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Elements of the Financial Statements of National Governments

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PREFACE

The objective of the Public Sector Committee (PSC) of the International Federation of Accountants is to develop programs aimed at improving public sector financial management and accountability. To that end, the 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.

In March 1991 the 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.

This Study is a companion to PSC Study 1. It considers the types or classes of financial information (the "elements") that may be reported in the financial statements of national governments and their major units.

The International Accounting Standards Committee has issued "Framework for the Preparation and Presentation of Financial Statements" which includes definitions of assets, liabilities, revenues, expenses and equity. These definitions provide a useful starting point for consideration of the characteristics of the information that might be included in the financial reports of public sector entities. However, those definitions have been prepared specifically for business undertakings. This Study will consider the implications of those definitions for financial reporting by non-business public sector entities, the extent to which those definitions are effective within the different bases of accounting that may be adopted by national governments and their major units, and the issues they raise for those contemplating their adoption for the public sector.

It is hoped that this Study will act to encourage readers, whether or not they be members of the accounting profession, to consider alternative approaches to public sector financial reporting issues. It is also hoped that this Study will contribute to debate, and developments, directed at enhancing the relevance, understandability and comparability of financial reporting by national governments and their major units.

Elements of the Financial Statements of National Governments

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CHAPTER 1

INTRODUCTION

Purpose of this Study

.001 The purpose of this Study is to consider:

(i) the "elements" (types or classes of financial information) that will be reported in financial statements prepared under the different bases of accounting that may be employed by national governments and their major units;

(ii) the way in which those elements may be defined; and

(iii) 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.

.002 By doing this it is hoped that the Study will assist in developing the full potential of the accounting models currently employed in individual jurisdictions to communicate financial information to users.

Scope

.003 Consistent with the IFAC Public Sector Committee (PSC) Study 1 "Financial Reporting by National Governments" (IFAC, 1991), the primary focus of this Study will be on financial statements prepared for national governments and the entities or units they establish for the delivery of goods and services and the achievement of government objectives. However, the matters it addresses may be equally applicable for other levels of government (state, provincial and local governments). (Readers should note that accounting for government-owned business enterprises is addressed in International Public Sector Guideline 1.)

.004 In particular, this Study deals with the elements that are recognized in the financial statements prepared for national governments. However, it is acknowledged that aspects of the delivery of goods and services and the achievement of government objectives will, in some cases, be best achieved through the display of financial or non-financial information in notes, schedules or statements other than the statement of financial position or statement of financial performance in the financial report[1]. This would be the subject of another Study.

Objectives of Financial Reporting

.005 Financial reporting is not an end in itself, but is a means of communicating relevant and reliable information about a reporting entity to users. The information which should be reported by public sector entities will be determined by reference to the information needs of the users of the financial reports of those entities and be conditioned by the nature of the reporting entity.

.006 The PSC's Study 1 (IFAC, 1991) considers the objectives of financial reporting by national governments and their units. That Study notes that the overriding objective of financial reporting is to communicate reliable information which is relevant to the decision making and accountability needs of users. It also notes that the overriding objective can encompass a number of component parts; for example, communicating information

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1. The delivery of goods and services and the achievement of government objectives can be viewed as a process of using inputs (for example, capital and personnel) to produce outputs (goods and services) which in turn produce outcomes (impacts on the community). For example, the government might have an objective to reduce road accidents. To achieve this outcome, it might obtain or produce services such as driver education, road patrols and road maintenance. Reporting of performance on either outputs or outcomes will require information in addition to the financial elements described in this Study.

about compliance with spending mandates, the financing of activities, financial condition and various aspects of the financial characteristics of performance (see Appendix 1 for a full exposition of those component parts).

.007 Dependent on the identity of the primary users of financial reports and their information needs, different components of the overriding objective identified by PSC Study 1 may be more or less relevant for particular reporting entities.

.008 The relative importance of those components can influence the basis of accounting and the reporting model considered appropriate for particular types of public sector entities and, therefore, the financial information which they disclose.

.009 While financial reports can provide information that is relevant for decision making and accountability purposes, they are unlikely to provide all information relevant for those purposes. This is likely to be particularly so in respect of non-business entities, since managers may be accountable for the achievement of service delivery as well as financial objectives. In addition, decisions about the allocation of scarce resources will be influenced by government policy priorities and the achievement of, for example, health, welfare and macro-economic objectives.

Elements of Financial Statements

.010 Financial statements disclose information about the financial effects of transactions and other events. To enable financial statements to communicate effectively, it is necessary to group the financial effects of a wide and diverse range of transactions and events into broad types or classes of information that have similar characteristics. The financial statements can then report, on an aggregate basis, meaningful groupings of transactions and events and subsets thereof. The broad types of financial information, or groupings of transactions and events, reported in financial statements are conventionally termed the "elements of financial statements". The following definition is intended to clarify the way in which the term is used in this Study.

.011 *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.

.012 The "elements" reported may encompass assets, liabilities, net assets (equity), revenues, receipts, expenses or expenditures. Under different bases of accounting, the elements may be defined differently and, therefore, different sets, or subsets, of these elements may be reported.

.013 PSC Study 1 includes definitions of "basis of accounting", "financial reporting", "financial reports", "measurement focus", "reporting model" and "financial statements". Where those terms are used in this Study, they are to be read with the same meaning as that defined in Study 1. Appendix 2 to this Study is a glossary which includes all terms defined in Study 1.

Financial Reports

.014 Financial reports are published by many public sector entities around the world. Those entities include:

(i) business enterprises which operate on a commercial basis and have operating objectives which include the earning of a positive return on invested funds;

(ii) administrative and service delivery units funded exclusively or predominantly from general government revenues; and

(iii) governments themselves, whether at a national, state or local government level.

.015 At any point in time a range of factors will influence the choices made by governments about such matters as: the basis of accounting and the reporting model which should be adopted by particular types of reporting entities; the elements around which financial statements should be constructed; and the manner in which those elements should be defined.

.016 Differences in the choices that are made may result from differences in the operating objectives of the entity and the social, economic and legal environment within which it operates. Differences can also result from focusing on different aspects of accountability, from adopting different objectives for financial reporting and as a result of structuring reports to respond to the perceived needs of different users.

.017 The usefulness and understandability of financial reports is likely to be enhanced if users are informed of the basis of accounting and the reporting model which has been employed in the preparation and presentation of those reports.

.018 The usefulness of financial reports is also likely to be enhanced if the "elements" reported in the financial statements have well understood and generally accepted characteristics. Within the parameters established by the basis of accounting adopted, users would then be aware of the characteristics that, for example, liabilities possess, and could have confidence that all claims that possess the agreed characteristics of a liability are indeed reported as liabilities.

.019 Clarification of the characteristics which the elements should possess is likely to be central to the discharge of accountability and will enhance the usefulness of the financial report as input for decision makers concerned with the allocation of scarce resources. Such clarification is also likely to be of benefit to preparers and auditors in determining how to classify particular transactions or events and whether to include them in the financial statements.

CHAPTER 2

ELEMENTS REPORTED UNDER DIFFERENT BASES OF ACCOUNTING

Bases of Accounting

.020 PSC Study 1 (IFAC, 1991) notes that the basis of accounting that may be adopted by governments and their units will lie in a spectrum from the pure cash basis at one extreme to the full accrual basis at the other extreme. That Study identifies and describes four points on that spectrum that are indicative of bases of accounting that may be adopted (pp. 9-12). The elements that will comprise the financial statements prepared consistent with those bases are indicated below.

The Cash Basis of Accounting

.021 The cash basis of accounting recognizes transactions and events only when cash has been received or paid. Consistent with the cash basis, a statement of receipts and payments (or expenditures) is usually prepared to disclose information about cash flows during a period and cash balances at the end of that period.

.022 The elements of the financial statement will be cash receipts, cash disbursements and cash balances. Receipts and disbursements will include cash inflows and outflows from taxation; the provision of goods and services; the purchase and sale of plant, equipment and investments; and borrowings and other financing transactions.

.023 The elements may be classified to highlight the major components, or sources, of cash inflows and cash outflows and the extent to which cash balances have been dedicated for particular uses, or relate to the provision of certain services or the acquisition of certain types of assets.

.024 For example, financing transactions involving loan receipts and disbursements may be classified (or reported) separately from other transactions, capital outlays may be distinguished from current outlays and transfer payments in respect of such matters as unemployment benefits, age or invalid pensions and other social security or community benefit payments may be distinguished from expenditures on operating costs.

.025 This reporting model is frequently adopted by national governments and government entities or units that are funded from general government revenues.

