and balances; and

(c) Explains how to recognize the financial effect of changes in exchange rates in the financial statements.

17.2 A foreign exchange gain or loss occurs when there are transactions payable or receivable in foreign currency and exchange rates change between the time of recognition of the transaction and the time of payment. Such gains or losses may be realized or unrealized at the end of the reporting period. Gains or losses may also occur due to changes in the rates used to translate the balances associated with foreign operations.

17.3 As noted in the International Monetary Fund (IMF) and World Bank's *Guidelines for Public Debt Management* (IMF and World Bank, 2003), excessive unhedged foreign exchange exposures are a common pitfall in public debt management. Excessive amounts of foreign currency denominated debt and foreign exchange indexed debt can leave governments vulnerable to volatile and possibly increasing debt service costs if their exchange rates depreciate, and the risk of default if they cannot roll over their debts.

17.4 Many governments will also have significant foreign exchange risk exposures arising from government entities' purchases and sales. The adoption of accrual accounting provides a government with a timely opportunity to review its management of foreign exchange exposures, both in relation to debt and the operations of its entities. Options include the establishment of specific thresholds beyond which cover will be taken, or remaining uninsured at the whole-of-government level (sometimes referred to as self-insuring). Foreign currency management of risks associated with the operations of individual entities can occur at an entity level or as a centralized function.

Definitions

17.5 The following terms are used in IPSAS 4:

Closing rate is the spot exchange rate at the reporting date.

Exchange difference is the difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate is the ratio of exchange for two currencies.

Foreign currency is a currency other than the functional currency of the entity.

Foreign operation is an entity that is a controlled entity, associate, joint venture, or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

Functional currency is the currency of the primary economic environment in which the entity operates.

Monetary items are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. Net investment in a foreign operation is the amount of the reporting entity's interest in the net assets/equity of that operation.

Presentation currency is the currency in which the financial statements are presented.

Spot exchange rate is the exchange rate for immediate delivery.

Summary of IPSAS 4

17.6 IPSAS 4 requires that an entity initially record its foreign currency transactions in the entity's functional currency.

17.7 At each reporting date an entity must translate all foreign currency items into the functional currency. The rate which must be used depends on the type of item (for example, foreign currency monetary items are translated using the closing rate).

17.8 Exchange differences arising on settlement of monetary items and on translation of monetary items at a rate different from when initially recognized are generally recognized in surplus or deficit. However, exchange differences arising from monetary items that form part of the reporting entity's net investment in a foreign operation are recognized in a separate component of net assets/equity in the consolidated financial statements (and subsequently recognized in surplus or deficit on disposal of that net investment).

17.9 An entity may present its financial statements in a currency other than its functional currency. IPSAS 4 specifies the requirements for this translation – there are separate requirements for an entity whose functional currency is hyperinflationary.

Implementation of IPSAS 4

17.10 Entities intending to comply with IPSAS 4 will need to:

(a) Determine the reporting entity's functional currency. This issue is particularly relevant for international public sector organizations. Most United Nations agencies collect assessments in a single currency, which is usually the functional currency of the organization.

(b) Identify transactions (purchases, sales, grants, loans and advances, borrowings) which are commonly required to be settled in foreign currency;

(c) Identify the magnitude of such transactions during the reporting period and the potential foreign exchange gains and losses associated with those transactions;

(d) Identify balances held in foreign currencies (for example, investments, trading activities, borrowings, loans and advances, overseas properties);

(e) Identify all foreign operations and classify them as either integral operations or foreign entities;

(f) Identify the extent to which some exchange differences should be classified as borrowing costs and whether borrowing costs are capitalized in accordance with the allowed alternative treatment in IPSAS 5, *Borrowing Costs*;

(g) Determine whether any entities within the reporting entity will be presenting their financial statements in a currency other than their functional currency;

(h) Develop accounting policies to cover actual and likely transactions and balances (draft policies are shown in Appendix A to this Chapter); and

(i) Where accrual budgeting is adopted, establish policies for the recognition of foreign currency gains and losses in budgets.

17.11 The disclosures required by IPSAS 4 are set out in paragraphs 60 to 66. Two key disclosures required are the amount of exchange differences arising recognized in surplus or deficit and net exchange differences classified in a separate component of net assets/equity. Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Foreign Currency Risk Management

17.12 Although management of foreign currency risk is not strictly an accounting issue, the adoption of accrual accounting often provides the impetus for improved risk management. In particular, the adoption of accrual accounting is likely to improve an entity's ability to accurately identify a wider range of foreign currency exposures. An entity wishing to review its management of foreign currency exposures would need to address the following issues:

(a) Decide whether foreign currency exposures will be managed at a central level or by individual entities.

(b) Develop a policy on the operation of foreign currency bank accounts, including the establishment of thresholds for government-wide exposure to particular banks and currencies.

(c) Develop policies (government-wide and individual entity policies as appropriate) for managing foreign currency exposures and for maintaining foreign exchange reserves. For example, governments are likely to adopt a risk-averse approach and to attempt to minimize foreign exchange costs.

(d) Develop tendering and expenditure approval processes which involve a proper assessment of foreign exchange risk and are consistent with policies on the treatment of foreign exchange risk.

