Definition and Recognition of Assets
This Study was prepared by the Public Sector Committee of the International Federation of Accountants.

International Federation of Accountants
114 West 47th Street, Suite 2410
New York, New York 10036

Copyright © 1995 by the International Federation of Accountants. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of the International Federation of Accountants.
PREFACE

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

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

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

This Study develops on Study 1 and in particular on Study 2. Its purpose is to identify, consider and explore current views held internationally on:

(i) the definition and recognition of assets;

(ii) the effect of different bases of accounting on the definition and recognition of assets; and

(iii) particular issues and problems arising from certain types of assets.

This Study identifies, and acknowledges, that a wide variety of views exist about whether, when and how certain assets should be measured and reported. It is intended that the Study should contribute to debate about these issues. The Study seeks to compare differing views expressed with the user needs identified in Study 1 and Study 2, and also seeks to indicate the direction of changes to good practice that will best inform both users of financial reports and decision makers in the public sector. This Study reaches conclusions which represent the Public Sector Committee’s position in relation to the general direction of change and its expectations of individual governments.

Major revision of public sector asset accounting is taking place in various parts of the world as countries adopt accrual accounting for the non-business public sector. The emerging experience in Australia and New Zealand has emphasized the benefits in decision making and in communication to the legislature and the public as justification of the efforts required.

Interest in management of public sector assets is leading to rapid development in accounting in many parts of the world. As this Study was written, the guidance quoted from different countries was being further developed and amended. Readers should note that this pace of change will continue after publication of this Study — indeed, it is the wish of IFAC PSC that this Study should accelerate change in public sector asset accounting.

IFAC PSC hopes this Study will encourage readers, whether or not they are members of the accounting profession, to consider alternative approaches to the definition and recognition of assets and to contribute to international developments which will lead to improvements in financial reporting by public sector entities and greater comparability of financial reports both between and within different jurisdictions. IFAC PSC welcomes the worldwide trend by governments to improve communication to citizens of objectives and performance by means such as the United Kingdom Citizen’s Charter. IFAC PSC considers that asset definition and recognition should be assessed in terms of their contribution to meeting user information needs.
## Definition and Recognition of Assets

### TABLE OF CONTENTS

**CHAPTER 1: INTRODUCTION**

- Context of Preceding Studies
- Purpose of this Study
- Scope of this Study
- Need for this Study
- Some Issues in Public Sector Asset Accounting
- Summary
- Footnotes - Chapter 1

**CHAPTER 2: ASSETS IN THE PUBLIC SECTOR**

- Introduction
- Characteristics of a Class of Assets
- Characteristics of an Asset
- Asset Descriptions
- Footnotes - Chapter 2

**CHAPTER 3: REPORTING ASSETS UNDER DIFFERENT BASES OF ACCOUNTING**

- Introduction
- Service Potential
- Objectives of Financial Reporting and Selection of Accounting Bases
- Acquisition of Assets
- Disposal of Assets
- Consumption of Assets
- Footnotes - Chapter 3

**CHAPTER 4: RECOGNITION AND REPORTING ISSUES UNDER DIFFERENT ACCOUNTING BASES**

- Introduction
- Cash Basis
- Cash Basis - Recognition
- Cash Basis - Reporting
- Modified Cash Basis
- Modified Cash Basis - Recognition
- Modified Cash Basis - Reporting
- Modified Accrual Basis
- Modified Accrual Basis - Recognition
- Modified Accrual Basis - Reporting
- Full Accrual Basis
- Full Accrual Basis - Recognition
- Full Accrual Basis - Reporting
TABLE OF CONTENTS

- Continued -

| Full Accrual Basis - Measurement Disclosures | .156 |
| Footnotes - Chapter 4                      |     |

CHAPTER 5: DISCUSSION OF SOME MEASUREMENT ISSUES

| Bases of Measurement - Introduction        | .157 - .162 |
| Bases of Measurement - Cash and Modified Cash Bases | .163 |
| Bases of Measurement - Accrual and Modified Accrual Bases | .164 - .169 |
| Discussion of the Measurement of Some Assets | .170 - .188 |
| Asset Consumption                           | .189 - .199 |
| Footnotes - Chapter 5                       |     |

CHAPTER 6: CLASSIFICATIONS OF ASSETS

| Effect of Basis of Accounting on Classification | .200 - .204 |
| Classification by Liquidity                     | .205 - .212 |
| Legal Classifications                           | .213 - .214 |
| Classifications by Nature and Function          | .215 - .219 |
| Physical Assets                                 | .220 - .232 |
| Examples of Asset Class Guidance                | .233 - .235 |
| Footnotes - Chapter 6                           |     |

CHAPTER 7: CONCLUSIONS

| Suggestions for Topics for Further Consideration | .236 - .242 |
| Footnotes - Chapter 7                            | .243 |

APPENDIX: GLOSSARY OF TERMS

| BIBLIOGRAPHY                                    |     |
CHAPTER 1
INTRODUCTION

Context of Preceding Studies

Objectives of Financial Reporting - Study 1

IFAC PSC’s Study 1 “Financial Reporting by National Governments” (hereafter called Study 1) 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, such as communicating information about compliance with spending mandates, the financing of activities, financial condition and aspects of financial performance. (See Appendix 1 of Study 2 and Study 1 for a full exposition of those component parts.)

Bases of Accounting - Study 1

Study 1 noted that the basis of accounting adopted by a government and its units lies on a continuum from the cash basis to the full accrual basis. Four points on that continuum are identified and described which are indicative of bases of accounting currently adopted. Those bases of accounting are:

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

These bases of accounting are described in Study 1 (paragraph .078 onwards) together with their relation to alternative reporting models and to the objectives of financial reporting.

Elements of the Financial Statements of National Governments - Study 2

IFAC PSC’s Study 2 “Elements of the Financial Statements of National Governments” (hereafter called Study 2) considers:

(i) the “elements” (elements are 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 their sub-sets, for the messages communicated by financial statements and the achievement of objectives identified in Study 1.

Elements of Financial Reports

To enable financial reports to communicate effectively, the effects of transactions and other events are portrayed by grouping them into broad classes and by reporting those classes on an aggregated basis in financial statements. The broad classes of transactions recorded in financial statements are conventionally termed the “elements" of
financial statements. In essence, the elements of financial statements are the classes of items around which the financial statements are constructed.

Under different bases of accounting the elements may be defined differently, and therefore different sets or sub-sets of those elements may be reported. The appropriate way in which to report various elements has come under careful consideration as government entities have considered alternative bases of accounting to meet the objectives of financial reporting.

The term “elements” may encompass assets, liabilities, net assets (equity), revenues, receipts, expenses or expenditures. While these elements have not been defined, Study 2 has identified the characteristics of these elements and items which should be reported as each of the elements under the different bases of accounting.

**Purpose of this Study**

The purpose of this Study is to identify and consider current international practice on:

(i) the definition and recognition of assets;

(ii) the effect of different bases of accounting on the definition, recognition and reporting of assets; and

(iii) issues and problems arising from physical and financial assets and from particular classes of those assets.

The Study also includes an introductory discussion of the classification of assets.

By highlighting different views and approaches adopted in different jurisdictions, it is hoped this Study will assist those considering alternative approaches to public sector financial reporting and will also assist in developing the full potential of accounting models employed in different jurisdictions to communicate information about assets to users. IFAC PSC hopes this Study will contribute to the emergence of consensus on what constitutes good practice in financial reporting by public sector entities.

**Scope of this Study**

Consistent with Study 1 and Study 2, the primary focus of this Study will be on the reporting of assets in financial statements prepared for national governments and entities or units they establish for the delivery of goods and services and the achievement of government objectives. However, as the issues relevant to the definition, recognition and reporting of assets to other levels of government (for example, state, provincial and local government) are similar, matters addressed may be of equal relevance to those other levels of government. (Readers should note that accounting for government-owned business enterprises is addressed in International Public Sector Guideline 1 “Financial Reporting by Government Business Enterprises”.)

This Study concentrates on the treatment of assets in the statement of financial position (balance sheet), but deals only generally with the effect of asset reporting on other elements of financial reporting — for example, the effect of recognizing asset consumption in the operating statement.

Earlier studies published by IFAC PSC include 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 should be read with the same meaning identified in earlier studies. The Appendix of this Study is a glossary of terms.
Need for this Study

General Duty to Manage Assets

Demand for government services has increased with population growth and with rising standards of living. This demand has been associated with governments' control of more assets whether financial, physical or intangible. This growth in demand has also meant increasing competition for government attention and resources. This competition has been further stimulated by improving education standards, communication and community interest in government actions. As a consequence, governments are under pressure to manage assets both efficiently and effectively. The demand for accountability for governments' use of assets has increased and will continue to increase. The efficiency and effectiveness of public sector asset management should be demonstrated through financial reporting. Better reporting provides a basis of understanding by the public, by elected decision makers and by management. This in turn supports better decision making and asset allocation.

Asset Records as Part of Asset Management

Regardless of the accounting basis adopted, most citizens expect governments to manage public assets efficiently, that is, they believe their government has a duty to acquire, hold and invest resources from the public only in amounts necessary for the purposes of government. To manage such resources requires sufficient records to identify assets. Lists of assets are used as alternative reporting models in some jurisdictions and, in practice, are necessary for any asset management system.

Typically, governments hold many lists describing physical aspects of their capital assets. In the absence of regular financial reporting of capital assets, those listings are seldom complete or up-to-date. To re-establish physical records of long-lived government assets where these have been neglected is a daunting and expensive task which is a major obstacle — often unacknowledged — to any proposal to extend asset recognition.

However, where a deficiency in physical asset records does exist, there are major implications for economic management of assets, as such a deficiency may impair decisions on maintenance, disposal of surplus assets and replacement of decayed or obsolete assets. Financial reporting of capital assets provides benefits by enhancing the quality of asset information to meet both internal management as well as external reporting and audit requirements.

Effective Delegation and Financial Control

The complexity of public sector management requires effective delegation, but over-detailed financial regulations and controls in the public sector often impede delegation and efficient management of resources. Such inefficient financial controls thereby obstruct good financial management, but may continue to operate because they form part of formal requirements for annual financial reports. Public sector financial reporting of assets should support the continuing search for effective delegation and control in the management of assets.

Governments as Owners of Major Physical Assets

One reason governments undertake and maintain projects is that they are too large to be undertaken by smaller groups of citizens who may be deterred by risk, complexity or size of the resources required. Investment in large long-lived assets is essential to maintain the present and future living standards of populations, particularly in urban areas. Such large long-lived assets are affected by obsolescence arising from wear, physical decay, changes in required service capacity and changes in their environment. At the sub-national/regional level of government in particular, the urgent simultaneous replacement of a number of major physical assets could require financial resources that would strain the capacity of the government. Information is necessary for the effective management of such assets. Information about replacement cost, for example, is relevant to the problem of financing the replacement of long-lived major physical assets.
Governments as Guardians of National Resources

Citizens rely on their government to manage national resources, including, for example, government decisions for retention or disposal of natural resources or state-owned entities. Financial reporting of assets should assist users to understand the current and possible future effects of such decisions.

Are Existing Financial Practices Adequate?

Issues of concern are whether existing financial reporting practices are capable of informing interested parties, and whether they are consistent with the objectives of financial reporting discussed in Study 1.

Some Issues in Public Sector Asset Accounting

Asset Accounting Issues in the Public Sector

The following issues in public sector asset accounting are widely debated:

(i) Most classes of non-financial assets are not recognized in financial reports prepared on bases other than full accrual. Are such general exclusions appropriate?

(ii) Certain classes of asset (for example, infrastructure and heritage assets) are thought by some to be too difficult to measure reliably.

Private sector practice in the full accrual system has not encountered these problems to the same extent, although assets identical to infrastructure or heritage assets are commonly held by private sector entities.

Asset Accounting Issues Common to the Private and Public Sectors

The following financial reporting issues are widely debated in the private sector as well as the public sector:

(i) recognition of remeasurement of non-current assets above their historical cost of acquisition; and

(ii) recognition and measurement of the consumption of long-lived assets.

Can Private Sector Accounting Standards be Applied to Public Sector Financial Reports?

One of the most significant debates concerns whether financial reporting standards for the public sector should be different from those approved for the private sector. For example, Canada continues to regard the public sector as requiring separate financial reporting standards. This separation is considered to be justified by the differing practices of each sector and by the separate interests and objectives of account users and preparers in the two sectors. In the United Kingdom, the Green Paper "Better Accounting for the Taxpayer’s Money" takes the view that private sector accounting standards will provide the bedrock for accounting in central government, but they must be supplemented to meet specific needs of the public sector. More recently, the United Kingdom Chartered Institute of Public Finance and Accounting (CIPFA) has proposed the establishment of a separate public sector standard setting body.

A different view of the standard setting process has emerged in New Zealand and Australia where it is intended that each financial reporting standard applies to financial reports in all sectors except in rare instances where a specific exemption is included in a particular standard. In New Zealand, this approach arose as a consequence of the way accountability relationships were defined. Performance was viewed in a way which implied that performance reporting in the public sector was similar (although not identical) to performance reporting in the private sector. Reporting was therefore derived from private sector generally accepted accounting practice. Considerations of efficiency supported the decision to use the existing financial reporting standard setting process.
rather than to replicate it. Such considerations of cost/benefit would support a separate public sector standard setting process if this could be justified in terms of benefits and costs. The cost/benefit considerations would include:

(i) effective treatment of aspects of financial reporting particular to the public sector; and

(ii) public perceptions of the neutrality of the standard setting process in dealing with private interests supported by lobbying, particularly where reporting requirements affected matters outside the jurisdiction of the standard setting body — for example, when financial reporting affects tax interpretation or securities regulation.

In New Zealand, the Financial Reporting Act 1993 established a statutory board to approve financial reporting standards which are to be legally binding on various classes of entities in both the public sector and the private sector.

This Study does not seek to resolve this difference of view on the applicability of private sector financial reporting standards to public sector financial reports. However, where the full accrual basis is adopted by a public sector entity, International Accounting Standards may be a source of useful guidance for particular accounting treatments.

Non-financial Information

Regardless of the financial reporting treatments adopted, governments have a duty to supplement their financial reporting with, for example, reports on performance against past budgets, budgets for future periods, and the condition and maintenance requirements of assets held. Where financial information is limited by the accounting basis adopted, governments need to assess how the financial information should be supplemented by a narrative explanation.

Summary

This Study discusses public sector assets and considers, in particular, the definition, recognition and reporting of those items which are considered to be assets under the various bases of accounting. It compares the different options and issues of measurement under the accounting bases discussed above in paragraph .002.

Footnotes - Chapter 1

1 Lüder, Klaus; *Valuation of Assets in Government*, Speyerer Arbeitshefte 93, Hochschule für Verwaltungswissenschaften, Germany, 1991.