The Full Accrual Basis of Accounting

.026 The full accrual basis of accounting is geared towards recognizing the financial effects of transactions and events in the periods in which they occur, irrespective of whether or not cash has been received or paid. 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.

.027 The elements of the financial statements will be assets, liabilities, net assets/equity, revenues and expenses. It is noted in Study 1 that moving along the spectrum from cash to accrual accounting does not mean a loss of the cash based information which can still be generated from an accrual accounting system. Indeed, entities adopting the full accrual basis of accounting frequently prepare a financial statement to report on cash flows during the period.

.028 It is recognized that accrual accounting, taken to its extreme, could involve the recognition of assets, liabilities, revenues and expenses that are not generally included in financial statements. For example, an entity's human resources may be assets but they are generally not considered to be reliably measurable and are not recognized in the financial statements. The recognition criteria for elements of financial statements are dealt with later in this Study and the term "full accrual basis of accounting" should be read as having regard to those criteria.

.029 Particular components or characteristics of each of the elements may be highlighted by subclassification. For example, assets may be classified as current/non-current and/or on the basis of the functions they serve or the types of services they provide. Similarly, revenues and expenses may be classified on the basis of particular activities or programs and/or by type of revenue or expense (for example, taxation revenue, user charges, salaries and wages and depreciation).

.030 The full accrual basis is commonly adopted by government business enterprises, corporations and, in some countries, by certain classes of non-business entity. PSC Guideline 1 "Financial Reporting by Government Business Enterprises" (IFAC, 1989) endorses the adoption of the full accrual basis of accounting for public sector business enterprises.

.031 In some cases the term accrual accounting has been adopted to describe some forms of modified accrual accounting. As noted in PSC Study 1, this may occur where, for example, the full accrual basis is modified by not recognizing depreciation on some assets, by excluding some assets from the balance sheet or statement of financial position and/or by preparing an operating statement which includes expenditures on some capital items and repayment of debt as well as some expenses (PSC, 1991, para. .090).

.032 The "full accrual basis of accounting" as defined for the purposes of this paper is limited to that basis which recognizes the financial effects of transactions and events on the economic resources of the entity in the periods in which those transactions and events occur. Therefore, the full accrual basis of accounting will recognize all assets, liabilities, revenues and expenses (including depreciation) of the entity.

The Modified Accrual and Modified Cash Bases of Accounting

.033 The modified accrual or modified cash bases of accounting can approximate the accrual basis of accounting, or the cash basis of accounting. Just where the model lies on the spectrum between cash and full accrual accounting, and therefore the nature of the elements which are reported, will depend on the nature and extent of the "modifications".

.034 A common modification at the accrual end of the spectrum is to exclude physical assets from the financial statements. Those statements will therefore highlight future funding requirements by reporting liabilities and financial assets. As such, the elements of the financial statements will be liabilities, revenues, those assets which are available to meet liabilities as they fall due (financial assets) and expenditures on the acquisition of assets for use in the provision of goods and services. In addition, the financial statements may be constructed to distinguish between amounts expended on the acquisition of goods and services consumed during the period, and amounts expended on the acquisition of assets which will be consumed in future periods.

.035 A common modification at the cash end of the spectrum is to include in the financial statements information about those transactions and events which will result in cash receipts or disbursements within a short period immediately following year end, as well as information about cash flows and cash balances. As such, the elements of the financial report would encompass cash flows during the period and some receivables and payables; and the financial statements will highlight current, or short term, financial resources and changes therein during the reporting period.

.036 A form of modified accrual or modified cash accounting is frequently employed for financial reporting by local governments and, in some countries, for national and state or provincial governments and other public sector entities. Figure 2.1 provides an illustration of where some bases of accounting currently adopted by, or currently recommended for, governments and other public sector entities lie on the spectrum between cash and full accrual accounting. Figure 2.1 is not exhaustive and may not be precise in respect of the point at which particular entities or recommendations should be placed, but it is generally illustrative of the range of alternatives.

Messages Communicated by Financial Statements

.037 Differences in the elements of financial statements reported under different bases of accounting arise from two related sources:

(i) identification of different events as critical in triggering recognition in the financial statements (for example, the receipt or disbursement of cash; or the occurrence of a transaction or event which has an effect on the financial resources of the entity, whether or not there is a cash flow consequence in the period in which the transaction or event occurs)[2]; and

(ii) perceptions of the financial information which is relevant for decision making and is necessary for the discharge of accountability. For example, the measurement focus reflected in the financial statements may be on reporting cash flows and balances, current financial resources, total financial resources or economic resources.

.038 There appears to be general agreement that financial statements prepared by business enterprises in the public and private sectors should adopt the full accrual basis of accounting and disclose information about assets, liabilities, revenues, expenses and equity (net assets). Disclosure of this information is perceived as necessary if the entity is to be accountable for the resources it controls and if users are to be able to adequately assess its performance and financial position, and changes therein. The International Accounting Standards Committee has issued "Framework for Financial Reporting" which reflects this view and the PSC Guideline 1 (July, 1989) requires that all IASC Statements be applied by public sector business enterprises.

.039 However, similar agreement does not appear to exist in respect of the accounting basis and financial reporting model which should be adopted by governments and other non-business entities in the public sector.

.040 Commercial models are constructed around operating statements which focus on a bottom line profit or loss, and balance sheets which highlight increments in shareholders' wealth. They are intended to assist investors in assessing the liquidity and solvency of the entity (and therefore riskiness of the investment) and the potential for future earnings growth.

.041 The objectives of governments and non-business entities in the public sector are different from business enterprises and commercial financial reporting models may not be appropriate for them. Their objectives are not to generate profits and thereby increase the wealth of owners, but to deliver goods and services consistent with government policy. Similarly, they are not dependent on revenue earned from sales to underpin their continued financial viability. Therefore, different measures of performance and financial position may be perceived to be more relevant to them.

2. Of course, in the long run, all transactions or events which have an effect on the financial resources of an entity will be reflected by cash flows. Consequently, in the long run, differences in reporting formats aside, the information reported under the different bases of accounting will converge. However, for purposes of reporting information relevant for decision making and accountability on a timely basis, the long term must be divided into discrete periods and reports must be prepared on a periodic basis.

FIGURE 2.1

BASIS OF ACCOUNTING ADOPTED/RECOMMENDED

(Numbers on the continuum from cash to accrual should be interpreted as a range, rather than a point)

CASH	MODIFIED CASH	MODIFIED ACCRUAL	ACCRUAL
1	2	3	4

1. Some national governments

2. Many governments which report primarily on the basis of cash flows but also disclose information about accounts receivable and payable. Luder identifies the following governments within this range: Federal Republic of Germany, United Kingdom, United States Federal Government, Commission of the European Communities [Luder, 1989]. (Readers should note that in respect of the United States Federal Government, the Federal Accounting Standards Advisory Board was established in 1990. If the ongoing deliberations of this Board are indicative, it is likely that the US Federal Government's position on this spectrum will move towards the accrual basis in the near future.)

3. Denmark, Canadian Provincial Governments of Alberta and British Columbia [Luder, 1989].

   Canadian Public Sector Accounting Statements (PSAS) 2: "Objectives of Government Financial Statements" [CICA,1984], "General Standards of Financial Statement Presentation for Governments" [CICA, 1986] and 6: "Local Government Financial Statements - Objectives and General Principles" [CICA, 1990]. United States Government Accounting Standards Board Statement 11 "Measurement Focus and Basis of Accounting-Governmental Fund Operating Statements" [GASB, 1990. Effective 1994].

   United Kingdom Chartered Institute of Public Finance and Accounting (CIPFA) "Code of Practice for Local Authority Accounts" [CIPFA, 1991].

4. New Zealand (National) Government and Government Departments. Austrian Federal and Swiss Cantonal Governments [Luder, 1989].

   New South Wales (Australia) State Government and Government Departments. (Some assets may be recognized at nominal amounts).

   IFAC Public Sector Committee Guideline 1 "Financial Reporting by Business Enterprises" [IFAC, 1989]. Government business enterprises in most jurisdictions and government non-business enterprises in a number of jurisdictions.

   Australian Accounting Standard AAS 27 "Financial Reporting by Local Governments" [AARF, 1989] and Exposure Draft ED 55 "Financial Reporting by Government Departments" [AARF, 1992].

.042 Nevertheless, users of financial reports of governments and other non-business entities in the public sector are likely to require those entities to be accountable for their performance and for the resources they control and changes therein. Users are also likely to require assurance that those entities have complied with relevant spending mandates.

