

Elements

**CONCEPTUAL FRAMEWORK – Group 2 Projects
Elements – Definition and Recognition**

OBJECTIVES OF THIS SESSION

To:

- (a) Agree on whether staff resources should be allocated to pursuing a rights and obligation approach to the definitions of assets and liabilities;
- (b) Decide if “ownership interests” should be defined separately from net assets.
- (c) Decide if IPSASB agrees with the other general improvements to the definitions.

ACTION REQUIRED

- Consider the *rights and obligations* approach set out in the IASB/FASB material as summarized in this material and its applicability to the public sector.
- Provide your views on whether ownership is a separate element.
- Consider the general improvements being made.

BACKGROUND

This paper is primarily focused on some very fundamental questions that need to be considered. The IASB/FASB convergence project is taking the opportunity to re-open the existing definitions of assets and liabilities and focusing them on *contractual rights and obligations*. IPSASB must make an assessment as to whether this approach appears suitable to the public sector and as a result direct staff to research the applicability of this model.

A summary of differences between the public sector and private sector has been included for your consideration in the assessment of the IASB/FASB proposals. Also staff has identified a number of reasons supporting changes in the existing definitions.

As an alternative, IPSASB could limit the extent of this project to general improvements in the definitions as set out in the general improvements section of this paper.

ISSUES RELATING TO DEFINING ELEMENTS

Introduction

- 1) The structure of this paper is issue-oriented. For the purposes of this paper GPFR refer to general purpose financial reports and GPFS refers to general purpose financial statements. The approach taken is to provide necessary background on the issues being raised by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) conceptual framework convergence project.
- 2) To begin, there are a number of unique characteristics of governments that need to be considered. Staff has set out a number of those characteristics that need to be considered when assessing the IASB/FASB proposals.
- 3) The paper first sets out a number of fundamental issues that must be discussed. In addition to that discussion, there are a number of general improvements that can be made to the existing definitions regardless of the outcome of the fundamental issues.
- 4) It is acknowledged that these issues are complex but staff needs IPSASB's input and views on the proposed direction being taken by the IASB/FASB convergence project.

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UNIQUE CHARACTERISTICS OF GOVERNMENTS

There a number of unique characteristics that must be considered throughout the development of the conceptual framework:

Governments manage the economy.

Unlike the private sector that can have a limited effect on the economy in terms of employment and pricing and the supply of goods and services, governments influence and manage the economy in terms of fiscal and monetary policies, influencing employment and regional development, and establish a myriad of other regulations and legislative requirements.

Government objectives are different.

Unlike the private sector whose objective is generate a profit or a return on invested capital, a government's objective is not to generate a profit but to redistribute wealth and provide public goods and services. To that end, many of a government's transactions and events that affect financial position and results are driven by non-exchange transactions such as the levying of taxes and providing grants and other transfers of economic resources to others. Government spending does not necessarily focus on maximizing a financial return.

Government budgets are a key accountability documents.

Governments are large and complicated entities. To manage public finances, a government's budget portrays the public policies initiatives to be undertaken, establishes estimates of revenue, expenses and expenditure and sets out the financing requirements for the period. The budget is generally developed in a public forum and represents a key focal point of public debate over resource allocation decisions. Unlike the private sector which is focussed on generating financial returns, the budget becomes a vital part of service delivery choice and represents a critical part of the accountability cycle in the public sector.

Governments acquire capital assets for non-financial reasons.

Although some capital spending in certain government types of government activities are acquired for a purpose similar to the private sector, many are not. For example, many assets such as military assets are not acquired to generate cash inflows but to provide an ongoing service. Those assets have an economic value, but that value is not based on their ability to generate net cash inflows.

Governments face volatility due to economic conditions.

Volatility in government can stem from external and internal factors. External changes in annual economic growth directly affect the revenues of a government. The

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cost of government programs is directly by changes in the economic situation due to changes in demographics that can affect various programs such as social benefits, changes in the labour market that can affect employment and productivity. Internally created volatility can results from a government's decisions to enter into a military conflict or address a natural disaster.

Government's net assets do not reflect "ownership" interest.

A key difference in the public sector is that, for the most part, the net assets of a government do not necessarily represent purely an "ownership" interest or a liability. In many cases, the net assets of a government are a reflection of the assets available to finance future operations or that can be used to repay debt. Depending on the individual government situation, there may be no outside ownership interest or there may, in fact, be net liabilities.

Do you agree that these are significant differences?

Are there other differences that need to be identified?

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THE NEED TO CHANGE THE EXISTING DEFINITIONS

Background

1. The IASB's existing definitions of assets and liabilities were originally approved by the International Accounting Standards Committee (IASC) in their Framework in April 1989 and adopted by the IASB in April 2001.
2. As part of the IPSASB's initial efforts to develop basic definitions of these elements, the current definitions were adapted from the existing IASB definitions. The notion of service potential was added to the IPSASB's definitions recognizing that the IASB defines future economic benefits as cash inflows whereas for certain types of economic benefits in the public sector the benefit relates to service potential.
3. The IASB and the FASB currently have a convergence project underway that is attempting to develop a common conceptual framework for the privatesector. As part of that review, the definitions of financial position elements have come under scrutiny. While the project could have simply converged existing definitions, it was recognized that there is the opportunity to improve these definitions from a number of aspects.

Reasons for IPSASB to change the existing definitions

No agreement of what the asset or liability is

4. Standard setters in both the private and public sectors have not agreed on the definition of a asset:
 - *is it a resource, an economic resource, the service potential or future economic benefits associated with the resource, or the right to access the economic benefits.*
5. Standard setters in both the private and public sectors have not agreed on the definition of a liability:
 - *is it an obligation, a present obligation, probable future sacrifices of economic benefits, future sacrifices of service potential or economic benefits or obligations or their equivalents.*

The need to consider contractual arrangements¹

6. Another important issue relates to whether the existing definitions address contractual arrangements effectively. IPSASB has recent undertaken to adopt IAS 39 and related standards. This standard deals with financial instruments from a recognition and measurement perspective. The existing IPSASB definitions need to be assessed from the perspective of contractual arrangements.

Linking the asset or liability to the entity

7. Control (a risk and rewards of ownership approach) has been used to link a specific asset to an entity. IPSASB notes that assets are resources controlled by an

¹ Adapted from IASB Agenda item 3, November 16, 2006.

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entity. As noted in the IASB/FASB proposals, some are of the view the use of the word control has been used in the same sense as that it is used for purposes of consolidation accounting. Yet, simply having 51% control over an individual asset does not mean the entire asset should be recorded. The IASB/FASB project is exploring the need to change how the asset is linked to the entity. This issue is discussed later. The IASB/FASB proposals link the asset to the entity by using the phrase:

*through an enforceable right or other means, the entity has access or can limit access of others.*²

8. While most definitions link a liability to an entity there is typically no guidance as to how it is linked. Others do not link it specifically to the entity.

Other issues related to the existing definitions of assets and liabilities

9. The following identifies other issues relating to the existing definitions of assets and liabilities that could be improved to add clarity and promote better understanding. These changes can be made without amending the fundamental taken in the existing definitions.
 - (a) *Past events* – Some have placed undue emphasis on identifying the past event that gave rise to an asset. Though its identification might be helpful, it can be a distraction and lead to debates about which event is the triggering event instead of focusing on whether the resource exists at the balance sheet date.
 - (b) *Benefits are expected to flow or result in an outflow* – This idea has included in many definitions, albeit using different phraseology, to alleviate concerns that the definition would require that the inflow or outflow of future economic benefits or service potential has to be certain in order to qualify as an asset or a liability. This is a recognition question not a definitional one.

² IASB/FASB Revenue Recognition Agenda paper 2 C, January 2008

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TWO FUNDAMENTAL ISSUES

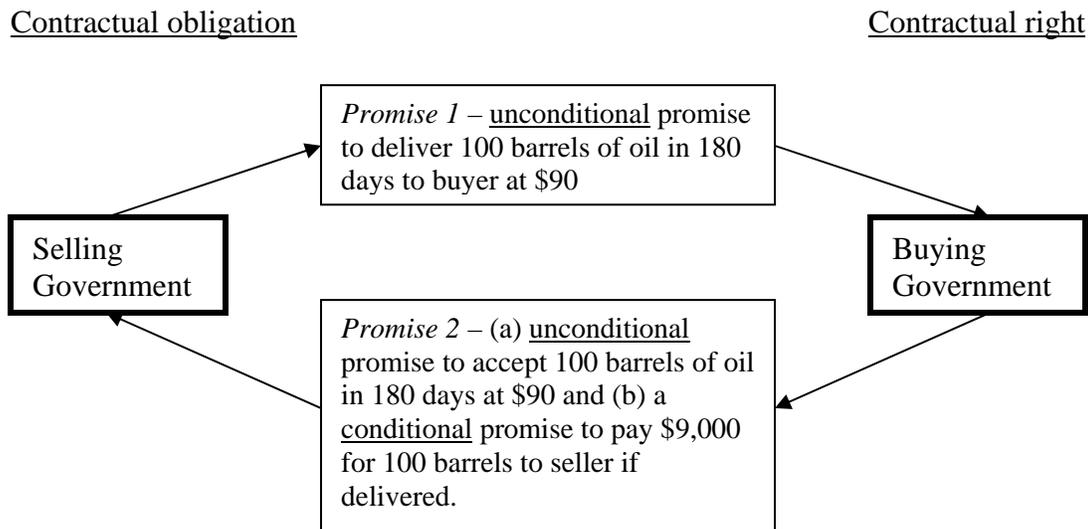
IPSASB needs to discuss:

- Taking a contractual rights and obligations approach to the definitions of assets and liabilities; and
- how assets and liabilities are linked to an entity.

These two issues are inherently associated with each other.

ISSUE – CONTRACTUAL RIGHTS AND OBLIGATIONS

10. An asset or a liability can result from some contractual arrangements. In certain circumstances, an asset or liability may result from an unconditional contractual promise from another party. Contracts generally involve exchanges of promises – one party promises to do something in exchange for a promise from another party to do something else in return.
11. For example, consider a contract between two sovereign governments for the supply and purchase of oil. The contract calls for 100 barrels of oil to be delivered in 180 days *at a fixed price* of \$90 to be paid 30 days after delivery. If the price is not fixed, then one cannot determine the value of the contract. A unconditional contract is entered into and the seller (promise 1) promises to deliver the oil to the buyer and the buyer (promise 2) agrees to pay \$9,000 to the seller 30 days after delivery.