CHAPTER 2
ASSETS IN THE PUBLIC SECTOR

Introduction

.027 Public sector entities control assets of various classes and all such entities have a duty of stewardship of assets under their control, irrespective of how such assets may be reported in their financial statements. Such a duty includes effective acquisition, use, protection, maintenance and disposal of assets in accordance with objectives of the entity. The duty of stewardship may be discharged in different ways to match different classes of assets.

Characteristics of a Class of Assets

.028 A public sector entity may group assets into classes by their nature (for example, all land or all buildings) or by their function (for example, assets used by a department) or by their liquidity or by some combination (for example, all buildings used by a particular department). Additional considerations may include the consolidation accounting policies of the next higher level of government, as well as the legal situation of particular assets which may be subject to restrictions or securities or where the benefits and obligations of ownership are separated from legal control. A discussion of classification is found in chapter 6.

Characteristics of an Asset

.029 Study 2 discusses assets as elements of financial reporting, and the discussion derives from the IASC asset definition predicated on the full accrual basis. The duty of stewardship for resources will extend as a minimum to resources that meet accepted definitions of an asset for financial reporting. There may be other resources such as human resources where a public sector entity (or, indeed, a private sector entity) has a duty of stewardship, but the resource does not meet an accepted asset definition. The entity may be accountable for such resources by means of non-financial reporting.

.030 A public sector entity will control assets that meet, for example, the IASC definition of an asset, which states: "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." A public sector entity will have a duty of stewardship for such assets. Whether an entity is accountable for the asset and reports on its stewardship will depend on the rules established in that jurisdiction. Further, the basis of accounting adopted (cash, modified cash, etc.) will determine the recognition criteria for inclusion or exclusion of the value of the assets in financial reports. Thus an entity may have control of an asset within accepted asset definitions and therefore has a duty of stewardship, but may not be required to account for that stewardship. For example, a government may own and occupy a building, but under the cash basis is required neither to recognize nor to report the capital value of the building after the period in which the building was purchased. Under different rules, an entity may be accountable for its stewardship only by non-financial reporting. Finally, if an entity has control of an asset as defined, and this asset meets recognition criteria for the accounting basis adopted for the entity, an entity will recognize the value of the asset in its financial reports.

.031 As discussed below at paragraph .038, this Study deals with assets (as defined for financial reporting purposes) rather than with the broader category of resources available to governments. Therefore, the characteristics of an asset considered in Study 2 form a useful starting point. However, public sector (and private sector) entities may also be accountable (by non-financial reporting) for resources that do not meet the asset definition. Study 2 states: "...the fundamental characteristics which assets will possess under all bases of accounting" are:
"(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."

Debate exists on whether the term “economic benefits” includes service potential, which may be measured other than in cash flows, and reflects governments’ wider objectives (for example, social or environmental objectives). “Assets” in this Study include assets such as works of art which are held for cultural reasons.

Asset Descriptions

.032 The following paragraphs discuss how asset descriptions which are commonly used, such as cash, financial assets, physical assets and intangibles, conform to the asset definition above.

Cash

.033 Cash in the form of money in the bank has the three characteristics mentioned above. The right to create money in the future does not conform to the second characteristic as it can be argued that the event has not yet occurred. The United States Federal Accounting Standards Advisory Board defined cash in its Statement of Federal Financial Accounting Standards No. 12 as follows:

“Cash, including imprest funds, should be recognized as an asset. Cash consists of:

(a) coins, paper currency and readily negotiable instruments, such as money orders, checks, and bank drafts on hand or in transit for deposit;

(b) amounts on demand deposit with banks or other financial institutions; and

(c) foreign currencies, which, for accounting purposes, should be translated into U.S. dollars at the exchange rate on the financial statement date.”

Financial Assets

(a) Definition of financial asset

.034 The definition of financial asset in IASC International Accounting Standard (IAS) 32 “Financial Instruments: Disclosure and Presentation” is:

“A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity instrument of another enterprise.”
Recent developments in financial instruments have led to arrangements which may combine elements of the above definition and may also include financial liabilities, as defined in IAS 32. However, regardless of the combinations possible, financial assets as defined will be assets where they conform to the three characteristics of an asset referred to above in paragraph .031.

(b) Taxation receivable as an asset

Taxation is a payment under compulsion. Thus, taxation does not meet the IAS 32 definition of financial asset in that the right to receive is not a “contractual right”, although it is enforceable at law and rights to receive benefits of taxation could be considered similar to other financial rights obtained under contract. If the power to levy taxes and other imposts is regarded as a right in terms of the IAS 32 description of contractual rights, the timing of the exercise of that power will determine whether the required characteristics are met. Power to tax in the future will not conform to the characteristic that an asset must arise from past events. Taxation which may be due, but is subject to formal agreement, (for example, by assessment or judicial decision) may not be an asset, depending on the interpretation of “control” and of “past event”.

Physical Assets - General

The three characteristics referred to in Study 2 are essential to restrict the scope of public sector assets to useful descriptions and to avoid the inclusion of items irrelevant to users. The key characteristics are that the benefits arise from a past event and that they are under control at reporting date. For example, a power to sequestrate a physical item is not an asset, although property obtained by the exercise of such a power is an asset in terms of the characteristics.

In general, physical assets reported by private sector entities will also be assets for public sector entities. However, the power of the State may have established control of physical resources where such control is rare for private entities — for example, in control of the continental shelf or other parts of the sea-bed, geothermal resources, etc. The asset characteristic which may be debatable for such resources is the existence of future economic benefits or service potential. Even if these items meet the definition of an asset, such resources usually involve difficulties of recognition, especially with regard to measurement, and may not be reported for that reason. Even where such resources are not reported in the financial statements, physical resources such as the sea-bed are under the control of public sector entities and those entities have a duty of stewardship including the duty to manage the asset effectively. The duty to manage effectively will include the duty to manage the asset economically and to be accountable for that management. Further discussion of natural resources is found in paragraphs .054 and .122 to .124 below. It is important to distinguish control in terms of the asset characteristics from control in terms of regulatory authority — for example, where a government establishes safety regulations for commercial products.

Physical Assets - Inventories

There is usually little debate on whether items held for future consumption are assets. However, the subsequent processes of recognition and measurement will depend on the basis of accounting and the purposes of the financial reports.

Physical Assets - Long Term Fixed Assets such as Plant and Buildings

Buildings or plant, etc., have the Study 2 characteristics of an asset unless they are shown to have no future economic benefits or service potential.

Physical assets - Infrastructure

"Infrastructure assets" is a term applied in the public sector. Similar assets in the private sector are considered, and accounted for, as long-term physical assets with no particular categorization. The term is used in the public sector to describe long-life major physical assets (such as roads, bridges, communication networks), and major civil
engineering works (such as sea-defenses, etc.). Implied in many definitions of the term is the idea of a network. For example, a length of road derives its service potential and future economic benefits from being part of a road system. The distinction between infrastructure assets and buildings or plant is not precise and the range of descriptions used for infrastructure assets is discussed below at paragraph .043 onwards.

.042 For reasons including the economic and financial significance of major infrastructure assets, public sector owners have a duty of stewardship for those assets. Because the continued uninterrupted operation of these assets is crucial to social and economic life, the acquisition, upkeep and replacement of infrastructure assets are vital duties of responsible public sector entities which should be accountable for the performance of their duty of stewardship. Total expenditure on infrastructure projects is very large; the recognition and measurement of infrastructure values and the periodic consumption of these assets involve large sums and major commitments by public sector entities and those who support them by taxes or finance. Therefore, the construction and replacement of infrastructure assets are matters of major political and financial consequence. Measurement of the value of such assets and of their consumption is discussed later in paragraph .171.

Descriptions of Infrastructure

.043 As the following paragraphs show, differing opinions exist on how infrastructure assets should be described. However, the differences relate to matters of detail rather than core meaning and it is possible there will be more uniformity in time.

.044 A United Kingdom (UK) description of infrastructure assets is:

"Infrastructure assets - expenditure of a capital nature on an immobile specialised asset, which is recoverable only by continued use of the asset created, which generally will not have a realisable value or earning potential. Such expenditure would normally comprise 'sunk costs', which create an asset which cannot reasonably be expected to have any alternative uses other than the propose for which it was created. Such assets are required generally to be maintained indefinitely. Notable examples of infrastructure assets are roads, sea defences, permanent ways and bridges." 4

A later description from the UK is:

"Infrastructure Assets: Inalienable assets, expenditure on which is recoverable only by continued use of the asset created. Examples of infrastructure assets are highways and footpaths." 5

The same reference includes roads, sea-defenses, bridges, permanent ways and water and drainage systems as examples under the heading of "Infrastructure".

A New Zealand description is:

"Infrastructure assets are those stationary physical assets which form a network to facilitate the delivery of goods and services." 7

The 1989 Canadian CICA Research Study "Accounting and Reporting for Physical Assets by Governments" commented:

"The term 'infrastructure' is sometimes broadly defined to include virtually all of the fixed assets held by governments and many of the fixed assets held by the private sector..." 8

.045 In conclusion, none of the quotations above suggests that any clear boundary or specific nature can be attributed to infrastructure assets. Reservations about current definitions of infrastructure are discussed below in paragraph .048.
Physical Assets - Heritage Assets

Public sector entities are often charged with the custody of culturally significant resources, such as works of art, historical documents, areas of land of historic or scientific significance, monuments and culturally significant buildings. Such resources are sometimes described (in the public sector only) as heritage assets. In the private sector, possession of works of art, architecturally significant buildings, and rare artefacts or documents are acquired, transferred and reported in the same way as other resources. In general, a heritage resource, although it may be an actual ruin, will have the characteristics of an asset for the public sector entity which controls it. The subsequent recognition and measurement of culturally significant items under public control is politically sensitive and the issues debated appear later in paragraphs .173 to .181.

Descriptions of Heritage Assets

Descriptions of heritage assets follow:

(i) “In general usage, the term ‘heritage assets’ refers to physical assets that a community intends preserving because of cultural, historic or environmental associations.”

(ii) The 1989 Canadian Research Study “Accounting and Reporting for Physical Assets by Governments” commented: the term “heritage assets [is used] to refer to fixed assets that a government intends to preserve indefinitely because of their unique historical, cultural or environmental attributes. A common feature of most heritage assets is that they cannot be replaced.... Examples of heritage assets are monuments, art and museum collections, wilderness preserves, battlefields and buildings designated for preservation.”

Reservations about Definitions of “Heritage” and “Infrastructure” Assets

“If infrastructure and heritage assets are a distinctive group of assets, which warrant distinctive accounting practices, it is important that they can be readily distinguished by observers from other physical assets.” However, Rowles’ examination of the definitions identified for such assets where they have been applied, showed that these did not “establish non-current physical assets of not-for-profit public sector entities as a conceptually distinct group of physical assets....Whatever meanings are attached to the terms ‘infrastructure assets’ and ‘heritage assets’ in general usage, or in other disciplines for accounting purposes, the terms do not denote a group of assets that can be readily distinguished from other physical assets.”

The Australian Accounting Research Foundation published, in 1992, “Definition, Recognition and Measurement of Non-current Physical Assets by Public Sector Reporting Entities; A Guide to Applying Professional Pronouncements” as a guide to current and emerging practice and law in Australian state and federal governments. On the topic of infrastructure and heritage assets, this guide states:

“Current professional pronouncements do not distinguish between different types of service potential or future economic benefits in assessing whether an item meets the definition of an asset. For example, no distinction is made between so-called infrastructure or heritage assets and other types of non-current physical assets in assessing whether such assets would satisfy the definition or recognition criteria for assets.”

In terms of generally accepted accounting practice in most countries, it is probable that most non-current physical items will meet the definition of assets. Thus assets could include monuments, museums and historical treasures, since all these items assist public sector reporting entities to achieve service delivery objectives. Such a view would claim that infrastructure and heritage assets are assets to be measured and recognized as any other non-current physical asset, and derives from consideration of the definition of asset.
In contrast, the UK Final Report of the Capital Accounting Steering Group, “Capital Accounting in Local Authorities”\(^{11}\) distinguishes infrastructure assets and other “specialized or historic assets” from other assets by requiring different measurement bases. Infrastructure assets, etc., were to be recognized at historic cost while other assets were to be recognized at “current value to the authority”. In a later (1993) report, the CIPFA Capital Accounting Working Group avoids the description “heritage assets” and uses instead “community assets” (see paragraph .055 below). At the central government level, the UK Treasury’s “Accounting for Capital Assets — A Working Draft of Guidance” (February, 1992) takes the view that: “There is no intention of ever replacing certain heritage assets, such as Stonehenge and Hampton Court Palace and every effort is made to maintain them at a constant level. Accordingly they are not valued and no depreciation charge is made for these assets.”

**Infrastructure and Heritage Assets - A Summary**

Despite debate on questions of recognition and measurement etc., (to be discussed later in this Study) it is generally accepted that both infrastructure and heritage assets are assets. Although some argue that these assets differ in nature from other assets, others contend that nothing in concept distinguishes assets described by these terms from other assets that meet accepted asset definitions. The distinctions between heritage or infrastructure assets in contrast with other assets may sometimes be arbitrary. For example, an architecturally significant government building occupied for administrative purposes may properly be considered either as a heritage asset or as a fixed asset used by a department. The terms are widely used in public sector accounting, and therefore, this Study refers in later chapters to the measurement and reporting of heritage and infrastructure assets.

**Physical Assets - Defense Assets**

The United Nations System of National Accounts distinguishes defense assets from gross fixed capital formation as follows:

> "Outlays for military purposes are, however, considered to be current expenditures, except for outlays by the military authorities on land and certain items for civilian use such as schools, hospitals, and family-type housing, and in some cases roads when for civilian use. ‘Military purposes’ are construed in terms of final use; they include the military airport, but not the bulldozer used in constructing the airport.”\(^{12}\)

A range of descriptions specifically for financial reporting are available:

In the UK, “defense assets” refers only to military hardware and excludes buildings, depots, land, etc. The justification for the separate classification of military hardware is that the speed of technological development and change is so rapid that reliable measurement of such assets is often impossible. The UK Treasury’s “Accounting for Capital Assets — A Working Draft of Guidance” takes the view that: “It is the agreed convention that defence equipment such as tanks, planes and warships are counted as current expenditure.”

In Canada, a 1989 description is: “Defense assets refer to the various types of assets, whether lands, buildings, works or equipment, used for national defense.” In some jurisdictions assets held for defense are treated as consumables for accounting purposes, that is, they are accounted for as current expenditure when paid for. A contrary view was reached by a Canadian study Group that: “defense assets have the same essential characteristics as other physical assets held by a government and should be accounted for in a similar manner.”\(^{13}\)

The references to defense assets as a separate category appear to rely on custom to justify separate treatment rather than conceptual differences with other kinds of assets. Such assets have the same characteristics as other assets and similarly have limited useful lives.