.043 Therefore, the choice of an accounting basis for, and the identity of the elements to be reported in respect of, governments and non-business entities in the public sector will reflect perceptions of:

(i) what they should be accountable for; and

(ii) what measures of performance and financial position are relevant for them.

.044 As noted in paragraph .037 (ii), financial statements of public sector entities prepared consistent with the cash, accrual or modified accrual basis will focus on different aspects of accountability and highlight different subsets of the information required for decision making. For example, financial statements may focus on reporting:

(i) cash flows and balances (and changes therein) - to provide users with information about the sources of cash raised during the period, the uses to which cash was applied and the cash balances at reporting date (the cash and modified cash bases);

(ii) current financial resources (and changes therein) - to provide users with information about cash flows during the period, those liabilities that must be met within a short period from reporting date and current cash balances and receivables available to meet those liabilities (the modified cash basis);

(iii) total financial resources (and changes therein) - to provide users with information about liabilities, the financial assets available to meet those liabilities and the amount and sources of the period's revenues and expenditures, as input for assessing future funding requirements and the likely sources of that funding (the modified accrual basis); or,

(iv) economic resources (and changes therein) - to provide users with information about assets, liabilities, revenues, expenses and net assets for use in assessing financial position and changes therein and whether the reporting entity is operating economically and efficiently (the accrual basis).

.045 The manner in which the financial statements are constructed and the classifications adopted for display of information can also influence the messages reported. For example, under the cash or modified cash basis of accounting, no distinctions need be made between capital, operating and financing flows. However, the classification and reporting of cash flows as, for example, user charges, taxation, borrowings, operating expenditure, capital expenditure and financing charges can have a significant influence on the message communicated by financial statements. In particular, whether or not borrowings are classified as a cash inflow of the same, or a different, character as user charges, taxes or grants can result in a quite different message being communicated about whether or not the entity has "broken even" during the period.

The Elements

.046 The range of elements which may be reported, issues related to the definition of those elements and the identification of items which conform with those definitions are more complex as one moves towards the full accrual accounting end of the spectrum outlined in Figure 2.1. Consequently, the necessity to make judgements about which transactions and events should be reflected in the financial statements increases as one moves towards full accrual accounting.

.047 Similarly, the cost of developing and maintaining the accounting system increases as one moves along the spectrum towards full accrual accounting. Decisions regarding the basis of accounting that is appropriate for governments and other public sector entities should be made after consideration of the costs and benefits associated with particular bases on that spectrum.

.048 Making such cost/benefit decisions is always difficult: the costs are borne by the reporting entity and can be determined with some precision; the benefits, however, are often enjoyed by third parties as well as the entity itself and can only be assessed subjectively. Those subjective assessments should include consideration of the benefits that are likely to flow from any improvements in decision making that result from the preparation of financial reports which disclose information about assets and liabilities and changes therein. They should also include consideration of whether or not the government has the obligation to be accountable for all the resources it controls and the results of that control.

.049 Figure 2.2 identifies the elements around which financial statements will be constructed under different bases of accounting and the measurement focus reflected by such financial statements.

Reporting Models

.050 Adoption of a particular basis of accounting does not require the preparation of any particular set of financial statements, nor does it mandate the configurations to be adopted for display of financial information. As noted in PSC Study 1 (IFAC, 1991, pp. 20-22), alternative reporting models may be adopted to highlight different messages. The format for presentation of financial information can be "disengaged" from the basis of accounting adopted for the recognition of that information. Governments adopt different configurations of financial statements for the display of information about "stocks" of assets and liabilities and "flows" of revenues (receipts) and expenses (expenditures or disbursements). As such, financial reports can be constructed to highlight different messages while still conforming with an underlying level of accountability.

.051 For example, the reporting model frequently associated with the cash or modified cash bases of accounting is a statement of cash flows and cash balances supplemented with information about receivables and payables. However, notes or supplementary schedules may also report information about costs, assets and liabilities.

.052 The reporting model frequently associated with the full accrual or modified accrual bases of accounting is one based on preparation of a balance sheet (or statement of assets and liabilities), a statement of revenues and expenses (or expenditures) and a statement of cash or funds flows. However, notes to those statements or supplementary schedules may also report summary information about such matters as compliance with spending mandates and relevant performance indicators.

.053 Decisions regarding the reporting model to be adopted, and the relationship between financial statements, notes thereto and supplementary schedules should be made after consideration of such factors as the particular "messages" to be highlighted and users' ability to understand the financial statements. Such decisions should also be conditioned by a concern to reflect, in an unbiased manner, complex transactions and events.

FIGURE 2.2

ELEMENTS OF FINANCIAL STATEMENTS UNDER DIFFERENT BASES OF ACCOUNTING

BASIS OF ACCOUNTING	MEASUREMENT FOCUS	ELEMENTS OF FINANCIAL STATEMENTS
CASH	**CASH BALANCES** (and changes therein)	Cash receipts Cash disbursements Cash balances
MODIFIED CASH	**CURRENT FINANCIAL RESOURCES** (and changes therein)	Cash receipts plus receivables* Cash disbursements plus payables* Cash and near cash balances
MODIFIED ACCRUAL	**TOTAL FINANCIAL RESOURCES** (and changes therein)	Revenues Expenditures Financial assets Liabilities Net financial resources
FULL ACCRUAL	**ECONOMIC RESOURCES** (and changes therein)	Revenues Expenses (including depreciation) Assets (financial and physical) Liabilities Net assets (equity)

* Receivable and payable within a specified period from period end

CHAPTER 3

CHARACTERISTICS OF THE ELEMENTS OF FINANCIAL STATEMENTS

The Elements of Financial Statements

.054 The basis of accounting and measurement focus adopted by governments and other public sector entities will determine the elements reported in financial statements. As noted previously:

(i) the basis of accounting refers to when a transaction or event is recognized - when cash flows or when the event occurs; and

(ii) the measurement focus refers to what is measured - economic resources, total financial resources, current financial resources or cash flows and balances.

.055 The messages communicated by financial statements can also be influenced by the manner in which the elements are defined and displayed, and the conditions which must be satisfied (the recognition criteria) if items are to be recognized in those statements.

.056 The elements reported by the cash and modified cash bases of accounting are unlikely to raise any conceptual or definitional issues. Under the cash basis only cash flows and cash balances will be reported, and adoption of a modified cash basis is usually accompanied by detailed specification of the circumstances under which particular items of future cash flow are to be recognized and reported.

.057 However, options in respect of the identity of the elements, how they are defined and the messages highlighted by the financial statements are greater under the accrual and modified accrual bases of accounting. For example:

(i) whether liabilities are defined as obligations the entity is currently legally bound to discharge or as legal, moral or equitable obligations it is likely to discharge, will influence the net financial position and changes in financial position reported under the modified accrual and accrual bases of accounting; and

(ii) whether or not assets are defined to include all infrastructure assets will influence the message communicated about resources controlled (or owned) and changes in them under a full accrual basis of accounting.

International Accounting Standards Committee

.058 The International Accounting Standards Committee (IASC) "Framework for the Preparation and Presentation of Financial Statements" has identified the elements of financial statements as assets, liabilities, income, expenses and equity and codified the general characteristics which those elements should possess.

.059 The IASC definitions of the elements of financial statements were developed for business entities which adopt the full accrual basis of accounting. Definitions which apply in respect of non-business public sector entities have not yet been developed and agreed by the accounting profession and/or regulators at an international level.

.060 However, development work has been undertaken by accounting policy units of governments in many jurisdictions and by the accounting profession in a number of countries. For example, exposure drafts, Statements and policy documents issued by the Public Sector Accounting and Auditing Committee (PSAAC) in Canada, the Governmental Accounting Standards Board (GASB) and the General Accounting Office (GAO) in the United States, the Accounting Research and Standards Board (ARSB) of the New Zealand Society of Accountants and the Public Sector Accounting Standards Board (PSASB) of the Australian Accounting Research Foundation include explanations of a range of potential elements.

.061 Taking the IASC definitions as a useful, but not necessarily definitive, starting point, the following sections of this chapter will consider the characteristics of the elements that may be reported under different bases of accounting, the transactions and events that may be encompassed by each element and the implications of reporting such elements for the achievement of the objectives identified in PSC Study 1. Depending on the basis of accounting adopted, the financial statements of governments and their units may report subsets of the elements identified by the IASC framework and/or may report different elements.

Assets

.062 The IASC defines an asset in the following way:

> "An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise." (IASC, 1989, para. 49)

.063 The IASC definition is, of course, predicated on application of the full accrual basis of accounting.