12. Promise 1 – the contract to deliver 100 barrels of oil at \$90 can result in economic value if the price of per barrel oil drops to \$85, the value of the selling government’s contract increases by \$5 per barrel.
13. Promise 2 has two components. Promise 2(a) – the unconditional promise to accept 100 barrels of oil at \$90 can result in economic value if the price of per barrel oil rises to \$95, the value of the buying government’s contract increases by

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- \$5 per barrel. The obligation to pay for delivery of the oil is conditional upon the delivery of the oil.
14. In this situation, each of the unconditional promises is capable of producing net cash inflows and therefore can be economic resources. If the price of oil rises above the agreed-upon price of \$90 per barrel (for example, if the supply of oil becomes limited), Promise 1 will increase in value, whereas if the price of oil falls below that price, Promise 2a will increase in value.
 15. Until the seller's promise to deliver the oil is fulfilled, the buyer's present economic resource is the seller's contractual promise to deliver 100 barrels of oil in 180 days (Promise 1). The seller and buyer's economic resource is not the oil itself (the seller may not yet have refined the oil yet) but the contracted price. When the seller delivers the oil, the seller's promise is fulfilled. The buyer's economic resource—the unconditional contractual promise to accept (Promise 1)—is replaced by a new economic resource – 100 barrels of oil – to which the buyer has property rights. At the same time, the conditional promise by the buyer to pay \$9,000 to the seller (Promise 2b) becomes unconditional. After 30 days that unconditional promise is mature.
 16. The question of recording these assets and liabilities in the financial statements needs to be dealt with at the standards level. The fact remains that if the price of oil changes during the 180 day period, one of the parties to the contract, be it the seller or buyer, has an economic value and the other an economic obligation.
 17. Nevertheless, the definitions of an asset and a liability need to be broad enough to include such items for consideration and to promote discussion at the standards level as to whether these types of things should be recognized.
 18. There are other types of contractual arrangements that also need to be considered when developing or assessing a definition of an asset or liability. For example, they can include promises to pay cash, deliver goods, or render services and financial guarantees.
 19. This is an important decision that relates to the breadth of issues that IPSASB wants to address from the point of view of simply amending the existing definition to make certain changes such as removing past events and the expectation of whether benefits flow to or from the entity. This is the easiest approach. However, IPSASB can make a choice to further improve these definitions from the perspective of contractual arrangements and linking the asset or liability to the entity. The IASB/FASB proposals are reflective of a desire to make such changes.
 20. To further the understanding of this approach being examined by the IASB/FASB staff have included a paper on revenue recognition that relates to identifying performance obligations that sheds some useful light on what changing to a “rights and obligations” might entail.

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This section of the paper is a reproduction from the IASB/FASB convergence project, Revenue Recognition, Performance Obligations (Agenda paper 11 C), April 17, 2008.

Definition of a performance obligation

21. In a contract between an entity and a customer, the entity promises to provide goods or services in exchange for consideration from the customer. These promises represent performance obligations of the entity and are sometimes referred to as “deliverables” or “elements” in existing literature.
22. Although the notion of a performance obligation is implicit in much of the existing literature, there is no definition of a performance obligation. Hence, the Boards have proposed the following tentative definition:

An entity’s performance obligation is a promise in a contract between the entity and a customer to transfer an economic resource to that customer.

Promises in a Contract

23. The promise underpinning a performance obligation is typically explicitly stated in the contract itself. For example, a contract to deliver a good in six months’ time typically details the specifications of the desired good. Similarly, a contract to provide cleaning services typically includes details such as how often the cleaning will be done and the extent of cleaning required. Such explicit promises within a contract are easily identified.
24. However, a promise may also arise when entering into a contract even though the contract itself makes no mention of the promise. For example, when a manufacturer sells a product, local law may require the manufacturer to warrant the product for a certain period of time. Even if the contract makes no mention of this warranty, the promise to provide such warranty coverage exists. In this way, the warranty obligation imposed by statutory requirement is an implicit promise that is added to a contract between the manufacturer and the customer. And this implicit promise gives rise to a performance obligation just as an explicit promise would. Whether by the explicit terms of the contract or by requirements imposed by law, any promise to transfer an economic resource to the customer that arises as a result of entering into the contract is a performance obligation of the entity.

Economic Resource

25. In the definition of a performance obligation, the focus of the promise is an economic resource. In recent work on the conceptual framework project, the Boards have proposed the following tentative definition of an economic resource:

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An economic resource is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources.

Goods

26. Goods such as computers, oil, and machinery represent economic resources because they are scarce and they can produce cash inflows or reduce cash outflows for the person or entity that owns them. These goods can produce direct cash inflows for the entity by their sale to another party (including a customer). These goods can also produce indirect cash inflows for an entity as they are used alone or together with other economic resources to produce other goods and services that can be exchanged for cash inflows. Because goods represent economic resources, any promise (in a contract between an entity and a customer) to transfer a good gives rise to a performance obligation.
27. A patented process that reduces the amount of inputs needed to build a product is another example of an economic resource (in this case, an intangible good) because the process is scarce and it can produce cash inflows or reduce cash outflows for its owner. For instance, the entity that owns the process (via the patent) could license the use of the process to a third party, and thus receive direct cash inflows from the licensee. The process also is considered an economic resource because the entity's own use of the process can reduce cash outflows expended on inputs. Because the process represents an economic resource, any promise (in a contract between an entity and a customer) to allow the use of the process represents a performance obligation.
28. The fact that a good (tangible or intangible) can be bought or sold separately on the market is a clear indication that the good is an economic resource. In fact, this simple test can often be used as a shortcut for determining whether a good is scarce and has the capacity, alone or together with other economic resources, to increase cash inflows or reduce cash outflows. An entity could sell a good, and a customer would buy a good, only if that good was indeed scarce and had the capacity to increase cash inflows or reduce cash outflows.
29. Applying this simple test (that is, asking whether a good can be bought or sold separately) will often identify more goods than those explicitly promised in the contract. This is because many contracts are not written in great detail—indeed, many contracts are not written at all. For example, a contract in which a painting company promises to paint a customer's house may make no mention at all about the paint that will be used to paint the house. In fact, painting contracts are often thought of in terms of the painting services only, and paint is merely considered an input into that service. However, examination of the contract clearly identifies paint as an economic resource to be transferred to the customer because paint can be bought and sold separately. As a result, the promise to transfer paint is its own performance obligation.
30. This example underscores the fact that a good does not have to be explicitly promised in a contract to give rise to a performance obligation. If a good must be

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transferred to the customer to fulfill a contract, whether explicitly mentioned or not, that promised good gives rise to a performance obligation.

Services

31. Services also represent an economic resource in that the service is scarce (that is, not freely available) and it has the capacity, alone or in combination with other economic resources of the recipient, to increase cash inflows or reduce cash outflows. Both Boards explain elsewhere that services represent economic resources or assets:

The *Framework* defines an asset and explains that the term ‘asset’ is not limited to resources that can be recognised as assets in the balance sheet (*Framework*, paragraphs 49 and 50). Although services to be received in the future might not meet the definition of an asset, services are assets when received. These assets are usually consumed immediately (IFRS 2, *Share-based Payment*, paragraph BC47, footnote omitted).

Services provided by other entities, including personal services, cannot be stored and are received and used simultaneously. They can be assets of an entity only momentarily—as the entity receives and uses them—although their use may create or add value to other assets of the entity... (FASB Statement of Financial Accounting Concepts No.6, *Elements of Financial Statements*, paragraph 31).

32. Because a service is an economic resource, the promise within a contract to provide a service is considered a performance obligation. As with goods, a simple test to identify performance obligations for services in a contract is whether the promised service can be bought or sold separately. A difficulty arises when trying to determine whether an activity required to provide a promised service also should be treated as a separate performance obligation. For example, in promising to deliver cleaning services, an entity must assemble a workforce and obtain cleaning supplies in order to ultimately deliver cleaning services to the customer. Do the activities of assembling a workforce and obtaining cleaning supplies constitute separate services that give rise to performance obligations, even though not separately promised?
33. Before answering too quickly, consider that either of these actions—assembling a workforce or obtaining cleaning supplies—can be bought or sold separately in a market. For example, rather than hiring cleaning employees itself, an entity could contract with an employment agency to provide a cleaning crew for the entity’s building. The entity could also contract separately with a local cleaning supplies store to provide cleaning supplies. Having assembled the cleaning crew and obtained the supplies, the entity would then only need to pay for the cleaning service itself by paying the newly contracted cleaning crew. So, in a contract in which all of these services are combined, and in which no mention of assembling a workforce or obtaining cleaning supplies is made, do either of these activities represent a separate performance obligation?

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34. As discussed earlier, the definition of a performance obligation is an entity's promise in a contract between an entity and a customer to *transfer an economic resource* to that customer. For activities such as assembling a workforce and obtaining cleaning supplies to be a performance obligation, the activity must actually transfer an economic resource to the customer. In the cleaning services example, the effort to assemble a workforce does not transfer an economic resource to the customer. Although assembling a workforce puts the cleaning service entity that much closer to providing cleaning services, the assembled workforce is not transferred to the customer. Similarly, obtaining cleaning supplies does not necessarily transfer an economic resource to the customer. The obtaining of cleaning supplies (that is, changing the location property of the cleaning supplies) is an economic resource to the entity if the cleaning supplies are still an asset of the entity. Because the activities of assembling a workforce and obtaining cleaning supplies do not transfer an economic resource to the customer, they do not give rise to performance obligations.
35. In summary, a good is an economic resource, and the promise to transfer a good constitutes a performance obligation. A service also is an economic resource, and the promise to provide a service to a customer constitutes a performance obligation.

Transferring an Economic Resource

36. The definition of a performance obligation emphasizes the word "transfer." In fact, the previous sections have used that word a number of times already without describing what it means. The Boards provide a hint at what transfer might mean in their tentative working definition of an asset in the conceptual framework project:

An asset of an entity is a present economic resource to which, through an enforceable right or by other means, the entity has access or can limit access by others.

37. For an economic resource to be an asset of an entity, the entity must be linked to that economic resource by either an enforceable right or some other means that gives the entity access to the resource or the ability to limit access by others. In a contract in which an entity has promised to transfer an economic resource, the entity must therefore transfer to the customer the enforceable right or other access to that economic resource. Until the customer obtains this enforceable right or access to the promised resource, the entity has not satisfied its performance obligation. In this regard, performance in the proposed model is about output (of economic resources) to customers and not activity of the entity under the contract.
38. Based on this reasoning, a promise to transfer an economic resource exists in any situation in which an entity promises to transfer to the customer an enforceable right or other access to an economic resource. When an entity promises to transfer a good, it means that the entity is promising to transfer to the customer the enforceable right or access to that good. When an entity promises to provide a service, it means that the entity is promising to transfer access to a resource, even though the resource itself may be simultaneously consumed.

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Identifying performance obligations

39. With the definition of a performance obligation in mind, a few concrete examples can now be considered to see how readily performance obligations can be identified. The following examples will be considered:

- painting
- goods sold with a right of return
- promotional promises

40. Consider the following example:

PainterCo is a contractor that provides painting services for private residences. PainterCo contracts with a customer on June 25 to paint the customer's house for CU3000. The price is inclusive of all paint, which PainterCo buys from its paint wholesaler. The customer is given the option to buy its own paint, for a corresponding reduction in the contract price, although the customer does not opt to do so.

