PREFACE

The objective of the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC) is to develop programs aimed at improving public sector financial management and accountability. To that end, the IFAC PSC issues Guidelines, Statements on Practice and Studies. Studies are undertaken by the Committee to provide information that contributes to public sector financial reporting, accounting or auditing knowledge and to stimulate discussion.

In March 1991, the IFAC PSC issued Study 1, *Financial Reporting by National Governments*. That Study considered the objectives of the financial reports of national governments and their major units, and the extent to which those objectives are met by different bases of accounting and different reporting models.

In July 1993 the IFAC PSC issued Study 2, *Elements of the Financial Statements of National Governments*. That Study identified the elements of financial statements (that is, the types or classes of information that may be reported in financial statements), considered the extent to which those elements would be reported under different bases of accounting and noted the implications of reporting particular elements or sub-sets thereof for the messages communicated by financial statements and the achievement of the objectives identified in Study 1.

This Study extends Study 1 and in particular Study 2. It is a companion to Study 5, *Definition and Recognition of Assets*, Study 6, *Accounting for and Reporting Liabilities*, and Study 9, *Definition and Recognition of Revenues*, all of which examine in greater detail accounting and reporting issues related to specific elements of the financial statements. This Study considers and explores current views held internationally on:

(i) the definition and recognition of expenses/expenditures;

(ii) the effect of different bases of accounting on the definition and recognition of expenses/expenditures; and

(iii) the particular issues and problems arising from certain types of expenses/expenditures.

Chapters 1 to 3 deal with the definition and recognition of expenses/expenditures, while Chapters 4 and 5 address aspects of those expenses/expenditures specific to the public sector.

A major revision of public sector accounting is taking place in various parts of the world as a number of national and sub-national governments shift towards accrual accounting for the non-business public sector. This Study identifies, and acknowledges, that a wide variety of views exist about whether, when and how certain expenses/expenditures should be recognized and reported. It is intended that this Study will contribute to the debate about these issues. The Study seeks to compare the differing views expressed with the user needs identified in Study 1 and Study 2, and to indicate a recommended direction of change necessary to best inform both users of the financial reports and decision makers in the public sector.

The IFAC PSC hopes that this Study will encourage readers, whether or not they are members of the accounting profession, to consider alternative approaches to the definition and recognition of expenses/expenditures and to contribute to international developments leading to improvements to financial reporting by public sector entities and greater comparability of financial reports both between and within jurisdictions.

Definition and Recognition of Expenses/Expenditures

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CHAPTER 1

INTRODUCTION

Purpose of this Study

.001 This Study examines the concepts, principles and issues related to the treatment of expenses/expenditures in the general purpose financial statements of governments and other non-business public sector entities. The Study identifies and discusses:

(i) concepts of expenses/expenditures under different bases of accounting and the application to them of the IASC definition of expenses;
(ii) the effect of different bases of accounting on the recognition of expenses/expenditures and related reporting issues;
(iii) particular issues and problems arising from expenses/expenditures unique to governments and other non-business public sector entities; and
(iv) classification and disclosure of expenses/expenditures.

.002 By highlighting different views and approaches adopted in different jurisdictions, the PSC hopes that this Study will help those considering alternative approaches to public sector financial reporting, and assist in developing the full potential of the accounting models in different jurisdictions to communicate information about expenses/expenditures to users.

Scope of the Study

.003 Consistent with IFAC PSC Study 1, *Financial Reporting by National Governments*, and Study 2, *Elements of the Financial Statements of National Governments*, the primary focus of this Study is on the financial statements prepared for national governments, the entities or units they establish for the delivery of goods and services and the achievement of government objectives. However, the matters the Study addresses may be equally applicable for other levels of government (e.g., state, provincial and local governments).

.004 Earlier studies published by the IFAC PSC include definitions of “basis of accounting”, “elements of financial statements”, “financial reporting”, “financial reports”, “financial statements”, “measurement focus”, and “reporting model”. Where those terms are used in this Study, they are to be read with the same meaning as that contained in earlier studies. Appendix 1 to this Study is a glossary of terms.

Need for the Study

.005 In many countries, demand for government services has grown with increases in population and with increased standards of living; this demand has been associated with higher government expenditures which in many cases has led to budget deficits. The desire to reduce these deficits means that there is increasing competition for government resources. Demand has been further stimulated by the expectation of higher standards of service in areas such as education and health, and by greater community interest in government actions. This interest is associated with growing demands for governments to be more accountable for the use of taxpayers’ funds. Consequently, governments are under pressure not only to manage their funds effectively but also to show that their management has been efficient. To achieve this, governments need complete information about their expenses/expenditures in order to assess their revenue requirements, the sustainability of their programs and their flexibility. In addition, they also need information about the cost of programs in order to make rational decisions about the viability and desirability of specific programs and activities, and to assess performance.

Context of Previous Studies

.006 This Study is one of a series of studies that examine government financial reporting practices and trends. The IFAC PSC Study 1, *Financial Reporting by National Governments* set the stage for this series of studies. It considered the objectives of financial reports of national governments and their major units, and examined the degree to which different bases of accounting and reporting meet those objectives. It also noted that the overriding objective of financial reporting is to communicate reliable information which is relevant to the decision making and accountability needs of users. Further, it identified that the overriding objective can encompass a number of component parts, such as communicating information about compliance with spending mandates, disclosure of sources of funding, and measuring of financial condition and aspects of performance.

.007 Study 1 noted that the basis of accounting adopted by a government and its units lies on a continuum from the cash basis to the full accrual basis. The Study highlighted four alternative bases of accounting that are currently adopted by governments:

(i) cash;
(ii) modified cash;
(iii) modified accrual; and
(iv) full accrual.

This Study will analyze the implications of each of these bases for the recognition of expenses/expenditures. The modified accrual basis is often referred to as the expenditure basis.

.008 The IFAC PSC Study 2, *Elements of the Financial Statements of National Governments* considered how the elements of financial statements (e.g., assets, liabilities, revenues, expenses/expenditures and net assets) are defined, and the sets, or subsets, of the elements that would be reported under different bases of accounting. It also explored the implications of reporting particular elements, or subsets thereof, for the messages communicated by financial statements and the achievement of the objectives identified in Study 1.

.009 Based on Study 1 and Study 2, IFAC PSC is now undertaking studies that explore accounting for and reporting of specific elements of government financial statements. This Study on expenses/expenditures is a companion to Study 5, *Definition and Recognition of Assets*, Study 6, *Accounting for and Reporting Liabilities*, and Study 9, *Definition and Recognition of Revenues*. Using the framework established in Studies 1 and 2, this Study explores the nature of expenses/expenditures incurred by governments and other public sector entities, identifies similarities and differences relative to expenses/expenditures in the private sector, and examines the financial reporting issues arising from those differences.

CHAPTER 2

DEFINITIONS OF EXPENSES/EXPENDITURES IN THE PUBLIC SECTOR

Introduction

.010 The IASC Framework defines the element of expenses as follows:

"Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants." (paragraph 70)

Problems in Applying the IASC Definition to Governments

.011 The IASC definition is based on the assumption that full accrual accounting is adopted and that an articulated set of financial statements is prepared. It links the existence of an expense to a reduction in assets or increase in liabilities. If the definition of expenses is related to decreases in assets or increases in liabilities reported in financial statements, disbursements or expenditures rather than the costs of service delivery will be reported in the financial statements of entities which apply bases of accounting other than the full accrual basis of accounting. Also, the term equity, meaning the owners' residual interest in, or rights to, the net assets of the entity is not commonly used in the whole of government context.

.012 IFAC PSC Study 2 concludes that "*therefore .... definitions such as those developed by the IASC will not be effective for public sector entities which:*

(i) *do not adopt the full accrual basis of accounting; and /or*
(ii) *adopt a reporting model which does not comprise a set of articulated financial statements.*" (paragraph 133)

Concepts of Expenses/expenditures

.013 The transactions and other events from which "expenses" arise, and the "expenses" themselves, may take many forms and are referred to by a variety of names. For example, under most forms of cash or modified cash systems disbursements rather than expenditures are recognized and referred to. Under a modified accrual accounting system, they are often referred to as expenditures. The term "expenditures" is used frequently throughout this paper. The term is sometimes used to refer to cash payments, in this Study it is used to refer to the cost of goods and services acquired, regardless of the timing of related payment. If the full accrual basis of accounting is adopted, the terminology would shift to expenses. Although some governments have adopted or are in the process of implementing full accrual accounting, most governments around the world still use a cash-based accounting system or a modified accrual system. This Study acknowledges that fact and refers to the different bases throughout the Study. IFAC Study 2 summarized the major differences between the different accounting bases as follows:

Cash Basis

.014 The use of a cash basis accounting system results in the reporting of those disbursements which involve a cash flow during the period. The cash disbursements reported under this basis would include cash flows resulting from, for example, the acquisition of assets, the repayment of debt or payments for services received.

Modified Cash Basis

.015 The modified cash basis recognizes as disbursements in a reporting period those amounts expended during the reporting period plus those cash flows in a specified period following the reporting date (e.g., 60 days) that relate to events or transactions incurred during the reporting period. Analogously, cash flows of the first 60 days of the reporting period that relate to the previous reporting period are deducted. In effect, the modified cash basis "leaves the books open" after year end to identify payables. Sometimes those amounts are set up as liabilities at year-end. In other cases, they are simply recorded as disbursements of the period, even though they are not paid until after the end of the period. Therefore, it is still reporting disbursements (flows of cash), rather than expenditures. The modified cash basis fails to identify or record the accrual of any long-term liabilities, such as pension liabilities. In addition, under the cash or modified cash bases of accounting debt repayments or investing in financial assets are included in disbursements when reporting the results of operations, whereas under a modified accrual or full accrual basis they would not be recognized as either an expenditure or expense.