.064 Under a modified accrual or cash basis of accounting a subset of those resources identified as assets by the IASC definition would be recognized. Under the cash basis of accounting, the only asset recognized will be cash. Under all versions of accrual or modified accrual accounting there appears to be general agreement that, at a minimum, all financial assets should be recognized.

.065 However, notwithstanding that under different bases of accounting what constitutes an asset may differ, it is possible to identify the fundamental characteristics which assets will possess under all bases of accounting:

(i) the existence of service potential or future economic benefits;

(ii) the service potential or future economic benefits must arise from past transactions or events (that is, "future" assets cannot be recognized in the financial statements); and

(iii) the service potential or future economic benefits, must be controlled by the reporting entity as at the reporting date.

.066 The IASC definition acknowledges that "economic benefits" encompasses service potential (IASC, 1989, para. 53). However, given its focus on business enterprises, the IASC interprets service potential to be the ability "to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise". Such an interpretation is too narrow to encompass governments and non-business public sector entities. Therefore, in application to governments and non-business public sector entities service potential should be interpreted to encompass the delivery of services and programs rather than only the generation of cash inflows.

.067 For public sector entities, as one moves along the spectrum from modified cash to full accrual accounting the concept of service potential reflected in assets reported in the financial statements can differ. For example, the concept of service potential may be limited to the ability to meet liabilities which fall due in the short term (cash and modified cash bases) or the longer term (modified accrual basis) or may encompass the means for the entity to produce goods and services consistent with its objectives (full accrual and some forms of modified accrual bases).

.068 PSC Study 1 notes "No single basis of accounting can meet all user needs and different bases might be more appropriate in different circumstances. Governments and units might, in fact, report on more than one basis to meet different needs." (IFAC, 1991, para. .080). (For example, reporting on budget execution and program operation may require adoption of the cash, modified accrual and full accrual bases for different components of the one financial report.) However, PSC Study 1 also notes that "as one moves along the spectrum from cash to full accrual, more of the objectives of financial reporting can be met." (IFAC, 1991, para. .101).

.069 The concept of service potential that an asset should possess if it is to be reported in the financial statements under different bases of accounting will therefore depend on the message to be communicated by financial statements and the objective of financial reporting. For example, if the objective of financial reporting:

(i) is limited to evidencing compliance with spending mandates and the disclosure of current financial resources and changes therein during the reporting period - assets reported in the financial statements should be limited to cash or near cash equivalents (amounts receivable and payable within a specified period from reporting date);

(ii) includes the provision of information that is useful in evaluating the government's financial condition, and changes therein during the reporting period - the financial statements should report cash and other resources which are on hand and which are available to finance the government's activities and meet its liabilities and commitments. That is, the "future economic benefits" or "service potential" of assets are related to the financing of activities, or the repayment of liabilities; or

(iii) requires governments to be accountable for all the resources they control on behalf of the community, and changes in those resources - the financial statements should report assets that assist the entity in achieving its objective, whether that objective is to generate positive cash flows or to provide needed goods and services consistent with government priorities. The concept of service potential would therefore encompass physical as well as financial assets.

.070 The characteristics which are considered to be essential and which, by their existence or otherwise, will determine whether a particular resource would qualify for recognition as an asset can also differ as one moves along the spectrum.

.071 For example, under the IASC definition, assets are service potentials (which give rise to future economic benefits) controlled by the entity. Therefore, characteristics such as exchangeability and ownership[3] are not essential, and the absence of any one, or both, of them is not sufficient to preclude an item from qualifying as an asset. However, under cash, modified cash and modified accrual bases of accounting, such characteristics may become essential. For example, an inability to realize an asset to meet liabilities which fall due within a particular time frame would be inconsistent with the measurement focus, and therefore concept of service potential, adopted under some of those bases.

.072 Figure 3.1 identifies measurement foci that may be adopted for financial reporting purposes and indicates the characteristics assets should possess if they are to be reported in financial statements prepared consistent with those measurement foci.

.073 Figure 3.2 reproduces definitions of assets proposed by authoritative bodies in respect of public sector entities including governments and their units, and Figure 3.3 outlines the types of items that would be reported as assets under different accounting bases. (Neither Figure is meant to be exhaustive.)

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3. The capacity of an entity to control the service potential or future economic benefits would normally stem from legal rights and may be evidenced by title deeds, possession, or other sanctions and devices that protect the entity's interests. However, legal enforceability may not be a prerequisite to the establishment of control over the asset. The service potential or future benefits expected to flow from a particular item or activity may be controlled in some other way. For example, while motor vehicles may be purchased by a central property agency and "owned" by a Minister of the Crown or other officer of the government, individual service agencies may have control over the service potential of those motor vehicles. The motor vehicles would qualify as assets of the entities which controlled their service potential. Similarly, under a lease agreement, control over the leased property owned by the lessor is transferred to the lessee (although the extent and duration of control will vary depending on the terms of the agreement).

.074 As governments move along the spectrum from cash towards accrual accounting the messages communicated by their financial statements will change, and those statements will evidence accountability for more of their assets.

.075 In such circumstances, the importance of developing agreed, well understood definitions of assets for governments and other public sector entities increases. As the range and complexity of the transactions and events that are "captured" by financial statements increases, the relevance and reliability of financial reports are increasingly dependent on the consistent application of such definitions.

.076 It may be appealing to adopt the IASC definition of assets for public sector entities which apply the accrual basis of accounting (acknowledging that for the public sector, service potential will encompass more than the generation of cash flows). However, adoption of the IASC definition will itself raise a number of issues not yet confronted by many governments and other public sector entities. Those issues will include consideration of whether governments or other public sector entities should be accountable for the assets they own, or the assets they control, and how ownership or control should be defined.

.077 It will also include consideration of whether plant, equipment, buildings, infrastructure assets (such as roads, parklands, libraries), state-run health centers, monuments, and historical treasures should be recognized in the financial statements. These assets provide needed or desired services to beneficiaries, typically at little or no cost to those beneficiaries. They would be assets consistent with the IASC definition because they enable governments to meet their objectives of providing services to members of the community. However, in many cases, the purposes for which they can be used and their availability for liquidation to meet liabilities is restricted.

.078 Decisions relating to whether all, or a subset of, assets should be reported in the financial statements should be resolved by reference to the objectives the financial reports are intended to satisfy and the messages to be highlighted by the financial statements. (For example, should the financial statements highlight financial resources or economic resources.)

Liabilities

.079 The IASC defines liabilities in the following manner:

"A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits." (IASC, 1989, para. 49)

.080 It is likely that the fundamental characteristics of liabilities as identified by the IASC will be common to all forms of modified accrual and full accrual bases of accounting. Those fundamental characteristics are:

(i) the existence of a present obligation arising from past events. That is a transaction or other event in the past has given rise to a "duty or responsibility" to a third party which has not yet been satisfied; and

(ii) liabilities have adverse financial consequences for the reporting entity. That is, the entity is required to incur substitute or replacement liabilities, or dispose of cash or other assets to one or more entities, to settle the obligation.

.081 It is also likely that differences between the operating characteristics of governments and other public sector entities will not, of themselves, influence what should or should not be identified as a liability.

FIGURE 3.1

ASSETS REPORTED IN FINANCIAL STATEMENTS

MEASUREMENT FOCUS	CHARACTERISTICS OF ASSETS
Current Financial Resources	Cash (or near cash equivalents) on hand at reporting date.
Total Financial Resources	Financial assets available as at the reporting date for conversion into cash (or other exchangeable resource) to finance future activities, or to settle liabilities and commitments.
Economic Resources	Service potentials (or future economic benefits) controlled by the entity as at the reporting date. (Service potential should be interpreted to encompass the ability to produce goods and services consistent with the entity's objective or mission, whether that objective be service delivery or the generation of profits).

.082 However, adoption of different bases of accounting can result in differences in the liabilities which are recognized in the financial statements at the reporting date. As one moves along the spectrum towards full accrual accounting, it is likely that obligations to be settled further into the future will be recognized as liabilities. For example, under a pure cash basis of accounting, no liabilities are recognized; under a modified cash basis of accounting, only those obligations to be settled in a nominated period from reporting date will be recognized as liabilities; and under some forms of modified accrual and full accrual accounting, obligations to be settled in the long term, such as employee pension entitlement and other post employment benefits, may be recognized as liabilities.

.083 While the fundamental characteristics of liabilities are likely to be common to all definitions, other characteristics may differ. For example, liabilities may be limited to those obligations which are legally enforceable, or may encompass all present obligations which are "expected" to be settled in the future (as in the IASC definition). Therefore, depending on how liabilities are defined, different transactions and events may be recognized in the financial statements as liabilities under the modified accrual or full accrual bases of accounting.