**Physical Assets - Natural Resources**

A 1989 Canadian description of natural resources is:
“Natural resources are economic resources in their natural undeveloped state. They can be further categorized as renewable or depletable. Renewable resources are those natural resources that can be developed and managed to produce a sustained yield for an indefinitely long period. Examples of renewable natural resources are farm land, forests, fish stocks and water for electricity generation, irrigation, recreation and consumption. Depletable resources are such natural resources as petroleum and mineral deposits that will diminish to the point of exhaustion over the period of their production. If not managed to provide a sustainable yield, renewable resources can also be depleted. The [Canadian] PSAAC in Public Sector Accounting Statement 2 identified natural resources as an area for future accounting research and noted the desirability of providing information on natural resource transactions in government financial statements:

‘Governments also enter into transactions by which the ownership of natural resources is transferred to outside parties. Financial statements could provide useful information about these transactions since administering public natural resources is an important responsibility of government and such resources may represent important sources of future revenue.’” 8

**Physical Assets - Community Assets**

0.055

The term is used in the UK guidance for local government.

“Community Assets: Assets that the local authority intends to hold in perpetuity, that have no determinable useful life, and that may have restrictions on their disposal. Examples of community assets are parks and historic buildings.” 6

**Intangible Assets**

0.056

A definition of intangible assets as applied in the public sector is as follows:

“For accounting policy purposes, intangible assets are classified into identifiable and non-identifiable intangible assets.

Identifiable intangible assets are those intangible assets which can be sold or acquired separately from other assets. They include rights that are created by virtue of legislation but are unconnected to natural resource use, patents, databases and concessions.

Non-identifiable intangible assets are all other intangible assets. These assets cannot be sold separately. They include goodwill, human resources and the power to tax.

(a) Identifiable Intangible Assets
- Rights Unconnected to Natural Resource Use
  Rights created by virtue of the Crown’s sovereign power are not to be capitalised.
- Other Identifiable Intangible Assets
  The asset is to be recorded at net current value only if there is foreseeable future service potential or economic benefit to the Crown.

(b) Non-identifiable Intangible Assets
Non-identifiable intangible assets should not be recorded.” 14

Different views exist on some aspects of this definition. For example, it may be argued that the power to tax is not an asset because the required past event (for example, earning of income) has not occurred.

0.057

The State is a source of intangible assets for other entities by issuing licences, patents to inventors, rights to fishing quota, rights to prospect, rights to use parts of the radio spectrum and so on. These rights are in effect delegations of sovereign power. While the power to issue such delegations does not meet the definition of an asset, the rights,
once issued, are assets for those who acquire them, and depending on whether the characteristics of an asset apply, the right may be an asset of the State when it has been formally created and before it is sold. As with any intangible asset, varying difficulties of recognition and measurement may exist for any entity, but a right available for issue by the State will often have the required characteristics of an asset.

Footnotes - Chapter 2

1 International Accounting Standards Committee (IASC); “Framework for the Preparation and Presentation of Financial Statements”, paragraph 49(a), July 1989.


4 Chartered Institute of Public Finance and Accountancy (CIPFA) Capital Accounting Steering Group (CASG); “Capital Accounting in Local Authorities”, 1990, paragraph 2.15.


6 The description of the term has been adopted in the CIPFA “Code of Practice on Local Authority Accounting in Great Britain - a Statement of Recommended Practice” London, September 1993.


8 Canadian Institute of Chartered Accountants Research Study; “Accounting and Reporting for Physical Assets by Governments”, CICA 1989; for heritage assets, see paragraphs 34-40; infrastructure, see paragraphs 22-33; natural resources, see paragraphs 48-51.


10 Australian Accounting Research Foundation (AARF); Exposure Draft (ED) 42C, “Definition and Recognition of Assets (see paragraph 14) AARF, 1987.


public sector business enterprises. However, government entities which control such enterprises may continue to employ the cash basis or other accounting bases.

As financial reporting moves along the continuum from cash towards accrual accounting, the financial reports will evidence accountability for more of the entity’s assets. More detailed issues of recognition and measurement arise towards the accrual end of the continuum. For example, full accrual accounting raises issues such as when and how libraries, monuments and other historical treasures, parklands, natural resources, intangible assets or infrastructure assets such as roads, should be recognized in financial statements.

The decision about which assets should be recorded in the financial statements should be made with reference to the objectives the financial reports are intended to satisfy and the messages to be highlighted by those financial statements. The voluntary adoption of accrual accounting by Swedish local authorities is said to have been motivated by the need to “devise more effective solutions to the problems arising from a precarious economic situation. An increasing number of authorities are looking for competitive alternatives, which in itself will tend to exert a downward pressure on costs.”

Study 2 sets out the types of items that would be reported as assets under different bases of accounting. Figure 3.3 of that Study provides a useful focus for consideration of particular classes of asset and is accordingly reproduced below.

**FIGURE 3.3**  
**ASSETS REPORTED BY DIFFERENT BASES OF ACCOUNTING**

<table>
<thead>
<tr>
<th>Cash Basis</th>
<th>Modified Cash</th>
<th>Modified Accrual</th>
<th>Full Accrual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Balances</td>
<td>Cash Balances</td>
<td>Cash Balances</td>
<td>Cash Balances</td>
</tr>
<tr>
<td>Within X Days</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Investments</td>
<td>• Investments</td>
<td>• Investments</td>
<td></td>
</tr>
<tr>
<td>• Inventories for Sale</td>
<td>• Inventories for Sale</td>
<td>• Inventories for Sale</td>
<td></td>
</tr>
<tr>
<td>• Loans Outstanding</td>
<td>• Loans Outstanding</td>
<td>• Loans Outstanding</td>
<td></td>
</tr>
<tr>
<td>• Revenues Receivable</td>
<td>• Revenues Receivable</td>
<td>• Revenues Receivable</td>
<td></td>
</tr>
<tr>
<td>• Other Receivables</td>
<td>• Other Receivables</td>
<td>• Other Receivables</td>
<td></td>
</tr>
<tr>
<td>Physical Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Inventories for Use</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Plant and Equipment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Infrastructure Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Accounts receivable are usually defined as those amounts receivable with 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.*

Taxes receivable may sometimes be part of accounts receivable under the modified cash basis, but will usually be included in the modified accrual basis and will always be included in reporting under the full accrual basis.
Acquisition of Assets

Effect of Basis of Accounting on Acquisition Records

The need for non-financial records (description, location, etc.) of assets acquired is identical regardless of the accounting basis.

Acquisition of Assets under the Cash Basis and the Modified Cash Basis

Under the cash and modified cash bases, only the cash outflow associated with the acquisition of assets will be included in the financial report. How to describe such a transaction in the financial report is discussed below at paragraph .070.

Acquisition of Assets under Modified Accrual Basis

Under the modified accrual basis, the situation will be the same except for the assets included as “realizable assets.”

Acquisition of Assets under the Full Accrual Basis

Under the full accrual basis, all assets that meet the particular government’s definition of “asset” and its recognition criteria will be reported in the financial report. Such a definition may be drawn from generally accepted accounting practice. As quoted earlier, Study 2 cites the IASC definition of asset, that is: “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.”

Asset Acquisition Reporting

Where assets are recorded under any of the bases of accounting discussed, careful distinction is necessary between expenditure applicable only to the current period (expense) and expenditure to secure future service potential (capital). Even under cash bases, users of the financial reports are highly interested in distinguishing regular operating expenditure from non-recurring expenditure, such as expenditure on assets to provide benefits in later periods. Users seek to separate the totals of recurring operating expenses required to provide ongoing services from non-recurring expenditure. Sometimes financial regulations require local authorities, for example, to prevent operating expenses from exceeding operating revenue — in such situations, identification of a material expenditure as capital or operating can have significant political and legal consequences.

Public sector entities may make grants to another entity to permit the recipient to acquire or construct assets. Such expenditure has been known to be reported by the public sector body making the grant as capital expenditure, although it has obtained no rights of ownership or control. In such a case, the public sector entity making the grant has no asset and the description is likely to mislead users of the financial report.

Acquisition and Asset Records

To distinguish between current period expenses and expenditure to secure future economic benefits or service potential (capital expenditure) becomes increasingly significant as more classes of assets are recognized in the financial reports, or where a government is considering extending the classes of assets recognized in the financial reports. The French government is currently listing real estate assets acquired in an asset register with their cost of acquisition. Eventually, such a database could enable the preparation of financial reports on a historical cost basis in terms of the reported intention of the French government to achieve “progressive capitalized of physical assets.” Iceland requires national public sector entities reporting on a modified accrual basis to publish a special ten-yearly asset report, disclosing physical assets valued at depreciated replacement value. These asset values are not recognized in the government balance sheet. A similar requirement exists in separate legislation for

Disposal of Assets

Effect of Basis of Accounting on Disposal Reporting

Where an asset has been recognized in the statement of financial position and is disposed of in the subsequent period, there will usually be a difference between the proceeds of disposal (if any) and the carrying amount included in financial report. Such a residual is an expense or revenue in the period of disposal.

Where an item has not been recognized in the statement of financial position, the total net cash proceeds from or cash costs of disposal (if any) affect the financial report of the period of disposal. Care is required in reporting such transactions when a receipt is material, so that users understand the non-recurring nature of what has happened and its effect on the reported surplus or deficit for the period.

Consumption of Assets

Effect of Basis of Accounting on Consumption Reporting

An asset can be regarded as consumed if its service potential declines from its acquisition to its eventual disposal — for example, a bridge's expected future useful life may decline with time, wear, or for some other reason.

Private sector depreciation accounting proposes the allocation of the recognized gross value (whether historical cost or valuation) of an asset over the "useful life" of the asset. The "useful life" is measured in time or units of production or of service. The relevance of this approach for applicable public sector assets (usually, but not always, physical assets) is discussed later in paragraph .189.

Consumption Reporting and the Cash, Modified Cash and Modified Accrual Bases

Under the cash, modified cash and modified accrual bases, the assets recognized will rarely have a "useful life" in the sense that their service potential will be consumed by use or over time.

Under these bases, it is implicit in the reporting of expenditure on assets other than cash or the financial assets recognized, that such assets not recognized are treated as entirely consumed for financial reporting purposes in the period of the original expenditure. Many argue that this assumption is unrealistic and severely limits the value of the financial reports for users.

Consumption Reporting and the Full Accrual Basis

Under the full accrual basis, the recognition of a wide range of assets entails the recognition for appropriate assets of the periodic consumption of their service potential, and indeed, this is one of the advantages claimed for the basis. The generally accepted accounting practice is to report the periodic loss of service potential as a period expense (depreciation expense) and as an addition to the cumulative depreciation provision deducted from the gross value of the asset.

Debate continues on whether the calculation of period depreciation/loss of service potential is intended to provide an approximation of the current value of the asset in question, or whether it is intended to allocate the asset value in some rational manner over its useful life. This debate is of major concern to public sector entities adopting the full accrual basis and therefore recognizing major public sector assets in the statement of financial position.

To recognize the periodic consumption of public investment in infrastructure (and by implication the future financial effect of restoring service potential) is to introduce into public sector financial reports totals of non-cash
expenditure that may dwarf other reported financial activity. This information may be unwelcome to politicians and taxpayers alike. However, Rowles cites studies from Australia and the US that the absence of generally available financial information about public infrastructure has prevented effective financial planning and provision being made to ensure maintenance and replacement of infrastructure assets as they reach the end of their useful lives. Further, some studies in Australia suggest that total investment in public sector infrastructure assets approached levels beyond what is sustainable in the long term. Also, under full accrual accounting, asset acquisitions are no longer fully "expensed" in the period of acquisition, reducing what may be a systematic bias against investment in infrastructure assets.

Footnotes - Chapter 3


4 International Accounting Standards Committee (IASC); "Framework for the Preparation and Presentation of Financial Statements", paragraph 49(a), July 1989.

5 Jones, Martha; "Accounting for Capital Property - Asset or Expenditure?", FMI Journal, November 1993.

6 IFAC PSC; Study 1: Financial Reporting by National Governments; Appendix D, paragraphs 19(c) and 21, March 1991.

7 Iceland Act #52 on Governmental Accounting, Governmental Financial Reports and Governmental Budgeting, Article 47; Iceland, 1966.


CHAPTER 4
RECOGNITION AND REPORTING ISSUES UNDER DIFFERENT ACCOUNTING BASES

Introduction

Recognition Criteria

"Under the IASC Framework, determining which items should be recognised 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."\(^1\)

The first step, discussed in chapter 2 above, is found in the IASC definition of an asset which states: "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."\(^2\)

The second step is discussed in Study 2, which quotes IASC Framework\(^3\) to the effect:

"...assets and liabilities should be recognised...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."\(^4\)

Framework of Chapter 4

This chapter follows the structure of figure 3.3 of Study 2 — that is, the chapter deals with recognition and reporting for each accounting basis for the following assets:

(i) cash balances;
(ii) realizable assets;
(iii) investments;
(iv) inventories for resale;
(v) loans outstanding;
(vi) revenues receivable;
(vii) other receivables; and
(viii) physical assets
   - inventories for use
   - plant, equipment, etc.
Also discussed in this chapter are infrastructure assets and intangible assets, as significant sub-sets of non-current assets, and other assets reported only under the full accrual basis.

Cash Basis

Objectives of Financial Reporting Addressed by the Cash Basis

The cash basis “can be used as an effective basis to demonstrate compliance with spending limits and with other legal and contractual requirements... The sources, allocation and uses of cash resources can be presented... and, if used as the basis of budgeting, cash requirements can be presented.”

Cash Basis - Recognition

Asset Balances Using the Cash Basis

Only cash or temporary investments in certain (for example, fixed term) marketable securities (“near cash”) will be recognized. Cash will include cash in hand, cash in transit and cash on deposit. All other assets will be mentioned only in relation to the cash effects of their acquisition or disposal.

Difficulties will rarely be encountered when establishing that assets reported under the cash basis meet the definition of an asset or the recognition criteria for an asset.

Cash Basis - Reporting

The reporting of cash or “near cash” should be relatively straightforward except where transactions and cash balances involve foreign currency. The terms, conditions and method of valuation for securities equivalent to cash or for bullion are important to users of the financial reports. For example, the US Consolidated Financial Statements include the following disclosures: “Gold is valued at market for fiscal 1991 and 1990. The market value represents the price reported for gold on the London fixing, and is based on 261,997,305.105 and 261,900,961.817 fine troy ounces as of September 30, 1991 and 1990, respectively (as reported by Treasury's general ledger). The statutory price of gold is $42.2222 per ounce.”