Modified Accrual Basis

.016 Under the modified accrual basis of accounting, expenditures rather than expenses are generally considered to be the "element". Expenditures are the costs incurred during the period related to the acquisition of goods and services, whether or not payment has been made, and include amounts transferred or due to eligible beneficiaries consistent with government policies. Unlike the cash and modified cash basis, the recognition of expenditures is not contingent on the timing of related cash flow. However, there is no deferral of costs that will be consumed in future periods; physical assets that will provide services over a number of future periods are "written off" in the period acquired. Therefore, expenditures tend to reflect the cost of resources acquired and/or transferred during the period rather than the cost of resources consumed in the provision of goods and services during the period.

Full Accrual Basis

.017 IFAC PSC Study 2 states that "*The full accrual basis of accounting reports on the economic resources or service potentials (assets) and obligations (liabilities) of the entity, and changes therein. It requires the capitalization of expenditures on the acquisition of all capital assets and the depreciation of those assets as their service potential is consumed.*" (paragraph .026)

The full accrual basis of accounting recognizes all assets, liabilities, revenues and expenses of the entity. The focus is on measuring and reporting the cost of goods and services consumed during the reporting period. Sometimes this is also referred to as expense accounting. Depreciation related to the use of fixed assets and valuation adjustments for all assets would be examples of the transactions or events that are recognized as expenses but are not included as expenditures.

Depending on the measurement model adopted, expenses could also include losses which occur in the absence of transactions. Losses may, or may not, arise in the course of ordinary activities of the entity and also include unrealized losses, for example, those arising from a change in foreign currency exchange rates.

.018 Figure 2.1 identifies the element (disbursements, expenditures or expenses) which will generally be recognized in financial statements prepared consistent with the different bases of accounting.

Figure 2.1

THE ELEMENT (DISBURSEMENT/EXPENDITURE/EXPENSE) RECOGNIZED UNDER DIFFERENT BASES OF ACCOUNTING

BASIS OF ACCOUNTING

CASH	MODIFIED CASH	MODIFIED ACCRUAL	FULL ACCRUAL
Cash Disbursements[1]	Disbursements to be made within X days of the reporting date	Expenditures	Expenses

.019 The difference between the different bases of accounting for expenses/expenditures is often not so much what is considered to be an expense/expenditure, but when an item is recognized in measuring the results of operations. For example, the full cost of acquisition of a capital asset will be recognized under both the modified accrual and full accrual bases. The difference is that the modified accrual basis fully recognizes the cost when the asset is acquired whereas the full accrual basis recognizes the cost over the life of the asset as the service potential of the asset is consumed.

Other Definitions

.020 The IFAC PSC Study 2 acknowledges that in addition to the IASC definition, the need for another definition of expenses exists. No definition of expenses applies to all bases of accounting and whilst the IASC definition substantially applies to the full accrual basis, it does not apply to other bases.

.021 Figure 2.2 summarizes other definitions of expenses/expenditures in existing accounting pronouncements.

.022 An entity will incur disbursements, expenditures and expenses. The bases of accounting adopted will influence the definitions adopted and determine the recognition criteria for a transaction or event being included in financial reports. The accounting bases may not always reflect the accountability of the entity. For example, an entity may have control of specific assets and, therefore, have a duty of stewardship for them, but may not account for their use as expenses because it has adopted a cash, modified cash or modified accrual basis of accounting. More specifically, a government may own assets, but under the cash basis is not required to report either the existence or consumption of the service potential of that asset because the cost of acquisition of assets is immediately written off when the disbursement is made to acquire the asset, that is, the "expense" recognition is entirely at the time of disbursement.

[1] The term "disbursement" is used in this Study to refer to expenditures under the cash and modified cash bases of accounting. In previous PSC Study 2, the term "expenditures" was used for these two bases of accounting.

Figure 2.2

COMPARISON OF DEFINITIONS OF EXPENSES/EXPENDITURES

Expenditures	
PSAR (Canada)	"*Expenditures are the cost of goods and services acquired in the period whether or not payment has been made or invoices received and include transfer payments due where no value is received directly in return.*" (Section PS 1500, paragraph 71, 1995)
GASB (USA)	"*Operating expenditures result from claims against financial resources that arise from transactions or events other than capital asset acquisitions, debt service, operating and residual equity transfers-out, and other transactions reported as other financing uses.* *Capital expenditures result from acquiring capital assets through purchase, construction, or capital lease.*" (Statement 11, paragraphs 74 and 82, 1980)
TREASURY (UK)	Operating Costs: "*The operating cost statement should include the full costs of goods and services consumed or received in the period.*" (Resource Accounting and Budgeting in Government - A Summary of Accounting Policies - Working Draft, 1994)
INTOSAI CAS	*"Expenditures are amounts paid during or in respect of a period to acquire goods and services, other than amounts spent to acquire things of value that the government recognizes as assets or spending to repay amounts due that the government recognizes as liabilities.*" (Accounting Standards Framework, Volume 1, paragraph 22, 1995)
Expenses	
FASAB (USA)	*"Outflows or other using up of assets or incurrence of liabilities (or a combination of both) during a period of providing goods, rendering services, or carrying out other activities related to an entity's programs and missions, the benefits from which do not extend beyond the present operating period."* (Statement 1, page 49, 1993)
AARF (Australia)[1]	"*Expenses are consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period.*" (SAC 4, paragraph 117, 1995)
CPNPC (Spain)	"*Expenses are outflows that represent the negative component of the financial result produced along budgeted and non-budgeted activities during the accounting period that result in a depletion of assets or incurrence of liabilities that result in decreases in equity. (Gastos son aquellos flujos que configuran el componente negativo del resultado, producidos a lo largo del ejercicio económico por las operaciones conocidas de naturaleza presupuestaria o no presupuestaria, como consecuencia de la varación de activos o el surgimiento de obligaciones, que implican un decremento en los fondos proprios de la entidad.)*" (Principios contables públicos, Documento 3, paragraph 24, 1994)
NZSA (New Zealand)[1]	"*Expenses are consumptions or losses of service potential or future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in equity during the reporting period*." (SC, paragraph 7.22, 1993)
INTOSAI CAS	"*Expenses are the cost of goods and services consumed during a period.*" (Accounting Standards Framework, Volume 1, paragraph 22, 1995)

[1] The AARF and NZSA definitions also apply to the private sector.

CHAPTER 3

RECOGNITION OF EXPENSES/EXPENDITURES AND REPORTING ISSUES UNDER DIFFERENT ACCOUNTING BASES

Introduction

.023 The IASC framework outlines the following recognition principles:

"*Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).*" (paragraph 94)

"*Expenses are recognised in the income statement on the basis of a direct association between costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of cost with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.*" (paragraph 95)

.024 The predominant government revenues are taxes imposed by the government. Whilst they are used to provide services or transfers to the population as a whole or a sub-section of it, a taxpayer may not receive services commensurate with taxes he or she pays. Payment of taxes does not entitle a taxpayer to an equivalent value of services or benefits as there is no direct exchange relationship between paying the tax and receiving government services or transfers. Recognition criteria that relate to a point of exchange are irrevelant in such cases. Governments may charge some fees for some services and, in those cases, the costs of providing the service may be matched with a linked revenue.

.025 Matching is not a concept that is readily applicable to many government services. For example, many social insurance, grant, and entitlement programs are non-exchange transactions. Under social insurance, the government uses its sovereign power to require payment of taxes/contributions, which it utilizes to finance benefits. Obviously, since taxes finance the payment of benefits, there is at least an indirect relationship between the payment of taxes and the provision of the benefits. But it is, in one sense, a reverse matching, because whilst the revenues allow the government to carry on activities, incurring expenditures does not give rise to taxation revenue. Any particular citizen may receive more or less benefits than the taxes he or she pays. As both transactions flow from the government's use of its sovereign power, the transactions are non-exchange in nature. Similarly, when a federal government creates an entitlement program or gives a grant to state or local governments, the provision of the payments is determined by federal law rather than through an exchange transaction.

.026 The IASC framework further states that "*When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.*" (paragraph 96)

"*An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.*" (paragraph 97)

.027 The application of these paragraphs is limited to those entities accounting on a full accrual basis because it is the only basis that allocates the economic benefits over future accounting periods. For example, under a cash or modified cash accounting basis, disbursements, which produce future economic benefits, are expensed immediately. Under a modified accrual basis, loans and other investments that could be considered to have future economic benefits would be recognized and not be shown as an expenditure as under a cash or modified cash basis of accounting. However, the modified accrual basis would recognize expenditures for fixed assets with useful lives extending beyond the period when those assets are acquired rather than consumed.

Recognition under Different Bases of Accounting

.028 The nature and type of expenses/expenditures that may be recognized in the financial reports of public sector entities will differ depending on the basis of accounting adopted which is dependent on the objectives of financial reporting. As discussed in chapter 2, the basis of accounting will be in a spectrum from the cash basis to the full accrual basis.

Cash Basis

.029 Under a pure cash basis of accounting, the recognition criterion is the incurrence of a cash flow, that is, when payment is made. Only those amounts paid during a financial year would be recognized in the financial statements and reported in the entity's operating results of the year. Grants, for example, would be recognized in the books of the donor when the payment is actually made, irrespective of when any eligibility criteria had been met.

The payment of cash sends, in most cases, an unequivocal signal that a consumption of cash resources, which are the only assets recognized under this basis of accounting, has occurred. Therefore, judgments with respect to both the timing of the event and measurement are not necessary under the cash basis of accounting.

Modified Cash Basis

.030 Under a modified cash basis, recognition is also associated with cash flows. Transactions are recognized when the associated cash flow occurs, with the exception that cash flows occurring in a specified period after year-end that relate to events that occurred in the reporting period are also recognized. In respect of the example given for the cash basis, the grant would be recognized if it is paid either during the year or within a specified time period after the year-end. As recognition is still associated with the related cash flow, judgments regarding measurement are usually not necessary.