Complying with Policies

17.13 For an entity to ensure that it operates in compliance with its accounting policies and risk management policies, it needs to carry out a series of regular checks to ensure that:

(a) The policy, operating procedures and guidelines are in place and communicated to all staff;

(b) The policy, operating procedures and guidelines are complied with, for example, by regular monitoring of various types of exposure thresholds;

(c) Staff responsible for managing foreign exchange exposure have the appropriate skills and experience;

(d) All foreign currency bank accounts comply with any policy on the operation of foreign currency bank accounts;

(e) The correct rate (as required by the accounting policies) is applied to each foreign exchange transaction;

(f) Foreign exchange rate coverage (in accordance with policies) is obtained where transactions exceed exposure thresholds; and

(g) The entity meets reporting requirements in a timely manner and that the information in such reports is correct.

Relevance to the Cash Basis of Accounting

17.14 This Chapter is relevant for entities intending to provide additional disclosure on the nature and amount of outstanding foreign currency exposures encouraged by the Cash Basis IPSAS. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the statement of cash receipts and payments. Management of foreign currency exposures can occur in a cash-based environment, but requires significant additional systems and is often restricted to management of foreign currency exposures associated with government borrowing.

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Appendix

Accounting Policies

This Appendix illustrates the accounting policies to be adopted to account for foreign currency transactions and balances. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The policies are based upon the requirements in IPSAS 4, where such requirements exist. (The government and its entities, whether domestic or foreign, do not operate in hyperinflationary economies.)

Foreign Currency Translation

(a) *Functional and Presentation Currency*

Items included in the financial statements of the entity (or each of the group's entities) are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated financial statements are presented in "Currency Units" (CU), which is the entity's functional currency and the group's presentation currency.

(b) *Transactions and balances*

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions or valuation where items are re-measured.

At the end of the reporting period, foreign currency transactions and balances are translated into the functional currency using the following exchange rates:

(a) Foreign currency monetary items are translated using the exchange rates prevailing at the end of the reporting period. Foreign currency monetary items include borrowings denominated in foreign currency and amounts owed for overseas purchases where the account is to be settled in another currency.

(b) Non-monetary items which are carried at historical cost are translated using the exchange rate prevailing at the date of the transaction.

(c) Non-monetary items which are re-measured are translated using the exchange rates prevailing at the date of valuation i.e., when the fair values were determined.

Foreign exchange gains and losses resulting from the settlement of transactions denominated in foreign currencies and from the translation of monetary assets and liabilities are recognized as revenue or expenses in the statement of financial performance in the period in which they arise except when deferred in net assets/equity as qualifying cash flow hedges and qualifying net investment hedges.[44]

Foreign exchange gains and losses that relate to borrowings and cash and cash equivalents are presented in the statement of financial performance within "finance revenue or cost." All other

[44] Refer to Chapter 13 for a discussion of financial instruments and hedging.

foreign exchange gains and losses are presented in the statement of financial performance within "other (losses)/gains – net."

Changes in the fair value of monetary securities denominated in foreign currency classified as available-for-sale are analyzed between translation differences resulting from changes in the amortized cost of the security and other changes in the carrying amount of the security. Translation differences related to changes in amortized cost are recognized in the net surplus or deficit, and other changes in carrying amount are recognized in net assets/equity.

Translation differences on non-monetary financial assets and liabilities such as equities held at fair value through surplus or deficit are recognized in net surplus or deficit as part of the fair value gain or loss. Translation differences on non-monetary financial assets such as equities classified as available-for-sale are included in the available-for-sale reserve within net assets/equity.

(c) *Group Entities*

The results and financial position of all the group entities that have a functional currency different from the presentation currency are to be translated as follows:

(c) Assets and liabilities for each statement of financial position are translated at the closing rate at the date of the statement of financial position;

(d) Revenue, income, and expenses for each statement of financial performance are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of rates prevailing on the dates of the transactions, in which case revenue, income, and expenses are translated at the rate on the dates of the transaction); and

(e) All resulting exchange differences are recognized as a separate component of net assets/equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instrument designated as hedges of such investments, are recognized as a separate component of net assets/equity. When a foreign operation is partially disposed of or sold, exchange differences that were recorded as a separate component of net assets/equity are recognized in the statement of financial performance as part of the gain or loss on sale.

Chapter 18: Segment Reporting

Key Points

- IPSAS 18, *Segment Reporting* establishes principles for reporting financial information by segments.
- In order to apply IPSAS 18, entities need to ensure they have systems for identifying the different activities that will be grouped as separate segments. Reporting these segments will provide information for accountability and decision-making purposes.

Introduction

18.1 This Chapter outlines the requirements of IPSAS 18 and explains the steps that an entity would need to complete if it is to comply with IPSAS 18.

18.2 Segment reporting provides information to assist users of the financial statements to better understand the entity's past performance and to identify the resources allocated to support the major activities of the entity. The disclosure of information by segments also enhances transparency of financial reporting and enables the entity to better discharge its accountability obligations.

18.3 Governments disclosing information about the general government sector in accordance with IPSAS 22 will still need to make the disclosures about segments required by IPSAS 18. As discussed in IPSAS 22, this is because information about the general government sector alone will not provide sufficient detail to enable users to evaluate the entity's past performance in achieving major service delivery objectives, when those objectives are achieved through entities outside the general government sector. Because the general government sector is a subset of the government as a whole, important information would be omitted if a government did not present segment information in respect of its consolidated financial statements.