Expenditure on Other Assets

The annual costs of acquiring or constructing other assets will appear as expenditure in the financial reports of entities using the cash basis. Disclosures of such acquisitions are usually categorized as “capital” if they are expected to have a life of some period in excess of a year, but a wide range of rules and practices are encountered in descriptions and treatments even within one country. Within the class of capital expenditure, annual asset expenditures may be reported by type (land, buildings, etc.) and/or function (health, defense, etc.). However, although this description conveys the notion that benefits will be received in later periods, no recognition of these benefits is included in the balance sheet.

Grants for Capital Expenditure by Other Entities

In addition to acquiring or constructing assets to be held by the government, governments often make payments to other entities so that other entities may acquire assets, as for example, grants to universities for capital works. Such expenditures are for capital purposes, but may not create any physical asset under the control of an entity. These expenditures do not create an asset in terms of the accounting definition of an asset, but they may be described as “capital expenditure” in the statement of revenues and expenditures in terms of a particular government’s rules of reporting. Such use of the term “capital expenditure” is not consistent with the same words to describe the acquisition of assets of the entity as discussed above in paragraph .070.
Narrative about Assets Not Recognized

Assets, other than cash, which are held but not recognized in the statement of financial position may be described by note.

Modified Cash Basis

Objectives of Financial Reporting Addressed by the Modified Cash Basis

"Simple modifications of the cash basis meet the same objectives, to the same extent, as the cash basis itself. The focus is on the flow of current financial resources, however, and there may be less room for manipulation." 7

The modified cash basis reports cash assets and, additionally, the financial asset represented by the total of accounts receivable within a specified number of days after balance date.

Cash Balances

The recognition and reporting of cash balances are the same for the modified cash basis and the cash basis — that is, the disclosure of cash on hand, cash in transit, cash on deposit and temporary investments in marketable securities.

Modified Cash Basis - Recognition

Revenues Receivable Using the Modified Cash Basis

The modified cash basis involves the inclusion of revenues receivable as specifically defined by government. In addition to the cash recognition questions discussed above, recognition of accounts receivable requires consideration of whether the receivable meets the asset definition and the recognition criteria. To meet the objectives of the modified cash basis, clear rules are required for when revenue and the consequent debt receivable are to be recognized. Such rules may vary from jurisdiction to jurisdiction.

Timing of Recognition of Revenues Receivable

"Revenues should be accounted for in the period in which the transactions or events occurred that gave rise to the revenues. Items not practicably measurable until cash is received would be accounted for at that time." 8 The timing of recognition of revenue arising from exercise of sovereign power is less simple, as taxation might be recognized — for example, at assessment, or when payable, or at some other stage.

Collectability of Receivables

Asset recognition criteria require that receivables are also reviewed in terms of collectability and the totals adjusted to reflect uncollectable receivables.

Exclusion of Internal Charges

The definition of a reporting entity will be significant in determining which receivables are recognized; it is common for government operations to provide services for and to invoice other parts of government. Such charges are only revenue (and give rise only to assets) when payment is due from outside the reporting entity.

Modified Cash Basis - Reporting

The reporting of cash will be as under the cash basis. The reporting of accounts receivable should include disclosure of measurement policies. Other disclosure may include disclosure of the gross amount outstanding less
provision for doubtful debts, but the amount of receivables expected to be realized is always to be disclosed. For example, the US Consolidated Financial Statements include the following disclosures for accounts and loans receivable: “All receivables in the Statements of Financial Position are shown net of allowances for doubtful accounts. Receivables exclude inter-governmental amounts.”

**Modified Accrual Basis**

**Objectives of Financial Reporting Addressed by the Modified Accrual Basis**

.100 “As one moves along the spectrum from cash to full accrual, more of the objectives of financial reporting can be met. For example, reporting on an expenditure basis is an appropriate basis for planning because it focuses on cash requirements and financing needs. It is also a relevant basis for measuring financial results by showing: the extent to which revenues were sufficient to meet expenditures, and either the future revenue required to pay for past transactions or the financial assets on hand that can provide resources for future operations. It is a key measure of a government’s or unit’s financial condition because it relates directly to future revenue requirements and the government’s or unit’s ability to finance its activities and meet its liabilities and commitments.”

**Modified Accrual Basis - Introduction**

.101 Under the modified accrual basis, the statement of financial position should account for the difference between a government’s liabilities and financial assets at the end of the accounting period. This difference provides users of the financial reports with a measure of the future revenues required to pay for past transactions and events, or the financial assets on hand which can provide resources to finance future operations or to meet existing or future liabilities. The assets recognized in the statement of financial position are those which can be considered available for financing payments of existing liabilities and operations in the immediate future. Such a view of availability implies assumptions that no physical assets acquired may be realizable, and that all loans receivable are readily realizable. The actual position will be much more complicated and, in practice, assessment of the financial condition will require analysis and information about unrecognized items. Such information will not usually be available to users.

**Modified Accrual Basis - Recognition**

**Recognition and Reporting Cash Balances and Revenues Receivable**

.102 Under the modified accrual basis, the recognition and reporting of cash balances and revenues receivable are the same as those used in the modified cash basis and the cash basis.

**Financial Assets**

(a) *Financial assets for the modified accrual basis*

.103 Figure 3.3 of Study 2 lists financial assets for the modified accrual basis as:

- investments;
- inventories for sale;
- loans outstanding;
- revenues receivable; and
- other receivables.
(b) Modified accrual basis recognition - investments

.104 To meet the objectives of the modified accrual basis it is important that assets recognized as investments should meet clearly identified conditions for possible realization to meet the liabilities reported. Such conditions may vary from jurisdiction to jurisdiction. It should be expected that assets described as investments will be transferable and acceptable to other investors so that users can compare assets recognized with liabilities recognized.

.105 Investments which conform to the expected conditions of possible realization will meet the definition of an asset and recognition criteria.

.106 Governments may sometimes hold saleable investments which are not available for realization. To recognize such investments would not meet the objectives of the modified accrual basis.

.107 It is an anomaly of the modified accrual basis that investments to control physical assets are recognized when identical physical assets are not recognized. For example, the purchase of a forest would not be recognized in the balance sheet although the purchase of a company that owned the same forest would appear in the balance sheet under this basis. It is possible the forest could be sold as readily as the investment in the forest owning company.

(c) Modified accrual basis recognition - inventories for resale

.108 Under the modified accrual basis, the assets recognized “do not include inventories of supplies, equipment, and other acquired physical assets with useful economic lives extending beyond the accounting period that are intended for consumption in the normal course of operations and that do not normally provide resources to discharge existing liabilities or finance future operations.” 11 Thus, the only physical assets recognized in the statement of financial position under the modified accrual basis are those where early realization for cash rather than consumption can be regarded as part of the usual operations of government.

.109 These inventories described above meet the definition of an asset. To meet the recognition criteria, it is necessary that their existence and value is established with reliability — this can be achieved by well-established accounting techniques.

(d) Modified accrual basis recognition - loans outstanding

.110 To recognize loans outstanding as financial assets under the modified accrual basis, it is necessary that their expected repayment will be available to discharge existing liabilities or finance future operations. However, it is common for governments to make loans for non-financial reasons, and complexities arise in considering whether such loans can be recognized in order to meet the objectives of modified accrual financial reports. These complexities are discussed in the Canadian Public Sector Accounting Recommendation, “Loans Receivable”.12 For example, governments may use loans to subsidize borrowers by offering loans with concessionary or forgivable terms, or they may provide funding to enable borrowers to repay their loans to the government. In other cases, government may offer loans to those who are unable to borrow from the market on commercial terms. Recognition of such loans meets only the objectives of financial reports under the modified accrual basis where the loans recognized will provide resources as reported to meet liabilities. The measurement issues involved are discussed in chapter 5 in paragraph .182.

(e) Modified accrual basis recognition - other receivables

.111 Governments have a wide range of inflows, such as cost recovery measures, joint venture contributions, proceeds of asset sales, and so on, that fall outside the term “revenues receivable”. However, where such receivables meet asset recognition criteria and are recognized, the objectives of the modified accrual basis are met and users are informed about the financial resources available to meet liabilities reported.
Modified Accrual Basis - Reporting

(a) Modified accrual basis reporting - recognition policies

The paragraphs above refer to identified conditions for recognition of assets to meet the objectives of the modified accrual basis — such conditions may differ between public sector entities and are entirely different to private sector practice. Users should therefore be informed of the policies adopted to define financial assets for recognition.

(b) Modified accrual basis reporting - measurement policies

Measurement policies adopted for the assets recognized require disclosure so that users can compare assets reported with liabilities reported. Measurement issues are discussed in chapter 5.

(c) Modified accrual basis reporting - classification of assets

Within the categories of revenues receivable, loans outstanding, etc, sub-categories may be shown to inform users. Such sub-categories may assist users in comparing assets reported with liabilities reported. Classification issues are discussed in chapter 6.

Full Accrual Basis

Objectives of Financial Reporting Addressed by the Full Accrual Basis

"The accrual basis provides users with information about such matters as the resources controlled by the entity, the cost of its operations (or cost of providing services) and other information useful in assessing financial position and changes in it, and in assessing whether the reporting entity is operating economically and efficiently." 13

Introduction and Background to Adoption of the Full Accrual Basis in the Public Sector

The full accrual basis accepts reporting of all assets which meet the generally accepted definition of an asset and recognition of these assets where recognition criteria are met. Thus, in addition to the financial assets recognized under the modified accrual basis, the financial reports will deal with physical assets and other assets. The full accrual basis is, of course, the sole basis adopted by the for-profit private sector. A very wide constituency of professionals exists which is accustomed to preparing, auditing and analyzing reports prepared on this basis together with a body of generally accepted accounting practice, which may differ in particular aspects from jurisdiction to jurisdiction, but is generally accepted.

In the context of applying some parts of private sector practice to public sector accounting, the proposals of the Comité Secteur Public of the French Ordre National des Experts Comptables are of interest. The Comité Secteur Public based its recommendations for reform of French local government on the application of (private sector) PCG-82, the French national standard accounting code. 14

Readers should note that adoption of the full accrual basis does not imply loss of information. The information available under the cash, modified cash or modified accrual bases, continues to be available under the full accrual basis. For example, in commercial practice, it is usually mandatory for an entity to provide a cash flow report as well as accrual financial reports. Nor does the adaptation of accrual accounting reduce the importance of good cash management to a government. However, governments adapting full accrual accounting will need to consider carefully the implications for their budgeting and appropriations systems, as it is usually desirable to budget, appropriate and report on the same basis.
.119 Growing demands on scarce resources have encouraged interest in full accrual accounting. Examples of the interest in recognizing physical assets can be found in:

(i) the work of the Comité Secteur Public in France;

(ii) the UK Chartered Institute of Public Finance and Accountancy (CIPFA) “Code of Practice on Local Authority Accounting in Great Britain”;


(iv) the New Zealand Public Finance Act 1989, the New Zealand Local Government Amendment Act (No. 2) 1989 and national and local government reports produced in accordance with this legislation;

(v) the application of private sector accounting principles by Swedish local authorities since 1986;


(vii) the Canadian Public Sector Accounting and Auditing Board’s project on “Accounting For and Reporting Capital Property of Government”. Work on this topic is also proceeding within the Canadian federal and provincial governments; and

(viii) the application of accrual accounting in Dutch provinces and municipalities since 1985, and the production of a “State’s Balance Sheet” by the Dutch government.

.120 Unlike other bases of accounting, where the items recognized as assets are generally accepted without debate, under the accrual basis there is a range of items which may or may not be regarded as assets. Such items require careful attention to recognition criteria and the asset definition adopted by the government in question. A national government has access to a wide range of resources and items with service potential. Many, but not all, such resources may be assets as defined for financial reporting purposes. In a significant number of cases, assets may meet the asset definition, but may not meet the criteria for recognition in financial reports. The public sector is no different from the private sector in this respect, but unfamiliarity with the recognition of some assets leads to more debate on the recognition of particular groups of assets.

Asset Definition Criteria

.121 Although governments, like private sector entities, hold assets for the provision of services, generation of financial income from an asset is normally an intermediate rather than a primary objective. Given the sovereign power to requisition and to tax, governments have potential control over all assets in their jurisdiction. However, both the objective of financial reports in providing information useful to users and the way a government interprets “past events” in commonly used asset definitions can provide limits to the scope of potential government assets.

.122 When rights to control an asset are unclear, asset recognition requires care, whether in public or in private sector financial reports. Particular difficulties relate to the State’s control over natural resources. A state-owned coal mine’s coal reserves are unlikely to be disputed as an asset, but to what extent should the State’s rights over minerals underground in general be regarded as an asset? There are differing views as to whether such assets should be recognized in the financial reports or should be disclosed only by note, if at all. Areas of sea within a government’s jurisdiction are similarly debated as to whether the future economic benefits and service potential controlled in such assets ought to be included in asset values in the financial reports. Even those who support recognition of physical assets, in general, ignore such assets unless specified service potential has been identified as being under direct government control — for example, off-shore oil extraction operations, repurchased fishing
rights, marine national parks. Similar issues for debate arise over the recognition or non-recognition of government control over the radio broadcasting frequencies as a financial asset.

The resolution of such problems can be sought by applying the provisions of Study 1 (discussed above), first in the application of the definition of an asset (paragraph .030) and then in the recognition criteria (paragraph .083). If an item meets these criteria, then under the full accrual basis, the item is an asset to be recognized. In general, most of the items questioned as assets in the public sector can be found to have parallel instances in the private sector. Such instances have been included or excluded in the private sector in conformity with generally accepted accounting principles and standards for private sector financial reporting. If assets meet asset definitions and conform to recognition criteria, they should be recognized regardless of whether their function is to provide services or to generate profit. Using the full accrual basis, an asset in the private sector is an asset in the public sector in so far as the two sectors use the same definition of an asset.

An example of the application of such an approach is the New Zealand ‘Treasury Instructions’:

"Natural resources are economic resources in their natural and undeveloped state:

(i) land;
(ii) forest land;
(iii) forests (trees);
(iv) oil fields; and
(v) other.

Each natural resource is to be divided into its component parts, eg. land, associated resources (if any) and right over the resources (if any). Where a right is granted for the use of the resource, the economic benefit resides in that right. On the other hand, where a right has not been granted, the economic benefit resides in the resource itself. The value of a right is to be capitalised if:

(i) there is an intention to realise/exercise the right; and
(ii) net current value of unsold rights can be measured objectively.

In this event, the payment received in respect of the sale of a right is to be treated as a capital receipt.

Land: Land is to be valued at net current value. Hence, land with a resource on or beneath its surface is to be recorded at the value of similar property situated in the same area that does not have the benefit of the natural resource.

Resources: The resource is to be valued at net current value."