.084 Most obligations are legally enforceable in that they stem from legally binding contracts or are imposed by legally authorized bodies or Government statutes. However, consistent with the broad definition adopted by the IASC, liabilities would encompass equitable and constructive obligations.

.085 Examples of obligations arising from contractual arrangements include amounts borrowed, amounts due for asset purchases, and amounts owed for obtaining the services of labor. Obligations imposed on an entity would include damages awarded in a law suit and payments due under workers' compensation schemes.

FIGURE 3.2

DEFINITIONS OF ASSETS

DEFINITIONS	COUNTRY	STATUS	APPLICABILITY
"Assets are service potential or future economic benefits controlled by the entity as a result of past transactions or other past events."	AUSTRALIA AARF	Statement of Accounting Concepts SAC 4 (para. 12, 1992)	Public Sector Entities (including Governments) and Private Sector Entities
"Financial assets are cash and those assets on hand at the end of an accounting period which could provide resources to discharge existing liabilities or finance future operations."	CANADA PSAAC	Recommendation Public Sector Accounting Statement (PSAS) 2 (para. 53, 1984)	Federal, Provincial and Territorial Governments. A definition applicable to local governments is included in Statement (PSAS) 6
"Assets are economic resources or service potential controlled by an entity as a result of past transactions or events from which future economic benefits are expected to be obtained."	NEW ZEALAND ARSB	Exposure Draft ED 60 (para. 4.5, 1991)	Public Sector Entities (including Governments) and Private Sector Entities
"An asset is any item of economic value owned by a governmental unit. The item may be physical in nature (tangible) or a right to ownership (intangible) that is expressed in terms of cost or some other value. An asset has three essential characteristics: - ... a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute to future operations of the government. - The entity can obtain the benefit from it and control access to it. - The transaction or other events giving the agency the right to control the asset has already occurred."	UNITED STATES GAO	Policy (Title 2) (Appendix 1, p. 4, 1984)	Federal Government Units
"Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. Assets include financial resources and capital assets."	UNITED STATES GASB	Statement 11 (para. 3c, 1990)	State and local governments (The GASB notes this is a "tentative definition of assets")
"Financial resources are cash, claims to cash, (for example, debt securities of another entity and accounts and taxes receivable), claims to goods or services (for example, pre-paid items), consumable goods (for example, supplies inventories), and equity securities of another entity obtained or controlled as a result of past transactions or events."	UNITED STATES GASB	Statement 11 (para. 3d, 1990)	State and local governments (Note, Statement 11 includes a definition of financial resources rather than financial assets)

FIGURE 3.3

ASSETS REPORTED BY DIFFERENT BASES OF ACCOUNTING

CASH BASIS	MODIFIED CASH	MODIFIED ACCRUAL	FULL ACCRUAL
CASH BALANCES	CASH BALANCES	CASH BALANCES	CASH BALANCES
	ACCOUNTS RECEIVABLE* WITHIN X DAYS	FINANCIAL ASSETS . Investments . Inventories for Sale . Loans Outstanding . Revenues Receivable . Other Receivables	FINANCIAL ASSETS . Investments . Inventories for Sale . Loans Outstanding . Revenues Receivable . Other Receivables
			PHYSICAL ASSETS . Inventories for use . Plant and Equipment
			INFRASTRUCTURE ASSETS
			OTHER ASSETS

* Accounts receivable are usually defined as those amounts receivable within a specified number of days from reporting date. The number of days specified will be extended as the basis of accounting adopted moves towards the modified accrual/full accrual basis.

.086 Equitable or constructive obligations arise from normal industry or public sector practices, from custom and from a desire to maintain good "client" or community relations, or to act in a fair and just manner.[4]

.087 The adoption of the broad concept of liabilities reflected in the IASC definition of liabilities raises issues for governments and their units which, for example, adopt a policy of providing financial assistance to members of the community who are victims of natural disaster or who face particular hardships. If liabilities were not to be limited to legally enforceable obligations, the amounts expected to be expended in accordance with the government policy in relation to disasters which have occurred would constitute obligations which could be

4 The IASC discusses such obligations in terms of business enterprises in the following manner:
"Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner." (IASC 1989, para. 60).

reported as liabilities. In the absence of a clear legal responsibility in respect of such matters, the existence of a present obligation would have to be assessed on the basis of available evidence.

.088 Often, the need to make estimates in respect of the amount to be paid in settlement of an obligation will increase as the date of settlement moves further away from reporting date. In addition, if the definition of liabilities adopted encompasses obligations that are not currently legally binding, estimation would be necessary not only in respect of the amount to be paid in the future, but whether or not it was expected that payment would be made.

.089 Decisions regarding the basis of accounting and the definition of liabilities to be adopted should be guided by consideration of the objectives that the financial report is intended to achieve. In particular, consideration of whether the definition of a liability should be extended beyond current legal obligations would depend on whether knowledge of amounts that the entity was likely to pay in the future in respect of such matters as employee pension entitlement "earned" up to reporting date, and relief to victims of disasters which had occurred, was considered to be relevant to the users of financial reports for accountability purposes, and as input for making decisions on such matters as future funding requirements.

.090 While options exist in respect of some of the specific characteristics that liabilities should possess, liabilities only arise as a result of past transactions or events. Therefore, a distinction is drawn between future commitments and present obligations - the intention to dispose of economic benefits in the future is not sufficient to give rise to a liability.

.091 For example, a decision to acquire assets in the future or the placing of an order for those assets does not, of itself, create a present obligation. A liability would normally only arise when the entity had acquired the assets and was obligated to pay for them or was unable to cancel the order without suffering a significant penalty.

.092 Similarly, the formal adoption of a budget, the passing of appropriation legislation, the establishment of a grant program or the expression of a general undertaking to expend funds on the provision of some services by a government do not, of themselves, give rise to liabilities of the government as a reporting entity.

.093 The government would normally have the discretion to avoid the disposition of cash or other resources by not incurring the obligations anticipated by the budget or appropriation legislation, or by indicating that circumstances do not allow the implementation of the grant program or provision of particular services. Only on the subsequent acquisition of goods and services, incurrence of wage and salary costs or approval of grant applications would a liability arise.

.094 Figure 3.4 reproduces examples of definitions of liabilities proposed in respect of public sector entities, including governments, and Figure 3.5 outlines the types of items that would be reported as liabilities under different bases of accounting. (Neither Figures are meant to be exhaustive.)

FIGURE 3.4

LIABILITIES

DEFINITION	COUNTRY	STATUS	APPLICABILITY
"Liabilities are the future sacrifices of service potential or future economic benefits that a reporting entity is presently obliged to make to other entities as a result of past transactions or other events."	AUSTRALIA AARF	Statement of Accounting Concepts SAC 4 (para. 46, 1992)	Public Sector Entities (including Governments) and Private Sector Entities
"Liabilities are financial obligations to outside organizations and individuals as a result of transactions and events on or before the accounting date."	CANADA PSAAC	Recommendation Public Sector Accounting Statement (PSAS) 2, (para. 52, 1984)	Federal, Provincial and Territorial Governments. A similar definition applicable to local governments is included in Statement (PSAS) 6
"Liabilities are obligations of an entity arising from past transactions or events, the settlement of which is expected to result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future."	NEW ZEALAND ARSB	Exposure Draft ED 60 (para. 4.6, 1991)	Public Sector Entities (including Governments) and Private Sector Entities
"Liabilities are amounts owed for items received, services rendered, expenses incurred, assets acquired, construction performed (regardless of whether invoices have been received), and amounts received but as yet unearned. Included are amounts owed for goods in the hands of prime contractors under the constructive delivery concept and amounts owed under grants, pensions, awards, and other indebtedness not involving the furnishing of goods and services."	USA GAO	Policy (Title 2) (Appendix 1, p. 6, 1984)	Federal Government Units
"Governmental fund liabilities are probable future sacrifices of resources arising from present obligations to transfer assets or provide services to other entities in the future as a result of past transactions or events, except for unmatured liabilities arising from the long-term financing of capital asset acquisitions". (The unmatured liabilities are to be reported in a separate account group.)	USA GASB	Exposure Draft ED 044 (para. 38, 1987) [now superseded by Statement 11]	Proposed in ED 044 for State and Local governments. However, the final Statement, GASB Statement 11, does not include a definition of liabilities.