Definitions

18.4 Definitions used in IPSAS 18 are:

A *segment* is a distinguishable activity or group of activities of an entity for which it is appropriate to separately report financial information for the purpose of evaluating the entity's past performance in achieving its objectives and for making decisions about the future allocation of resources.[45]

A *service segment* refers to a distinguishable component of an entity that is engaged in providing related outputs or achieving particular operating objectives consistent with the overall mission of each entity.

A *geographical segment* is a distinguishable component of an entity that is engaged in providing outputs or achieving particular operating objectives within a particular geographical area.

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[45] It should be noted that definition of segments in IPSAS 18 differs from the definition of an operating segment in IFRS 8 *Operating Segments* (2006).

Reporting Structures

18.5 An entity complying with the requirements of IPSAS 18 will have to identify and determine each distinguishable activity or group of activities as separate segments. In most cases, the major classifications of activities identified in budget documentation will reflect the segments for which information is reported to the senior management of the entity. These are a useful starting point in determining segments. This is because senior management requires information about segments to evaluate the performance of the entity and for decision making in the future. Because management is likely to require detailed information, the segments reported in financial statements may be at a higher level than the way in which information is reported to senior management.

18.6 Segment reporting is usually consistent with an entity's budget, but the factors outlined in IPSAS 18, paragraph 15, should also be considered. These are:

(a) The objective of reporting financial information by segment;

(b) The expectations of members of the community and their elected or appointed representatives regarding the key activities of the entity;

(c) The qualitative characteristics of financial reporting; and

(d) Whether a particular segment structure reflects the basis on which the governing body and senior manager require financial information to enable them to assess the past performance of the entity in achieving its objectives, and to make decisions about the allocation of resources to achieve entity objectives in the future.

18.7 Other examples where financial information is often aggregated and reported include:

(a) Major economic classifications of activities undertaken by the general government (these may reflect the Government Finance Statistics Manual (GFSM 2001) functional classifications by government) and major trading activities undertaken by GBEs;

(b) Portfolio responsibilities of individual ministers or members of the executive government;

(c) Service segments; and

(d) Geographical segments.

Information Requirements

18.8 Entities intending to comply with IPSAS 18 will need to:

(a) Identify the nature, component, and relevant activities of each segment reported;

(b) Develop segment accounting policies that conform to the accounting policies adopted for preparing and presenting financial statements;

(c) Identify each individual segment revenue, segment expense, total carrying amount of segment assets and segment liabilities, and provide a reconciliation between the segmental information and the aggregate information in the financial statements;

(d) Be able to generate the total cost incurred to acquire, manage, and maintain segment assets;

(e) Be able to generate the aggregate of the entity's share of net surplus (deficit) of associates, joint ventures, or other investments accounted for under the equity method if substantially all of those associates' operations are within a single segment;

(f) Develop policies on the basis of pricing inter-segment transfers; and

(g) Be able to identify the prior period segment data, when there is a change in segment accounting policies or a creation of a newly identified segment. This is because an entity will need to disclose the restated comparative information.

18.9 The specific disclosures required by IPSAS 18 are set out in paragraphs 51 to 75 of the Standard. Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Cost Allocation

18.10 The IPSAS 18 requirement to identify segment revenue and expense means that an entity will need to develop a cost allocation system that provides reliable cost information. IPSAS 18 provides some guidance on attributing items to segments. It presumes that an entity will look to its internal financial reporting system as the starting point in identifying those items that can be directly attributed, or reasonably allocated, to segments. IPSAS 18 also notes that the cost allocation guidance in IPSAS 12, *Inventories* and IPSAS 11, *Construction Contracts* may be useful.

18.11 Most of the cost allocation guidance for public sector entities has been developed in the context of costing outputs (for example CICA, 2006).

18.12 Costing models applied in the private sector, such as activity based costing, have also been applied in the public sector. There are mixed views as to the applicability of activity based costing in governments (Granof, Platt and Vaysman 2000 and Lienert 2008).

Transitional Provisions

18.13 There are no transitional provisions in IPSAS 18. It is applied retrospectively in accordance with IPSAS 3. Comparatives would be required in the first year of adoption, unless this were impracticable, as discussed in IPSAS 3.

Relevance to Cash Basis of Accounting

18.14 An entity preparing its financial statements on the cash basis of accounting may provide a statement of segmental information on the cash basis in its general purpose financial statements. Other information which the entity may disclose in that statement includes the types of goods and services provided by each reported service segment, the composition of each reported geographical segment, and if neither service nor geographical basis of segmentation is adopted, the nature of the segment and activities encompassed by it.

18.15 Many of the other issues identified in this Chapter are relevant to entities intending to provide additional information encouraged by the Cash Basis IPSAS.

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Appendix

Accounting Policies

This Appendix illustrates the accounting policies for allocation of costs to inputs for the purposes of reporting segment expenses in accordance with IPSAS 18. These policies could be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. However, uniform application of costing policies may not be appropriate across different types of entities.

Cost allocation

Salaries and related costs of service delivery divisions are charged to outputs on the basis of activity analysis. Activities that are directly related to individual outputs are regarded as direct costs and charged accordingly.

All other costs of service delivery divisions and total costs of support groups are regarded as indirect costs to outputs and are allocated to outputs on the basis of measurement of resource consumption or activity analysis.