All paint and materials necessary to complete the contract are delivered to the customer's house on June 30, the end of PainterCo's reporting period. PainterCo renders the painting services continuously from July 1 through July 10. In accordance with the contract terms, the customer pays in full upon completion of the house painting.

41. Based on the discussion in the previous section, performance obligations can be identified by searching a contract for promises to transfer goods and services to a customer. If a contract requires the provision of a number of goods, each good represents a separate performance obligation if that good can be bought or sold separately. Similarly, when multiple services are promised, each promised service represents a separate performance obligation if it can be bought or sold separately.

42. In this painting services contract, there are a number of goods that PainterCo must transfer to the customer in the process of painting or preparing to paint the customer's house. These include the following:

- putty
- primer
- paint

Because each one of these goods can be bought or sold separately and because PainterCo must transfer each of them to the customer to complete the promised painting services, each good gives rise to a performance obligation.

43. It is important to note that PainterCo does not necessarily have to account for each of these performance obligations separately. After identifying the promised goods in this contract, if PainterCo determines that all of these goods transfer to the customer at the same point in time (a question dealt with in Chapter 4), then the separate performance obligations can be treated as a single unit of account. The important point here is that each good represents its own performance obligation.

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- When those goods actually transfer to the customer does not determine whether the good gives rise to a performance obligation.
44. In this painting services contract, there are also a number of services that PainterCo promises to provide to the customer, including:
- prepping the house
 - painting
 - project management
 - performance guarantee
45. In a typical painting services contract, PainterCo will have to prepare the house to be painted (by power-washing it, scraping off any loose paint, puttying any holes, and priming the surface), paint the house, manage any employees or subcontractors hired to do these tasks, and stand ready to fix or repair any substandard work done during any of these tasks. Because each one of these services can be bought or sold separately, each one represents a performance obligation.
46. Of course, in such a simple painting services contract, it is somewhat artificial to think of project management being a separately promised service. Nonetheless, this example is in principle the same as a more complex construction contract, and the project management obligation is therefore similar to the obligation that a general contractor would have in such a contract. Indeed, each of these resources is currently sold separately in a number of different industries.

Goods Sold with a Right of Return

47. As a second example, consider the following situation:
- RetailCo is an electronics retailer that requires customers to pay for its goods before leaving the store. The printed receipt given to customers clearly states that (in accordance with local law) the title to purchased goods transfers to the customer at the point of payment. The receipt also indicates that the customer can return any good within 90 days for a full refund as long as the good is in its original packaging and in good condition.
48. In this example, the goods that RetailCo promises to transfer to the customer clearly give rise to performance obligations. The more difficult question is whether RetailCo's promise to accept returns gives rise to a performance obligation. As a reminder, a performance obligation is defined as a promise in a contract between an entity and a customer to transfer an economic resource to that customer. RetailCo clearly promises to accept returns, and this promise arises from entering into a contract with a customer. So, the question is whether RetailCo's return right represents an economic resource promised to the customer. If the return right is an economic resource that transfers to the customer, then the promise of a return right meets the definition of a performance obligation.

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49. There are two strongly held views regarding this question. The first view argues that a return right is an economic resource. A return right provides customers a window of time in which they can change their minds about the purchase. This additional time is an economic resource to the customer for one key reason—it can sometimes be bought and sold separately. Customers sometimes purchase this option separately when buying flexible airline tickets and hotel reservations. Some entities even charge a separate “restocking fee” to customers who choose to return goods. Thus, the customer is clearly in a better position having the return right than if it did not. In this way, a return right represents an economic resource promised to the customer. As a result, proponents of this view conclude that return rights represent a separate performance obligation in the contract.
50. The second view argues that return rights convey to customers an ability to cancel or unwind the sale. Because the customer has the ability to cancel or unwind the sale, return rights simply represent the potential for an incomplete or failed sale. Proponents of this view argue that when a customer obtains a good with a right to return that good for a full refund, it is uncertain whether a performance obligation to transfer a good has actually been satisfied. In essence, it is uncertain whether the enforceable rights or other access to the good have actually been taken by the customer. In cases where a return right exists and a customer has paid in advance, the entity treats that advance as a deposit or refund obligation until the customer has accepted the enforceable rights or other access to the good.
51. This second view meets with difficulties on two different fronts. First, treating all sales of goods with a right of return as deposit or refund obligations precludes revenue recognition for the vast majority of retail sales at the point of sale because most retail sales are made with a right of return. Some argue that reliable historical evidence about the likelihood of returns can be used to estimate the percentage of customers who have accepted a good as of a particular point in time. However, this estimate can only indicate the number of customers who are likely to let the return right expire. Until the return period actually expires, all customers still have the right to return the good. .
52. The other difficulty with this second view is that it ignores the fact that RetailCo has actually transferred the electronic good to the customer at the point of sale. That is, according to contract terms plainly stated on the customer’s receipt and consistent with the operation of local law, the customer has title—and thus the enforceable rights or access—to the electronic good when he leaves the store. If RetailCo is required to treat all or even a small portion of sales as refund obligations, RetailCo may also want to delay recognizing an expense for the cost of the good. As a result, it may continue to recognize the electronic good as its asset (perhaps described as inventory subject to return). This would not be a faithful depiction of the actual circumstances because RetailCo has *no* present rights to that good. If RetailCo has transferred to the customer the enforceable rights or other access to the good at the point of sale, then RetailCo no longer has an obligation to transfer that good to the customer.
53. The Boards have not reached an agreement on this issue. Because the treatment of return rights can have a significant effect on the timing and amount of revenue

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recognition, the issue will be revisited again in more detail later in the discussion paper.

Promotional Promises

54. As a final example in this chapter, consider an entity's promise to sell products or services in the future at a discount. When does such a promise result in a performance obligation? Consider the following situation:

TuneCo is a manufacturer of music players and an online retailer of music. As part of its spring sale, TuneCo is offering with each of its music players a gift card for CU20 worth of free online music.

SongCo is a competitor of TuneCo that also manufactures music players and retails music online. As part of its spring sale, SongCo is offering with each of its music players a discount card for 20% off its online music, for purchases up to CU100 in value (CU20 maximum discount savings).

TuneCo's gift card and SongCo's discount card expire after one year.

55. When a customer purchases music players from either of these entities, it receives a promised discount on a future product or service. In the case of TuneCo, the customer receives a music player and a gift card that offers a discount of 100% on CU20 worth of online music. In the case of SongCo, the customer receives a music player and a discount card that offers a discount of 20% on up to CU100 worth of online music. What are the performance obligations in these two situations?
56. In both of these contracts, the promise to transfer a music player to the customer represents a performance obligation. The music players can be bought and sold separately without the gift and discount cards, indicating that they are economic resources on their own. The promise within a contract with a customer to transfer a music player is a performance obligation of the entity.
57. Determining whether the gift card and discount card represent performance obligations is more difficult. TuneCo's inclusion of a gift card in its contract represents a promise to transfer up to CU20 worth of online music in the future, whenever the customer exercises the gift card. Online music is clearly an economic resource in that it can be bought and sold separately. Thus, a promise to transfer online music within a contract with a customer gives rise to a performance obligation.
58. It is important to note here that the gift card itself is not the promised economic resource. It is the online music that is the promised economic resource. The promise to provide the gift card is not itself a performance obligation because the gift card represents the claim that the customer has against TuneCo. In other words, the gift card represents the customer's claim to a promised economic resource, much like a contract can represent a customer's claim to a promised

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- economic resource. TuneCo is not in the business of providing gift cards, but is instead in the business of providing goods (music players and music).
59. Now consider SongCo's contract with its customer. SongCo's 20% discount card also represents a promise to transfer online music—in this case up to CU100 worth of online music for 20% off—whenever the customer exercises the discount card. Here again, online music is clearly an economic resource in that it can be bought and sold separately. Thus, SongCo's promise to transfer online music within a contract with a customer gives rise to a performance obligation.
 60. Some Board members disagree with this conclusion for the discount card. They think that a gift card (which implies a 100% discount) is different from a discount card (which implies something less than a 100% discount) in ways that warrant different treatment under the proposed revenue recognition model. For example, with the gift card, the customer is not required to pay any additional consideration to receive the promised music. In contrast, with the discount card, the customer is required to pay additional consideration to receive the promised music. Even though both TuneCo and SongCo are likely to receive additional consideration from customers when they exercise their cards, only SongCo's customers are required to pay additional consideration to exercise their cards. Moreover, the additional consideration paid by SongCo customers to exercise their discount card is likely to exceed SongCo's cost of providing the online music to the customer.
 61. Another potentially significant difference between the gift card and the discount card is the likelihood that the customer will exercise the card. Given that the customer does not have to provide any additional consideration to receive TuneCo's music, the customer is much more likely to exercise the gift card than the discount card, which requires additional consideration. In other words, the likelihood of exercising a discount card is so insignificant in some cases that it should not give rise to a performance obligation. Given the difference in expected consideration and the likelihood of exercise, some Board members think the promise to transfer music at a 20% discount (even though included in a contract with a customer) should not be treated as a performance obligation.
 62. Other Board members agree with the conclusion that both the gift card and the discount card give rise to performance obligations. These Board members note that both promises (gifts and discounts) arise within a contract with a customer, and the entity is promising to transfer the same economic resource (online music at a discount) to the customer at the customer's option. In neither case has the customer agreed to exercise its option by taking possession of online music. The fact that the customer is more or less likely to exercise one type of card than the other does not change the fact that the entity has promised within a contract to transfer online music to the customer. Although the likelihoods and the additional consideration should affect the measurement of the performance obligations (indeed, the measurement may be immaterial for some discounts), the likelihoods and additional consideration have no bearing on whether a promise to transfer an economic resource has been made in the current contract.

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Promotional promises arising outside of a contract

63. In the previous example, the promotional promises clearly arose as part of a contract with a customer. Sometimes an entity makes promotional promises that are clearly outside of a current contract with a customer. For example, entities frequently make promotional promises in advertisements. Although the entity will often be obliged to honor these promotional promises to its customers, the promise is not made as part of an agreement with a customer. As a result, such promotional promises do not give rise to performance obligations.
64. However, it sometimes is unclear whether an entity's promotional promise is part of or outside of a contract with the customer. For example, consider the situation in which a retailer drops a coupon or voucher into a customer's bag as he is paying for merchandise. This section has already argued that the promise to transfer an economic resource, whether at a 100% discount or a 20% discount, still gives rise to a performance obligation as long as the promise is part of a contract with a customer. Thus, the primary question seems to be whether the promise arises as part of a contract with a customer.
65. One way to determine whether a promotional promise is part of a contract may be to determine whether the entity priced the promised goods and services in the contract differently because of the promotional promise. For example, if the decision to distribute a coupon or voucher in each customer's bag at the point of sale had no bearing on the pricing currently charged to customers for goods and services that would suggest that the voucher or coupon was not part of the current contract with the customer. However, if the decision to distribute a coupon or voucher to a customer clearly affected the price currently charged for the goods and services delivered, that would suggest that the coupon or voucher was part of the current contract with the customer.
66. The Boards have not examined this issue in great depth, although the Boards generally agree that the definition of a performance obligation would capture such promotional promises as long as they are clearly part of a current contract with a customer. So, the issue seems to be more practical than conceptual in that the Boards have not yet decided how best to determine whether a promotional promise is part of a contract in some circumstances. The Boards invite comments on how this concept can be applied consistently in practice and whether the concept needs additional refinement that would make the practical determination more straightforward.