For another view of natural resources as public sector assets, see paragraph .054 for the 1993 Canadian description.

**Full Accrual Basis - Recognition**

**Recognition Criteria**

The following criteria have been quoted earlier in this chapter, but the criteria are repeated because of their significance to the application of the full accrual basis:

"Under the IASC framework, determining which items should be recognised 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 liability; and
(ii) determining whether the item satisfies the recognition criteria."  

16

.126 The first step has been discussed in chapter 2 and can be found in the IASC definition of an asset which states: "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."  

2

The second step is discussed in Study 2, which quotes the IASC Framework to the effect:

"...assets and liabilities should be recognised 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."  

4

.127 The first half of the recognition criteria may be no more difficult to apply in public sector reporting than in private sector reporting. However, cost records or valuation market standards do not exist for many state assets which meet the definition of asset above. This absence of the means to measure value and hence to meet the second half of the recognition requirements poses questions about the meaning of "to measure reliably the value of assets".

.128 To distinguish between "reliable" and "not reliable" measurement requires a judgement of the qualitative characteristics of the information involved in relation to the needs of users of financial reports. Narrative disclosure is available, of course, to inform users of the background to the account preparer's exercise of judgement, and to share any particular information necessary to interpret the fact of recognition or non-recognition.

.129 "To communicate effectively, financial reports must reflect certain characteristics. Qualitative characteristics define and describe the attributes of financial information that make it useful to users..."  

17

.130 Conflict between qualitative characteristics is unavoidable, and it is a matter of professional judgement to assess which balance between competing characteristics best meets the needs of users of financial reports. In recognizing and reporting public sector assets, such conflicts are as common as they are in the private sector.

.131 Two qualitative characteristics are relevance and reliability. Reliability is achieved through representational faithfulness and verifiability. The financial report representation of an asset is verifiable if knowledgeable, independent observers agree that reporting reflects the actual underlying transaction or event with a reasonable degree of precision. However, the characteristics, based as they must be on professional judgement, remain subjective. Real estate valuation practices, for example, are highly developed, but real estate valuation remains a matter of opinion rather than objective fact.

.132 Verifiability focuses on the correct application of a particular basis of measurement rather than its appropriateness.

**Application of Recognition Criteria in the Public Sector**

.133 Governments seeking to change to an accrual basis of accounting will usually be unable to establish useful opening asset values based on cost of acquisition for many material classes of assets, because records of initial acquisition frequently do not exist. Thus an initial valuation of such assets is often required, if only to establish an opening value for an accrual accounting basis to continue on historical cost lines in the future. Even where acquisition costs exist, current valuations may be more appropriate due to changes in asset prices subsequent to acquisition.
Currently, those who have recognized major physical assets in government financial reports have stressed relevance over reliability in measurement and have accepted that the "reasonable degree of precision", mentioned above, should be interpreted less stringently. Measurement of infrastructure assets, for example, is difficult because no market may exist for such assets and because private sector valuation standards, with their benchmarks or reference to cash inflows, may not be appropriate for a non-profit situation. A typical solution is to measure such assets at an optimized depreciated replacement cost value, which ascribes value on the basis of depreciated replacement cost, adjusted for any excess of capacity embodied in the asset. A balance can be struck between the qualitative characteristics of relevance and reliability. Information on the extent of financial investment in roads, for example, is highly relevant for users of financial reports, and the search for relevance may justify some sacrifice of reliability. In either sector, private or public, professional judgement must be exercised when balancing relevance and reliability in relation to recognizing any item in financial reports.

To meet the reliability criterion for asset recognition involves costs of valuation and therefore questions of benefit / cost. The benefits are seen as being for users of financial reports while the common perception is that the costs of time, personal effort and money are the responsibility of the reporting entity's governing body and executive. There is often a natural, if mistaken, resistance by the management of reporting entities to recognize previously unrecognized assets. Nevertheless, when an entity has established the identity and the value of its assets, this information will be of benefit to the entity in seeking to achieve its objectives.

When assets held by a public sector entity are of a class where an active market exists, (certain financial instruments, for example) then the task of achieving sufficient reliability to justify recognition can follow established practice. Markets for a specific service may exist outside the particular jurisdiction. For example, certain utilities, such as water or electricity supply, are privately operated and shares in the operating entities may be traded elsewhere. In certain circumstances the values attributed to these private sector operating entities can provide guidance on the value of public sector assets employed in the same field.

Recognition or Non-recognition of Infrastructure Assets

It is difficult to argue that items such as road systems, power reticulation, etc. (described in chapter 2, paragraph .041) fail to meet the definition of an asset given in chapter 2. One argument presented is that governments are unable to deny or regulate access to roads, for example, and therefore do not control the item in terms of commonly accepted asset definitions. This argument ignores the common practices of governments in setting and enforcing road-user charges, for example, or in traffic regulation such as restriction of access to motorway systems, bridges, minor roads and so on.

If infrastructure systems are agreed to meet the definition of an asset, the question remains about whether they can be measured with sufficient reliability to justify recognition under the full accrual basis or some basis approaching full accrual. This question is of major concern in relation to public sector financial reports, as the assets in question are large both in physical terms and in terms of past expenditure. For example, in one New Zealand municipality of less than 500,000 inhabitants, the replacement value (undepreciated) of road, drainage and water reticulation is reported at NZ$3.4 billion, approximately US$1.87 billion. The debate in the United Kingdom illustrates the development of views on this topic. Measurement of infrastructure assets is discussed further in chapter 5, paragraph .171 onwards.

Internationally, there are differing views on the recognition of physical assets and, as might be expected, debate has focused on infrastructure and heritage assets, in particular. One approach was that of the United Kingdom CIPFA Capital Accounting Steering Group (CAGS), "Capital Accounting in Local Authorities", which included recommendations for the setting up "of full asset registers and for the inclusion of assets in the balance sheet at their current value to the authority, with the exception of infrastructure and other specialised or historic assets which may be held at unamortised cost." These views can be compared with the descriptions and treatments in the subsequent 1993 CIPFA "Code of Practice on Local Authority Accounting in Great Britain", which recommends that "infrastructure assets and
Community assets should be included in the balance sheet at historical cost, net of depreciation, where appropriate", while other fixed assets "should be included in the balance sheet at the lower of net current replacement cost or net realisable value ..." 22

.141 Reporting of public sector infrastructure assets by state and local governments in the US is optional under the AICPA industry audit guide23. Where included, these assets are not depreciated. A survey in 1986 by the US Governmental Accounting Standards Board identified a requirement for information on deferred maintenance as a means of indicating what expenditure is required to restore assets to prime condition.

Recognition or Non-recognition of Heritage Assets

.142 Descriptions of heritage assets have been given in chapter 2 from paragraph .047 onwards.

.143 Debate of the recognition of heritage assets turns on whether sufficiently reliable measurement of values can be established to justify recognition of unique items usually unavailable for sale. Measurement of heritage assets is discussed in chapter 5 from paragraph .173.

Full Accrual Basis - Reporting

Reporting Under the Full Accrual Basis - General

.144 Once questions of asset recognition have been resolved, reporting under the full accrual basis needs to inform users in terms of the objectives discussed in Study 1. As the range of assets recognized is broader, more detail may be required, particularly in the early stages of adoption of the full accrual basis by a public sector non-business entity. However, existing generally accepted accounting practice in the private sector will often be applicable to asset reporting in these public sector financial reports and may simplify the task of explanation.

.145 In general, reporting of conventional assets such as land, buildings or plant will follow private sector generally accepted accounting practice, including the reporting of accumulated depreciation where appropriate. However, some assets may need to be supported by additional information where the asset is of major political significance (heritage assets or national parks, for example) or of major social or economic importance (infrastructure systems, for example).

Reporting Under the Full Accrual Basis - Unrecognized Assets

.146 Users of financial reports prepared under the full accrual basis (or a basis approaching full accrual) will have the expectation that all significant assets have been recognized. However, particularly when the full accrual basis is first adopted, many significant assets may be unrecognized for pragmatic reasons or because recognition criteria cannot be met. Where significant assets are unrecognized, narrative details should be provided.

Reporting Under the Full Accrual Basis - Heritage Assets

.147 Debate exists between those who argue for reporting to show a market assessment of value and those who argue for recognition of a symbolic value as appears in one example of heritage asset reporting ("The Castle £1"). This is discussed in chapter 5.

.148 Given the current debate over measurement, recognition of heritage assets requires narrative disclosure on the basis of recognition and measurement.

.149 In many instances, heritage assets are subject to general restrictions on disposal (for example, statutory prohibitions on the export of culturally significant items) or to restrictions specific to the asset(s) recognized. Narrative reporting on such restrictions may often be important to users of financial reports.
Historical Cost Reporting of Non-current Physical Assets

Governments, like private sector entities, may follow the generally accepted accounting practice of historical cost as a basis for the recognition of assets — that is, to recognize only the acquisition cost of assets without any recognition of subsequent changes in the value of long-lived assets. In accounting for long-lived assets in this way, the costs of assets are treated as "prepaid" or "deferred" charges. The actual costs required to acquire the assets are allocated over the assets' useful lives as they are used in providing programmes and services. Therefore, programmes and services reflect the actual costs incurred by the government. This practice can provide verifiable information although the information may have little relevance to decision making. In some jurisdictions, for example, the USA or Germany, a tradition of aversion exists to the revaluation of assets above acquisition costs in private sector financial reports. The United Kingdom CIPFA "Code of Practice on Local Authority Accounting in Great Britain" recommends that "infrastructure assets and community assets should be included in the balance sheet at historical cost, net of depreciation, where appropriate." However, land and properties and other assets should be included in the balance sheet "at the lower of net current replacement cost or net realisable value ...". The latter approach gives greater weight to the qualitative characteristic of relevance by representing more effectively the value of the assets.

Consolidation

IFAC PSC is currently developing a Study on "The Government Financial Reporting Entity".

The objectives of financial reports of governments and their major units will determine the range of activities and entities (such as the "major units" mentioned in Study 1) to be covered in each set of financial reports, as the degree of detail or the degree of aggregation provides useful information.

Selection of the appropriate consolidation technique will depend on the relevance of information to users and their decision making, and on the substance of relationships of the reporting entity with subordinate entities. Various financial reporting techniques are available for the consolidation of subsidiary entities for the purpose of financial reporting, depending on the relationships of the reporting entity with entities to be grouped. For political or equity reasons, governments may sometimes wish to be at arm's length with entities which are wholly owned by the reporting entity. In some cases, the reporting public sector entity has less than complete control by being equivalent to a minority shareholder. The amount of sub-entity assets and liabilities recognized in consolidated financial statements will vary depending on which consolidation technique is selected.

It has been argued that relationships between sub-entities and government are more diverse in the public sector than in the private sector. Governments select such arrangements to reflect the degree of detailed direction which the government wishes to exercise over a sub-entity. For example, a government department is typically under the detailed direction of and directly accountable to the minister(s) responsible. On the other hand, governments often set up state corporations to establish distance between political and administrative control from the center and the managers responsible for services. In other cases, service agencies with governing bodies, where the majority of the members may or may not be appointed by the State, are often economically dependent on government finance. In instances where state-related entities are not under detailed government direction, the question arises as to how the State’s stake (if any) in such entities should be reported in the state financial reports. Much attention has been given to this issue of what should constitute the reporting entity in the public sector — reference can be made to published guidance in the USA, Canada, Australia and elsewhere. The question is also pertinent to local government: "Sweden's local authorities own 1,500 joint-stock companies with a total turnover of 60,000 million SEK. Consolidated accounting should thus form part of any future review of local government activities." This view is supported by the proposals of the Comité Sector Public for the progressive adoption of consolidation accounting in French municipalities.
Further problems will arise where different parts or levels of the reporting entity use different accounting policies or accounting bases. The availability of asset information at sub-entity level will affect asset reporting at higher levels of consolidation.

**Full Accrual Basis - Measurement Disclosures**

Users of financial reports are informed by disclosures on asset measurement policies and valuation methods adopted where revaluation has taken place.27

**Footnotes - Chapter 4**

1. International Federation of Accountants (IFAC), Public Sector Committee (PSC); *Study 2: Elements of the Financial Statements of National Governments*, paragraph .097, 1993.


8. Canadian Institute of Chartered Accountants (CICA); *Public Sector Accounting Statement 3*, “General Standards of Financial Statement Presentation for Governments”, paragraph .81, November 1986.


“Natural resources are economic resources in their natural and undeveloped state.”

In relation to natural resources, the following is an example from the New Zealand Crown Accounting Policies:

“Each natural resource is to be divided into its component parts, eg, land, associated resources (if any) and right over the resources (if any). Where a right is granted for the use of the resource, the economic benefit resides in that right. On the other hand, where a right has not been granted, the economic benefit resides in the resource itself. The value of a right is to be capitalised if:

- there is an intention to realise/exercise the right; and
- net current value of unsold rights can be measured objectively.”

Later in this reference, the New Zealand Crown Accounting Policies specify that no asset arising from the exercise of sovereign
power is to be capitalized (see paragraph .034, chapter 2). Such a policy of excluding such assets from consideration for recognition means that the general power to tax is not an asset of a government.


IFAC PSC; Study 1: *Financial Reporting by National Governments*, March 1991, paragraph .065. Study 1 continues with discussion of particular qualitative characteristics in paragraphs .066 through to .074.


Auckland City Council; *Annual Report to 30 June 1992 of Auckland City*. Note 12 on page 35.


The reasons for the CASG view that infrastructure should not be recognized at current value are as follows:

“The application of the proposals to infrastructure assets, whilst a case can properly be made for it in theory, would not commend the general support of practitioners for the simple reason that such assets, for the most part, have no alternative service uses and in many respects can, if properly maintained, be retained in perpetuity. It was accepted however, that the service should bear a charge for the cost of the capital investment.

The treatment of infrastructure assets has been the most technically demanding part of the debate. It has raised issues of whether infrastructure should be accounted for as a perpetual asset, and the treatment of “sunk” costs where there are likely to be no alternative uses. The pilot work demonstrated that the proposed system could be applied to infrastructure, and that the information - although it led to large charges which dominated the service revenue account - did create a wider interest in the uses to which the information could be put, including, encouragingly, amongst members. For example, comparing the annual repairs and renewals expenditure with the gross replacement cost yielded a useful financial management ratio. Also, the comparative investment in highways compared with other services was more clearly shown.

The CASG’s overall conclusion, however, was that applying the original proposals to infrastructure would have been of doubtful value, particularly in giving signals to management, since realisation of infrastructure assets is rarely a practical proposition. The principal concern of management with respect to infrastructure, such as roads, is with maintaining the asset in perpetuity, and this brings forward the prospect of developing a renewals accounting approach through revenue provisions to meet that need.