Modified Accrual Basis

.031 Under a modified accrual basis, transactions are recognized when they occur rather than when cash is paid. Therefore, on this basis, grants may be recognized when the eligibility criteria have been met even though payment may occur in a future period. In effect, expenditures are recognized on an accrual basis, in the sense that they are recognized in the period the underlying event occurs. In the modified accrual basis, the underlying event is the acquisition of goods and services or the point when a transfer becomes due. There is no allocation of costs of non-financial assets to the periods in which they are used. Costs are recognized for non-financial assets when they are acquired, even though they will be used to provide goods and services in the future.

IFAC PSC Study 2 notes that the modified accrual basis fails to show the costs of resources consumed: "*Expenditures encompass many of the costs incurred in service delivery during the period. However, they also encompass amounts expended on the acquisition of resources which will be consumed in service delivery over future periods. Therefore, expenditures tend to reflect the cost of resources acquired and/or transferred during the period rather than the cost of resources consumed in the provision of goods and services during the period*." (paragraph 127)

The best example is the acquisition of a fixed asset, where the item is bought in one year for cash settlement in the following year. It is recognized as an expenditure of the first year. Thus, total expenditure in any year includes the capital acquisitions of the year; depreciation of fixed assets is not an element of expenditure. Therefore, the definition of expenditure under the modified accrual basis differs considerably from the definition of expense under the full accrual basis.

In some cases, the cash flows related to certain expenditures may take place well into the future, such as employee pension benefits that are earned by employees during the period. In some circumstances, it may not be possible to measure the amount with sufficient reliability to recognize the expenditure. Where employee pension benefits can be measured reliably, they would be recognized.

.032 Figure 3.1 shows the recognition criteria adopted by accounting statements in the United States (for state and local governments) and Canada.

Figure 3.1

GASB (USA)	"*Most expenditures and transfers out are measurable and should be recognized when the related liability is incurred.*" (GASB Section 1600.117)
PSAR (Canada)	"*Expenditures should be accounted for in the period the goods and services are acquired and a liability is incurred, or transfer payments are due.*" (PSAR Section PS 1500.72)

Full Accrual Basis

.033 The full accrual basis recognizes expenses when service potential or future economic benefits are consumed or otherwise diminished. For example, the costs of assets that embody future economic benefits or service potential are deferred on acquisition and are allocated to the periods in which they are used. Fixed assets, for example, would be depreciated over their expected service lives. For grants, the recognition criteria would be the same as under the modified accrual basis, that is, the grants would be recognized when the eligibility criteria have been met and the amounts can be estimated reliably.

.034 Figure 3.2 shows the recognition criteria adopted by accounting statements in Australia, Spain and New Zealand.

Figure 3.2

AARF (Australia)	"*An expense of a government shall be recognised in the operating statement when and only when:* *(a) it is probable that the consumption or loss of future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred; and* *(b) the consumption or loss of future economic benefits can be measured reliably.*" (AAS 31, paragraph 13.2)
CPNCP (Spain)	"*For the recognition of expenses, the following requirements have to be met:* *(a) The underlying event which results in a decrease of equity associated with a depletion of assets or incurrence of liabilities has occurred. The recognition of the expense has to be made at the same time as the recognition of the depletion of the asset or incurrence of the liability from which they result.* *(b) The expense has a cost or amount which can be estimated reliably. This criteria includes the use of reasonable estimates to quantify certain expenses.* (*Para reconocer contablemente un gasto han de cumplirse los siguientes requisitos:* *(a) Que se haya producido un hecho contable que implique un decremento en el patrimonio neto de la entidad asociado a una variación de activos o surgimiento de obligaciones. El reconocimiento del gasto ha de realizarse simultáneamente al momento en que se registren las variaciones de activo u obligaciones que los mismos originan.* *(b) Que la partida tenga un coste o un valor que pueda ser medido con fiabilidad. Dentro de este requisito cabe incluir el uso de estimaciones razonables como un método válido para cuantificar ciertos gastos*.)" (Principios contables públicos, Documento 3, paragraph 41, 1994)
NZSA (New Zealand)	"*Expenses shall be recognised in the determination of the result for the reporting period, when and only when:* *(a) it is probable that the consumption or loss of service potential or future economic benefits resulting in a reduction in assets and/or an increase in liabilities has occurred; and* *(b) the consumption or loss of service potential or future economic benefits can be measured with reliability.* *It has been common practice when recognising expenses in the statement of financial performance to make a direct association between costs incurred and specific items of revenue. This process, commonly referred to as the matching principle, is the linked recognition of revenues and expenses that result directly and jointly from the same transactions or other events. For example, using the matching principle, the various components of expense which make up the cost of goods sold are recognised in the statement of financial performance at the same time as the revenue derived from the sale of goods. This approach may result in recognition and/or classification decisions that are inconsistent with the definitions of elements adopted in this Statement. If the application of the matching principle would result in the recognition of items which do not meet the definition of assets or liabilities, it is inappropriate and not permitted.*" (SC, paragraphs 7.24 and 7.25)

Probable Consumption or Loss of Service Potential or Future Economic Benefits

.035 In moving towards a full accrual basis of accounting, it is more likely that estimates of amounts are necessary, and issues relating to both the probability of the consumption or loss of service potential or future economic benefits, and the ability to measure that consumption or loss become relevant. The Statement of Accounting Concepts 4 (SAC 4) of the Australian Accounting Research Foundation (AARF) describes the terms used in the recognition criteria as follows: "*For an expense to qualify for recognition, it must be probable that the consumption or loss of future economic benefits has occurred. The term "probable" means that the chance of the consumption or loss of service potential or future economic benefits having occurred is more likely rather than less likely.*

The probability of such consumption or loss of future economic benefits will vary. Most expenses result from the production or delivery of goods and services during the reporting period and the large majority of these involve little or no uncertainty that future economic benefits have been consumed; for example, cost of goods sold, cost of services, supplies used and equipment used. However, in some cases there will be uncertainty as to whether there has been a consumption or loss of future economic benefits during the reporting period; for example, it may be difficult to determine whether the future economic benefits embodied in long-lived assets have suffered commercial impairment (in addition to physical wear and tear) during the reporting period. In situations where there is uncertainty about the consumption or loss future economic benefits, expenses would qualify for recognition when the consumption or loss is probable." (SAC 4, paragraphs 133, 134)

Reliable Measurement

.036 In many cases a consumption or loss of future economic benefit or service potential is probable; however, it can not be measured with reliability. The Framework for the Preparation and Presentation of Financial Statements of the IASC describes reliability as follows:

"*To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.*" (paragraph 31)

.037 In the United States, Statement of Federal Financial Accounting Standards (SFFAS) No. 5, "*Accounting for Liabilities of the Federal Government*" discusses the various recognition points for liabilities/expenses associated with different types of events and transactions. A distinction is made between government related events and government acknowledged events.

Government Related Events

.038 Government related events can be defined as "*events that involve interaction between the federal government and its environment. The event may be beyond the control of the federal entity*." (SFFAS No. 5, paragraph 27)

.039 If such a government related event results in a liability, and therefore in an expense, "*the liability should be recognized in the period the event occurs if the future outflow or other sacrifices of resources is probable and the liability can be measured or as soon thereafter as it becomes probable and measurable.*" (SFFAS No. 5, paragraph 29) In this respect "probable" means more likely than not, and "measurable" means reasonably estimable.

Government related events include:

"*(1)* *cleanup from federal operations resulting in hazardous waste that the federal government is required by statutes and/or regulations, that are in effect as of the Balance Sheet date to clean up (i.e., remove, contain, or dispose of);*

(2) *accidental damage to nonfederal property caused by federal operations; and*

(3) *other damage to federal property caused by such factors as federal operations or natural forces.*" (SFFAS No. 5, paragraph 28)

Government Acknowledged Events

.040 On the other hand, government acknowledged events *"are those nontransaction-based events that are of financial consequence" to the federal government because the it chooses to respond to the event.*" (SFFAS No. 5, paragraph 30) The government may be seen to have a responsibility for the public's general welfare. The government has established programs to fulfill many social needs and often assumes responsibilities for which it does not have a legal obligation.

Therefore, costs associated with the occurrence of natural disasters such as earthquakes, floods, hurricanes, volcano eruptions or forest fires may be assumed by the government as its responsibility, and appropriations are often made to assist those adversely affected. The U.S. federal liability standard outlines that in such cases no liability and expense would be recognized until the government formally acknowledges financial responsibility for the cost from the event and an exchange or nonexchange transaction has occurred. In other words, the federal entity should recognize the liability and expense when both of the following criteria have been met:

- the Congress has appropriated or authorized (i.e., through authorization legislation) resources; and
- an exchange occurs (e.g., when a contractor performs repairs) or nonexchange amounts are unpaid as of the reporting date (e.g., direct payments to disaster victims), whichever applies.

For example:

"A tornado damages a U.S. town and the Congress appropriates funds in response to the disaster. This event is of financial consequence to the federal government because the federal government chooses to provide disaster relief to the town. Transactions resulting from this appropriation, including disaster loans, outright grants to individuals, and work performed by contractors paid by the federal entities are recognized as exchange or nonexchange transactions. In the case of exchange transactions, amounts payable for goods and services provided to the government are recognized when the goods are delivered or the work is done. In the case of nonexchange transactions, a liability should be recognized for any unpaid amounts due as of the reporting date." (SFFAS No. 5, paragraph 32)

.041 There are other accounting treatments than that advocated by U.S., for example, in Malaysia both government related events and government acknowledged events are recognized only at the point of payment. PSC Study 6 "Accounting and Reporting Liabilities" further discusses the issues when drawing the line between liabilities, contingencies and commitments.

CHAPTER 4

TYPES OF EXPENSES IN THE PUBLIC SECTOR

Types of Expenses/expenditures

.042 Public sector entities usually have some political or social welfare objectives. They are responsible for providing health, safety, education, social and other services to their constituencies. In rendering these services, public sector entities incur a range of different expenses/expenditures, some of which, for reasons of type or relative amount, are more significant than in the private sector. The types of expenses/expenditures that governments may report include:

- Personnel expenses;
- Government transfers;
- Cost of goods sold;
- Costs of services provided;
- Capital asset use (depreciation);
- Interest;
- Tax expenses/expenditures; and
- Maintenance & working expenses.