Consideration

67. IPSASB needs to consider whether staff should be directed to expend efforts on exploring this approach to the public sector. The question is whether IPSASB wants to change its current definitions to a rights and obligations basis or, instead, restrict changes to the definitions from a general improvement perspective. If IPSASB chooses to pursue a rights and obligations basis for defining assets and liabilities, this has the potential to have a significant effect on existing work. On the other hand, there appears to be some benefits in adopting this approach as,

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from staff's perspective, it will assist in applying the definitions of assets and liabilities to non-exchange type transactions.

Government transfers

68. IPSASB has recently pronounced on recipient accounting for government transfers. It is contractually based in its approach. It requires that certain performance obligations are met or if that is not the case, a return of those resources. However, the IPSASB does not have guidance on determining if a transferring government has an asset as a result of the contractually based transfers. In some cases these transfers can be unconditional and in others they can be conditional.
69. The notion adopted in the IASB/FASB convergence project is defining assets and liabilities, for the most part, from a *contractually based rights and obligations* point of view. This needs to be considered in the environment of non-exchange type transactions where in many cases there is no contract per se.

Stand-ready assets and liabilities

70. Stand ready assets could include a guarantee on an amount receivable provides an entity with an unconditional right to receive a cash payment of the amount receivable from the guarantor, if the original debtor is unable to pay. For example, they can include promises to pay cash, deliver goods, or render services and financial guarantees.
71. Stand ready liabilities could include guaranteeing the amount receivable by providing assurance through an unconditional obligation to pay cash or its equivalent, if the original debtor is unable to pay. For example, a government involved in insurance providing coverage to the public generally. These types of contracts may require the government to make a payment if an insurable event occurs. In these cases, there is an unconditional obligation on behalf of the insuring government to stand ready
72. These types of contractual arrangements also need to be considered.
73. The next issue of linking the assets and liabilities to the entity is also part of this issue. It sets out how the assets and liabilities would be linked to the entity using a rights and obligations approach.

Do you agree that staff should review the definitions of assets and liabilities from the perspective of contractual arrangements?

Do you see any public sector issues that would indicate that this approach would not work in the public sector?

Are there any specific public sector issues that need to be dealt with?

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ISSUE – HOW SHOULD AN ASSET OR LIABILITY BE LINKED TO AN ENTITY?

Background

74. The existing IPSASB definitions of an asset and liability are:

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

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

75. It could be argued that one could simply define an asset or a liability generically and stop there. The question is whether these elements should be defined as being “of the entity”.
76. Typically, standards setters have included a first level of what some might consider as recognition criteria in the definition of an asset. For example, introducing the term “controlled” draws a line around which assets are linked to the entity. Alternatively, the definition of a liability does not provide such guidance and relies on the phrase “of an entity” to link the liability to a particular entity.
77. It is possible to structure recognition criteria in such a way that one could determine if the particular asset or liability should be included in the reporting entity’s financial statements. The advantage of this approach would be that the definition of asset and liability would be general and the determination of whether it is “of the entity” would be left to the recognition criteria. Thus, it makes clear that there are two separate questions to be answered: what is the asset or liability and then who does it belong to.
78. This has the advantage of not having to reach agreement on a word or two that attempts to explain that link. Additional guidance could be provided that would better explain the notion of whatever concept is proposed to provide such a link.
79. However, this approach would create the thought pattern of first identifying all assets and liabilities, then determining if it is of the particular entity. This is a different approach than is used now so removing the link to the entity has the disadvantage of being unfamiliar.
80. In some cases it might not be possible to determine whether something is an asset or liability without knowing whose it is, for example, an intangible asset such as right or a liability related to a financial guarantee of others would not be apparent to the reporting entity.
81. The major disadvantage of this approach³ is that readers may not read any additional guidance and ascribe their own meaning or concepts to how the asset is

³ IASB/FASB Phase B Element & Recognition: Asset Definition, Agenda paper 16 c, October 2007

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- linked to the entity. The IASB members felt this approach was too brief and that more clarity in the definition itself was needed.
82. Staff is also proposing that IPSASB provide a link of these elements to the entity within their definitions. One still needs to determine *how* the asset or liability is to be linked. Once again, this issue depends on how the IPSASB chooses to approach the project.

LINKING ASSETS TO THE ENTITY

83. IPSAS 1 provides the link to the entity as:
- Assets are resources controlled by an entity.*
84. The use of the word “control” is generally thought to mean when the risks and rewards of ownership have been transferred. For example, IAS 17, *Leases*, notes that a financing lease is:
- a lease that transfers substantially all of the risks and rewards incidental to ownership of an asset.*
85. Further, IAS 18, *Revenue*, notes that revenue from the sale of goods and services shall be recognized when:
- the entity has transferred to the buyer the significant risks and rewards of ownership of the goods.*
86. The IASB/FASB proposal for how an asset is linked to an entity as set out in the working definition of an asset is:
- An asset of an entity is a present economic resource to which, through an enforceable right or other means, the entity has access or can limit access of others.⁴*

Alternatives

- Using control and risk and rewards to link the asset to the entity (current practice)*
87. The IASB definition of an asset focuses on a resource *controlled* by the entity and the FASB definition focuses on probable future economic benefits *controlled* by the entity. Of other definitions consulted the Australian, Canadian, German, Japanese, FASAB and GASB definitions focus on resources *controlled* by the entity, while the New Zealand definitions focus on future economic benefits *controlled* by the entity. The UK definition focuses on rights [or other access] to future economic benefits controlled by the entity.
88. However, in the case of the FASB the use of the term “control” may be a reflection of determining what the asset is – is it the resource or the benefits. For the New Zealand and in the case of the UK, the issue is similar – is it the resource or the economic benefit or the right to future economic benefits that is controlled.

⁴ IASB/FASB Revenue Recognition Agenda paper 2 C, January 2008

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89. Even though the words of the IASB *Framework* definition of an asset focus on *a resource controlled by the entity*, paragraph 57 of the surrounding text discusses *control* by stating that, “property held on a lease is an asset if the entity *controls the benefits* which are expected to flow from the property”. It is not clear whether control applies to the resource, or to the ultimate benefits that the resource produces, or both.
90. In many examples involving the definition of an asset, an entity will have the ability to obtain economic benefits. For example, in the case of accounts receivable the entity has an ability to cause benefits to arise from those resources. However, in other examples, such as water treatment and distribution facility, the entity may control the resource, its capacity to provide economic benefits to arise is dependent on usage or consumption external to the entity.
91. The problem with the use of the word control, in this instance, appears to stem from the surrounding text in both the IASB and FASB existing material. This has led to review of the word “control” in the existing definition.
92. This need to review the linkage between the asset and the entity has been raised by the monitoring group of national standards setters reviewing the IASB/FASB proposals from a public sector point of view. They support addressing the issues related to the term control. This term has always been problematic, bearing in mind its usage in different contexts with quite obviously different meanings. It would seem likely that the term will continue to be used in the context of consolidation accounting and therefore replacing it here is desirable.

Using enforceable rights⁵ to link the asset to the entity

This Section of the paper has been adapted from the IASB/FASB Phase B: *Elements and Recognition – Asset Consultation* (agenda paper 2A.1), July 17, 2007. It provides a useful; description of using rights to form the link of the asset to the entity.

93. Rights are the most common mechanism that society uses to distinguish who is entitled to specific resources and to facilitate exchanges of resources. For example, when inventory is sold the seller relinquishes its rights to the inventory in exchange for cash and the buyer receives its rights to the inventory in exchange for cash.
94. An entity’s association with economic resources can be represented by property rights (such as the right to possess, use, and enjoy a parcel of land), in which case there is no corresponding obligation of another party. However, for other rights, such as contractual rights another party must have a corresponding obligation and, thus, a liability.

⁵ Adapted from IASB Agenda item 2A.1, July 17, 2007

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95. An entity can demonstrate that it has rights in various ways. Often an entity has rights by virtue of ownership of an item. Such ownership usually gives the owner access to the various means of deriving economic benefits from the economic resource, including by using and enjoying the resource, selling or exchanging it, or exploiting its value, such as by pledging it as security for borrowing.
96. However, an entity can have legally enforceable rights to an economic resource without having ownership of the resource, as is the case with contractual rights. This occurs, for example, when property is leased or when an entity has rights only to cash flows arising from an item, such as with a contract that provides rights to receive royalty payments from sales of a particular book or publication.
97. Other legally enforceable rights to economic resources include the right to require other parties to make payments or render services and the right to use a patent or trademark. Thus, legally enforceable rights include, among other rights, contractual rights, statutory rights and property rights.
98. Rights may be single (held solely by the entity) or shared (held in conjunction with others). Two or more entities can have different rights to economic resources arising from the same item at the same time, or can have rights to the same economic resource at different times. For example, a lease arrangement might give the lessee the right to an economic resource in the form of use of a property and the lessor the right to an economic resource in the form of rental receipts. Also, time-share property owners have the right to an economic resource in the form of use of a property during specified time periods. Each entity has an asset based on the rights that it has.
99. Two or more entities can have an interest held under the same title in a single economic resource, such as a parcel of land or mineral deposit. Each has a right to the economic benefits deriving from that interest that would qualify as an asset, even though the right of each is subject at least to some extent to the rights of the other entity (or entities).
100. Rights also can be enforceable by other external means that are equivalent to legal enforcement, such as those arising within a self-regulatory structure such as a professional organization—for example, the right to issue assurance opinions on financial statements conferred on a qualified accountant by a professional accounting organization. If such rights are enforced similarly to how rights would be legally enforced (even though the consequences of enforcement might differ), they are regarded as the equivalent of legally enforceable rights.
101. Rights may better express the association of an entity than control. Control refers to the ability to direct, manage, or have power over something so as to obtain or access benefits, or to increase, maintain or protect those benefits (benefits that have the capacity to give rise to cash inflows). However, what is important in associating an entity with an economic resource is not necessarily whether an entity can direct, manage, or have power over the entire economic resource. Rather, it is whether the entity can direct, manage, or have power over its rights to the resource.