The CASG’s recommended systems set out in Part V (Statement of Recommended Practice) therefore accounts for infrastructure - as carefully defined - on the basis of amortising historical cost. We propose that an estimate of the gross replacement cost should be recommended to be included as a note to the balance sheet.”

These views should be compared with the descriptions and treatments in the September 1993 CIPFA “Code of Practice on Local Authority Accounting in Great Britain” quoted in paragraph .139.

CIPFA CASG; “Capital Accounting in Local Authorities”, paragraph 2.15, 1990.

The CASG definition of an infrastructure asset is:

“Infrastructure assets - expenditure of a capital nature on an immobile specialised asset, which is recoverable only by continued use of the asset created, which generally will not have a realisable value or earning potential. Such expenditure would normally comprise ‘sunk costs’, which create an asset which cannot reasonably be expected to have any alternative uses other than the purpose for which it was created. Such assets are required generally to be maintained indefinitely. Notable examples of infrastructure assets are roads, sea defences, permanent ways and bridges.”


27 IASC; International Accounting Standard 16, "Accounting for Property, Plant and Equipment", paragraph 50 (b), IASC, 1993. "In cases where property, plant and equipment are stated at revalued amounts, the method adopted to compute these amounts should be disclosed, including the policy in regard to the frequency of revaluations. The nature of any indices used, the year of any appraisal made, and whether an external valuer was involved should also be disclosed."
CHAPTER 5

DISCUSSION OF SOME MEASUREMENT ISSUES

Bases of Measurement - Introduction

.157 The IASC “Framework for the Preparation and Presentation of Financial Statements”, paragraph 99 onward, states: "Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement."

.158 "A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

(a) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition...

(b) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently...

(c) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal...

(d) Present value. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business..."

.159 "The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Further more, some enterprises use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets."

.160 The IASC Framework has been prepared specifically for business undertakings. This chapter will consider the implications of these descriptions of measurement bases for financial reporting of assets by non-business public sector entities.

.161 As with business enterprises, historical cost is the basis most commonly used by public sector entities, although as with business enterprises, certain assets are often measured on a different basis. Other measurement bases have seldom been applied in the non-business public sector. The realizable value basis is appropriate to decision making by a government about a sub-entity to be privatized or wound up, but most public sector entities operate as going concerns where break-up values are not of direct relevance to the financial position and operations of the entity. The present value basis, with its emphasis on the present value of cash flows to be generated by assets, is often used in cost-benefit analysis before creation of major fixed assets. However, it can be difficult and expensive to assign cash flow values to the actual services rendered once the fixed asset is in operation. Consequently, the present value basis is used mainly in special purpose studies of particular assets. Similarly, the present value basis is of limited use, if any, for assets whose service potential is not primarily dependent on their ability to generate net cash inflows.
Of measurement bases described by the IASC, historical cost is commonly used. Where physical assets and non-financial assets are recognized under the modified or full accrual bases, the historical cost basis of measurement is open to criticism for its lack of relevance to the needs of users of the financial reports. As mentioned earlier, public sector non-business entities seeking to extend the classes of assets recognized seldom have historical records of acquisition costs. This will mean that they must initially use a valuation to record the asset — thereafter they may apply historical cost.

**Bases of Measurement - Cash and Modified Cash Bases**

Where financial reports are prepared on a cash or modified cash bases, assets recognized are cash and near cash. Use of the historical cost basis will conform to users' needs in providing an accurate view of the significance of items recognized; only under hyper-inflationary conditions will the basis obstruct seriously the users' understanding of changes in the financial position reported or of the assets held.

**Bases of Measurement - Accrual and Modified Accrual Bases**

**Modified Accrual and Full Accrual Bases - Reductions in Recognized Historical Cost Asset Values**

In the private sector, generally accepted measurement practice modifies historical cost records where:

(i) inventories' realizable value is considered to be less than the cost of acquisition or manufacture;

(ii) revenues receivable and other receivables are estimated to realize less than the amount invoiced;

(iii) repayment of a loan or part of a loan is doubtful;

(iv) plant, buildings or other fixed assets do not meet the "recoverable amount test" (see paragraph .185 below), that is, where depreciated historical cost is in excess of expected future cash flows generated by an asset's income and disposal;

(v) the forecast completion cost of work in progress is estimated to be in excess of its future completed "net current value"; and

(vi) any asset has a permanent diminution in value below the cost of acquisition.

Such reductions of historical cost numbers can appropriately be applied in the public sector where such assets are recognized. The only exception may be the "recoverable amount test" for fixed assets where the service potential of those assets is not primarily dependent on their ability to generate net cash inflows.

There are particular problems in the public sector in measuring financial assets where the government has chosen to provide concessionary terms. The CICA Public Sector Accounting Recommendation "Loans Receivable" proposes the revaluation of loans receivable downwards where the terms of the loan are significantly more favorable to the borrower than loan terms offered commercially in the open market. This is discussed below at paragraph .184.

**Remeasurement of Assets Where Increases from Recognized Historical Cost Asset Values May Occur**

Private sector practices of modifying recognized historical cost values downward are widely accepted internationally. However, it is not so widely accepted that modification of historical cost asset values should be permitted when they lead to an increase in recognized asset values. Certain jurisdictions like Germany and Japan do not accept any form of remeasurement which results in an increase in asset value above acquisition cost. The differences internationally spring from a range of legal, financial and social traditions. Arguments for and against
are colored by the tax effects of any change to accepted measurement bases in a particular country, and by fears of auditors that acceptance of upward revaluation of assets may expose auditors to litigation.

.167 Debate in the private sector centers on the perceived needs of users. Those who oppose remeasurement above historical cost claim:

(i) the purpose of financial statements is not to show the value of the business;

(ii) the current value of an asset is not relevant when an asset is not held for sale; and

(iii) valuation methods are subjective.

.168 Those who support recognition of asset remeasurement above historical cost claim:

(i) users can better assess performance and financial condition when they are aware of the current value of assets being managed;

(ii) valuation methods are subjective, but their results are more informative than historical costs aggregated over periods when there have been significant changes in the purchasing power of money or in the market value of the assets remeasured;

(iii) the values of assets will be consistent between entities, and across assets held in the same entity, because their values will not be dependent on the date of acquisition;

(iv) it is more difficult for entities to “manage” their results by selling assets at convenient times in order to realize previously unrecognized changes in asset prices; and

(v) real profit can be ascertained after maintaining the value of the business.3

.169 Remeasurement by periodic valuation, in preference to historical cost, has been applied only to selected classes of assets in financial reports prepared under the accrual or modified accrual basis. This limited application may have been, in part, because public sector entities followed private sector examples and, in part, because the costs of revaluing all assets exceeded the benefits. General asset recognition is a relatively new process in public sector financial reporting and valuation techniques are still being developed for many classes of assets. However, the common absence of historical cost records obliges public sector entities to confront issues of valuation methods if they wish to extend the classes of assets recognized in their financial reports. There is discussion of valuation issues in paragraph .185 below.

Discussion of the Measurement of Some Assets

Introduction

.170 As recognition of non-current physical assets is still a matter of emerging rather than general practice in the public sector, problems of measurement of particular asset classes have stimulated debate.

Measurement and Infrastructure Assets

.171 Roads, drainage, water supply and similar networks are owned by private sector entities, but few such networks are as large as those commonly held by public sector entities. Public sector records of historical cost of acquisition are unlikely to be available or useful if available. Relevant market information will be scarce as such networks are rarely traded. The remaining approaches to measurement derive from current cost, that is, measuring the asset at the current cost of replacing the service potential embodied in the asset.
An infrastructure system can be considered as a single asset or more usefully as a collection of assets. For example, a water supply system could be a collection of individual assets in classes such as land, buildings, plant, and pipe networks. The individual assets could be measured in terms of their individual historical cost (if available) or their replacement value adjusted for age and obsolescence in relation to each asset's role in the water supply system as a whole.

**Measurement and Heritage Assets**

A heritage asset could be measured in one of the following ways:

(i) **Market value**

As noted below in paragraph .175, well-established national and international markets exist for many classes of heritage assets; values can provide a basis for measurement that is sufficiently reliable to inform adequately users of public sector financial reports.

(ii) **Replacement cost**

Whether a replacement asset has the same service potential as the heritage asset replaced can be debated; would a replica of Stonehenge, for example, have the same service potential as the original monument? However, if an asset were replaced if destroyed, then the replacement cost provides a benchmark in the measurement of the original.

(iii) **Value in alternative use**

If an asset were not or could not be replaced, and where market information is unavailable, the value in the next available alternative use may be appropriate.

Where there are legal restrictions on the sale of an asset, that asset may be measured as if the legal restriction had been removed or measured at a value which discounts market prices for similar assets by a factor to reflect the restriction. In general, financial reports prepared using the going concern assumptions will be more useful if the values recognized reflect the current legal position of the entity. However, the resolution of this issue depends on a number of factors, including the measurement basis adopted by an entity and the facts in a particular case. For example, legal restrictions may be irrelevant if the continued use of an asset were to generate cash flows greater than the carrying amount.

Significantly, there is no use of the term "heritage assets" in the private sector; identical kinds of works of art, historic buildings, rare documents, etc, are bought, sold, taxed, insured or transferred by inheritance, etc, without the difficulties of measurement and asset recognition reported in the public sector. Similarly, no conceptual difficulties are reported in establishing a transfer price when such assets pass from public to private ownership. Instances of illegal export and looting of collections of cultural treasures confirm that when the opportunity is afforded, rare items of cultural interest can readily be traded.

**Some Approaches to Reporting Heritage Assets**

(a) **Symbolic values**

In its white paper on reform of local government accounting, the Comité Secteur Public of the French Ordre National des Experts Comptables distinguishes between recognizing assets contributing to public service and other assets. The Comité Secteur Public recommends that these other assets are assigned a symbolic value in the financial statements with supporting disclosures in the notes to the financial reports.
A paper by the Australian State of New South Wales Treasury\textsuperscript{4} and another by the Australian State of Victoria\textsuperscript{6} contain differing views on heritage assets. In New South Wales these are to be valued in the balance sheet at $1. In Victoria, heritage assets are considered similar in essential character to other assets, but difficult to measure. Appropriate accounting for them has yet to be resolved.

(b) Market values

In contrast to advocates of the use of symbolic values, those who support recognition of more “realistic” financial measurement of heritage assets argue that financial decisions are made in relation to the monetary value of such items — for example, in allocating funds for preservation, in insuring such items, in expanding or contracting heritage collections. They argue that in general it is highly relevant to users of financial reports, who wish to understand the often considerable management and periodic maintenance expenditure relating to heritage assets, to receive information about the value of the heritage asset itself in the view of knowledgeable and experienced experts. The practice of assigning token values, for example $1, to such assets serves to alert users to the difficulties of valuation, but only by providing irrelevant (and inaccurate) information.

In the New Zealand public sector, considerable effort has been applied in valuing infrastructure assets and heritage assets and the values established have been recognized in national and local government financial reports.\textsuperscript{7} For example, the recognition of the contents of the National Library’s research collection (that is, a heritage collection of rare and unique items held indefinitely) was recognized at NZ$475 million. The value of this information to users was that in addition to the item itself, it conveyed the level of change from the previous year (NZ$2 million), a comparison with the “in-use” (standard reference) collection of NZ$26 million and provided a context for assessment of the operations of the Library and of the investment of NZ$77 million in buildings and other fixed assets of the Library.\textsuperscript{8}

*Heritage Assets - A Summary*

Assessed in terms of user needs, “...it is reasonable to expect that communities financing public entities controlling assets of the heritage type, as with other types of assets will require the provision of information about the stock of assets and the consumption of service potential. Such information would seem necessary as input to the assessment of the economy, efficiency and effectiveness of controlling entities.”\textsuperscript{9}

The public can generally be expected to have an interest in understanding the financial implications of policy decisions about the use of scarce resources for heritage, cultural or recreation purposes. The community will have an interest in the financial value of the stock of such assets, the alternative opportunities this stock represents, and the costs implicit in the use of resources for heritage purposes.\textsuperscript{9} In general, the selection of a measurement base for particular heritage assets will be made to provide users of financial reports with an understanding of the economic costs of holding such assets. The best measure of those accrual costs will usually be market prices. Alternative valuation bases could give users a significantly different view of the information contained in the financial statements. Therefore, where heritage assets are included in financial statements, it is particularly important that the basis of valuation is properly disclosed. Where certain assets are shown in the financial statements and others are not, this should also be disclosed.

*Measurement of Financial Assets*

Some financial assets can change in value when held for more than one period. For example, bullion values can fall or marketable financial securities can lose value as interest rates change. The original basis of measurement can be reassessed in the light of conditions at the new balance date. Private sector accounting standards for reporting such changes to financial assets would usually apply to financial assets in the public sector and may be significant in establishing accounting policies for financial reports produced under any of the accounting bases discussed.
Private sector generally accepted accounting practice in most jurisdictions does not usually support recognition of increases in the value of financial assets, although this topic is currently under debate. Public sector entities will need to establish and disclose their accounting policies in relation to the recognition of changes in value of financial assets. Practice in the private sector is changing in some jurisdictions to permit or require the use of fair values in certain circumstances.

Loans receivable by governments may require adjustment from the amount provided to the recipient, where particular conditions of interest concessions or terms for forgiveness reduce the value of the loan to below its original cost. For example, the Canadian Public Sector Accounting Recommendation "Loans Receivable" states:

"When the terms of a loan are so concessionary that the substance of the transaction is that all or a significant part of the loan is more in the nature of a grant, the grant portion of the transaction should be recognized as an expenditure when the loan is made.... Loans receivable should be initially reported on a government's statement of financial position at cost. Valuation allowances should be used to reflect loans receivable at the lower of cost and net recoverable value.... Loans receivable should be reported net of their related valuation allowances on a government's statement of financial position. Changes in valuation allowances should be reflected in the statement of revenues and expenditures."

Valuation Methods and the Recoverable Amount Test

At present, valuation methods for some assets are a matter of emerging rather than agreed practice in both the private and public sectors. Although methods for valuation of most assets exist, valuers have developed such methods to meet objectives different from those of public sector financial reporting. Professional valuers accept that the intended purpose of a valuation report will determine valuation methods used; valuation reports which support property tax assessments may require valuation methods different from those used for valuation reports to provide asset values for a financial report intended for the general public.

Valuation practices for financial reporting in general have developed with emphasis on market prices as a basis for valuation. However, there are significant assets for which there are no active markets; such assets are not unique to the public sector although the public sector typically has more of these assets, and they are usually important in size, scope and value (for example, road assets). An existing valuation practice is to value such assets on the basis of replacement value depreciated for loss of the asset's service potential since acquisition, and adjusted for any technical obsolescence or redundant capacity, that is, the so-called "optimized depreciated replacement cost value" basis.