.043 Most of these items may be similar to expenses recognized by business enterprises, such as personnel expenses, or interest on debt, but may be more material in the government context. Exchange expenses/expenditures that are similar to those identified in the private sector do not pose particular accounting or reporting issues for government. It should be noted, however, that, as discussed in Chapter 3, the timing of recognition of a particular expense/expenditure in the entity's operating statement depends on the basis of accounting adopted by the entity.

.044 Most recognition criteria for business enterprises relate to the point of exchange or consumption of an asset. In the case of non-reciprocal transfers, there is no point of exchange on which to base recognition. However, failing to recognize the transaction until the cash disbursement occurs, ignores valid claims on resources which the modified accrual and full accrual bases of accounting would capture. Non-reciprocal expenses that are unique to governments include government transfers and tax expenses/expenditures and distinctive recognition criteria may be required for these. Also, depreciation, the activity of transfer agencies and development expenses can pose some different problems in the public sector. The following paragraphs discuss the issues of these particular expenses in the public sector.

Government Transfers

Introduction

.045 In IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance* the IASC makes a distinction between government assistance and government grants. They are defined as follows:

"*<u>Government assistance</u> is action by government designed to provide an economic benefit specific to an enterprise or range of enterprises qualifying under certain criteria.*"

"*<u>Government grants</u> are assistance by government in the form of transfers of resources to an enterprise in return for past or future compliance with certain conditions relating to the operating activities of the enterprise*." (paragraph 3)

Recognition Criteria in International Accounting Standard 20

.046 The IAS gives the following guidance regarding the non-recognition and recognition of government grants respectively:

"*Government grants, including non-monetary grants at fair value, should not be recognised until there is reasonable assurance that:*

(a) *the enterprise will comply with the conditions attaching to them; and*
(b) *the grants will be received*" (paragraph 7)

"*Government grants should be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis. They should not be credited directly to shareholders' interests.*" (paragraph 12)

Problems in Applying International Accounting Standard 20

.047 IAS 20 is clearly restricted to government transfers in the records of the receiving enterprise. In addition, IAS 20 was developed before the IASC Framework and any future review of IAS 20 may lead to different requirements. More guidance is needed in the public sector to address the specific accounting issues for government transfers. For example, Australia developed guidance consistent with the IASC Framework which considers that government transfers would be recognized as expenses when the recipient gains control of those transfers.

.048 The approach taken in this Study is drawn mainly from the guidance given in the Public Sector Accounting Recommendation (PSAR) Section PS 3410, *Government Transfers* of the Canadian Institute of Chartered Accountants (CICA).

Definition

.049 "***government transfers*** *are transfers of money from a government to an individual, an organization or another government for which the government making the transfer does not:*

(a) *receive any goods or services directly in return, as would occur in a purchase/sale transaction;*
(b) *expect to be repaid in the future, as would be expected in a loan; or*
(c) *expect a financial return, as would be expected in an investment.*" (PSAR Section PS 3410, paragraph .03)

.050 Whilst this definition specifically mentions "transfers of money" it can also be applied to non-cash transfers. The major characteristic of these transfers is that they are non-reciprocal, in the sense that the government does not receive equal value in exchange directly from the transferee. In contrast with the IASC definition of grants, this definition also embraces transfers to individuals and intergovernmental transfers.

General Recognition Criteria

.051 PSAR Section PS 3410 states that the "*Government transfers should be recognized in a government's financial statements as expenditures or revenues in the period that the events giving rise to the transfer occurred, as long as:*
(a) *the transfer is authorized;*
(b) *eligibility criteria, if any, have been met by the recipient; and*
(c) *a reasonable estimate of the amount can be made*." (PSAR Section PS 3410, paragraph .07)

The PSAR recognizes that it might not always be possible to estimate the exact transfer to be paid or received and that estimates may need considerable judgment. Estimates also may need to be reappraised as more experience is acquired. However, "*the basis for determining the amount recognized for any particular transfer should be applied consistently from year to year*." (PSAR Section PS 3410, paragraph .07)

Types of Transfers

.052 The PSAR identifies three major types of transfers: entitlements, transfers under shared cost agreements and grants. These categories are based on a concept of a spectrum in the degree of discretion the government has in making a transfer. Other countries such as Australia apply the same recognition criteria to expenses of all types and do not make a distinction between entitlements, transfers and grants.

(a) Entitlements

.053 Entitlements are defined as *"transfers that a government must make if the recipient meets specified eligibility criteria. Such transfers are non-discretionary in the sense that both:*

(i) "who" is eligible to receive the transfer; and
(ii) "how much" is transferred

are prescribed in legislation and/or regulations." (PSAR Section PS 3410, paragraph .04)

.054 This definition is consistent with the one used in the U.S. federal liability standard which similarly describes an entitlement program thus: An entitlement program is "*a program in which the federal government becomes automatically obligated to provide benefits to members of a specific group who meet the requirements established by the law.*" (SFFAS No. 5, page 71)

.055 An example of such a transfer could be welfare benefits. For example, in the New Zealand Crown Financial Statements, welfare benefits are recognized "*in the period when an application for a benefit has been accepted and the eligibility criteria met.*" (NZ CFS 1995, page 73) This may be ahead of a cash payment; however, it does not anticipate any liability for payments that might be made if the existing welfare policy continued in future years.

.056 The same approach is used in Canada. For example, individuals may receive entitlements under provincial or local government social assistance programs. Under such programs, governments may be committed to make a series of payments over some future periods. Commitments for future payments would not be recognized as liabilities and therefore not as expenses. However, governments may have current liabilities for amounts already owed to eligible individuals but not yet paid. The recognition criterion foresees that an expense/expenditure "*should be recognized by the transferring government for estimated unpaid entitlements due at the end of the accounting period to those individuals who had met eligibility criteria*." (PSAR Section PS 3410, paragraph .19) Examples of such entitlements could be old age benefits, family allowances and unemployment insurance benefits.

.057 As mentioned above, the acceptance of an application is one of the conditions for the recognition of entitlements in New Zealand; however, this might not necessarily be the case in other countries. It can also be argued that an application is not necessary to recognize the expense; however, the receipt of the application may be the government's only way of making a reliable estimate of the entitlement.

.058 There may also be entitlements due to governmental institutions rather than to individuals. Instead of individuals meeting an eligibility criterion, governments or institutions would be eligible according to existing legislation or regulation. Such programs usually have goals such as federal/provincial/local fiscal equalization, regional development of various kinds, etc. Whilst the recognition criteria would remain the same as for individuals receiving the benefit, estimating the amounts of entitlements of other governments might be a little more complex. For example, the necessary data for the calculation might not be available for a considerable time period, or the accounting period of the two governmental institutions involved in a transfer could be different.

.059 The PSAR gives some guidance on recognition in those cases: "*When the final amount .... cannot be calculated within the time frame necessary for the preparation of the financial statements, those amounts that are known with reasonable certainty before the financial statements are completed would be recognized. Adjustments to estimates of current or previous years' entitlements that are known before the financial statements are completed would be recognized as expenditures or revenues*." (PSAR Section PS 3410, paragraph .27) As for different fiscal years, the statement acknowledges that considerable judgment will be required: "*Depending on the underlying agreement, such transfers might reasonably be allocated over time or on a basis that approximates the recipient's expenditure pattern. The basis for allocating the obligation should be applied consistently from year to year.*"(PSAR Section PS 3410, paragraph .28)

.060 Another issue is whether potential obligations arising from an existing policy, but relying on a future event (e.g., a person becoming or remaining unemployed next year) constitute a liability (and thus, an expense of the current year). In some jurisdictions, the assessment underlying the treatment in the financial statements is that such potential future obligations are not present liabilities because the Government can change the policies without anyone having a legal claim. In Australia, for example, "*the intention of a government to make payments to other parties, whether advised in the form of a budget policy or election promise, does not of itself create a present obligation which is binding on the government. A liability would be recognised only when the government is committed in the sense that it has little or no discretion to avoid the sacrifice of future economic benefits. Similarly, a government does not have a present obligation to sacrifice future economic benefits for social welfare payments that might arise in future reporting periods. A present obligation for social welfare payments arises only when entitlement conditions are satisfied for payment during a particular payment period. Consequently, only amounts outstanding in relation to current or previous periods satisfy the definition of liabilities.*" (AARF, AAS 31, paragraph 12.1.2)

.061 In other jurisdictions, legal obligations to continue benefit programs may be such that they do represent present liabilities, changes in which should be recorded each year as an expense. The treatment in a particular country will depend on the institutional arrangements of that country. The difficulty often lies in the interpretation of the arrangements to establish how far forward a government becomes firmly committed and has no discretion to avoid an expense/expenditure. Even in those cases where an expense/liability should be recognized, the reliability of the measurement can prevent the recognition of that expense/liability. For example, in the U.S. a lack of unanimity on whether social security should be treated as a liability resulted in a proposal to report on its financial effects off balance sheet, thereby taking changes in actuarial factors and huge consequent swings in expenses out of the financial statements.

.062 Another argument sometimes presented concerning the recognition of these future obligations is that if future transfer payments were recognized as liabilities/expenses then future taxes would similarly require recognition.

(b) Transfers under Shared Cost Agreements

.063 Transfers under shared cost agreements are defined as "*reimbursement of eligible expenditures pursuant to an agreement between the transferring government and the recipient*." (PSAR Section PS 3410, paragraph .04)

.064 These transfers are similar to entitlements in that the recipient has the right to a transfer after incurring eligible expenditures. They are different from other entitlements in that an expenditure is the prerequisite to eligibility for reimbursement. There are different types of shared cost agreements, for example, the government making the transfer may pay for all eligible expenditures or for only a portion. There may also be a ceiling on the total eligible amount. The specific terms of the shared cost agreement are in legislation or contracts between the different parties.