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102. Using the notion of rights may also clarify non-exchange transactions from the perspective of the transferor. For example, when an entity provides funding to another, it loses its rights over the economic resource transferred. The transferee has received rights to access and use the transferred resource. This can help clarify whether restrictions placed on the use of funding by the transferor could be considered to result in an asset of the transferring entity.
103. Clearly if there are no restrictions placed on the use of the resources transferred, then the transferring entity cannot have an asset. If there are restrictions placed on the use of the resources transferred, that too does not give the transferring entity a right to access the resource. Further, even if there are restrictions (some consider this to be control) and a repayment clause in the transfer contract, the right to access the transferred resource is dependent on the transferee not meeting the terms. It is not until the transferee must repay the transfer that the transferring entity gains rights to access the transferred resource.
104. The proposed IASB/FASB working definition of an asset attempts to deal with the entity's link to the economic resource by replacing *control* with the notion of *enforceable rights and being able to limit access of others* to the resource. They note that it better reflects how an entity is associated with an economic resource than *control*.

Comparing enforceable rights, access, and the risks and rewards of ownership (control model)

This Section of the paper has been adopted from the IASB's Revenue Recognition project, *Satisfaction of performance obligations* (Agenda paper 11D), April 17, 2008. It provides a useful description of the differences that should be considered when choosing to link an asset to an entity using a control, risk and rewards approach or an access through enforceable rights approach.

105. The transfer of enforceable rights or other access to a good does not always coincide with a transfer of the risks and rewards of ownership of the good. Consider the following example:
- A ski shop sells and rents skis to customers. Occasionally, a customer is uncertain whether they will be pleased with a pair of skis. To encourage customers to make the purchase, the ski shop allows customers to purchase the skis with a right to return them within 30 days, as long as the skis are in good condition when returned. The terms of the sale indicate that the customer has legal title to the skis after the point of sale, although the ski shop bears a more than insignificant risk that the skis will be returned.
106. In this example, the customer clearly has the enforceable right or other access to the skis after the point of sale. The customer can decide how to use the skis and whether to return the skis to the ski shop. She can also sell or rent the skis to

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- someone else if she chooses. Moreover, the ski shop has no rights or access to the skis. For instance, it cannot require that the customer return the skis.
107. On the other hand, the risks and rewards usually associated with owning the skis do not reside only with the customer. It is true that the customer gets to experience the rewards of owning the skis, such as the ability to use them at the local ski resort, the right to sell them on eBay, and the right to etch drawings all over the top of the skis. The customer also bears a number of the usual risks of owning the skis, such as the risk that the skis are stolen, lost, or damaged.
108. However, some of the usual risks of owning the skis are still borne by the ski shop for the first 30 days after the customer's purchase. For instance, the ski shop bears the risk of obsolescence because the customer can return the skis for any reason as long as they are in good condition. If the customer decides that the skis are not fashionable, she can simply return the skis and all the risks and rewards of owning the skis revert back to the ski shop.
109. The fact that the risks of owning the skis do not entirely belong to the customer (for the first 30 days) is what makes the notion of risks and rewards difficult to apply. If the transfer of the skis was defined in terms of the risks and rewards of owning the skis, the ski shop would find itself having to judge whether a preponderance (or some other balance) of the risks and rewards of owning the skis had transferred to the customer. Despite the fact that the customer clearly has the enforceable rights to the skis and can limit the use of the skis by others (suggesting that the skis are indeed the customer's asset), a judgment about the risks and rewards of owning the skis might lead the ski shop to conclude that the skis should still be reported as if they were its asset.
110. To avoid the confusion and inconsistency that exists in the current literature when the notion of enforceable rights or access are pitted against the risks and rewards of ownership, the model judges the transfer of a good strictly in terms of the enforceable right or other access to the good. To be clear, judgment about the balance of risks and rewards will often give the same answer as a judgment about who holds the enforceable right or other access to the good. But because these judgments can differ, this model proposes that the transfer of a good depends only on the enforceable rights or other access to the good.

LINKING LIABILITIES TO THE ENTITY

111. The IPSASB definition of a liability only refers to a liability as being of the entity – it does not provide any guidance as to how that liability is the entity's.
112. In the IASB/FASB definition of an asset, the economic resource is "linked" to the entity *through an enforceable right or other means*.
113. The working definition of a liability of the IASB/FASB convergence project is:
A liability of an entity is a present economic burden or requirement to which the entity has an enforceable obligation.

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This Section of the paper has been adopted from the IASB/FASB convergence project, *Elements and Recognition – Liability Definition* (Agenda paper 14 A), December 13, 2007. It provides a useful description of how a liability could be linked to an entity when using an enforceable rights approach.

114. As with *rights* in the definition of an asset, the IASB/FASB agree that the obligation should be *enforceable*. The only obligations that financial reporting should reflect are those that another party could force an entity to fulfil, otherwise satisfy, or settle by legal or other equivalent means. This approach will exclude “moral obligations” that are not enforceable by another party.

115. Consistent with the approach in the asset definition to restrict rights to those that are enforceable, the IASB/FASB propose that the definition of a liability should also limit obligations to those that are enforceable by legal or other equivalent means. Therefore, to clarify the use of *obligation* in the liability definition, they propose to describe the obligation as being *enforceable* and defines this key term as:

An enforceable obligation establishes the link between the entity and the present economic burden or requirement. Obligations are legally enforceable or enforceable by equivalent means.

116. Enforceable obligations include those that are established by contract or imposed by government [external to the reporting entity], as they can be enforced by a court of law. In some cases, constructive obligations—those that are created, inferred, or construed from the facts in a particular situation—may also be enforceable by the operation of legal doctrines, such as *promissory estoppel*. Such doctrines can be considered part of law and thus, are also legally enforceable.

117. In some cases, equitable obligations—those that stem from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right—might also be enforceable when they are supported by courts of equity. However, obligations that arise merely from ethical, moral or economic compulsion do not qualify because management of an entity could decide not to honour these kinds of obligations and another party could not enforce them against the entity. Only obligations that are enforceable by legal or other equivalent means should qualify for financial reporting purposes.

Extent of enforceability

118. The IASB/FASB is considering whether the obligation for the economic burden or requirement is *capable* of being enforced upon the entity through legal or other equivalent means. This is consistent with what an entity commonly considers when making business decisions – a greater than zero ability of another entity to enforce an economic burden or requirement upon the entity. In contentious situations, such ability can influence a decision as to whether to settle a contract

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- dispute or to honour a liability. The other entity need not have demonstrated its intent or taken actions to begin the enforcement.
119. The definition of an *enforceable obligation* includes obligations that are enforceable by means that are equivalent to legal enforceability. The following examples might be cited to illustrate such situations.
- (a) A self-regulatory body can impose and enforce obligations upon its members. If those obligations are enforced similarly to how legally enforceable obligations would be enforced, even though the consequences of enforcement might differ somewhat, they are regarded as the equivalent of legally enforceable obligations.
 - (c) Two or more parties might agree to accept the decisions of an arbitrator. Even though the arbitrator might be court-appointed and thus have legal backing, such legal backing is not necessary. Other mechanisms might make it very difficult for the parties to avoid abiding by the arbitrator's decision.
120. These examples highlight a couple of essential factors that *enforceable by equivalent means* has in common with legal enforceability:
- (a) *Separate party* is involved. In the examples, a self-regulatory body forms a formal or informal group to represent the individual members or traders. In the case of the arbitrator, it is an individual appointed by the parties in dispute.
 - (b) *Mechanism* exists that is capable of forcing an entity to take a specified course of action or consequence. If that specified course of action is not taken by the entity, then the claimant or intended recipient of the action can seek assistance from the separate party to enforce the consequences. Again, in the examples above, the potential withdrawal of a license or qualification, rejection of a trader from trading in the diamond market, a fine or other penalty can have a significant effect on an entity. Those potential binding effects will result in the entity honouring the mechanism, both the process and the resulting decision. .
121. Obligations that would not be enforced by a separate party or mechanism would not qualify for financial reporting purposes. For example, an entity would not have an enforceable obligation merely because its employees are on strike to demand additional compensation, because there is no mechanism or separate party by which to enforce any action. If a regulator became involved to arbitrate an existing labour contract, such a situation could result in an enforceable obligation because it could be enforced by legal or equivalent means.
122. This approach has implications for things such as liabilities that have been recorded as a result of deciding what one ought to do rather than what it is legally compelled to do. Further, it can have affect those who have recorded liabilities because they find it to be in their own best interests economically to take action.

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123. Both of these situations are problematic in that it is difficult to determine whether an entity really feels compelled until it makes the sacrifice of economic benefit. Compulsion is often in the eye of the beholder. Focusing on linking the liability to an entity through enforceable obligations would limit the extent to which these types of “obligations” meet the definition of a liability.

Do you agree that there is a need to change the linkage between the asset and liability and the entity?

Do you think using enforceable rights as the link to the entity provides a better understanding of how an asset or liability is linked to the entity?

Are there any public sector related issues that you see if the notion of enforceable rights and obligations is used to provide that linkage?

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**ISSUE – THE NEED TO DEFINE EQUITY/NET ASSETS
DIFFERENTLY IN THE PUBLIC SECTOR**

Background

124. In July 2006, the International Accounting Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly published a Discussion Paper, *Preliminary Views Conceptual Framework for Financial Reporting: Objective of Financial Reporting and Qualitative Characteristics of Decision-Useful Financial Reporting Information*. On May 29, 2008 the IASB and FASB issued a common exposure draft with the same title.
125. Among others, one key issue that is being proposed is the adoption of an “entity” perspective in the financial statements. This means that financial statements will be prepared reflecting the perspective of the entity rather than focusing on the equity investors. The current focus of financial statements is said to follow the proprietary perspective.
126. Under the entity perspective, the reporting entity is deemed to have a substance or existence of its own separate from its owners. Economic resources provided by capital providers cease to be their and become those of the entity. In exchange for resources provided, capital providers are granted claims to the resources of the entity. Claims of different resources providers have different priorities and rights associated with them, but they all represent claims to the economic resources of the entity. From this point of view, the accounting equation becomes $\text{Assets} = \text{Claims}$.
127. From this perspective, all credits could be considered “claims” thus $\text{Assets} = \text{Claims}$. Applying this perspective of claims and the entity approach, it could be argued that *there may be no need to define equity as a separate element*. The element could simply be “claims”. Claims could then be sub-classified by type and characteristic, for example liquidity, variable and non-variable interests and ownership interests.
128. In Agenda paper 3 of the IASB meeting on February 20, 2007 it is noted that the claims approach provides opportunities to eliminate some of the difficulties associated with classifying some hybrid instruments given the existing line that has been drawn between liabilities and equity.
129. Under the proprietary perspective, the reporting entity is not thought of being distinct from its owners. The resources of equity providers remain their own and do not become those of the entity. Lenders and creditors provide economic resources to the owners for a claim against the economic resources of the entity that would otherwise accrue to owners. From this point of view the accounting equation becomes $\text{Assets} - \text{Liabilities} = \text{Owners' Equity}$. Owners' equity represents an interest in the net assets rather than a claim in the same sense as liabilities.