In particular, valuation practice in private sector financial reporting limits the recognized amount (whether based on historical cost or on revaluation) of a reported asset to no more than that asset's expected future contribution of cash to the income of the reporting entity by operation and disposal of the asset (the "recoverable amount test"). "The accounting concept of recoverable amount refers to a general presumption that an asset ought not to be carried at an amount greater than it is anticipated will be recovered through continued use or, where applicable, disposal." If such an amount is defined in terms of inwards cash flow, it is generally not relevant for not-for-profit entities, and therefore is not relevant to most non-business public sector entities. An amendment to the Australian AAS-10 "Accounting for the Revaluation of Non-Current Assets" has established that the recoverable amount test need not be applied to non-current assets of not-for-profit entities "whose service potential is not related to their ability to generate cash inflows.... The carrying amount of non-current assets recognised in the statement of financial position of a not-for-profit entity should reflect their service potential as at the reporting date, measured at an amount consistent with the measurement model adopted by the entity in respect of its assets."

Although valuation as part of measurement for financial reporting purposes is a key problem for financial reporting using the full accrual basis, valuation for other purposes is often performed for assets held by government entities using other accounting bases — for example, when a public sector entity contemplates the sale of assets, or prepares economic assessments for investment or disinvestment decisions, or seeks insurance protection.
Asset Consumption

Introduction - Loss of Service Potential - Physical Assets

.189 Where public sector physical assets exist, such assets will often be consumed over time and the loss of service potential is an expense of the period. When it occurs, the loss of service potential of major assets from wear and obsolescence is material to users of financial reports and the accurate reporting of such expense is one of the chief benefits from using accrual accounting in the public sector. However, the accepted practice of allocating the acquisition cost of a physical asset over its estimated life on an arithmetical basis (that is, depreciation) may not be sufficiently accurate for financial reporting of very large assets, such as infrastructure assets, unless there is also appropriate accounting for material renewal, expansion and abandonment.

Loss of Service Potential - Infrastructure Assets

.190 Roading, water supply and drainage, etc., networks have long lives and are composed of many particular assets which contribute to the operation of the network. In practical administration, the component assets should be grouped for financial recording and management. As this is done, the concept of “useful life” becomes more difficult to apply to the groups of assets. If the lives are long, and the system extensive, then it is probable that any single predetermined “life” will be inappropriate either for the system as a whole, or for any material group of components, unless component assets are grouped according to their useful lives and depreciated appropriately. An alternative to assigning “lives” to network assets is to measure the consumption of their service potential by periodic inspection and assessment of deterioration from a given standard, usually based on operational performance of the system. Such inspections are a necessary part of the management of the operation and maintenance of the network, regardless of financial reporting requirements.

.191 In the case of some classes of infrastructure assets, some public sector entities have established an asset management plan with an engineering-based forward estimate of renewals and replacements that are necessary to maintain the assets in full operation in perpetuity. Such maintenance plans are held to justify an absence of depreciation expense accounting and are sometimes referred to as renewal accounting systems or deferred maintenance. “The renewal accounting approach to recognition of the consumption of asset service potential treats a collection of assets making up a network, or system, as a single asset which is to be maintained in service indefinitely. All expenditures on an asset system, whether creating or replacing service potential, or maintaining existing service potential, are perceived to be in the nature of ‘maintenance’ of the system, and are expensed as they occur…. In essence, renewal accounting is a form of cash accounting. Only when expenditures made in one accounting period on maintaining an asset system coincide with the cost of consumption of asset service potential will period expenses and assets stocks not be misstated. It is unlikely that such chance circumstances will pertain over the long life span of infrastructure type assets, on a period-by-period basis.”

Deferred Maintenance

.192 “The deferred maintenance system involves recognising, in each reporting period, an amount estimated to be the expenditure necessary to make up the decay that has occurred in an asset system.” The (single) annual expense figure for executing such a plan amalgamates the following transactions:

(i) the cost of repairs (maintenance expense);
(ii) the loss of service potential in the asset as a result of time, wear and obsolescence; and
(iii) the restoration of service potential in the asset (capital expenditure).

.193 The engineering assessment of physical condition of the asset, and of the work required to maintain this condition, is intended to ensure that restoration expenditure matches and restores the loss of service potential for the period
(depreciation expense). If the engineering assessment ceases to be correct (for example, as a result of unexpectedly high use and wear), the infrastructure asset values will be misstated in the financial reports. If the planned expenditure does not occur, the shortfall will indicate a reduction in the recognizable value of the asset. The shortfall will not be a liability nor an expense in terms of, for example, the definition of liability and expenses quoted in Study 2, although some proponents of deferred maintenance accounting argue that the shortfall should be recognized as a liability of the entity.

"Such a system differs from a renewal accounting system in that under renewal accounting 'expense' of asset use is determined by the amount spent on asset renewal. In a 'deferred' maintenance system 'expense' is determined by reference to estimates of what ought to have been spent to maintain the system. Both differ from a depreciation system in which expense is determined by reference to estimates of consumed service potential."^9

.195 Delay in needed infrastructure maintenance is an issue of great concern to users. In the long run, such deferral increases the costs of providing services and results in inter-generational inequities. The ongoing cash requirements associated with these assets are also important information for users.^11

**Loss of Service Potential - Heritage Assets**

.196 The existence of loss of service potential for heritage assets has been questioned by those who oppose the recognition of anything more than a symbolic value for a heritage asset. However, if a heritage asset is recognized at cost or market value and the asset suffers loss of service potential, then the loss of service potential of the heritage asset should be recognized. Heritage assets will have physical deterioration identical to other physical assets. However, the argument is occasionally made that it is possible, if particular heritage assets are maintained, restored, and have a long life, that their depreciation will be so small in the early years of life as to be immaterial. In this case, a statement that depreciation of, for example, a work of art is immaterial, implies that the work of art is regularly inspected, maintained under optimal conditions, and restored as necessary by skilled professionals. These implications are valid for only a small number of cultural treasures; storage conditions for many museum and gallery contents are rudimentary, particularly for the majority of items which remain undisplayed. The alternative position is that depreciation is independent of restoration and maintenance activities, and the two types of events should be accounted for separately.

**Loss of Service Potential - Intangible Assets**

.197 Intangible assets will only be recognized under the full accrual basis. Their basis of measurement will usually be by reference to some market value, and loss of service potential may be assessed in relation to changes in market value of the intangible asset. In those instances where an intangible asset has been measured on some basis other than market value, the original measurement basis could be used to assess value at the new balance date in relation to the asset’s current expected useful life. One of the areas in which public sector entities make significant investments in intangible assets is databases.

**Measurement Questions in Relation to Consumption of Service Potential of Long-Lived Assets**

.198 There is debate on how assets should be measured for financial reporting purposes under the full accrual basis of accounting. Many accounting bodies, and legislation in some jurisdictions, require that assets should be reported at their cost of acquisition (historical cost reporting) while others object, claiming that such costs are often irrelevant for the purposes of financial reporting. A compromise position called modified historical cost reporting accepts periodic revaluation of some or all non-current physical (fixed) assets.\(^3\)

.199 This debate is relevant to the public sector. The periodic expense reported for loss of service potential of a long-lived asset will usually be materially different depending on whether the asset is recognized at acquisition cost or at a current value. Users of public sector entity financial reports are likely to be informed better if long-lived assets are recognized at current value.
Footnotes - Chapter 5


3. International Capital Markets Group, Harmonisation of International Accounting Standards, July 1992, see chapter III "Accounting Standard Setting in Five Countries" (Germany, France, Japan, UK, US) and chapter IV "What are the Major Differences?" particularly page 27, Historical Cost-Valuations.


CHAPTER 6
CLASSIFICATIONS OF ASSETS

Effect of Basis of Accounting on Classification

A number of conventional classifications of assets are employed to distinguish between groups of assets displayed in a statement of financial position. The significance of these classifications is affected by the basis of accounting in both the types of assets recognized and the objectives appropriate to the basis of accounting used. A convention in private sector accounting is for assets or groups of assets to be displayed in some perceived hierarchy of liquidity, that is, the ease or otherwise of converting an asset to cash, and this display convention is often adopted in government reports. The classification of assets displayed in a statement of financial position requires consideration of a linked display of liabilities comparable to the classes of assets. This chapter, therefore, is an introduction only to the topic of classification of assets, and seeks to raise questions for consideration rather than to define good practice.

In addition to the users’ need to assess the current financial position, the government’s financial reports, including the statement of financial position, are almost always used to demonstrate detailed compliance with the appropriations authorized for the period by the legislature or superior government body. The display of information in the statement of financial position may be influenced by the need to group assets reported in relation to a common appropriation authority — for example, by function such as transport, defense, etc.

Cash and Modified Cash

The limited number of asset types recognized under the cash and modified cash bases usually means that the grouping of assets reported is reasonably straightforward.

Modified Accrual

The modified accrual basis requires reporting of a number of asset classes. However, the objectives discussed for the modified accrual basis mean that users will wish to concentrate their attention on the relationship of assets to financing of operations, etc, and therefore the classifications will group assets of similar financial characteristics, such as investments, revenue receivables, etc.

Full Accrual

The full accrual basis has an objective of informing users of the stewardship of assets held by government and of the financial condition of government. Thus, the range of reported assets is much wider and the grouping of assets is potentially much more complex in serving a range of user needs. Classification of assets reported in a statement of financial position is therefore a matter of more consequence under the full accrual basis than under other accounting bases.

Classification by Liquidity

Information about an organization’s economic resources, obligations and net resources also provides direct indications of the cash flow potential of some resources and their ability to meet obligations of the entity. The assessment of cash flow potential is important because it relates directly to the organization’s ability to provide the goods and services for which it exists. One of the ways to illustrate cash flow potential of assets is to display assets in the balance sheet in order, or in groupings based on their ease of conversion into cash.
Current and Non-Current Assets

Current assets are often defined as those assets expected to be realized in cash or sold or consumed within the organization’s operating cycle, usually interpreted as within one year after balance date. Non-current assets are assets outside the definition of current assets. The distinction between current and non-current assets has little consequence in a cash basis. The cash effect (if any) of acquisition or disposal will appear in the financial reports, but other than an indication of the purpose of the expenditure or source of the receipt, the distinction has slight information value to users of the financial report.

Under the modified cash basis, the distinction between current and non-current assets is also of little consequence. The recognition of accounts receivable, in addition to the cash recognized under the cash basis, adds a further current asset, but non-current assets are expensed in the same manner as under the cash basis.

Under the modified accrual basis, the expectation of realization means that in general the reported assets could be described as current assets in terms of the usual definitions of what is “realizable”. However, in the absence of reporting of assets which are not expected to be realized, the term “current assets” is largely redundant when applying the modified accrual basis.

Under the full accrual basis in the private sector, the distinction provides a useful classification of realization expectations and a grouping for comparison with the parallel current liabilities. In the public sector, it is unusual for the government to be assessed in terms of its continued existence as a going concern, and the categorization of assets and liabilities as current will usually provide, at best, only indications of short-term funding requirements. However, the distinction in a public sector entity financial report may inform users, in some circumstances, about the entity’s acquisition of current assets and its intentions to dispose of certain assets.

(a) Banking and financial institutions

National government balance sheets in particular will often have a range of financial assets similar to banks and other financial institutions; International Accounting Standard IAS 30 “Disclosures in the Financial Statements of Banks and Similar Financial Institutions” (June 1990) paragraph 15 states: “The most useful approach to the classification of the assets and liabilities of a bank is to group them by their nature and list them in the approximate order of their liquidity; this may equate broadly to their maturities. Current and non-current items are not presented separately because most assets and liabilities of a bank can be realised or settled in the near future.”

(b) Realizable and non-realizable assets

Under the modified accrual basis, certain assets are sometimes described as realizable as they are considered significant when assessing the financial condition of the government concerned and, in particular, when assessing the resources available to meet its liabilities and to finance its activities. Realization is used to describe the process of converting assets to cash or cash equivalents. The idea of realization is clearly elastic. The process of privatization in many countries has shown that almost any public sector asset can be sold given the political will to do so. Use of the term in relation to the modified accrual basis implies the firm intention to realize or the ability to do so at short notice. In the full accrual basis of accounting, such a classification as “realizable assets” is almost identical to that of current assets. However, non-current is likely to be less misleading than non-realizable in relation to financial reports produced for a full accrual accounting basis.

The term “non-realizable” is rarely encountered, but has been used in a different sense to mean those physical assets such as infrastructure assets which cannot be sold except with considerable effort and are often considered inappropriate for private ownership. The argument that some specific assets are appropriately state owned is challenged by the history of the development of infrastructure for private ownership in many countries in the
Industrial Revolution and by recent privatization decisions; even such a strategic service as the supply of water has instances of continuing private ownership (France) or privatization (United Kingdom).

**Legal Classifications**

.213 Assets may be classified by legal conditions accepted by government in terms of the appropriation process or in terms of obligations to lenders, including lenders at a higher level of government.

**Restricted, Unrestricted, Secured Assets**

.214 Secured assets are those specific assets which have been identified as being reserved to a lender in the event of default. It is accepted practice in private sector financial reporting that where assets are disclosed, secured assets are disclosed separately from unsecured assets. The term "restricted assets" is applied where assets are disclosed but are subject to restrictions on the disposal of the asset or income derived from its use. Such assets are often those donated to an entity for a specific purpose. Other restrictions may be imposed by statute, such as restriction of the right to dispose of reserve land or national parks.

**Classifications by Nature and Function**

.215 The full accrual basis, with its aim of demonstrating stewardship, should show how funds have been invested in categories of similar assets. Such assets may be physical assets, that is, the ownership of physical property, or they may be financial assets such as rights to money or a right that can readily be traded for money, or they may simply be rights which have a recognizable value (intangible assets).

**Intangible Assets**

.216 In private sector accounting practice, intangible assets are held to be recognizable rights to future economic benefits. Examples include patent rights or purchased goodwill on consolidation. The value to be recognized is subject to uncertainty. In the public sector, such assets are seldom reported other than under the full accrual basis. Complexities arise when considering recognition of some or all of the many rights available under the exercise of sovereign power, given the range and nature of such rights.

**Financial Assets**

.217 Using the full accrual basis, financial assets will include assets very similar to those regarded as financial assets in private sector generally accepted accounting practice.

.218 It is possible for some financial assets to be included in a cash or modified cash basis if the financial asset met the required status of being "near cash" or "amount receivable within the required period". A broader range of financial assets would be included under the modified accrual basis. Under the full accrual basis, no financial asset as defined would be excluded from the financial reports. However, financial assets reported by governments may require different measurement policies to reflect the range of purposes of government in holding such assets.