.065 PSAR Section PS 3410 states the recognition criteria of shared cost agreements as follows:

"*Transfers under shared cost agreements should be recognized when the recipient incurs eligible expenditures because, under the agreement, the government must reimburse the recipient for the specified percentage of those eligible expenditures.*

Liabilities should be recognized by the transferring government at the end of the accounting period for the estimated, unpaid portion of incurred eligible expenditures owed to recipients pursuant to a shared cost agreement." (PSAR Section PS 3410, paragraphs .31, .32)

(c) Grants

.066 PSAR Section PS 3410 defines grants as "*transfers that are made at the discretion of a government. The government making the transfer has discretion in deciding whether or not to make a transfer, the conditions to be complied with, if any, how much will be transferred and to whom.*" (PSAR Section PS 3410, paragraph .04)

Another definition of grants used in New Zealand is as follows:

"*"Grants" are non-reciprocal transfers by an entity (donor) to another entity (donee) except where the transfer is a contribution by owners or a distribution to owners. Grants may take the form of cash, services, transfer of an asset or reduction of an existing liability. Conditions may or may not attach to the grant.*" (ED 70, paragraph 4.2) [1]

This definition of a grant is broader than the one used in the PSAR and there is no reference to the discretion which a government has in making the transfer.

.067 PSAR Section PS 3410 describes grants further and distinguishes entitlements:

"*Grants include such transfers as: cultural grants, scholarships, research grants and regional development grants. In most cases, recipients have to apply for the money or meet some eligibility criteria; however, in contrast to entitlements, applying or meeting eligibility criteria does not guarantee that the recipient will receive the money. The government still has discretion to decide whether or not to make the transfer.*" (PSAR Section PS 3410, paragraph .34)

As long as the grant is discretionary, the government has no obligation and therefore no expense is incurred in the financial statements at the time the application is made.

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[1] The New Zealand Society of Accountant's Financial Reporting Standards Board withdrew this exposure draft (FRSB) at the 1 June 1995 meeting. The FRSB considered that a Technical Practice Aid would be a better means of providing guidance on the financial reporting issues addressed through ED 70. This is yet to be issued.

.068 Finally, the recognition criterion for grants in PSAR Section PS 3410 is as follows:

"*Liabilities should be recognized by the transferring government for any unpaid, authorized grants at the end of the accounting period for which recipients have met eligibility criteria, if any, prior to the end of that period.*" (PSAR Section PS 3410, paragraph .38)

The accounting policy in the financial statements of the New Zealand Government also incorporates the eligibility criteria and includes a requirement to give notice to the Crown:

"*Where grants and subsidies are discretionary until payment, the expense is recognised when the payment is made. Otherwise, the expense is recognised when the specified criteria have been fulfilled and notice has been given to the Crown*." (Crown Financial Statements 1995, page 73)

Conclusion

.069 Government transfers may have characteristics of more than one type discussed above. In deciding when to recognize the specific type of transfer, the criteria can be summarized as follows:

- Has the event giving rise to a transfer occurred? As discussed above, an event could be described as a "*happening of consequence to an entity*" and can be classified either as government related or government acknowledged.

- Has the transfer been authorized? In many countries, transfers cannot be made without the approval of government or the legislature. Therefore, even though the other criteria have been met, without the proper authorization the transfer might not be recognized by the governing legislation.

- Has the recipient met the eligibility criteria? A government might make payment to the recipient prior to the eligibility criteria being met. In that case, the government should not expense the payment, but record it as a financial asset until the transferee meets the eligibility criteria.

- Can the amount be reasonably estimated? In many cases, this seems to be a serious impediment to recognizing a transfer. Professional judgement is required in such cases.

Finally, the presentation and disclosure of the adopted accounting policies is essential: "*In addition, disclosing a description of the accounting policies regarding government transfers and information on the major kinds of transfers made or received is useful in understanding the sources and types of revenues a government receives and in understanding the programs and activities it undertakes.*" (PSAR Section PS 3410, paragraph .55)

Current Practice

.070 A survey reported in IFAC PSC Study 6, *Accounting for and Reporting Liabilities* shows the following accounting practices regarding transfer payments:

Figure 4.1

Transfer payments payable (e.g., grants, entitlements)

Australia	Obligation is recognized and measured on the basis of the best estimate of the amount payable as at the reporting date.
Canada	Recorded in the financial statements at estimated amount ultimately payable, as long as terms and conditions, if any, have been met.
Italy	Recorded in the financial statements at commitment specified by laws.
Netherlands	Recorded in the financial statements at historical cost.
New Zealand	Recorded in the financial statements at estimated obligation to pay (for benefit applications accepted where eligibility criteria have been met).
Taiwan	Recorded in the financial statements based on approved budget.
United Kingdom	Recorded in the financial statements at actual amounts due but unpaid.
United States	Recorded in the financial statements at amounts due but unpaid.

(IFAC PSC Study 6, appendix 1, page ii)

Expenses Related to the Consumption of Fixed Assets

Depreciation

.071 Regardless of the accounting basis adopted, governments are expected to manage public assets efficiently. The recognition of depreciation is often considered necessary for transparent representation of the expenses incurred in conducting government operations for the reporting period. Financial reporting of fixed assets provides benefits by enhancing the quality of asset information. Lüder (1991) identifies the need for change from the traditional accounting for fixed assets to avoid the weaknesses of that system, that is,

- poor management control over assets;
- lacking information on the value of realizable assets; and
- lacking information on the value of unrealizable assets compared to long-term debt.

.072 The consumption of limited-life physical assets over a period occurs in the public sector just as it does in the private sector. Therefore, where the full accrual basis of accounting is adopted, depreciation accounting is generally accepted and IAS 4, *Depreciation Accounting* and IAS 16, *Property, Plant and Equipment* should be fully applicable. However, since the majority of public sector entities are still using accounting bases other than the full accrual basis, the assets would not be recognized in the financial statements and no depreciation would be reported.

.073 Sometimes the view is taken that depreciation is not relevant for public sector assets such as infrastructure, heritage and community assets, because their economic benefits are realized over a very long period of time.

The services or economic benefits also cannot be related directly to specific revenues. SAC 4, *Definition and Recognition of the Elements of Financial Statements* identifies as a determinant whether or not the service potential or future economic benefits embodied in the assets will be consumed or will expire. The fact that the rate of consumption or expiration of service potential or future economic benefits takes place over a long period of time does not preclude such items from giving rise to expenses. Also, the argument that such consumption or expiration is not readily identifiable with the recognition of specific resources or with the provision of particular services, or cannot be associated with particular events or reporting periods, does not necessarily mean that no expense should be recognized. If the asset has a finite life — and very few types of assets could be regarded as having an infinite life, the exception being land in most circumstances **-** the service potential or future economic benefits embodied in the asset will be consumed or will expire and will therefore give rise to expenses.

.074 Some people have argued that, independently of the accounting basis used, depreciation is not a concept relevant to the public sector for a number of reasons. Some of the reasons include that:

- in the public sector there is no need to measure income, and hence match revenues and expense;
- a continuing obligation to maintain capital by recognition of depreciation conflicts with the notion of the supremacy of parliament in the control and direction of public financial resources;
- accumulation of funds from depreciation within an organization prior to there being a need to replace capital undermines the control taxpayers would normally have over the management of public finances; and
- depreciation is arbitrary.

.075 The Auditor General of Canada recently recommended the implementation of capitalization and depreciation of physical assets to improve management discipline in departments, reduce costs and improve accountability reporting by departments to Parliament. To avoid the pitfalls that can accompany such an accounting change, the Auditor General made the following suggestions to the Canadian Government:

“• *Capitalization of physical assets should be implemented at the departmental level, not just at the summary level.*
• *The capitalization and depreciation of physical assets and the Government’s appropriation process should be harmonized.*
• *Stringent rules for depreciating and valuing physical assets should be developed and implemented to avoid manipulation of reported results.*
• *The potentially adverse behavioural aspects of capitalizing physical assets should be considered carefully and avoided.*
• *Certain of the Government’s physical assets may require special consideration*.” (Extracts from Observations by the Auditor General on the Canadian Federal Government’s 1995 Financial Statements concerning capitalization)

Renewal Accounting

.076 Recently, a number of accountants, academics and authoritative bodies have commented on the problem of how best to account for certain government fixed assets, and suggested alternatives to depreciation. Renewal accounting and deferred maintenance are systems that have been suggested as alternatives to depreciation accounting to measure the cost of consumption or loss of service potential.

.077 The Australian Accounting Research Foundation (AARF) describes one form of the renewal accounting approach as follows:

"*The renewal accounting approach to recognition of the consumption of asset service potential treats a collection of assets making up a network, or system, as a single asset which is to be maintained in service indefinitely. All expenditures on an asset system, whether creating, or replacing service potential, or maintaining existing service potential, are perceived to be in the nature of "maintenance" of the system, and are expensed as they occur.*

Underlying renewal accounting is the assertion that expenditures made on a system to maintain it in operation are an adequate representation of the cost of asset service potential consumed. In practice, expenditures made each period to renew assets may not equate with the full cost of consumption of asset service potential for a variety of reasons.

In essence, renewal accounting is a form of cash accounting. Only when expenditures made in one accounting period on maintaining an asset system coincide with the cost of consumption of asset service potential will period expenses and asset stocks not be misstated." (AARF 1992, DP 17, pages 58-59)

Other forms of renewal accounting are the deferred maintenance approach and conditioned-based depreciation.