FIGURE 3.5

LIABILITIES REPORTED UNDER DIFFERENT BASES OF ACCOUNTING

CASH*	MODIFIED CASH	MODIFIED ACCRUAL	ACCRUAL
	Accounts Payable within a specified number of days**	Accounts payable	Accounts payable
	Transfer payments payable within a specified number of days	Transfer payments payable	Transfer payments payable
	Borrowings	Borrowings	Borrowings
		Accrued liabilities*** (e.g. employee pension obligations and accrued interest)	Accrued liabilities*** (e.g. employee pension obligations and accrued interest)

* Under the pure cash basis, liabilities are not recognized in the financial statements. However, separate schedules of borrowings are frequently prepared and published.

** The specified number of days will be extended as the basis of accounting moves from the modified cash towards the modified accrual and full accrual bases. Borrowings may be reported under some forms of modified cash accounting (usually in the form of a separate schedule).

*** The concept of a liability under some forms of modified accrual and some forms of full accrual accounting will be the same/similar.

Recognition of Assets and Liabilities in Financial Statements

.095 "Recognition" is defined in the IASC Framework as "the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition" (IASC, 1989, para. 82). The IASC Framework establishes that assets and liabilities should be recognized in the financial statements when:

(i) it is *probable* that increases (assets) or decreases (liabilities) in economic benefits (or service potential) will occur; and

(ii) the amount of settlement of liabilities and the cost or other value of assets *can be measured reliably* (see IASC, 1989, paras. 89, 91).

.096 To be applicable in the public sector context, the IASC definition of "recognition" would need to be extended to acknowledge that different reporting formats may be adopted and financial statements other than a balance sheet or income statement may be prepared. Given that extension, the IASC recognition criteria appear appropriate viz. to qualify for recognition in the financial statements, assets and liabilities must be probable, quantifiable and measured with an acceptable degree of reliability.[5] (Of course, under different bases of accounting the nature of the assets and liabilities that may be recognized would differ.)

.097 Under the IASC Framework, determining which items should be recognized in the financial statements as assets and liabilities involves the following two steps:

(i) determining whether the item meets the definition of an asset or a liability; and

(ii) determining whether the item satisfies the recognition criteria.

.098 Consistent with this approach, items which conform with agreed definitions of assets and liabilities may not be recognized in the financial statements because they do not satisfy the recognition criteria. For example, while most items which qualify as assets or liabilities will possess a cost or other value which is quantifiable and can be measured with sufficient reliability for inclusion in the financial statements, some may not.

.099 In addition, adoption of definitions and recognition criteria developed along the lines of the IASC may require judgements to be made about the values which should be ascribed to the assets and liabilities reported in the financial statements. Those judgements can influence the messages communicated by financial statements and the way those statements should be interpreted.

.100 The receipt or payment of cash sends, in most cases, an unequivocal signal that the resources of the entity have increased or decreased (and by how much). Therefore, judgements will not be necessary, or at least will be significantly reduced, under the cash basis of accounting. However, transactions and events which do not have a cash consequence during the reporting period can also increase or decrease the resources of the entity. Many such transactions and events will be recognized under the modified accrual and full accrual bases of accounting. Where the consequences of such transactions and events on the financial or economic resources of the entity are not known with certainty at reporting date, judgement as to the amount to be recognized in the financial statements will be necessary.

.101 In this respect, the decision to move towards the accrual basis of accounting involves an assessment of whether the benefits of the relative certainty of the cash basis of accounting are greater or less than the benefits that will flow from including information about non-cash assets and liabilities (and changes in them as a result of the period's operations) in the general purpose financial report. As noted by PSC Study 1, information about

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5 PSC Study No. 1 "Financial Reporting by National Governments" includes a discussion of the "qualitative characteristics" that accounting data should possess. It explains the concept of reliability.

non-cash assets and liabilities will be useful in assessing a government's ability to provide services in the future, and its need to raise funds from future generations of taxpayers.

Net Assets

.102 Integrated or summary financial statements may be prepared whether the cash, accrual, modified accrual or modified cash basis of accounting is adopted. Under a cash basis of accounting the summary statement would be a statement of sources and disbursements of cash (extended to include some receivables and payables under a modified cash basis). Under an accrual basis of accounting the summary financial statements would include a statement of financial position (or balance sheet), which would disclose information about assets and liabilities. Under a modified accrual basis, the summary financial statements would include a statement which reports liabilities and financial assets.

.103 Where the assets and liabilities are not equal, a residual net asset figure will be reported. The amount of net assets reported, and its meaning, will be influenced by the reporting model adopted. For example, net assets reported in the summary financial statements would represent:

(i) under the cash basis of accounting, cash balances (in the case of the modified cash basis, net assets would include the balance of some receivables and payables);

(ii) under the full accrual basis, a measure of the resources that may be applied for the provision of goods and services in the future and therefore the community's investment in the resources of the reporting entity; and

(iii) under a modified accrual basis, the community's investment in financial assets (net assets would be a negative amount if liabilities at reporting date were greater than financial assets).

The net amount recorded in (iii) would be a measure of the financial assets available to finance future operations or, in the case of a negative amount, a measure of the future revenues required to meet the effects of past events.

.104 Under the full accrual basis of accounting, the change in net assets over a reporting period is a financial measure of the change in the capacity of the government (or other entity) to provide goods and services in the future, whether that change flows from the consumption of existing service potential, a reassessment of the value of service potential or the acquisition and/or disposal of certain assets.

.105 However, all the assets reported consistent with the accrual basis of accounting may not be readily available for liquidation to meet liabilities and fund the provision of services in the future. For example, consistent with undertakings about the provision of particular goods and services, plant, equipment and other operating assets may not be able to be sold. Similarly, governments frequently are bound to maintain much of the existing stocks of community, cultural and heritage assets. While assets may be classified to identify those that are available and/or intended to be deployed to meet existing liabilities and fund future activities, net assets as reported under the accrual basis will not identify the extent to which existing liabilities are greater or less than financial assets.

.106 As noted in paragraph .034, the reporting focus adopted by modified accrual bases of accounting is frequently geared towards highlighting such information - financial statements prepared consistent with a modified accrual basis highlight the existing surplus of financial assets over liabilities (or the amount of taxes and other revenue needed to be raised to meet existing liabilities) and changes in net financial resources as a result of the period's activities.

.107 The definitions of assets and liabilities adopted under accrual and modified accrual bases of accounting will also influence the message communicated by net assets. For example, whether liabilities are defined to encompass moral and equitable obligations will determine whether, under a modified accrual basis of accounting, what is reported is the surplus or deficit in financial assets over liabilities the entity is legally obligated to settle as at reporting date, or the surplus or deficit of financial assets over liabilities the entity has agreed to settle and/or is likely to require funds to settle in the future.

Equity

.108 The IASC defines equity as "the residual interest in the assets of the enterprise after deducting all its liabilities" (IASC, 1989, para. 49). The IASC also makes it clear that such a definition presumes adoption of the full accrual basis of accounting.

.109 The IASC definition of equity may be appropriate for public sector business entities which adopt the full accrual basis of accounting. For such entities, the reporting focus is on economic resources and net assets (or equity) is a measure of the wealth of the entity and is indicative of "the residual interest" in the net assets of the enterprise.

.110 However, governments and non-business public sector entities may not adopt the accrual basis of accounting and the perception of equity as indicative of owners' residual interest in, or rights to, the net assets of the entity does not appear appropriate for many public sector entities. It is therefore unlikely that the concept of equity as conventionally understood for private sector entities, and as reflected in the IASC Framework, is relevant for governments and their units.

Concepts of Revenue/Income, Expenses and Expenditures

Revenue/Income

.111 Revenue or income can be defined in different ways. Some definitions may limit revenue/income to only those resource inflows which result from the primary or central ongoing activities of the entity, others adopt a broader view and define revenues to encompass resource inflows from such sources as donations, gifts and windfall gains. In addition, some authorities, like the IASC, may use the term income and others the term revenue.

.112 The IASC has defined income in the following way:

> "Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants." (IASC, 1989, para. 70)

.113 Consistent with the recognition criteria for assets and liabilities, income would only be recognized if the increase in assets or decrease in liabilities was probable and could be reliably measured.

.114 Figure 3.6 identifies definitions of revenue (or equivalent) proposed in respect of public sector entities. (The GAO adopts the concept of "financing sources", which encompasses revenues and income - the GAO definition of "financing sources" is included in Figure 3.6.) For entities whose objective is to provide goods and services consistent with government policy (rather than to generate a profit), revenues will encompass, and may more usefully be thought of as, cost recoveries.

.115 Whether described as revenue or income, or included as a component of "financing sources", all definitions make it clear that the net effect of revenues is to increase the resource base of the entity - that is, consistent with the measurement focus adopted, revenues result in an increase in assets over liabilities. In addition, most definitions exclude contributions by owners from classification as a revenue. As such borrowings and equity contributions are unlikely to qualify as revenues under most definitions.