.219 Governments extend loans in pursuit of policy objectives in addition to any financial returns that may be received and, therefore, such loans usually have terms and conditions that favor the borrower in terms of market requirements for loans. The recognition of such loans among "realizable assets" raises questions of their measurement, given the concessions provided to the borrowers — a loan at 0% interest is a different asset to a loan at market interest, although the sums advanced may be identical. Further questions arise when a forgivable loan is made as to how much (if any) of the loan should be recognized as an asset. Users will be informed better where financial assets are displayed to illustrate the grouping of financial assets of a similar nature — for example, where loan assets with concessionary terms are aggregated and reported separately.
Physical Assets

The recognition of physical assets is confined to the full accrual basis. As discussed in chapter 3, the recognition of physical assets is still evolving in generally accepted accounting practice. Good public sector administration always considers various forms of government physical assets when assessing economic policies, particularly when comparing alternative investment strategies. Therefore, knowledge of physical asset holdings is relevant to users of, for example, modified accrual basis financial reports in assessing the significance of the difference between governments’ liabilities and financial assets. Without values of physical assets, such relevant knowledge is difficult for governments to provide and for users to acquire.

The term “physical assets” is used to classify assets which are not financial and not intangible. Apart from inventory items, physical assets are usually non-current assets unless a clear intention to dispose of them exists. The financial value of physical assets is not recognized in financial reports produced on a cash or modified cash basis; the financial value of physical non-current assets is excluded from financial reports produced on a modified accrual basis. Under the full accrual basis, physical assets are usually reported as sub-classes; discussion of these sub-classes and the financial values to be included in financial reports is in the following paragraphs.

Physical Assets - Depreciable and Non-depreciable Assets

Once physical assets are recognized, the next question is how to recognize their loss of service potential in the appropriate accounting periods. Such consumption of service potential is a non-cash expense, whose recognition is commonplace in the private sector, but a matter of debate in the public sector. This debate arises because of unfamiliarity with the consequences of accruing accounting in the public sector and because the quantum of expense to be recognized is large in comparison with most private sector operations. The recognition of large totals of depreciation expense poses questions of maintaining service levels in terms of quality, volume (and the consequent funding decisions), measurement of physical loss of service potential, and of how money values should be assigned to that physical loss of service potential.

Under the cash accounting bases and the modified accrual basis, assignment of financial values to physical depreciation of physical assets is not part of the financial reporting system.

Physical Assets - Community Assets

The term “community assets” has been applied to non-current physical assets held by governments where restrictions (moral or otherwise) on disposal existed and where no market existed for the class of assets. Such assets are held by some to be without recognizable value and without recognizable depreciation. The classification has been challenged as uninformative and too subjective in operation. Although an Exposure Draft of accounting guidance on community assets was issued in New Zealand, the Exposure Draft was subsequently withdrawn.

The United Kingdom CIPFA “Code of Practice on Local Authority Accounting in Great Britain” uses the term “community assets” to mean “assets that the local authority intends to hold in perpetuity, that have no determinable useful life, and that may have restrictions on their disposal. Examples of community assets are parks and historic buildings”. Such assets are to be recognized at historical cost net of depreciation “where appropriate”.

Physical Assets - Heritage Assets

The term “heritage assets” is applied in full accrual accounting bases to non-current physical assets which the government is required to maintain, usually for other than short-term economic reasons. Various descriptions are quoted in paragraph .047 above. Implicit in use of the term is the idea that the government or government body is acting as custodian of the asset in question. Ownership and care of culturally prized assets is politically sensitive. For this reason, and because heritage assets can entail considerable amounts of expense and investment in their protection and preservation, the separate display of heritage assets from other assets may be useful to users.
Physical Assets - Infrastructure Assets

The term “infrastructure assets” is applied in full accrual accounting bases to describe non-current physical assets such as roads, drainage systems, power reticulations, and similar. Descriptions are quoted in paragraph .050 above. The connotation of network is important because any value of part of the infrastructure asset (such as a length of road) must be considered in relation to the whole asset (the road system). The valuation methods for such assets are evolving.

Because most of these assets are systems required to work as one unit to provide services, historical cost information about each of the components of the system would be of little use to users of financial reports. Infrastructure assets such as a sewer system can be viewed as single multi-part assets — that is, individual total service delivery systems.

Infrastructure assets exist as the result of large expenditures over many years. These expenditures are material in assessing the financial position, performance and condition of an entity. As infrastructure assets usually provide essential public services, the condition and eventual replacement of infrastructure assets are matters of the highest concern to users of financial reports and citizens in general. Regardless of the accounting basis used for financial reporting, government entities will often have detailed physical and economic assessments of their infrastructure assets as part of internal management systems and for economic policy reasons. A number of national papers have been published on road assets.

Infrastructure assets typically have very large value when considered as single systems; they are important to users for both their economic value and the essential services they provide. It can therefore be argued there is benefit in displaying infrastructure assets separately.

Physical Assets - Defense Assets

The classification “defense assets” has been suggested as a separate classification of non-current physical assets used for defense purposes to indicate that although non-current, such assets could be consumed at short notice in the event of hostilities. (See also paragraph .053 above.) Some argue that the concept of a useful life is not relevant for assets whose usefulness may change at short notice as a result of technical or political developments. Others, on the contrary, argue that the useful life of defense assets can be predicted in a manner identical with those used for other assets. Unexpected termination of asset life in the event of hostilities, or for any other reason, can be recognized at the time.

Physical Assets - Unrecognized Assets

Where physical assets are not recognized, there may be narrative disclosure of the assets controlled. Narrative disclosures may include the state of repair and related operating costs. Either as a transition system or as a final management system, asset databases may be created by public sector entities (see, for example, “Accounting for Capital Assets — A Working Draft of Guidance”) and should be a source for statistical information on the extent and condition of assets unrecognized. Clearly, although assets may be unrecognized in financial reports, user needs for information about public sector assets should still be considered and met as far as possible. In some cases this may require a significant expansion of explanatory notes.

Examples of Asset Class Guidance

A Canadian Research Study, “Accounting and Reporting for Physical Assets by Governments”, categorizes government physical assets as follows:

(i) infrastructure or community assets;
(ii) heritage assets;

(iii) defense assets;

(iv) natural resources;

(v) public lands.

The study also recognizes the existence of general physical assets, such as inventories, which may be held by governments. Discussion in the study focuses on classification issues; it does not address the common situation where government has control of natural resources as sovereign power without paying for them. Recognition of property rights or assets held without prior expenditure will depend on the accounting basis adopted by the government.

In the US Consolidated Financial Statements, prototype 1991, the categories of assets (with a total value of US$1,393.7 billion) are summarized as:

(i) cash and other monetary assets;

(ii) inventories;

(iii) receivables;

(iv) property and equipment; and

(v) investment and other assets.

These classes are then described in detail in notes to the financial statements.

In other jurisdictions, similar categories have been used to classify public sector assets. As expected, class descriptions may overlap — that is, a single asset could be in more than one of the classes described in this chapter. The classes adopted in practice by a reporting entity will depend on an entity's assessment of users' information needs. In general, at the national level of financial reporting, the summarized totals are likely to be for classes based on the nature of an asset (inventories, receivables, etc) rather than the function for which the asset is used (social welfare, defense, and so on). However, a functional classification (or classes of a combination of function and nature) may in certain circumstances be more informative.

Footnotes - Chapter 6


3 CIAC; Accounting and Reporting for Physical Assets by Governments, restricted use assets, page 38, 1989.

"Restricted Use Assets are those whose use is restricted by legislation, by donee request or other measures."


"For accounting policy purposes intangible assets are classified into identifiable and non-identifiable intangible assets. Identifiable intangible assets are those intangible assets which can be sold or acquired separately from other assets. They
include rights that are created by virtue of legislation but are unconnected to natural resource use, patents, databases and concessions.

Non-identifiable intangible assets are all other intangible assets. These assets cannot be sold separately. They include goodwill, human resources and the power to tax.

(a) Identifiable Intangible Assets
- Rights Unconnected to Natural Resource Use
  Rights created by virtue of the Crown’s sovereign power are not to be capitalised.
- Other Identifiable Intangible Assets
  The asset is to be recorded at net current value only if there is foreseeable future service potential or economic benefit to the Crown.

(b) Non-Identifiable Intangible Assets
Non-identifiable intangible assets should not be recorded.”

“A financial asset is any asset that is:
(a) cash;
(b) a contractual right to receive cash or another financial asset from another enterprise;
(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or
(d) an equity instrument of another enterprise.”


CICA; CICA Handbook, 3060 - Definitions - physical assets definition.
“Physical assets comprise property, plant, equipment, infrastructure, intangible properties and other identifiable assets that meet the following criteria:
(a) the economic lives of the assets extend beyond the accounting period;
(b) they are not intended for sale in the ordinary course of operations;
(c) they have been acquired, constructed or developed with the intention of being used or applied on a continuing basis.”


“Infrastructure assets are those stationary physical assets which form a network to facilitate the delivery of goods and services.”


"The USS Coral Sea was worth nothing last year when it was scrapped, but it was worth a lot 2 years before when it was sailing in the Mediterranean at a dangerous time. We could still be running the Coral Sea now. It didn't wear out. It was just older and a little less valuable than the nuclear ships. We are going to see major changes in the level of military armaments as a result of the end of the Cold War and sudden retirement of virtually new assets. The Coral Sea ran for well over 40 years; it was built in 1943. Who would have thought in 1943 to give that aircraft carrier a useful life of almost 50 years. But who also would have thought even a year ago that we would be scrapping missiles that were built only a few years ago to fight the Cold War? All this illustrates is that these assets are really not sensibly depreciable and need to be dealt with differently and excluded in the evaluation of efficiency or effectiveness of the operating agency. That doesn't mean to say that we don't look at the operating costs of the Coral Sea or how much it cost; but, we don't need to try to depreciate the expenditures. All we have to do is track all the capital expenditures as we go along through the years and accumulate them in the third set of statements. We have to know what they cost, but depreciation is not a useful idea."

CHAPTER 7

CONCLUSIONS

The need for this Study arises from the duty of governments to manage a portfolio of assets of major economic significance. Users of public sector financial reports need information "to help them evaluate a government's use or unit's use of the public resources entrusted to it." The need to report on management and use of assets raises a number of accounting issues peculiar to, or of more significance in, the public sector.

Given the size of annual public sector expenditure on the acquisition and maintenance of assets, it can be expected that users of public sector financial reports will be interested in the accumulated assets held by the public sector. Accounting for public sector assets, other than financial assets, is a matter of rapidly evolving practice and of debate on the respective qualities of relevance and reliability offered by different accounting bases.

This Study has examined the characteristics of assets, and then considered the application of those characteristics to cash, financial assets, physical assets, and intangible assets. The physical assets category includes inventories and plant and buildings, but particular attention is paid to infrastructure assets, heritage assets, defense assets, natural resources and community assets.

This Study examines the recognition and reporting of different types of assets under the cash, modified cash, modified accrual and full accrual bases. The growing interest internationally in recognizing physical assets and in moving to full accrual accounting is noted, and is reflected in the coverage of recognition and reporting issues under this basis.

The adoption of the modified or full accrual basis raises a number of measurement issues which are discussed in chapter 5. Issues addressed in the Study include remeasurement of assets, and measurement issues for infrastructure and heritage assets. Those jurisdictions which have extended their accounting base to a full accrual basis are currently developing experience in the recognition, measurement and reporting issues which arise, and in the reactions of users to the new information available. The Public Sector Committee will monitor these developments with great interest.

The IFAC Public Sector Committee concludes that:

(i) a wider range of information which users need in respect of assets is met when the accounting basis moves along the continuum described in Study 2 from the cash basis to the full accrual basis. Such transitions do not require sacrifice of information previously available from the former accounting basis used;

(ii) movement along the continuum towards full accrual accounting in no way diminishes the need for sound cash management and may facilitate improvements in this area;

(iii) asset information needs of users can in general be met best by adoption of the full accrual basis, although this conclusion should have regard to the objectives of financial reporting in a particular jurisdiction; and

(iv) transition from one accounting basis to another poses a series of asset accounting questions; this Study has reviewed some responses to such questions. IFAC PSC notes the value gained frequently by reference to parts of private sector accounting standards when developing answers to these public sector asset accounting questions. The Public Sector Committee also notes the significant role of explanatory notes in meeting user needs for information on assets and their management.
While individual governments have the right to select whatever basis of accounting they consider most appropriate, IFAC PSC encourages high standards of accounting practice in all jurisdictions. Further, IFAC PSC determined that in general full accrual accounting will better meet the information needs of users. In reaching this conclusion, IFAC PSC notes it is highly desirable that an entity budget and account on the same basis.

The Public Sector Committee recognizes that introduction of full accrual accounting has significant implications for budgeting and appropriations, and involves substantial implementation. IFAC PSC proposes to address these issues in later studies and thereby assist governments to move toward full accrual accounting.

Suggestions for Topics for Further Consideration

IFAC PSC hopes that further study of aspects of public sector asset financial reporting will be undertaken by academic bodies, professional organizations and other interested researchers. Topics of interest include:

(i) classification options for public sector assets and liabilities;

(ii) threshold issues and practicalities in measuring collections of heritage assets;

(iii) whether infrastructure assets are better treated as single systems or as collections of assets;

(iv) if a basis other than historical cost is adopted, what practical solutions exist to establish market values and other benchmarks for valuation of assets;

(v) measurement of taxation receivables;

(vi) asset reporting in reporting public sector performance; and

(vii) the notion of interperiod equity.

Footnotes - Chapter 7

APPENDIX

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 (that is, effects of transactions or events are recognized when cash is paid or received) and the accrual basis of accounting (that is, 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 to them 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 usually 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 programmes or activities.

Financial Reports: refers to the general purpose financial reports that are designed to meet the common information needs of users outside an 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 the messages and information 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 (that is, the basis of accounting), but also which 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, which statements are included in the set of financial statements, how they interrelate, and how key measures are displayed in them.
BIBLIOGRAPHY


Canadian Institute of Chartered Accountants, "CICA Handbook", Toronto, Canada.


Canadian Institute of Chartered Accountants (CICA), Research Study, Accounting and Reporting for Physical Assets by Governments, CICA, Toronto, 1989.


Department of Management and Budget (DMB) Victoria, Draft Accounting Policy Statement No 4, "Recording and Reporting of Non-Current Physical Assets", DMB Victoria, Australia, October 1989.


Iceland Act #52 on Governmental Accounting, Article 47, Governmental Financial Reports and Governmental Budgeting, Iceland, 1966.


International Federation of Accountants (IFAC), Public Sector Committee (PSC), Study 2: Elements of the Financial Statements of National Governments , IFAC, New York, July 1993.


VICROADS (the State Authority for Roads, Victoria, Australia), Finance Division, Capitalisation of Road Infrastructure Assets, Victoria, Australia, 1990.