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Alternatives considered

Eliminate the need for equity/net assets as an element

130. The IASB/FASB paper suggests that there is an argument that can be made that the balance sheet elements could be limited to assets and claims. The different types of claims that comprise to meet that element would continue to be useful for sub-classification, but they would not be elemental.
131. The IASB/FASB convergence project⁶ notes that while there are differences between liabilities and equity they have certain commonalities:
- (a) they all supply capital to the corporation;
 - (b) all of their claims are against the corporation and they lack any recourse to any other party;
 - (c) their claims are to interests in the corporation, not to the specific assets of the corporation;
 - (d) they all demand a return on their invested capital; and
 - (e) they are not directly involved in the management of the corporation's business activities.
132. This approach has a major advantage in that the standard setters no longer would need to debate the liability or equity question and would be free to distinguish among classification characteristics that are relevant to the particular item. However, it does not seem to suit the public sector environment as not all net assets represent claims or ownership interests.

Eliminate ownership interest altogether from public sector financial statements

133. Unlike the IPSASB and other standard setters in the public sector that recognizes net assets/equity as an element, in Canada there is no ownership interest presented on the face of the financial statements. Ownership interests are excluded by applying proportionate consolidation or proportionate modified equity accounting making the residual simply a reflection of accumulated surplus or deficit. As such there is no element "net assets/equity" because the resulting number is simply the accumulation of surpluses and deficits (as defined).
134. However, it can be argued that this approach understates the total extent of assets and liabilities of the whole-of-government.

Defining equity/net assets in the public sector

135. The above indicates that IPSASB should not eliminate the idea of net assets/equity as an element of public sector financial statements. However, there is an issue as to how it is currently defined.
136. Most standard setters have defined equity/nets assets as simply a residual "interest". The focus on the word interest needs to be considered.

⁶ IASB Agenda paper 2, Perspectives of Financial Reporting, April 21, 2008

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DATE	PUBLICATION	NET ASSET/EQUITY DEFINITION
2006	IPSAS 1, Presentation of Financial Statements	Net assets/equity is the residual interest in the assets of the entity after deducting all its liabilities.
2007	IFRS Framework	Equity is the residual interest in the assets of the entity after deducting all its liabilities.
2006	Canada PS 1000	No definition offered but implied residual difference between assets and liabilities.
	Canada 1000	Equity is the ownership interest in the assets of a profit-oriented enterprise after deducting its liabilities. While equity of a profit-oriented enterprise in total is a residual, it includes specific categories of items, for example, types of share capital, contributed surplus and retained earnings.
2007	US FASAB ED	Net position or its equivalent, net assets, is the arithmetic difference between the total assets and total liabilities recognized in the federal government's or a component entity's balance sheet. Net position may be positive (assets greater than liabilities) or negative (assets less than liabilities).
2007	US GASB	Net position is the residual of all other elements presented in a statement of financial position.
1985	US FASB CON 6	Equity or net assets is the residual interest in the assets of an entity that remains after deducting its liabilities.
1999	UK ASB Principles	Ownership interest is the residual amount found by deducting all of the entity's liabilities from all of the entity's assets.
2004	Australia AASB	Equity is the residual interest in the assets of the entity after deducting all its liabilities.
1993	NZ ARSB	Equity is the residual interest in the assets of the entity after deduction of its liabilities.
2002	German ASB Draft	Equity embodies the claims of owners. Equity is distinguishable from liabilities. The criteria for distinguishing between equity and liabilities are based on whether the claims are for a fixed amount (liabilities) or for a residual amount (equity).
2006	Japan ASB DP	Net assets is the difference between total assets and total liabilities.
2006	South African ASB	Net assets are the residual interest of the owners in the assets of the entity after deducting all its liabilities.

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137. The reasons for defining equity/net assets as an element varies among standard setters:
- (a) it could be used to determine whether there has been a return on capital or a return of capital;
 - (b) owners' contributions/distributions have separate economic characteristics;
 - (c) it is used for the purposes of articulation; and
 - (d) it represents the component of net assets attributable to the owners/shareholders.

Unique features of the public sector

138. There appears to be some *unique features of the public sector* that need to be considered.
139. A key difference in the public sector is that, for the most part, the net assets of a government do not necessarily represent an "ownership" interest. In many cases, the net assets of a government are a reflection of the assets available to finance future operations or that can be used to repay debt. Depending on the individual government situation, there may be no outside ownership interest or there may be net liabilities. However, in others there may be.
140. The FASB notes that a not-for-profit organization has no ownership interest in the same sense as a business enterprise. A not-for-profit organization's net assets are increased by receipts of assets from resource providers who do not expect to receive either repayment or economic benefits proportionate to their contributions. Its net assets are decreased by providing goods and services. It, too, is a residual but in contrast to a business enterprise it does not represent an ownership interest.

Alternatives

Define "net assets" and treat any ownership interest as a sub-classification of net assets

141. This can be justified from the perspective that elements share common characteristics. Clearly ownership interests have distinct characteristics from accumulated surplus/deficit in a public sector environment. Accumulated surplus/deficit does not represent an outside claim but net economic resources at the disposal of the government.
142. This could be accomplished by simply removing the reference to "interest" in the above definitions. For example, the GASB definition offers a possible approach:
- Net position is the residual of all other elements presented in a statement of financial position.*
143. This approach offers a simple definition of net assets and removes the notion of "interests" from it.
144. This major advantage of this approach is that other "items" that may be presented in the net assets/equity section of the statement of financial position. For example items such as capital maintenance adjustments and fair value changes are treated

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as sub-classifications of net assets/equity and would not need separate element definitions. It is acknowledged that there may be a need to define these items just not at the element level.

Define “ownership interest” as a separate element

145. In one regard, a government is similar to a not-for-profit who do not have owners, the residual amount represents economic resources available or needed as a result of past transactions and events recognizing the limitations of recognition and measurement. From this perspective, the net assets of not-for-profit organizations and governments (generally) share common economic characteristics.
146. However, given that ownership does exist in the public sector, the breadth of activities that exist within a government’s reporting entity and that IPSASB applies to entity level financial statements, ownership interest can exist both at the whole-of-government and at the entity level.
147. This may reflect the unique situation of governments in that, unlike the private sector and the not-for-profit sectors, there can be ownership interest but not all net assets represent “ownership” interests as net assets are likely to include economic resources to be used for financing future operations and ownership interests. Owner’s interest share different characteristics from that of the government-as-whole accumulated earnings or surplus/deficit.
148. From this perspective, one could define ownership interest as an element in that ownership is “outside” interest and does not share the same common characteristics of a liability or of the net assets of the reporting government. In this sense, there is no third party ownership existing in the net assets from a consolidated financial statement perspective after considering liabilities and ownership interests.
149. This approach is not unlike current IPSAS 6 paragraph 54 (black letter) that notes that minority interest shall be presented separately from the controlling entity’s nets assets/equity. Defining minority ownership interest as a separate element leaving the residual as accumulated surplus/deficit is a possibility. From this perspective, minority interests in any accumulated surplus or deficit are attributable to that interest. The remaining amount is a simple representation of the accumulated surplus/deficit. From this point of view the accounting equation could be something like this: $Assets - Liabilities - Ownership\ Interests = Accumulated\ Surplus/Deficit$.
150. Any accumulated deficit would be attributable to the extent of the minority interest and the balance would represent that of the government-as-a-whole. This is in line with existing IPSAS 6 paragraph 56 that notes where losses exceed the minority interest those losses are attributable to the majority interest – which in this case would be the accumulated surplus/deficit.
151. This can be justified from the perspective that ownership interests share common characteristics. Clearly ownership interests have distinct characteristics from accumulated surplus/deficit in a public sector environment. Accumulated

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- surplus/deficit does not represent an outside claim but those net economic resources at the disposal of the government.
152. IPSAS 6 provides some guidance in this regard. It defines minority interest as:
- That portion of the surplus or deficit and net assets/equity of a controlled entity attributable to net assets/equity interest that are not owned, directly or indirectly through controlled entities, by the controlling entity.*
153. The definition of ownership interests as a separate element could be:
- Ownership interest is that portion of the net assets of a public sector entity that is not owned, directly or indirectly by the controlling public sector entity.*
154. Because any losses can be attributable to ownership interests to the extent of their interests there does not appear to be a need to define the negative aspects of ownership interest.
155. Recognizing that “outside” ownership interests do not extend to the total residual difference between assets and liabilities and that the balance are those attributable to the entity reporting, it would be possible to define that balance as:
- Net assets/liabilities represent that portion of the net assets of a public sector entity that is attributable, directly or indirectly to the controlling public sector entity. Net assets/liabilities represent the accumulations of past revenues/gains and expenses/losses.*
156. The phrase past revenues/gains and expenses/losses was preferred to operating results reflecting the need the need to consider such things as capital maintenance adjustments and fair market value changes that may not be recognized in the operating statement.
157. Staff recognizes that this reporting model implications that are not at issue with this project. Nevertheless, there is a question as to whether ownership interests should be defined separately from other net assets/liabilities or whether this is simply a matter of display.
- Define all of the components of net assets/equity as elements*
158. Typically the components of the net assets/equity section of the statement of financial position can include and may not be limited to:
- contributions from owners;
 - distributions to owners;
 - capital maintenance adjustments;
 - fair value changes;
 - operating results;
 - prior period adjustments: and
 - effects of adopting existing or new IPSAS for the first time.

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159. Each of these components, it could be argued, share common economic characteristics and warrant a separate element.
160. However, elements are not the individual items themselves (such as cash, accounts receivable, number of employee hours, costs of purchased services or the extent of specific services provided or goods produced). They represent the basic categories of things that share similar characteristics.
161. Distinctions of individual items that fit in the same basic category do not require different elements. While making further distinctions of items within the individual element through display adds usefulness, display or sub-classification is a separate matter.
162. IFRS Framework, paragraph 48 notes that:

The presentation of the elements in the balance sheet and the income statement involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the entity in order to display information in the manner most useful to users.

163. FASB's Concepts Statement 6 explains this notion in the context of equity:

In financial statements of business enterprises, various distinctions within equity, such as those between common stockholders' equity and preferred stockholders' equity, between contributed capital and earned capital, or between stated or legal capital and other equity, are primarily matters of display that are beyond the scope of this Statement. [Footnote 29]

Do you think there is a need, given the unique situation in the public sector, to define "ownership interests" as a separate element? Please consider that outside ownership interests are different from the net assets/liabilities attributable to the reporting entity.

Do you think it would be useful and promote a user's understanding to define the remaining net assets/liabilities as the accumulation of past revenues/gains and expenses/losses.

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GENERAL IMPROVEMENT ISSUES

ISSUE – WHAT IS THE ASSET?

164. The existing IPSASB definition of an asset is:

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

165. The working definition of an asset of the IASB/FASB convergence project is:

An asset of an entity is a present economic resource to which, through an enforceable right or other means, the entity has access or can limit access of others.⁷

Assets as economic resources

166. Webster’s Ninth New Collegiate Dictionary defines assets as:

sufficient property to pay debts or legacies; the property of a deceased person subject to law to the payments of his debts and legacies; the entire property of all sorts of a person, association, corporation, or estate applicable or subject to the payment of his or its debts; an advantage, resource; the items on a balance sheet showing the book value of property owned.