.078 However, the AARF acknowledges that it is unlikely that such circumstances will pertain on a period-by-period basis over the long life span of infrastructure type assets. Thus, in periods where expenditures on the acquisition of service potential are made, period expenses will be overstated, and asset stocks understated, since no expenditures are capitalized. The discussion paper therefore concludes that "*renewal accounting is neither consistent with the requirements of the SAC 4 definition of expenses, nor does it provide an alternative mechanism for the measurement of expenses.*" (AARF 1992, DP 17, page 59)

Deferred Maintenance

.079 "*"Deferred Maintenance" is maintenance that was not performed when it should have been or was scheduled to be and which, therefore, is put off or delayed for a future period.*" (SFFAS No. 6, paragraph 77)

.080 Deferred maintenance is a concept that involves the disclosure of a liability for future maintenance costs and thus, arguably, presents a more realistic picture of an entity's financial position. The difference between this and a renewals accounting system can be described as follows:

"*Such a system differs from a renewal accounting system in that under renewal accounting "expense" of asset use is determined by the amount spent on asset renewal. In a "deferred" maintenance system "expense" is determined by reference to estimates of what ought to have been spent to maintain the system. Both differ from a depreciation system in which expense is determined by reference to estimates of consumed service potential.*" (AARF 1992, DP 17, page 59)

.081 The U.S. is considering new concepts for the expense of consuming fixed assets. In a preliminary views document, the GASB states that "*governmental entities are permitted, but not required, to report a charge for cost of use based on planned maintenance rather than on an allocation of the historical cost of these assets. The amount of planned maintenance should be based on a capital asset management plan that is intended to maintain the asset at the established level of service indefinitely. ....the amount of planned maintenance for the current period should be charged against the contra-asset account. The reported value of the capital asset should be the net of its historical cost less the accumulated amount of planned maintenance that has not been expended* - *that is, the balance in the contra asset account.*" (GASB 1995, page 33, paragraph 35)

.082 A deferred maintenance approach involves a great deal of judgment about the standards to which assets should be maintained. It is necessary to specify these standards in order to determine the estimates of the deferred maintenance costs.

.083 It is argued that public sector assets are often not maintained to their optimum levels, and that, to the extent that a public sector entity can be said to have a liability to maintain such assets, the required maintenance has been deferred. The corresponding debit would affect the amount of expense recorded. To provide the public with meaningful financial information, the advocates of deferred maintenance argue that the ongoing expenses/expenditures for maintaining infrastructure assets should be disclosed and accounted for. A contrary position is reflected in the Consolidated Financial Statements of New South Wales:

"*School buildings are depreciated at a rate of 1% per annum based on an estimated life expectancy of one hundred years. However, over a 100 year cycle, school buildings would normally be subject to a number of major refurbishments in order to maintain their service potential. This element has not been taken into account in assessing depreciation charges and the carrying value of school buildings*." (CFS of N.S.W., page 18)

.084 In the United States, SFFAS No. 6, *Accounting for Property, Plant and Equipment*, does not provide for recognition as an expense the "liabilities" for deferred maintenance, and permits flexibility in disclosing information on deferred maintenance. (See paragraph .112 for a possible disclosure of deferred maintenance)

.085 In Australia, the Road and Traffic Authority (RTA) of New South Wales suggest that condition-based depreciation is an appropriate technique to use for the management of infrastructure assets. Burns (1993) explains that "*under this approach, road condition is continually assessed as part of the management and operation of the road systems. As such, the RTA can calculate not only the current condition but also how much it would cost to bring the road back to a "fair" or "as new" condition. Comparing the beginning and end of year assessment gives the amount by which the road network has detoriated during the year. This amount is then a charge on the income and expenditure account and is shown in the balance sheet as a deduction from the value of the asset.*"

.086 To date there is little experience with applying depreciation accounting concepts to government non-business fixed assets. Whilst many of the methods developed for the private sector can be applied by governments, there is debate on whether governments' depreciation methods should also take into account the full life-cycle costs associated with the assets, that is, in addition to the acquisition cost of the asset also the cost of maintaining and operating the assets. A Study Group of the CICA recommended that at the current stage in the development of government accounting standards, the "*standards should provide scope for governments to experiment with different methods of measuring the annual consumption of fixed assets.*" (CICA Research Study, "Accounting and Reporting for Physical Assets by Governments", page 65, paragraph 76) For example, the treatment of depreciation within UK local government accounting allows for the use of demonstrable expenditure on repairs and maintenance to negate the need to charge for depreciation where appropriate: "*Depreciation need not be provided for where the local authority can demonstrate that it is making regular repairs and maintenance to extend the asset's useful life in its existing use, such that any depreciation would not be material*." (CIPFA/LASAAC Code of Practice on Local Authority Accounting in Great Britain, paragraph 3.35)

Tax Expenditures

.087 Governments use the tax system to meet their economic, social or other goals in two different ways:

- as a primary vehicle to raise revenue; and
- as a way of giving particular incentives or promoting particular behaviour among taxpayers.

Many jurisdictions, for example, give tax exemptions to provide incentives to invest in particular areas. They also commonly utilize measures other than exemptions, such as allowances, tax rate reductions, tax credits or tax exempt status. These measures are referred to as tax expenditures because they reduce the tax bills of those who receive them and are therefore analogous to subsidies, which involve directly expenditures. Tax expenditures can be defined as follows:

"*Tax expenditures are estimates of the revenue forgone because of preferential provisions of the tax structure. They are due to special exclusions, exemptions, deductions, credits, deferrals, and tax rates that depart from a "baseline." These exceptions are generally intended to achieve public policy objectives by providing benefits to qualifying individuals or entities or by encouraging particular activities. They also may be intended to improve tax equity or offset imperfections in other parts of the tax structure. Tax expenditures are not revenue. They are not inflows of resources to the reporting entity.*" (SFFAS No. 7, paragraph 192)

.088 Tax expenditures represent a tax revenue foregone by the government. The issue is whether such items should be recognized as expenses. Even though foregone revenues are normally not recognized as expenses, some countries feel that the figures involved are significant and should at least be disclosed in supplementary information. Other countries believe that, whilst estimates of tax expenditures are of benefit as internal management guides, the estimation of the likely revenue foregone is too subjective to be a reliable measure in published external financial statements. For example, tax expenditures are not recognized and considered an expense in the Government financial statements of Spain. Their only effect is that the tax revenue is recognized as the amounts actually received, that is, the gross tax revenue reduced by corresponding exemptions, bonifications, deductions etc. established by the law of each individual tax. Nevertheless, the information on these tax expenditures is supplied to the legislature, given the fact that the budgets of the Government ordinarily and systematically comprise the amounts of tax benefits which affect the tax revenue of the government.

.089 The U.S. Government is the only government so far to disclose estimates of tax expenditures in its routine financial reporting (see also discussion in paragraphs .110 and .111). However, the numbers shown in the tables in the consolidated financial statements of the US government have to be used with caution, since they are estimated from a static perspective. Tax expenditures affect the behavior of the taxpayers, and have effects in both the short and long term. Measurement remains the critical issue in the identification of a nominal tax rate from which a deduction can be estimated. A joint study by the Office of the Auditor General of Canada and the U.S. General Accounting Office acknowledged that estimates of the values of tax expenditures may have significant error for the following reasons:

"- *Each tax provision is considered in isolation for estimation purposes. No attempt has been made to estimate the effect of taxpayers rearranging their affairs to lessen the impact if a particular tax measure were removed. The resulting revenue gain would thus be less than the estimates in the tables.*

- *Removal of a major tax expenditure might in fact have a negative impact on outputs and incomes in the economy, producing less additional tax revenue in total than the estimates in the table would suggest.*

- *The elements in the table are not additive: they cannot be added together to produce a total foregone revenue amount because removal of provisions would cause interactions of effects, with unpredictable total net effect, and because estimates are lacking for some individual tax expenditures.*

- *Tax Expenditures may have a greater effect than direct aid in the form of grants, because selective measures directly increase after-tax income and grants would normally be taxed or would reduce deductible expense.*" (Federal Government Reporting Study, 1986, page 23)

Other Issues

Transfer Agencies

.090 Some agencies and governments manage and disburse resources as agent on behalf of a principal, such as a higher level of government or private foundation. There is an issue whether such flows of resources should be accounted for in the financial statements of the agent, as revenues and expenses, or should be accounted for separately. This depends upon whether it is the principal or the agent who has ownership rights to the resources involved and makes key decisions such as:

- the identity of (class of) recipients, or criteria for their selection;
- the conditions of entitlement of third party recipients;
- refund of unexpended funds by the agent;
- any right of recovery of unfunded expenditure by the agent; and
- separate reimbursement of the agent's expenses.

.091 IFAC PSC Study 8, *The Government Financial Reporting Entity* identifies other cases where the government may have the legal custody of resources without controlling them:

"*This would be the case where the government holds monies in trust for private individuals, acts as a collector or distributor of monies for other entities, or acts as a trustee for disaster relief or other funds, but other entities control the ultimate deployment of those monies. In some cases, the superannuation or retirement benefits of government employees may be maintained in a trust and governments may have only limited access to the funds in the trust.*

Information about resources which the government collects or distributes on behalf of another entity, and resources that the government has legal custody over but does not control, may be relevant for accountability and performance evaluation purposes and can be included as supplementary disclosures in the financial report. However, such resources should not be recognized in the financial statements of the government. Accountability obligations in respect of those trusts would be discharged by the preparation of special purpose reports for relevant parties and by disclosure in the financial report of a government." (paragraphs .074, .075)

.092 A similar approach is suggested in Australia:

"*Whether a government department should recognise revenues in respect of amounts appropriated for transfer during the reporting period, and expenses in respect of those amounts transferred during that period, is dependent on whether the department controls the assets that are to be transferred, and whether the amounts subsequently transferred constitute a reduction in the net assets of the department.*

In respect of amounts to be transferred to eligible beneficiaries, where the identity of the beneficiaries and the amounts to be transferred to them are determined by reference to legislation or other authority, it is unlikely that the department controls the funds to be transferred. The department is merely operating in the capacity of an agent responsible for the administration of the transfer process. As such, the department does not benefit from the assets held for transfer, nor does it have the capacity to deny or regulate the access of eligible beneficiaries to the assets. Accordingly, the department should not recognise assets and revenues in respect of amounts appropriated for transfer, nor expenses in respect of the amounts subsequently transferred." (AARF, AAS 29, paragraphs 103, 104)

.093 Even though these transfers do not have to be recognized, disclosure of this information in the notes in the financial report is required in the Australian Accounting Standard. Such information will be relevant for the assessment of the department's performance.