Chapter 19: Related Party Disclosures

Key Points

- IPSAS 20, *Related Party Disclosures* contains requirements on the disclosure of related party relationships and certain transactions with related parties.
- Applying IPSAS 20 involves identifying related parties (the reporting entity's controlled and controlling entities, associates, and key management personnel and their close family members) and making the required disclosures about them.
- To comply with the Standard, a reporting entity will need to have in place:
  - Mechanisms to identify related party transactions that are not conducted within the parameters of the normal operating procedures/mandate of the reporting entity; and
  - Records of the remuneration and benefits received by the key management personnel and their close family members, from the reporting entity.

Introduction

19.1 Related party relationships exist throughout the public sector. Ministers and other elected/appointed members of the government and senior management can exert significant influence on the operations of government departments and other entities. Government departments and entities frequently conduct activities necessary for the discharge of their responsibilities and achievement of their objectives through separate controlled entities, and through entities over which they have significant influence.

19.2 IPSAS 20 requires the disclosure of the existence of related party relationships where control exists, and the disclosure of information about transactions between the entity and its related parties in certain circumstances. The information is required for accountability purposes and to facilitate a better understanding of the financial position and performance of the reporting entity. Disclosure of transactions with key management personnel and their close family members is intended to reduce the risk of these related parties entering into transactions that expose the entity to risks or are on more favorable terms than usual.

19.3 IPSAS 20 is drawn primarily from the 1994 version of IAS 24 *Related Party Disclosures*.

Definitions

19.4 IPSAS 20 defines the following terms

Close members of the family of an individual are close relatives of the individual or members of the individual's immediate family who can be expected to influence, or be influenced by, that individual in their dealings with the entity.

Key management personnel are:

(a) All directors or members of the governing body of the entity; and

(b) Other persons having the authority and responsibility for planning, directing, and controlling the activities of the reporting entity. Where they meet this requirement, key management personnel include:

(i) Where there is a member of the governing body of a whole-of-government entity who has the authority and responsibility for planning, directing, and controlling the activities of the reporting entity, that member;

(ii) Any key advisors of that member; and

(iii) Unless already included in (a), the senior management group of the reporting entity, including the chief executive or permanent head of the reporting entity.

Oversight means the supervision of the activities of an entity, with the authority and responsibility to control, or exercise significant influence the financial and operating decisions of the entity.

Related party means parties are considered to be related if one party the ability to (a) control the other party, or (b) exercise significant influence over the other party in making financial and operating decisions, or if the related party entity and another entity are subject to common control. Related parties include:

Entities that directly, or indirectly through one or more intermediaries, control, or are controlled by the reporting entity;

(c) Associates (see IPSAS 7, *Investments in Associates*);

(d) Individuals owning, directly or indirectly, an interest in the reporting entity that gives them significant influence over the entity, and close members of the family of any such individual;

(e) Key management personnel, and close members of the family of key management personnel; and

(f) Entities in which a substantial ownership interest is held, directly or indirectly, by any person described in (c) or (d), or over which such a person is able to exercise significant influence.

Related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged. Related party transactions exclude transactions with any other entity that is a related party solely because of its economic dependence on the reporting entity or the government of which it forms part.

Remuneration of key management personnel is any consideration or benefit derived directly or indirectly by key management personnel from the reporting entity for services provided in their capacity as members of the governing body, or otherwise as employees of the reporting entity.

Significant influence (for the purpose of this Standard) is the power to participate in the financial and operating policy decisions of an entity, but not control those policies. Significant influence may be exercised in several ways, usually by representation on the board of directors or equivalent governing body but also by, for example, participation in (a) the policy making process, (b) material transactions between entities within an economic entity, (c) interchange of managerial personnel, or (d) dependence on technical information. Significant influence may be gained by an ownership interest, statute, or agreement. With regard to an ownership interest, significant influence is presumed in accordance with the definition contained in IPSAS 7.

Identification of Related Parties

19.5 It will be necessary for the reporting entity to create a process to identify and review its related parties. The process will include:

(a) Identifying the reporting entity's controlled and controlling entities. IPSAS 6, *Consolidated and Separate Financial Statements* provides guidance on the concept of "control" of another entity for financial reporting purposes;

(b) Identifying the reporting entity's associates. IPSAS 7, *Investments in Associates* provides guidance on what is an associate;

(c) Identifying individuals and entities which have joint control over the reporting entity. IPSAS 8, *Interests in Joint Ventures* provides guidance on joint ventures. Although the definition of related parties in IPSAS 20 does not specifically refer to individuals or entities that have joint control over the reporting entity, for the purposes of IPSAS 20, significant influence is defined to encompass entities subject to joint control (IPSAS 20 paragraph 15);

(d) Maintaining a record of the reporting entity's key management personnel and their close family members. This record will include information on:

(i) The amount of remuneration and benefits received from the reporting entity; and

(ii) Entities in which a substantial ownership interest is held (directly or indirectly) by the key management personnel and their family.

Related Party Transactions

19.6 Related party transactions include all transfers of resources or obligations between related parties, regardless of whether a price is charged. However, only certain related party transactions must be disclosed in the financial statements. IPSAS 20 does not require disclosure of transactions between related parties if they are on normal terms and conditions.

19.7 To identify these types of transactions, the reporting entity will need to:

(a) Review its relationship with its related parties; and

(b) Identify what constitutes the normal operating procedures/mandate with its related parties and develop new policies to deal with any uncertainties.

19.8 If an entity is required to maintain a register of interests for elected or high-ranking officials, this would be a useful starting point for identifying information relating to key management personnel.