167. There are many types of assets that do not meet the definition of an asset in financial statements. For example, one could refer to a gentleman whose wit is his asset. The essence an asset that can be reported in financial statements are those things that have *economic* value. This is the first criteria one can use for the purposes of defining what an asset is for the purposes of financial statements.

168. For property, an advantage or resource to be recognized as an asset it is the type of resource that will provide some form of an *economic* value that can be measured for financial statement purposes.

169. The basic difference among standard setters is the emphasis being placed on what is the asset is:

<i>Resource</i>	<i>Economic Resource</i>	<i>Future economic benefits</i>	<i>Service potential or future economic benefits</i>	<i>Rights or other access</i>
IPSAS 1	Canada PS	FASB	NZ ARSB	UK ASB
IFRS	Canada			
FASAB	Japan ASB			
GASB				
AASB				
German ASB				
SA ASB				

⁷ IASB/FASB Revenue Recognition Agenda paper 2 C, January 2008

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170. While there are several wording differences among the definitions, the issue identified is whether the asset is the resource itself, the future economic benefit or service potential embodied in the resource, or the rights or other access to future economic benefits.

Alternatives considered

Assets as future economic benefits or service potential

171. Those that focus on the *resource* as the asset indicate that the resource *provides* future economic benefits or service potential. For example, IPSAS 1 definition of an asset:

Assets are resources... from which future economic benefits or service potential are expected to flow...

172. Focusing on the economic benefits or service potential alludes to a characteristic of an asset. IPSAS 1 paragraph 11:

To encompass all the purposes to which assets may be put, this Standard uses the term “future economic benefits or service potential” to describe the essential characteristic of assets.

173. Even though the definition in FASB Concepts Statement No. 6 (CON 6) focuses on probable future economic benefits, paragraph 28 notes that the *common characteristic possessed by all assets* (economic resources) is “service potential” or “future economic benefit”. The NZ ARSB notes in paragraph 7.8 (b) that: “the entity is *able to enjoy the benefits*”. The UK ASB focuses on the right or other access to the future economic benefits, but their Concepts Statement notes that the “capacity to obtain future economic benefits is the *essence of an asset* and is common to all assets irrespective of their form.”

174. The IASB/FASB Conceptual Framework – Phase B: Elements and Recognition, Project Update as of February 2008 indicates that the working definition of an asset also places the emphasis on the resource and not the future economic benefits associated with the asset.

Assets as the rights or other access

175. The UK’s ASB definition of an asset focuses of the right or other access to future economic benefits. This appears to place the emphasis of the asset definition on the right to something as opposed to the resource itself. Paragraph 4.8 of their Statement of Principles for Financial Reporting says:

An asset is not the item of property itself, but rather the rights or other access to some of the future economic benefits derived from the item of property.

176. It is important to note that the UK also makes it clear that not all rights result in assets – only those that are rights to economic resources, or rights to benefit from economic resources are assets.

177. Of all the definitions used by national standards setters, only the UK focuses on the asset as being the *rights or other access*. All others focus on the asset as being

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- the economic resource or economic benefits. This approach has the disadvantage of being unfamiliar (except in the UK).
178. Furthermore, this alternative may focus on the wrong thing as being the asset. In the case of a lottery ticket, purchasing a lottery ticket provides a right to a chance of winning the lottery and not the winnings themselves. So this approach could lead some to the wrong conclusion about what right represents. Similarly, it can lead some to think of a loan guarantee as not being an asset to its holder because the holder does not presently have the right to demand payment from the writer of the guarantee because the holder has not gone into default.⁸
- Assets as the resource*
179. The existing IFRS Framework and the proposals in the IASB/FASB convergence project define assets as the resource. The question of whether an asset has the capacity to produce future economic benefits is a different question from whether the asset itself has economic value. It is the economic value embedded in the resource itself that makes the item an asset. Expectations or probabilities that an asset will produce future economic benefits are different questions.
180. The existing IPSASB definition has the right correct focus – *resources*.

Improving the definition

181. That is not to say, however, it cannot be improved. Webster's Ninth New Collegiate Dictionary defines a resource as:
- a source of supply or support: an available means; a natural source of wealth or revenue; computable wealth; a source of information or expertise; something to which one has recourse in difficulty; a possibility or relief or recovery; a means of spending one's leisure time; and an ability to meet and handle a situation.*
182. The definition above indicates that like the definition of an asset, a resource can be many things.
183. For the purposes of financial statements, an asset is an *economic* resource that has an economic value greater than zero. An item that has a sentimental value such as a family photograph is typically incapable of having value to others and items that are available for all to enjoy such as the air one breathes do not have an economic value.
184. Financial statements focus on stocks and flows of *economic* things.
- Elements are not individual items, but the fundamental components of information that share common economic characteristics portrayed in general purpose financial statements.*
185. Introducing the word "*economic*" before resources is a useful addition to the working definition of assets and by clarifying which resources the definition of an

⁸ IASB Agenda item 16C, October 16, 2007, paragraph 86.

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asset encompasses. For example it would exclude things such social or political resources.

What “economic resource” would include

186. An economic resource is something that has economic value. Something is of *value* when it is capable of being used to meet the objectives of an entity when carrying out activities such as financing operations, producing goods and services, settling liabilities and redistributing wealth. For financial statement purposes, we are interested in those things that have *economic* value—that is, those things that are capable of being used by the entity to meet its objectives. Thus, something that only has sentimental value is incapable of having value to others and does not have *economic* value. On the other hand, something that is available to anyone such as air does not have *economic* value.
187. Economic value can arise either directly or indirectly from a single resource or from a combination of resources. That value can result in either cash flows or in the resource’s ability to be used to provide for future services (service potential).
188. The IASB/FASB defines economic resource to mean:
- something that has a positive economic value. It is scarce and capable of being used to carry out economic activities such as production and exchange. It can contribute to producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources include unconditional contractual promises that others make to the entity, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.*⁹
189. Economic resources of a government can include:
- (a) *Cash* – Cash can be used for a variety of different purposes such as investing, purchasing other economic resources, settling liabilities, redistributing wealth or paying for costs incurred;
 - (b) *Claims to future cash* –Accounts receivable or investments, are direct sources of *future* cash inflows;
 - (c) *Items that generate future cash flows* – Inventories of supplies and property, plant and equipment used in exchange transaction type situations can contribute either directly or in combination with other assets to future cash flows;
 - (d) *Items that provide service potential*– Inventories of supplies and property, plant and equipment can be used to provide community services such as water treatment and distribution in a non-exchange type situation where it is the power to tax that provide the necessary cash flows. These resources have value in terms of service provision;
 - (e) *Intangible assets* –Various types of software, licenses, patents, rights etc., held by a government; and

⁹ IASB Agenda item 16B, October 16, 2007, page 25.

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- (f) *Contractual arrangements* – Unconditional contractual promises can result in an economic resource.

Items requiring a public sector perspective

Items that provide service potential

190. Other economic resources, such as those associated with a tax supported water treatment and distribution facility may not directly or indirectly generate cash in flows from the sale of water, but provide the resources necessary to provide that service. Cash inflows associated with this function may be generated from the government's ability to tax.
191. Nevertheless, these resources have economic value. Where a government chooses to provide water services itself, without the related assets the government would necessarily need to find a supplier of the service and pay for it directly. Alternatively, the community would need to buy directly from a private sector supplier. There are numerous examples of where governments have sold these and other types of assets to the private sector.

Intangible assets

192. Intangible assets are identifiable non-monetary assets without physical substance¹⁰ and can arise from such things as copyrights, patents and licenses and include items such as computer software. They represent economic resources as they can be sold, assist in the generation of economic benefits from the sale of goods and services, exchanged for other economic resources and used in the provision of goods and services. IAS 38 does not recognize internally generated goodwill because it is not an identifiable economic resource because it is not separately identifiable nor does it arise from contractual or other legal rights.

*Contractual arrangements*¹¹

193. Economic resources can also result from contractual arrangements. In these circumstances, the economic resource is an unconditional contractual promise from another party. Contracts generally involve exchanges of promises – one party promises to do something in exchange for a promise from another party to do something else in return. This is particularly important in the consideration of government transfers and social policy benefits.

Stand ready assets

194. Stand-ready assets can also be considered assets. A guarantee on an amount receivable provides an entity with an unconditional right to receive a cash payment of the amount receivable from the guarantor, if the original debtor is unable to pay. The guarantee reduces the risk that the entity will incur losses as a result of non-payment of the debt by the debtor. The lender (holder of the guarantee) has a *conditional* right to be paid by the guarantor (writer of the guarantee) if and when default occurs. The lender also has an *unconditional* right

¹⁰ IAS 38

¹¹ Adapted from IASB Agenda item 3, November 16, 2006.

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throughout the term of the debt for the guarantor to stand ready to pay the lender if the borrower fails to pay when the debt comes due. The lender would not relieve the guarantor of that obligation before the debt's term expires without being paid an acceptable amount (presumably an amount something less than the receivable balance assuming that default is not imminent).

195. Staff understands that additional work in this area is needed from the perspective of its applicability to the public sector. The point is that IPSASB must consider unconditional contractual promises when developing its definition of an asset.

Do you agree that the asset is the economic resource?

Do you agree that definition of economic resource should be broad enough to promote standards-level discussion of various issues such as contractual arrangements?

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ISSUE – WHAT IS THE LIABILITY?

196. The existing IPSASB definition of a liability is:

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

197. The working definition of a liability of the IASB/FASB convergence project is:

A liability of an entity is a present economic burden or requirement to which the entity has an enforceable obligation.

Liabilities as economic burdens

198. Webster’s Ninth New Collegiate Dictionary defines being liable as:

being obligated according to law or equity; responsible, subject to appropriation or attachment; exposed or subject to some unusual adverse contingency or action.

199. There are many types of obligations that cannot be recognized in financial statements. For example, an obligation to reduce the speed limit on a road is not a liability. The essence of a liability that can be reported in financial statements are those things that result in giving up something that has economic value.

200. For something that results in one being obligated, responsible or exposed that meets the definition of a liability it is the type of obligation that results in some form of economic value being transferred to another party.

201. The basic difference among the standard setters is the emphasis being placed on what the liability is:

<i>Obligations</i>	<i>Present Obligations</i>	<i>Probable future sacrifices of economic benefits</i>	<i>Future sacrifices of service potential or of future economic benefits</i>
Canada	IPSAS 1	FASB	NZ ARSB
UK ASB	Canada PS		
Japan ASB	FASAB		
	GASB		
	German ASB		
	SA ASB		

202. While there are several wording differences among the definitions, the issue identified is whether the liability is the obligation itself or the future sacrifices of economic benefit or service potential embodied in the resource.