.094 However, in some cases it may not be clear whether or not the department has control over the transfers. In such cases, preparers and auditors need to use professional judgment in deciding whether the department should recognize the transfers as revenues and expenses.

.095 If the department is appropriated funds with the discretion to distribute those funds within broad parameters established by the government, control may exist. In such cases, the department would recognize an asset and revenue when control of the funds to be transferred is obtained, and recognize a liability and expense when decisions on the transfer or the identification of a clear entitlement to those funds occurs.

.096 In the United States, state and local governments have a different practice regarding the recognition of these revenues and expenses. Statement 24 "*Accounting and Financial Reporting for Certain Grants and Other Financial Assistance*" states that "*Governmental entities often receive grants and other financial assistance to transfer to or spend on behalf of a* ***secondary recipient****. These amounts are referred to as pass-through grants. All cash pass-through grants received by a governmental entity (referred to as a recipient government) should be reported in its financial statements. As a general rule, cash pass-through grants should be recognized as revenue and expenditures or expenses in a governmental, proprietary, or trust fund. In those infrequent cases in which a recipient government serves only as a cash conduit, the grant should be reported in an agency fund. A recipient government serves only as a cash conduit if it merely transmits grantor-supplied moneys without having administrative or direct financial involvement in the program*." (GASB 1994, paragraph 5)

Development Expenses

.097 Governments commonly use a proportion of their resources to add to the human resources of their country without acquiring physical assets. Some of these investment-type expenses, while not adding or qualifying for the recognition of assets, enhance the future productivity of the country. Such developmental expenses would include, for example, outlays for education and training, or research and development. The Prototype Financial Statements of the United States Government 1993 disclose the amounts of such developmental expenditures in supplemental tables.

CHAPTER 5

CLASSIFICATION AND DISCLOSURE OF EXPENSES/EXPENDITURES

Classification of Expenses/expenditures

.098 As noted in IFAC Study 9, *Definition and Recognition of Revenues*, the United Nations' System of National Accounts (SNA) and the International Monetary Fund's Government Finance Statistics are two of the existing systems to classify outflows of national governments for purposes of economic analysis and international comparison. The SNA framework is used by economic analysts for measuring activity in sectors of the economy, including the public sector. For example, the European System of National and Regional Accounts (ESA), which is fully consistent with the present SNA, is used to harmonize the determination of the budget deficits and the national debts of the member states of the European Union who want to qualify for participation in the European Monetary Union (EMU). The IMF classification system provides internationally comparable figures for its member countries. The focus of these figures has been largely cash-based, however, the IMF is currently revising the GFS Manual and a change in the recording basis in the revised GFS Manual from cash to accrual is possible. The following paragraphs show some of the possible classifications used in government financial statements.

.099 There is a variety of ways in which expenses/expenditures could be classified in financial statements. It is important that an appropriate classification is used throughout the budgeting, accounting, and reporting processes and that it satisfies the information needs of the various users. The major accounting classifications of expenses/expenditures are:

- by function or program;
- by output;
- by organization;
- by activity; and
- by input.

Classification by Function/program

.100 A classification by function or program provides useful information on the purposes or objectives of expenses/expenditures. It helps broad allocative decision making and the review by the legislative and executive branches of government. Most government outlays can be assigned to a specific function; some however require judgement. For example, military colleges are usually classified under "defense" rather than "education". Other problems may arise when some branches have more than one purpose or provide services to other units.

.101 The Canadian Institute of Chartered Accountants recommends that "*the Statement of revenues and expenditures should report a government's expenditures of the accounting period by function or major program*." (PSAR, Section 1500, paragraph 74)

It further gives an example of what such major government functions or programs could include:
"*Health, education, social services, transportation, natural resource development, public protection, communications and general government*." (PSAR, Section 1500, paragraph 75)

Table 5.1 shows two examples for a classification by function used in New Zealand and New South Wales.

Table 5.1

NEW ZEALAND	**NEW SOUTH WALES**
Expenses by functional classification: - *Social security and welfare* - *Education* - *Health* - *Core government services* - *Law and order* - *Defense* - *Transport and communications* - *Economic and industrial services* - *Primary services* - *Heritage, culture and recreation* - *Housing and community development* - *Other* - *Finance Costs* - *Net foreign-exchange (gains)/losses*	***Expenses by functional classification:*** - *Law, Order and Public Safety* - *Education* - *Health* - *Welfare Services* - *Housing and Community Services* - *Recreation and Culture* - *Economic Services* - *General Administration*

Classification by Output

.102 Classification of expenses by output is essential for efficiency evaluation. Such a system of classification requires both a clear specification of the outputs produced by government and robust cost allocation systems.

Reporting which relates expenses to outputs produced provides a basis for the assessment of performance which enables a comparison of actual efficiency against expectations, changes in efficiency between periods, and in some cases a comparison with non-government suppliers. Such reporting is particularly useful for accountability purposes.

This system of classification is generally not amenable to aggregation at the whole of government level. However, the New Zealand Treasury, which administers a system that requires all government departments to allocate expenses to output classes, has recently identified eight major groupings of outputs produced by government departments. Table 5.2 shows this grouping.

Table 5.2

Expenses by Output Grouping

Customer oriented: Outputs with identifiable individual customers who voluntarily consume a service for their benefit.

Transactions: Large scale processing of identical transactions (e.g., assessment of claims for income support payments).

Professional/Managerial: Outputs characterized by a mixture of ongoing service and projects (e.g., policy advice).

Investigations: Public good outputs where considerations of risk, due process, legal compliance and quality of judgment are most important.

Behavioural: involve outputs which try to change individual attitudes and behaviours such as counselling.

Control: These outputs involve the use of coercive powers either to keep individuals within a controlled environment or preventing entry to an area.

Emergency Services: These outputs involve the purchase of a planned level of response to emergencies.

Contingent Military Capabilities: These outputs involve the purchase of specified levels of military capability.

Classification by Organization

.103 Expenses/expenditures can also be divided into separate sections for each ministry, department or agency. These organizations can then be held responsible for their expenses/expenditures. Such a classification is tailored to the particular structure of the government. Within each spending organization, the expenses/expenditures can be further classified according to objects of expenditures. For example, the organization unit may be a Ministry of Agriculture and the objects could be personal services, non-personal services, materials and supplies etc. The object classification enables an entity to exercise control at various levels of management. For example, travel expense is an item that is under particular scrutiny in many jurisdictions. Its separation would facilitate the review of this particular cost item.

Within its function or program classification, the CICA recommends that "*Financial statements should disclose a government's expenditures of the accounting period by object of expenditure*." These objects of expenditures "*represent the major types of resources acquired, such as physical assets, employee salaries and benefits, operating goods and services, as well as debt servicing, and transfer payments to other governments and to the public. Total expenditures related to the acquisition of capital items such as buildings, equipment, highways and bridges should be disclosed clearly.*

Notes or schedules to the financial statements could also be used to display expenditures by department, ministry or other government organization to ensure specific responsibility for the utilization of financial resources required during the period is reported." (PSAR, Section PS 1500, paragraphs .77, .78)

Table 5.3 shows the classification used in the US. It uses different departments as separate items.

Table 5.3

UNITED STATES
Expenses by agency:
- *Legislative branch*
- *Judicial branch*
- *Executive branch:*
Executive Office of the President
Funds appropriated to the President
Departments:
Agriculture
Commerce
Defense (military)
Defense (civil)
Education
Energy
Health and Human Services, except Social Security
Health and Human Services, Social Security
Housing and Urban Development
Interior
Justice
Labor
State
Transportation
Treasury:
Interest on debt held by the public
Other
Veterans Affairs
Independent Agencies

Classification by Activity

.104 The GASB describes a classification by activity as follows: "*Activity classification is particularly significant because it facilitates evaluation of the economy and efficiency of operations by providing data for calculating expenditures per unit of activity. That is, the expenditure requirements of performing a given unit of work can be determined by classifying expenditures by activities and providing for performance measurement where such techniques are practicable. These expenditure data, in turn, can be used in preparing future budgets and in setting standards against which future expenditure levels can be evaluated. Further, activity expenditure data provide a convenient starting point for calculating total and/or unit expenses of activities where that is desired, for example, for "make or buy" and "do or contract out" decisions.*" (GASB, Section 1800, paragraph 119)

.105 The Australian AAS 31 "*Financial Reporting by Governments*" requires that the general purpose financial report of a government shall disclose, in respect of each broad sector of activity of the government, revenues and expenses which are reliably attributable to that sector, classified according to their nature or type. It further acknowledges that "*Given the nature and extent of dissimilarity in the activities of a government, disclosure of disaggregated information will assist users in their assessments of the effects of the different activities on the financial performance and financial position of the government.*" (AAS 31, paragraph 15.12.1)

The AARF also acknowledges, however, that some judgement is needed in identifying the broad sectors of a government's activities. When identifying them, consideration should be given to the users of government financial reports, the extent of the dissimilarity in the activities undertaken by the government and the qualitative characteristics that financial information should possess. One basis for identifying the broad sectors about which disaggregated information could be disclosed is the International Monetary Fund's Government Finance Statistics (GFS). The use of information which has been disaggregated using the GFS classification is encouraged in Australia; it is recognized, however, that this classification has been developed for specific purposes which may not always be compatible with the objective of general purpose financial reporting.