Related Party Disclosures

19.9 To comply with the disclosure requirements of IPSASs regarding related party disclosures, an entity will need to:

(a) Identify all of its related parties.

(b) Identify and maintain records of the relevant related party transactions. These records should outline:

   (i) The nature of the related party relationships;

   (ii) Types of transaction that have occurred; and

   (iii) Other elements of the transactions necessary to clarify the significance of the transactions to its operations such as the terms and conditions of these transactions.

(c) Identify and disclose aggregate remuneration of key management personnel (see also IPSAS 25, *Employee Benefits*) and all other remuneration and compensation provided to key management personnel and their close family members.

(d) Identify loans provided to key management personnel and their close family members, the availability of which is not widely available to persons who are outside the key management group or which are not widely known by the public. Management should establish policies and criteria on when and how such loans can be approved. An entity providing these types of loans should have systems that are able to generate:

   (i) The amount advanced and the terms and conditions thereof;

   (ii) The amount repaid during the period and the closing balance of all loans and receivables; and

   (iii) Where the recipient is not a member of the governing body nor part of the senior management group of the entity, the relationship of the individual to the governing body or senior management group.

19.10 Details of documents, including disclosure checklists, which summarize disclosure requirements in IPSASs are included in the references to this Chapter.

Transitional Provisions

19.11 There are no transitional provisions in IPSAS 20. It is applied retrospectively in accordance with IPSAS 3. Comparatives would be required in the first year of adoption, unless this were impracticable, as discussed in IPSAS 3.

Relevance to the Cash Basis of Accounting

19.12 The issues identified in this Chapter are relevant for entities intending to provide additional disclosure on related party disclosures as encouraged in Part 2 of the Cash Basis IPSAS.

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Chapter 20: Disclosure of Financial Information about the General Government Sector

Key Points

- Compliance with IPSAS 22, *Disclosure of Financial Information about the General Government Sector* is optional. It applies only where a government chooses to present financial information about the general government sector in its consolidated financial statements.
- When information about the general government sector is provided in a government's consolidated financial statements, IPSAS 22 establishes requirements relating to accounting policies, presentation, and disclosure.

Introduction

20.1 IPSASs specify the requirements for the preparation and presentation of accrual-based financial statements for public sector entities and governments. In addition to preparing accrual based financial statements, many governments prepare macroeconomic data in accordance with statistical reporting frameworks.

20.2 At an international level there are three main statistical reporting frameworks:

(a) The System of National Accounts 2008 (2008 SNA) is a set of macroeconomic accounts to meet the needs of government and private-sector analysts, policy-makers, and decisions-takers. It was prepared jointly by the International Monetary Fund, the European Union, the Organization for Economic Co-operation and Development, the United Nations, and the World Bank. It updates the 1993 SNA.

(b) The Government Finance Statistics Manual 2001 (referred to as GFSM, 2001) is created by the International Monetary Fund (IMF, 2001). GFS is designed to produce statistics relating to the financial operations, financial position, and liquidity situation of the general government sector of the public sector in a consistent and systematic manner. GFS data is likely to be used by the government compiling the information as a fiscal policy instrument and is frequently linked to the budget process. It is also used by external agencies seeking to monitor the fiscal performance of a range of governments.

(c) The European System of National Accounts developed by Eurostat (ESA 95, Eurostat).

20.3 GFSM 2001 and ESA 95 are consistent with 1993 System of National Accounts as regards definitions, accounting rules, and classifications. However, there are differences between the treatment and measurement of some items within these systems and accrual-basis IPSASs. Although GFS include many financial reporting principles and statements on how to account for various types of items, they are primarily designed to produce statistics to inform economic decision making, in particular, policy decisions, of governments. As a result they are aimed at a government sector level of reporting.

20.4 The IPSASB has a policy of appropriate convergence with macroeconomic accounting. One of the first steps in this process was to document the differences between the accounting and statistical systems. Differences as at June 2004 were documented in a Research Report, *International Public Sector Accounting Standards (IPSAS) and Statistical Bases of Financial Reporting: An Analysis of Differences and Recommendations for Convergence* (IPSASB 2004). This report made a number of recommendations to promote convergence between IPSASs and GFS.

20.5 The IPSASB and the IMF aim to further align IPSASs and statistical frameworks.

20.6 Despite this work there continue to be differences between financial statements prepared in accordance with IPSASs and GFS. These differences can lead to difficulties comparing GFS outturn data with IPSAS financial statements. The IPSASB acknowledged the important role of GFS data and the desire of certain governments such as Australia to disclose information prepared on a GFS basis in their consolidated financial statements. In order to assist users to understand the differences between these two sets of information, and to provide guidance on the disclosure of GFS data in the financial statements, the IPSASB developed IPSAS 22.

20.7 If a country budgets on a GFS basis IPSAS 24 is relevant. IPSAS 24 addresses the disclosure of budget and actual amounts in financial statements.

Summary of IPSAS 22 requirements

Scope

20.8 IPSAS 22 applies only where a government, such as a national, state/provincial or local government, chooses to present financial information about the general government sector in its consolidated financial statements. Not all governments will choose to do so. Because IPSAS 22 relates to the consolidated financial statements of a government, it is not relevant to the financial statements of individual public sector entities or public sector entities that are not governments.

General Government Sector

20.9 IPSAS 22 focuses on comparisons between financial information on the GFS general government sector and the reporting entity for general purpose financial reporting. The general government sector is defined in the 2008 SNA as consisting of all resident central, state, and local government units, social security funds at each level of government, and non-market non-profit institutions controlled by government units.