Liabilities as the future sacrifice of economic benefits [or service potential]

203. Those that focus on the obligation as the liability indicate that the obligation results in an outflow or future sacrifice of economic benefits. For example, IPSAS

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obligations ... result in an outflow from the entity of resources embodying economic benefits or service potential

204. Both the FASB and the NZ ASRB note in their characteristics of liabilities:
it embodies a present duty or responsibility, the duty or responsibility obligates a particular entity (FASB Con 6 paragraph 6)
there must be a present obligation, that is, the entity must have duty or responsibility (NZ ASRB Concepts paragra 7.11)
205. Even though the definitions of liabilities in the FASB and NZ ARSB material refer to the liability as being the future sacrifice of economic benefit {service potential} a common trait illustrated in the definitions and in the characteristics of liabilities is that are obligations first and that they are the types obligations that result in an outflow or sacrifice of economic benefits.
206. The IASB/FASB paper notes that focusing on *future sacrifices of economic benefits* is the wrong focus. Financial statements can be viewed as reporting on things that exist (sometimes referred to as *stocks*) and changes in those things (sometimes referred to as *flows*). Like the definition of an asset, the definition of a liability should focus on stocks – the things that exist. A liability is not itself an outflow (or sacrifice) of economic benefits, but rather it is something that is capable of resulting in an outflow (or of reducing an inflow). The problem with the existing FASB definition is that it defines a ‘stock’ by reference to a ‘flow.’ That is, it states that, “Liabilities are probable future sacrifices ... arising from present obligations”. It focuses on the things that have arisen from the present obligation, rather than on the present obligation itself.¹²
207. The existing IPSASB definition has the correct focus – *present obligations*.
208. The IASB/FASB working definition of an asset is structured to first focus on the “good thing” that exists—an economic resource, and then on how the entity is linked to that good thing.
209. In the same manner, the liability definition is proposed to be structured to first focus on a “bad thing” and then on how the entity is linked to that bad thing. Compared to the proposed definition that “a liability is a present economic obligation of the entity,” this proposed structure would more explicitly and clearly describe the two essential components of a liability.

Opposite Term of *Economic Resource*

This Section has been reproduced from the IASB/FASB convergence project Phase B: Elements and Recognition – Liability Definition, (Agenda paper 14 a), December 13, 2007.

¹² IASB/FASB Agenda paper 14 A, December 13, 2007

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210. Previously, we had proposed the term “economic burden” as the opposite of “economic resource.” However, some Board members have expressed concern with the use of the word *burden*. The term *burden* does have several meanings. The *Oxford English Dictionary Online*¹³ describes *burden* as: “a heavy load, cause of hardship or worry, and the main responsibility for a task.” To put the term in its intended financial context, it would be described as an *economic burden*. Though not defined in dictionaries, *economic burden* is used in economic studies to refer to costs that society bears, such as national debt.
211. In light of the concerns about the word *burden*, we have sought out alternative words, such as “encumbrance,” “onus,” “duty,” “responsibility,” or “requirement.” We think some of these alternatives do not capture all the things we think of as liabilities or may have different meanings depending on the facts and circumstances. For example, *encumbrance* is often interpreted from a legal perspective which is defined in the *Oxford English Dictionary Online* as “a mortgage or other charge on property or assets.” Some of the terms are synonyms of *burden* or *obligation*, such as *onus* or *duty*, respectively.
212. *Responsibility* and *requirement* are possible candidates to replace *burden*. They are defined in the *Oxford English Dictionary Online* as:
- (a) *Responsibility* is “the opportunity or ability to act independently and take decisions without authorisation, and a thing which one is required to do as part of a job, role, or legal obligation.”
 - (b) *Requirement* is “something required, a need, and something specified as compulsory.”
213. We do note that *responsibility* can be viewed as a positive ability, which is opposite of the notion intended in the liability definition. A *responsibility* also implies that a person who is “responsible” for something has the ability or power to decide what to do and when to act. For these reasons, we think the term “requirement” more clearly implies that there is something one must do or cannot avoid, than “responsibility.” However, describing the thing to which the entity is obligated as a “requirement” does introduce some ambiguity, as this might be read by some to imply that others can require the entity to do something, which is the role of the “*link*.”
214. On balance, we think that *economic burden* and *economic requirement* most clearly capture the opposite of “economic resource.”
215. To follow a parallel approach used in the working definition of an asset and to describe the first essential component of a liability, this suggests that we should further amend the definition of a liability in paragraph 30 above, as follows:

“A *liability of an entity* is a present economic *burden or requirement*¹⁴ _{3 obligation} of the entity.”

¹³ Accessed *Oxford English Dictionary Online* in November 2007

¹⁴ We have suggested using both *burden* and *requirement* in the working definition. However, if the Boards agree that one or the other term is clearly preferable, then that term might be used alone.

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216. To communicate the meaning of *economic burden or requirement*, the definition of a liability should be accompanied by the following definition:

“An *economic burden or requirement* is something that is scarce and capable of resulting in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic burdens or requirements.”

This parallels the equivalent definition of an economic resource, supporting the working definition of an asset, as follows:

“An *economic resource* is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources.”

Do you think the use of economic burden is an appropriate change to consider?

Is linking the definition of an asset with that of a liability useful and helpful?

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ISSUE – REMOVING PAST TRANSACTIONS FROM THE DEFINITIONS

217. The existing IPSASB definitions of an asset and liability are:

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

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

Alternatives considered

Include past events in the definitions

218. All of the standard setters include a reference to past transactions and events (albeit to varying degrees) in their existing definitions of assets and liabilities.

219. It is believed that the inclusion of the “past” transactions or events were included in the definitions primarily to exclude future events from meeting the definitions. This has led to much debate around identifying the past transaction or event that gave rise to the asset or liability. From this perspective, it may be that certain assets or liabilities were not recognized simply because of a failure to determine the “past” transaction or event.

220. For example, in some cases intangible assets, financial guarantees and recipients of government transfers may create difficulties when recognizing an asset because preparers are unable to identify the past transaction or event, yet an economic resource may exist. In others, determining whether a liability existed at the financial statement was complicated by trying to identify the past event. To that end they may have been unrecognized.

Remove the reference to past events

221. How the economic resource or claims to it were obtained should not affect whether something under consideration meets the definitions. Although an observed transaction or other event might provide a signal that an asset or liability might be present and provide a clue as to its nature, the failure to observe such a transaction or other event does not demonstrate that an asset or liability is not present. Conversely, just because a transaction or other event has occurred, that does not mean an asset or liability has resulted from it. For example, expenditure could have resulted in an expense rather than an asset.

222. The difficulty with keeping the phrase *as a result of past events*:

- (a) This does not reflect that there may have been past transactions or events that resulted in assets or liabilities which no longer exist.
- (b) It has resulted in unwarranted debates about what the past event was (how the asset or liability arose should not be at question).
- (c) The inability to identify a past event may lead to non-recognition of an asset or liability.

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223. Staff are proposing that IPSASB focus on the asset or liability's present existence regardless of how it was attained.
224. Both the existing IASB and FASB definitions refer to the need for an asset and a liability to have arisen as a result of something having happened in the past. To avoid the undue emphasis some people place on identifying the past transaction or other event that gave rise to an asset, the Boards decided to improve the definition of an *asset* by focusing on the present, rather than on past transactions or other events.
225. In a parallel manner, by focusing on a *present* economic resource or obligation in the proposed definition of a liability, it becomes redundant to refer to the need for a past event. This also has the advantage that the economic resource or obligation must exist today—so it cannot be an economic obligation that will not arise until the future or that existed in the past, but no longer exists at the financial statement date.
226. To the extent that a past transaction or event might help to identify the existence of an asset or liability, the surrounding text can explain that being aware of the event or transaction is a sufficient but not a necessary condition.
227. The IASB/FASB working deliberations considered using the word “*existing*” in front of the phrase economic resource and liability. They concluded that this may exclude items such as prepaid rent because prepaid rent gives the entity the right to a future, not a present, use of the item rented.
228. Using the term “*future*” economic resource or liability is not appropriate as it could introduce the possibility of accruing future assets such as yet to be levied tax revenues. While a government may have the power to tax, until it exercises its authority to do so, it cannot have an asset. Future liabilities could include items such as future program expenses or other commitments.
229. Inserting the word “*present*” before economic resource or liability requires that the resource or liability must exist as at the reporting date emphasizing that it cannot be an asset or liability that will arise until the future or one that existed in the past, but no longer exists at the reporting date. For purposes of clarity, this does not preclude additional guidance being provided relating to “past events” but it is not required and may even add a level of difficulty in the definitions.
230. To avoid undue emphasis on seeking out the event that happened that gave rise to an asset, it is proposed that the focus on past events be removed from the definition and that the word “present” be included in the definitions to stress that only those assets and liabilities that are present at the financial statement date meet the definitions.

Do you agree that it is not necessary to include past events in the definitions?

Do you agree with including the word “present” in the definitions of assets and liabilities deals effectively with the issues related to future events that existed in the past but are no longer available?

Elements

ISSUE - REMOVING RECOGNITION CRITERIA FROM THE DEFINITIONS

Background

231. The existing IPSASB definitions of an asset and liability are:

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

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.

232. Both of the existing IASB and FASB definitions of an asset and liability make reference to likelihood, but using different words (“expected” in the case of the IASB and “probable” in the case of the FASB) the benefits will flow to or from the entity. Likelihood was included in the existing FASB definition in response to constituents’ concerns on earlier proposals that the definition would require that an item be certain in order to qualify as an asset or liability. Since few things in life are certain, the FASB observed that few items that are commonly thought to be assets or liabilities would qualify in accordance with the definition. Accordingly, the FASB included likelihood with the intent of indicating that the item in question need not be certain (that is, it could be less than certain) to meet the definition. It is likely that similar reasons resulted in the inclusion of *expected* in the IASB definition.
233. Given that the IPSASB adopted the IASB definitions as part of its initial efforts to develop basic definitions of the elements, it is likely that same reasoning was used when they were adopted.
234. The definitions have been misinterpreted as implying that there must be a high likelihood of future inflow or outflow of economic benefits for the definition to be met. Thus, some think that unless there is a high likelihood of future outflow of economic benefits, the asset and liability definition is not met.
235. If there is any question of likelihood to be considered, that might be a factor in assessing whether a particular asset or liability (or class) qualifies for recognition, or in determining its measurement, not in the definition of a liability.
236. This was the most favoured improvement in the draft definition by participants at the AAA/FASB conference in December 2006.

Recognition

237. Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition as set out below¹⁵.

¹⁵ IASB Framework

Elements

238. An item that meets the definition of an element should be recognised if:
- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
 - (b) the item has a cost or value that can be measured with reliability.
239. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. For example, when it is probable that a receivable owed to an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset.
240. One of the difficulties with continuing with this aspect “expected” in both the definitions is different than the word used in the recognition criteria “probable” which may lead confusion.
241. The IASB/FASB convergence project removes these references from the definitions themselves.

Do you agree that these aspects contained in the definitions are best addressed in the recognition criteria?

Do you see any public sector specific issues arising from this?