Classification by Input

.106 The notes to the financial statements of the Government of New Zealand display expenses by input type and disclose an additional analysis of subsidies and transfer payments, and operating expenses:

Table 5.4

By Input Type	***Analysis of Subsidies and Transfer Payments***	***Analysis of Operating Expenses***
Subsidies and transfer payments *Operating expenses* *Personnel* *Personnel expenses (excluding pension expenses)* *Pension expenses* *Movement in unfunded pension liability* *Depreciation* *Physical assets* *State highways* *Rental and leasing costs* *Loss on sale of assets* *Finance costs* *Net foreign-exchange gains on liabilities* *Net foreign-exchange losses on assets* *Supplementary Estimates provision*	*Social Assistance Grants* *New Zealand superannuation* *Unemployment benefit* *Domestic purposes benefit* *Family support* *Accommodation supplement* *Invalids benefit* *Sickness benefit* *Student allowances* *Disability allowance* *Training benefit* *Accident compensation for non-earners* *Other social assistance grants* *Subsidies* *Other Transfer Payments* *Official development assistance* *Other*	 *Education purchases* *Early childhood education* *Primary and secondary education* *Tertiary education and training* *Health purchases* *Personal health services* *Disability support services* *Public health purchasing* *Science purchases* *Treaty of Waitangi settlements* *National Provident Fund Board Indemnity* *Other operating expenses*

Classification and User Needs

.107 Classification will depend on users' needs and on how they can best be met. Having identified different classifications of expenses/expenditures, it is necessary to consider what users need to know about the expenses/expenditures, and which of these needs can be met by each of the classifications. The identified user needs will provide a basis for determining the most appropriate classification.

.108 IFAC PSC Study 1, *Financial Reporting by National Governments* identified these user needs as follows:

"*In broad terms, users need information to help them make economic, social and political decisions and to* *evaluate a government's or unit's use of the resources. They are interested in plans as well as the results of implementing those plans, including the government's or unit's performance and the state of its finances.*

Users look to financial reports for information on a government's or unit's:
- *stewardship and compliance;*
- *state of finances;*
- *performance; and*
- *economic impact*." (paragraphs 32, 33)

.109 The needs of the reporting entity will influence the classification and disclosure basis. However, meeting needs of the user of the financial statements has also to be considered, as well as the following constraints:

- level of detail of the information required.

  The level of detail provided in the financial statements should be representative of the objectives of the classification and disclosure used. Classification and disclosure considered to be too detailed for the whole of government financial statements could be relevant for inclusion in additional reports (e.g., departmental annual reports);.

- the ability to classify the information and the reliability of the resulting numbers.

  For example, some expenses/expenditures may not be easily classified into functions and arbitrary estimates may be necessary; and

- benefit versus cost.

  The benefit versus the cost of providing a specific classification or disclosure is a necessary consideration. If the benefits are few and the cost is excessive, the classification or disclosure should not be provided.

Disclosure of Tax Expenditures

.110 The benefits of grossing up tax revenues in showing them separately from tax expenses lie in the additional information on the performance of government programs involving tax expenditures. Without this information governments with fiscal problems may also be tempted to increase tax revenues rather than to cut tax expenditures, that is, the decision making process of the government is probably not efficient due to incomplete information.

.111 However, the United States is one country that systematically discloses information on tax expenditures. Recognition and disclosure of tax expenditures is a complex issue. It is presently unlikely that other countries will introduce any requirement regarding supplemental information of tax expenditures though in the future this may occur. The United States, for example, opted for the voluntary disclosure of tax expenditures:

> "*The Board decided not to require supplementary information on tax expenditures in component entity financial statements for several reasons. The definition of the baseline for comparison is in part a matter of values and judgment. In some cases the association with particular programs is not sufficiently clear. Furthermore, the information is available elsewhere now. However, the Board agreed to permit reporting entities to present, as other accompanying information, information on tax expenditures that the reporting entity considers relevant to its programs, if suitable explanations and qualifications are provided.*" (SFFAS No. 7, paragraph 197)

Disclosure of Deferred Maintenance

.112 In the U.S., federal accounting standards do not require the recognition of deferred maintenance but suggest the disclosure, at a minimum, of the following information:

“• *Identification of each major class of asset for which maintenance has been deferred.*

• *Method of measuring deferred maintenance for each major class of PP&E.*” (SFFAS No. 7, paragraph 83)

The major classes of property, plant and equipment (PPE) can be determined by the entity and could include, among others, buildings and structures, furniture and fixtures, equipment, vehicles and land. The standard also illustrates how the deferred maintenance could be disclosed in a chart in the notes of the financial statements. Table 5.5 shows one of the possibilities; it should be noted, however, that different entities may develop different asset categories, condition codes or descriptive terminology.

Table 5.5

CATEGORY	METHOD	ASSET CONDITION (See Note 1)	COST TO RETURN TO ACCEPTABLE CONDITION (See Note 2)	CRITICAL	NONCRITICAL
Buildings	Condition Assessment Survey	4	$100,000-125,000	$75,000-100,000	$25,000-50,000
Communications Eqp/Systems	Condition Assessment Survey	4,5	$10,000-15,000	$2,000	$8,000-13,000
Laboratory Eqp	Condition Assessment Survey	5	$500,000-550,000	$300,000	$200,000-250,000
Heating & Air Cond. Eqp.	Condition Assessment Survey	5	$40,000-42,000	$5,000	$35,000-37,000

Note 1: Condition Rating Scale

Excellent	1
Good	2
Fair	3
Poor	4
Very Poor	5

Note 2: Acceptable condition is “fair” or “3".

CHAPTER 6

CONCLUSIONS

.113 Financial Reports prepared by governments and their units may be directed at satisfying different objectives. PSC Study 2, Elements of the Financial Statements of National Governments, notes that "*these objectives may range over, for example, reporting on the entity's compliance with spending mandates, its ability to finance activities and meet liabilities, its financial condition and/or its performance in terms of service costs and efficiency*." (paragraph 146)

.114 This Study has noted that the definition of expenses of the IASC Framework is based on the assumption that full accrual accounting is adopted. Dependent on the basis of accounting adopted and the messages to be highlighted by the financial statements, expense or expenditure may be defined in different ways. This Study identifies definitions of expenses or expenditures adopted or proposed by a number of authoritative bodies.

.115 To be able to meet the information needs of users, governments need to report information about all their expenses. Such information is important for sound decision making about the financing of future services and resource allocation. Yet many government financial statements are based on cash accounting systems and do not account for all their expenditures on an accrual basis in their financial statements, and certainly do not attempt to measure unit costs by recognizing expenses on a full accrual basis. Governments that have not moved beyond the cash or modified cash basis of accounting should be encouraged to move along the spectrum of the different bases of accounting to at least a modified accrual basis. Accrual accounting is essential if financial reporting is to provide aggregate information useful in evaluating the government's performance in term of service costs, efficiency and accomplishments.

.116 Irrespective of the accounting basis used, the explanatory notes to the financial statements disclosing, for example, a description of the accounting policies regarding government transfers and information on the major kinds of transfers made or received, are key for understanding the types of expenses/expenditures a government has and in understanding the programs and activities it undertakes.

.117 This Study has examined characteristics of expenses or expenditures which may be significantly more material in the public sector than in the private sector, and then considered the recognition of those items under the different bases of accounting. Particular attention was paid to government transfers, depreciation and tax expenditures.

.118 This Study also recognizes that government expenses/expenditures can be classified in different ways. The classification adopted in practice by a reporting entity will depend on that entity's assessment of users' information needs.

.119 Given the size of annual public sector expenditures and the large fiscal deficits in most countries, users of government financial reports increasingly demand completeness in the reporting of government expenditures. Those countries accounting on an accrual basis of accounting have developed experience in a number of accounting issues significant for the public sector. However, future study and debate on many of the issues outlined in this Study will be needed and the Public Sector Committee will monitor such developments.

APPENDIX 1

GLOSSARY OF TERMS

Basis of Accounting: refers to the body of accounting principles that determine *when* the effects of transactions or events should be recognized for financial reporting purposes. It relates to the timing of the measurements made, regardless of the nature of the measurement. Common bases of accounting are the cash basis of accounting (i.e., effects of transactions or events are recognized when cash is paid or received) and the accrual basis of accounting (i.e., effects of transactions and events are recognized when they take place). There are many variations of both bases.

Elements of Financial Statements: refers to the types or classes of items that are reported in the financial statements, including notes thereto and related schedules. That is, the classes of items around which the financial statements are constructed.

Financial Reporting: refers to the communication of financial information by an entity to interested parties. It encompasses all reports that contain financial information based on data generally found in the financial accounting and reporting system. It includes financial statements as well as financial information presented in budgets, fiscal plans and estimates of expenditure or reports on the performance of individual programs or activities.

Financial Reports: refers to the general purpose financial reports that are designed to meet the common information needs of users outside the entity. Those external users rely on the reports as an important source of financial information because they have limited authority, ability, or resources to obtain additional information. While financial statements comprise the core of the financial reports, other financial information, such as performance measures and budget information, might also be included.

Financial Statements: refers to the accounting statements prepared by a reporting entity to communicate information about its financial performance and position. They include those notes and schedules that are needed to clarify or further explain items in the statements. For business-oriented enterprises, financial statements normally include a balance sheet, income statement, statement of retained earnings, and statement of cash flows. Governments and governmental units may have a similar set of statements or may have lists of assets and liabilities, revenues and expenditures. The statements similar to the balance sheet and income statement are commonly referred to as statement of financial position and statement of financial performance in the public sector.

Measurement Focus: refers to what messages and information are portrayed in the financial statements. A particular measurement focus is accomplished by considering not only when the effects of transactions and events involving those resources are recognized (i.e., the basis of accounting), but also what resources are measured. For example, the financial statements of business enterprises are designed to measure profit or loss and changes in shareholders' equity. Government financial statements could be designed to express, for example, the flow of economic resources, the flow of total financial resources or the flow of current financial resources.

Reporting Model: refers to the configuration and presentation of financial statements, in particular, what statements are included in the set of financial statements, how they interrelate, and how key measures are displayed in them.

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