Consistent Accounting Policies

20.10 IPSAS 22 requires the use of consistent accounting policies between the accrual-based IPSAS financial statements and the general government sector disclosures in those financial statements. There are two exceptions to this requirement:

(a) In preparing the general government sector disclosures, a government shall not apply the requirements of IPSAS 6to entities in the public financial corporations and public non-financial corporations sectors (paragraph 24). If IPSAS 6 were applied it would blur the GFS sector classifications and change the boundary of the general government sector.

(b) In preparing the general government sector disclosures, the general government sector shall recognize its investment in the public financial corporations and public non-financial corporations sectors as an asset and shall account for that asset at the carrying amount of the net assets of its investees (paragraph 25).

Presentation

20.11 A government can decide where it wishes to present the general government sector information in the financial statements (for example, note disclosure or separate columns in the primary financial statements) but the general government sector disclosures are not to be more prominent than the financial statements themselves (paragraphs 35 and 37).

Disclosure

20.12 IPSAS 22 specifies the information to be disclosed in respect of the general government sector. These disclosures include:

(a) Major classes of assets, liabilities, revenue, expenses, and cash flows (paragraph 35);

(b) The significant controlled entities that are included in the general government sector and any changes in those entities (paragraph 40); and

(c) A reconciliation of the general government sector disclosures to the consolidated financial statements of the government showing separately the amount of the adjustment to each equivalent item in those financial statements (paragraph 43).

20.13 Disclosure of disaggregated general government sector information is optional. Entities may provide disaggregated information classified by economic nature or in accordance with the Classification of Functions of Government (paragraph 38).

20.14 The general government sector disclosures in the consolidated financial statements will not be the same as the general government sector disclosures under the statistical bases of financial reporting. This is because there will be differences between the GFS treatment of certain items and balances and the accounting policies used to prepare the financial statements. IPSAS 22 permits but does not require a reconciliation from the general government sector disclosures in the consolidated financial statements with the general government sector disclosures under statistical bases of financial reporting (paragraph 46).

20.15 The Implementation Guidance that accompanies IPSAS 22 provides illustrative disclosures.

Implementation Issues

20.16 IPSAS 22 is not mandatory. One of the first issues for an entity considering complying with IPSAS 22 is to consider the costs and benefits of providing these disclosures.

20.17 The assessment of benefits is generally subjective, although where possible it should be informed by knowledge of specific users and user needs. For example, the disclosure of general government sector information in the entity's financial statements may be regarded as more useful in a jurisdiction that budgets on a GFS basis than in a jurisdiction that does not.

20.18 The cost of complying with IPSAS 22 will depend on a number of factors including:

(a) What stage a jurisdiction is at in terms of its migration from GFSM 1996 to GFSM 2001, including the reliability of the accrual-based GFSM 2001 data and the manner in which that data is compiled; and

(b) Whether the chart of accounts has been designed to support both the preparation of GFSM 2001 data and the external financial statements. Matters that might be considered in designing a chart of accounts are discussed in Chapter 2 of this Study.

20.19 Because IPSAS 22 prohibits the application of IPSAS 6 requirements to entities in the public financial corporations and public non-financial corporations sectors, an entity will need to identify:

(a) Entities that are controlled for the purposes of financial reporting but which do not form part of the general government sector; and

(b) Entities that are not controlled for the purposes of financial reporting but which form part of the general government sector.

20.20 If an entity is considering providing the reconciliation referred to in paragraph 46 of IPSAS 22 it will also need to identify the material accounting policy differences between IPSASs and GFS. Although the IPSASB 2004 Research Report identified the differences at that time, ongoing changes to IPSASs mean that readers should seek more recent information.

Relevant Experience

20.21 This section notes some experiences of aligning the preparation and/or presentation of accrual-based financial statements and GFSM 2001 data.

South East European countries

20.22 The Center of Excellence in Finance (CEF) and the IMF have worked with various South East European countries to improve their government finance statistics and the interaction of GFS with accounting reforms. Information on South East European countries which are considering linking the compilation of GSFM 2001 data with accrual based financial statements is available on the CEF website. The rationale for encouraging jurisdictions considering accounting reforms to streamline the method in which they compile their GFS data is based on efficiency. Establishing linkages between the financial statements and GFS data helps a government to establish efficient procedures for the compilation of accurate and reliable data. The objective is to ensure that accounting records contain the necessary information for the compilation of GFS data. This is generally more efficient than trying to fix existing problems with the compilation of GFS data.

Australia

20.23 Many of the States in Australia budget, and report against budget, using a framework based on GFS. Because this information is used by the Commonwealth Grants Commission in establishing funding of States, the presentation of this information in accrual-based financial statements is widespread. The existence of two sets of accrual-based financial information for states and the use of differing reconciliation formats by various states led to some confusion by users attempting to reconcile reported information with budgets. The Australian Accounting Standards Board therefore developed a financial reporting standard to harmonize general purpose financial statements of governments prepared in accordance with Australian Accounting Standards (AAS) with GFS information prepared in accordance with the Australian Bureau of Statistics' Government Finance Statistics Framework. The resulting standard, AASB 1049 *Whole of Government and General Government Sector Financial Reporting* (October 2007) includes GAAP/GFS harmonization requirements for financial reporting by whole of governments (Australian Government and State and Territory governments) and the sectors therein.