.116 Under most bases of accounting, the core of items recognized as revenue, or cost recovery, will be common. They will include taxes, rates, fines, fees and other imposts, user charges, investment income and windfall gains. However, the timing of recognition of items as revenue may differ under different bases of accounting. For example, under the cash basis of accounting, revenue will only be recognized in the financial statements in the period in which cash is received, but under many forms of accrual and modified accrual accounting, revenue will be recognized in the period in which the transaction or event giving rise to the increase in resources occurs.

.117 Therefore, the basis of accounting adopted can influence whether, for example, a government would:

(i) recognize income taxes as revenue when income is earned by the taxpayer, when taxes are due and payable or when taxes are received; or

(ii) recognize sales tax as revenue when the sale is made, when the tax is payable or when the tax is paid.

.118 Definitions such as those adopted by the IASC are premised on the adoption of the full accrual basis of accounting and are related to changes in net assets/equity. Where the reporting model adopted is not one which encompasses articulated financial statements, the relevance of such definitions is diminished. A statement of assets and liabilities may not be prepared and, therefore, the change in the related asset or liability may not be recognized in the financial statement.

.119 In addition, while the IASC definition of income may be applied to those public sector entities which adopt the modified accrual basis of accounting, it should be interpreted consistent with that basis of accounting. The modified accrual basis highlights financial assets available to meet liabilities. Consequently, physical assets are not usually reported in the statement of assets and liabilities. As such, changes in net assets represent changes in financial assets available to meet liabilities, rather than revenue or income as envisaged by the IASC definition, or conventionally understood by the business community.

.120 Figure 3.7 indicates the types of items that are typically identified as revenues under different bases of accounting, and the circumstances under which they will be recognized and reported in the financial statements.

Expenses and Expenditures

.121 As with revenues, expenses may be defined in a number of ways. Frequently, those definitions identify expenses as the costs of operations for the reporting period. In respect of non-business entities in the public sector, they are the costs incurred in the delivery of government programs and/or services. In respect of business enterprises, they are the costs incurred in the provision of goods and services to customers and are often related directly or indirectly to the earnings of revenue during the reporting period.

.122 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 accrual and modified accrual accounting they will encompass wages and salaries, cost of goods sold, rent and interest and may include any losses resulting from the sale of assets or from natural disasters such as fire and flood. If the full accrual basis of accounting is adopted expenses will encompass depreciation and amortisation.

.123 Expenses can be classified by type and can be related to relevant programs and/or goods and services. As such, costs attributable to the provision of particular goods and services or of operating particular programs, as well as the costs related to the general operation of the entity, can be identified and reported.

.124 Adoption of the cash basis of accounting would result in the reporting of only those expenses which involved a cash flow during the period. However, the cash disbursements reported under a cash basis of accounting may also encompass cash flows resulting from, for example, the acquisition of assets or the repayment of debt.

.125 Under the cash basis of accounting appropriate classifications of cash outflows will enable users to distinguish between those cash outflows which relate to the provision of goods and services and those which relate to the repayment of debt or the acquisition of assets.

.126 Adoption of a modified cash or modified accrual basis of accounting would encompass the reporting of a wider subset of expenses than under the cash basis. However, expenditure on the acquisition of goods or other physical assets which will provide services over a number of future periods would also be "written off" in the period in which they were acquired. As such, expenditure rather than expense is an "element" of the modified cash and modified accrual bases of accounting.

.127 Expenditures usually refer to amounts expended on the acquisition of resources during a reporting period and amounts transferred to eligible beneficiaries consistent with government policies. 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.

.128 Under the modified cash and modified accrual bases of accounting, expenditures identify the financial resources consumed and liabilities incurred as a result of operations. Revenues are increases in financial resources during the period, and any statement of revenues and expenditures will report the extent to which revenues raised during the period were sufficient to meet expenditures.

.129 The IASC defines expenses in the following way:

> "Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants." (IASC, 1989, para. 70)

.130 Like the definition of income, this definition is predicated on the assumption that 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.

.131 As was the case in respect of income, it is likely that definitions of expenses which are linked to changes in net assets will have little relevance to public sector entities which do not prepare balance sheets and operating statements.

.132 In addition, if, as in the IASC framework, the definition of expenses is limited to decreases in assets or increases in liabilities reported in the financial statements, expenditures rather than the costs of service delivery will be reported in the financial statements of entities which apply the cash, modified cash or modified accrual bases of accounting.

FIGURE 3.6

REVENUE/INCOME

DEFINITION	COUNTRY	STATUS	APPLICABILITY
"Revenues are inflows or other enhancements, or savings in outflows, of service potential or future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the reporting period."	AUSTRALIA AARF	Statement of Accounting Concepts SAC 4 (para. 95, 1992)	Public Sector Entities (including Governments) and Private Sector Entities
"Revenues are increases in economic benefits or service potential during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from owners."	NEW ZEALAND ARSB	Exposure Draft ED 60 (para. 4.8, 1991)	Public Sector Entities (including Governments) and Private Sector Entities
Revenues "In government funds, increases in financial resources from transactions other than interfund transfers, the issuance of general long-term capital debt, and the sale or capital lease of capital assets. Governmental fund revenues usually result from taxation and other non exchange transactions or events."	USA GASB	Statement 11 (p. 99, 1990)	State and Local Governments
"Financing sources are actual inflows and/or other enhancements of assets, or certain settlements of liabilities, or a combination of both. Financing sources is a term used in statements of operations to include expanded appropriations and revenues. Revenues differ from gains only in that revenues generally result from normal operations, while gains usually result from non operating activities. The only practical difference between gains and revenues is their presentation in statements of operations; revenues are commonly shown at their gross amount, and gains are usually shown net of related expenses. Income is a generic term which encompasses financing sources and gains."	USA GAO	Policy (Title 2) (Appendix 1, p. 6, 1984)	Federal Government Units

FIGURE 3.7

EXAMPLES OF ITEMS WHICH SHOULD BE RECOGNIZED AS REVENUES UNDER DIFFERENT BASES OF ACCOUNTING

ITEMS*	CASH BASIS	MODIFIED CASH	MODIFIED ACCRUAL and ACCRUAL
Income tax Sales and property tax Fees Fines Donations User charges, tolls, licenses Investment gains Lease revenues Sales of capital assets*** Transfer payments from other governments Dividends	Recognize when cash received	Recognize when it is likely that cash will be received within X days	Recognize when the underlying transaction or event occurs**

* This list is illustrative only. Note that some items may be excluded under different bases of accounting, for example, if physical assets are not recognized in financial statements under some forms of modified accrual accounting, then donations of physical assets are unlikely to appear as revenue items.

** The term "earned" is frequently used in respect of the recognition of revenues. However, in respect of governments and other non-business entities in the public sector, "earned" is more appropriately interpreted in terms of the incurrence of transactions or events which give rise to an inflow of resources and the ability to reliably measure the amount of that resource inflow. Within the context of that interpretation of the "earning process", the perception of what constitutes "earned" may differ under different forms of accrual or modified accrual accounting, as such an item may be recognized as revenues in different periods.

*** Under some forms of modified accrual accounting only the proceeds of the sale of physical assets will be recognized. Under the accrual basis of accounting, the net gain (or loss) would be recognized.

.133 Therefore, if the objective of financial reporting is to encompass the disclosure of information about the total costs of providing goods and services, 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.

.134 Where a cash, modified cash or modified accrual basis of accounting is adopted and the reporting objective encompasses the disclosure of the costs of providing goods and services, it will be necessary to develop a definition of expense (or cost) which focuses on resources consumed. It will also be necessary to consider mechanisms for the display of the cost information. That is, under cash, modified cash and modified accrual bases of accounting, expenses (or costs) as well as expenditures may be identified as an element of the financial report.

.135 Figure 3.8 identifies the element (expenditure or expense) which will generally be recognized in financial statements prepared consistent with different bases of accounting. It also includes examples of different definitions of expenses and expenditures and/or the transactions or events which may give rise to those expenses and expenditures.[6] The Figure is not meant to be exhaustive.

6 Note - the Figure includes a definition of expense and expenditure from a 1980 GAO exposure draft. A final statement flowing from that exposure draft will not be issued. Responsibility for establishing guidance on financial reporting issues now resides with the Federal Accounting Standards Advisory Board.

FIGURE 3.8
THE ELEMENT (EXPENDITURE/EXPENSE) RECOGNIZED
UNDER DIFFERENT BASES OF ACCOUNTING

BASIS OF ACCOUNTING

CASH	MODIFIED CASH	MODIFIED ACCRUAL	FULL ACCRUAL
Cash Expenditures	Expenditures to be made within X days	Expenditures (1)	Expenses (2)

1. PSAAC (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." (Statement 3, para. 71, 1986).

   GASB (USA): notes that "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." (Statement 11, para. 74, 1990).