20.24 AASB 1049 differs from IPSAS 22 in a number of ways. It accommodates GFS principles to a greater extent than IPSAS 22. For example, IPSAS 22 does not require a comprehensive operating statement classifying items as transactions or other economic flows and presenting GFS key fiscal aggregates on the face of the financial statements. Nor does it require the separate presentation of sector information on the public financial corporations and public non-financial corporations sector, nor a reconciliation to GFS measures of key fiscal aggregates.

Relevance to the Cash Basis of Accounting

20.25 The Cash Basis IPSAS notes that some governments may prepare budgets that focus on the general government sector and provides guidance on disclosures that may be appropriate when there is a difference between the entities included within the budget and the financial statements. However, it does not address the disclosure of information about the general government sector in the financial statements.

20.26 The issues identified in this Chapter are relevant for entities intending to provide additional disclosure on the general government sector in cash basis financial statements, including providing additional disclosure of assets and liabilities and revenue and expenses.

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Chapter 21: Presentation of Budget Information in Financial Statements

Key Points

- IPSAS 24, *Presentation of Budget Information in Financial Statements* applies to public sector entities that make their approved budget publicly available.
- Entities within the scope of IPSAS 24 must present a comparison of budgeted and actual amounts in their financial statements.
- If the budgeted and actual amounts are on a comparable basis they may be presented as an additional column within the financial statements or as a separate statement.
- If the budgeted and actual amounts are not on a comparable basis they must be presented in a separate statement.
- Entities reporting may be able to meet the requirements of IPSAS 24 by adapting existing comparisons of budgeted and actual amounts.

Introduction

21.1 IPSAS 24 has a limited scope. It applies only to public sector entities that make their approved budget(s), or components of those budgets, publicly available. It does not require that entities make their budgets available. Nor does it establish any requirements about the basis of accounting in a budget or the presentation of information in a budget.

21.2 If an entity makes its approved budget publicly available, IPSAS 24 requires that the entity present a comparison of budgeted and actual amounts in its financial statements.

21.3 The IPSASB developed IPSAS 24 because it considered that reporting comparisons of budgets and the results of budget execution enhances the transparency of financial statements and is an important element in demonstrating accountability, particularly for those entities that make their budgets publicly available.

21.4 Budgets are not static. They are often updated throughout the reporting period and differing versions of a budget may be made available to the public at different points in the reporting period. Because there can be more than one budget IPSAS 24 establishes the following definitions.

(a) Original budget is the initial approved budget for the budget period.

(b) Approved budget means the expenditure authority derived from laws, appropriation bills, government ordinances, and other decisions related to the anticipated revenue or receipts for the budgetary period.

(c) Final budget is the original budget adjusted for all reserves, carry over amounts, transfers, allocations, supplemental appropriations, and other authorized legislative, or similar authority changes applicable to the budget period.

21.5 Budgets can also be for more than one year. IPSAS 24 therefore distinguishes between annual and multiyear budgets.

21.6 IPSAS 24 requires the presentation of a comparison of budgeted amounts (original and final budget) and actual amounts in the financial statements. The comparison must be provided for each level of legislative oversight. The way in which this comparison is presented depends on whether the financial statements and the budget are prepared on a comparable basis.

21.7 If the financial statements and the budget are prepared on a comparable basis (for example, accrual financial statements and an accrual budget) the comparison may be presented by way of additional columns in the primary financial statements or in a separate statement. If the financial statements and the budget are prepared on a different basis (for example, accrual financial statements and cash basis budget) the comparison must be presented in a separate statement.

21.8 The comparison between budget and actual amounts must be presented on a comparable basis to the budget (for example, if the budget is presented on a cash basis then the comparison of budgeted and actual amounts must also be presented on the cash basis). The figures in the comparison statement must be reconciled to key figures in the financial statements.

21.9 IPSAS 24 also specifies note disclosures to help the reader understand the comparison. These include:

(a) An explanation of material differences between the budget and actual amounts. There is an exception to this requirement if this information is provided in another public document issued in conjunction with the financial statements and the financial statements include a cross reference to that other document;

(b) An explanation of whether changes between the original and final budget are a consequence of reallocations within the budget, or of other factors. Again, this explanation may be in the notes to the financial statements or in another document

(c) An explanation of the budgetary basis and classification basis adopted in the approved budget;

(d) The period of the approved budget; and

(e) The entities included in the approved budget.

21.10 The transitional provisions in IPSAS 24 allow an entity to apply the Standard prospectively.

Relevance to the Cash Basis of Accounting

21.11 The Cash Basis IPSAS has similar requirements to IPSAS 24 with regard to budget comparisons. It also requires that an entity that makes its budget publicly available present a comparison of the budget and actual amounts.

Accounting Policies

21.12 This Chapter does not include examples of accounting policies for accrual budgeting. If an entity is budgeting on the same basis as it reports, then the same accounting policies should be applied. An entity will need to decide how to deal with assets and liabilities that may fluctuate in value throughout the year. One approach is to exclude any gains or losses on such items from the forecasts. An exception to this general policy is that expected physical growth changes in agricultural assets would be forecast. Forecasts could use the exchange rates and interest rate curves prevailing at the forecast reference date.

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Chapter 22: Entity Combinations

Key Points

- There is currently no IPSAS on entity combinations.[46]
- This Chapter summarizes the requirements of IFRS 3, *Business Combinations*.
- The IPSASB has a project to develop IPSASs dealing with entity combinations.