   GASB (USA): notes that "capital expenditures result from acquiring capital assets through purchase, construction or capital lease." (Statement 11, para. 82, 1990).

   GAO (USA) (proposed in a 1980 exposure draft): "An expenditure is the financial measure of goods and services received during a specific period or a measure of grant and subsidy funds required to be paid to the recipient since the recipient has met the grantor agency requirements and is entitled to payment." (GAO ED, p. 21, 1980 - note, the exposure draft will not be issued as a final statement).

2. GAO (USA) (proposed in a 1980 exposure draft): "An expense is the financial measure of goods and services consumed during a specific period, whether or not it is paid for during the period." (GAO ED, p. 21, 1980 - note, the exposure draft will not be issued as a final statement).

   GAO (USA): "Expenses and losses are outflows of assets or incurrences of liabilities (or a combination of both) during a period. These can result from rendering services, delivering or producing goods, or carrying out other activities. Expenses relate to normal operating activities, while losses generally relate to all other transactions. The distinction between expenses and losses is a matter of classification in the statement of operations; expenses are commonly displayed at their gross amount, and losses are usually shown net of related revenue. Transfers out are assignments of appropriations or contributions of other assets to another agency." (Title 2, Appendix I, p. 6, GAO 1984).

   AARF (Australia): "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." (SAC 4, para. 101, 1992).

   ARSB (New Zealand): "Expenses are decreases in economic benefits or service potential 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 by owners." (ED 60, para. 4.9, 1991).

CHAPTER 4

OBJECTIVES OF FINANCIAL REPORTING AND BASES OF ACCOUNTING

Objectives of Financial Reporting

.136 PSC Study 1 establishes that the overriding objectives of financial reporting should be the disclosure of information relevant to the decision making and accountability needs of users. Consistent with those overriding objectives, PSC Study 1 identifies a range of specific objectives that the financial reports of national governments and other public sector entities may be directed at satisfying. It also identifies the extent to which those objectives are achieved by different bases of accounting.

.137 As noted in Chapter 3, decisions regarding the objectives that financial reporting is to satisfy will influence the basis of accounting which is adopted and the nature of the elements that are reported in financial statements. Arguably, the primary determinant of these matters will be the concept of accountability that is adopted.

.138 Therefore, whether or not all assets, liabilities, expenses and revenues, or a subset thereof, should be recognized in the financial statements will be influenced by considerations of whether governments and their units should be accountable for all resources under their control; and the role financial statements should play in the discharge of accountability obligations. Decisions regarding the elements that are reported in financial statements will, in turn, influence the relevance of the financial statements for particular decision making purposes.

Accountability

(a) Cash and modified cash bases

.139 The cash basis of accounting recognizes cash flows and cash balances as the only elements of financial statements. The modified cash basis of accounting recognizes amounts receivable and payable within a nominated period from reporting date as well as cash flows during the reporting period and cash balances as at the end of the reporting period.

.140 Reporting of cash flows is likely to be relevant for the "compliance" aspect of accountability (demonstrating compliance with spending mandates) and will provide input for determining future funding requirements. However, the reporting of only cash flows and cash balances is unlikely to reflect the costs of service delivery or the results of resource management. As such, cash flow data, while relevant for some decision making purposes, is unlikely to provide sufficient information for an assessment of the economic condition of an entity and its efficiency in allocating and managing scarce resources for the achievement of service delivery objectives. If public sector entities are to be accountable for the resources they control and the deployment of those resources, financial reports should encompass wider financial dimensions than can be reflected by the cash or modified cash basis of accounting.

(b) Modified accrual

.141 The modified accrual basis of accounting recognizes liabilities, financial assets, revenues, expenditures and net assets as the elements of financial statements. Adoption of such a basis will result in the preparation of financial statements which reflect a broader concept of accountability than that reflected by the cash (or modified cash) basis and which report information relevant for a wider range of decision making purposes. However, balance sheets or other statements of assets will exclude physical assets. Similarly, the cost of resources consumed in the provision of services may not be distinguished from amounts expended on the acquisition of assets that were not consumed during the period.

.142 The modified accrual basis of accounting will therefore highlight the extent to which the results of activities during the current period have enhanced or eroded the government's ability to meet its liabilities and fund future activities from financial assets. This information will be relevant for assessments of the future funding requirements of government.

(c) Full accrual

.143 The elements recognized under the "full accrual basis of accounting" will be assets, liabilities, revenues, expenses and net assets (in respect of some public sector entities, net assets may be interpreted as equity). Financial statements prepared consistent with this basis will report on the costs of services provided during the period (necessary for assessments of efficiency of service delivery), the extent to which those costs were recovered from revenues generated during the period and the sources of those revenues (useful input to deliberations on inter-period or inter-generation equity) and the resources controlled during the period. Adoption of this basis of accounting is therefore consistent with the view that governments and other public sector entities should be accountable for all resources that they control and the changes in those resources as a result of the period's activities.

.144 A balance sheet or other statement of assets and liabilities prepared using the accrual basis of accounting can be structured to identify financial assets available to meet liabilities. However, statements constructed to disclose revenues and expenses will not report cash flows (as under the cash basis) nor highlight whether, as a result of the period's activities, the entity's ability to meet its liabilities and fund additional activities from financial assets has been enhanced or eroded (as under some forms of modified accrual accounting).

.145 While the accrual basis is most appropriate for reporting on resources controlled, cost efficiencies and cost recoveries, it may not be the most appropriate basis for reporting if other objectives are determined to be primary. For example, if reporting on costs is relatively less important than reporting on cash receipts and disbursements.

CHAPTER 5

SUMMARY

.146 Financial reports prepared by governments and their units may be directed at satisfying different specific objectives. PSC Study 1 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.

.147 The particular objectives adopted for the financial report will influence decisions made by governments about the basis of accounting and the reporting model to be adopted. Those decisions will also influence the elements that are reported by the financial statements and how those elements are defined.

.148 The elements that may be reported by the financial statements of governments and their units are assets, liabilities, net assets, revenues and receipts, expenses and expenditures. Dependent on the basis of accounting adopted and the messages to be highlighted by the financial statements, the elements may be defined in different ways and all, or a subset of them, will be reported in the financial statements.

.149 This Study has noted that definitions of the elements of financial statements of non-business public sector entities have not been agreed at an international level, but that the IASC has developed definitions for application where the full accrual basis of accounting is adopted. This Study has considered the implications of those definitions for governments and their units which adopt the full accrual basis of accounting and report on economic resources and changes therein.

.150 However, this Study has also noted that subsets of the elements as defined by the IASC will be reported by governments which do not adopt the full accrual basis of accounting but prepare financial reports to satisfy objectives related to the disclosure of information about cash flows, current financial resources or total financial resources. This Study explores the ways in which the IASC definitions could be modified or redefined to be relevant for governments and their units and identifies definitions of elements adopted or proposed by a number of authoritative bodies.

.151 The Committee hopes that this Study will contribute to the continuing evolution of financial reporting by governments and their units. It is intended to stand as a companion to Study 1. Its purpose is to encourage governments to identify the objectives of financial reporting, the elements that should be reported if those objectives are to be achieved and to clarify the characteristics which those elements should possess. The PSC is of the view that the usefulness of financial reports of governments and their units will be enhanced if users are informed of the basis of accounting and reporting model adopted in the preparation of financial statements, and if the elements reported in the financial statements have well understood and generally accepted characteristics.

APPENDIX 1

Objectives Of Financial Reporting

Financial reporting should demonstrate the accountability of government or (government) unit for the financial affairs and resources entrusted to it, and provide information useful for decision-making by:

a. Indicating whether resources were obtained and used in accordance with the legally adopted budget.

b. Indicating whether resources were obtained and utilized in accordance with legal and contractual requirements, including financial limits established by appropriate legislative authorities.

c. Providing information about the sources, allocation and uses of financial resources.

d. Providing information about how the government or unit financed its activities and met its cash requirements.

e. Providing information that is useful in evaluating the government's or unit's ability to finance its activities and to meet its liabilities and commitments.

f. Providing information about the financial condition of the government or unit and changes in it.

g. Providing aggregate information useful in evaluating the government's or unit's performance in terms of its service costs, efficiency and accomplishments.

(Source: PSC Study 1 "Financial Reporting by National Governments", IFAC, 1991, p. 11)

APPENDIX 2

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 of 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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