Introduction

22.1 There is currently no IPSAS on entity combinations. In the absence of an IPSAS, IFRS 3 *Business Combinations* may be used as a starting point to illustrate implementation issues associated with entity combinations. This Chapter summarizes the requirements of IFRS 3.

22.2 The IPSASB has an active project to develop requirements in relation to entity combinations. The IPSASB has indicated that, in its view, the requirements of IFRS 3 are likely to be appropriate for a limited number of entity combinations undertaken by public sector entities. IFRS 3 is commonly applied in the private sector to transactions which involve consideration that is approximately equal to the net assets acquired. In contrast many public sector entity combinations involve reorganizations or amalgamations where there is little or no consideration involved. Many public sector entity combinations also involve entities under common control which are excluded from the scope of IFRS 3.

22.3 In May 2009 the IPASB issued ED 41, *Entity Combinations from Exchange Transactions* which was based on the requirements of IFRS 3, but with a restricted scope. In April 2010 the IPSASB agreed that the scope could not be made sufficiently clear to enable finalization of a Standard based on ED 41 and decided instead to progress work on the public sector specific aspects of entity combinations. The IPSASB proposes to address requirements for both entity combinations under common control and those not under common control.

Summary of IFRS 3

22.4 The objective of IFRS 3 is to establish principles and requirements on how an acquirer in a business combination recognises and measures in its financial statements the results of the acquisition transaction. IFRS 3 requires the application of the acquisition method when an acquirer obtains control of one or more businesses. A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return directly to investors or other owners, members, or participants.

22.5 Under IFRS 3, an acquirer measures the cost of a business combination, recognizes (with some exceptions) the acquiree's identifiable assets and liabilities at their acquisition date

[46] This Study uses the term "entity combinations" when referring to combinations involving public sector entities and "business combinations" when referring to the requirements of IFRS 3.

fair value, and treats any excess of the cost of the business combination over the aggregate acquisition date fair value of the acquiree's identifiable assets and liabilities as goodwill.

22.6 IFRS 3 establishes requirements for the measurement of consideration, treatment of acquisition costs, identification and measurement of the assets and liabilities acquired, and the calculation of goodwill. Generally assets and liabilities are measured at their acquisition-date fair value, although there are some exceptions. IFRS 3 also addresses accounting for step acquisitions and partial acquisitions. An entity subsequently accounts for the assets and liabilities acquired in a business combination using its usual accounting policies although IFRS 3 specifies requirements for items such as contingent liabilities recognized at acquisition date and contingent consideration.

22.7 Pending the development of an IPSAS dealing with entity combinations, the treatment of goodwill resulting from an entity combination is not addressed in IPSASs. IAS 36, *Impairment of Assets* is one source of guidance on the impairment of goodwill, the allocation of goodwill to cash-generating units, and the testing for impairment of cash-generating units with goodwill. Under IAS 36 goodwill is subject to annual impairment reviews, but is not amortized.

Implementation Issues

22.8 The first step is to decide whether application of a particular national or international standard, such as IFRS 3, is appropriate to the transaction. In the absence of an IPSAS on entity combinations this will continue to be a matter of judgement, having regard to the requirements of IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*. The implementation issues associated with entity combinations can be separated into issues associated with the accounting for the transaction at the time of acquisition and subsequently.

22.9 At the time of acquisition an entity will need to:

(a) Determine the amount of the consideration payable, making sure that any acquisition costs are separately identified and expensed;

(b) Assess whether the fair values of assets and liabilities acquired can be reliably determined; and

(c) Ensure that it has systems in place to provide the disclosures required by the accounting standard adopted.

22.10 Subsequent to an entity combination, an entity will need to consider the allocation of goodwill to cash generating units and review any remaining goodwill for impairment. Chapter 12 of this Study discusses impairment of assets.

22.11 IFRS 3 requires a number of disclosures. The general requirement is that an entity must disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either during the current reporting period or after the end of the period but before the financial statements are authorised for issue (IFRS 3 paragraph 59). The implementation guidance that accompanies IFRS 3 gives examples of specific disclosures that are required (IFRS 3 Appendix B). An entity is also required to disclose information that enables users of its financial statements to evaluate the financial effects of adjustments recognised in the current reporting period that relate to business combinations that occurred in the period or previous reporting periods (IFRS 3 paragraph 61).

Relevance to the Cash Basis of Accounting

22.12 The issues identified in this Chapter are not generally relevant for entities reporting in accordance with the Cash Basis IPSAS. However, entities electing to make additional disclosure of assets and liabilities, other than cash, of a controlled entity or operating unit acquired during the period could have regard to the requirements of IFRS 3 in identifying such assets and liabilities and determining the basis on which they are recognized and measured (refer to paragraph 2.1.48 of the Cash Basis Standard).

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Appendix

Accounting Policies

This Appendix illustrates an example of accounting policies for goodwill that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The illustrative policy is based largely upon IFRS 3.

Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the group's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in "intangible assets." Goodwill is tested annually for impairment and carried at cost less accumulated impairment losses. Impairment losses on goodwill are not reversed. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

Goodwill is allocated to cash-generating units[47] for the purpose of impairment testing. The allocation is made to those cash-generating units or groups of cash-generating units that are expected to benefit from the business combination in which the goodwill arose identified according to operating segment.

[47] Refer to Chapter 12, Impairment of Assets.

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