



**INTERNATIONAL FEDERATION
OF ACCOUNTANTS**

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Agenda Item
2B

DATE: May 8, 2009
MEMO TO: Members of the IPSASB
FROM: Tim Beauchamp
SUBJECT: Conceptual Framework Phase 2 – Elements and Recognition

OBJECTIVE OF THIS SESSION

To discuss the issues set out in the Discussion Paper – Phase 2.

AGENDA MATERIAL

2B.1 Discussion Paper – Phase 2

ACTION REQUIRED

Review the Discussion Paper – Phase 2 with a view to provide staff with directions for development of the Consultation Paper. Specifically:

- Provide your views on whether an asset and liability or revenue expense view should be adopted as the basis for defining the elements.
- Provide your views on which elements should be defined, in particular those related to financial performance.
- There are a number unresolved issues included in the paper representing preliminary thoughts, please be prepared to provide your views on those issues.

BACKGROUND

At the October 2008 meeting, the IPSAB was presented with a discussion paper dealing with Conceptual Framework (Framework) Phase 2 issues. This Phase of the Framework deals with Elements of Financial Statements. The IPSASB provided the following directions for the development of this draft:

- Take a neutral approach by analyzing alternatives for the purposes of seeking views
- Discuss the elements in terms of meeting the overall objectives of GPFs
- Provide a description of what is meant by elements
- Provide a definition of service potential
- Include definitions of capital maintenance adjustment, other remeasurements and transactions with owners
- Develop recognition criteria
- Consider using Service Concessions as a basis for understanding control
- Sovereign rights should be considered in the paper

Fundamental to exploring many of the above issues is the issue of which elements should take primacy from a definitional point of view. There are two views in accounting: some believe that assets and liabilities should take primacy; and others believe the revenue and expense should take primacy. This is a fundamental issue to resolve as it not only affects the measurement of financial position and performance but it also has an effect on which elements are defined and how they are to be defined.

The paper has been divided into Sections which represent the major issues to be discussed. The first three Sections represent a neutral approach by offering various points of view and alternatives for the purposes of seeking input. The remaining Sections are preliminary views and writings but they offer issues to be considered. These Sections, as they deal with the definitions themselves, will depend on the outcome of discussion on Sections 1 and 2.

Section 1 Basis for defining the elements

This Section provides a discussion of the purposes of elements, background on the characteristics of a public sector entity that need to be considered when assessing the approach to defining the elements, and a discussion on the two views of measuring financial position and performance. This Section is intended to form a good part of the discussion at the meeting.

Section 2 Representations of financial position and performance

This Section provides discussion on the statements of financial position and performance and which elements to define. This discussion is provided with the understanding that the outcome of the discussion relating Section 1 may affect the content. This Section will also be an important part of discussion.

Section 3 The breadth of elements

This Section addresses a number of issues to consider for the purposes of identifying the types of things that should be included in the definitions themselves. For example, should moral and equitable obligations be considered in or excluded from the definitions.

Section 4 Elements

This Section provides views on the elements and the alternatives for their definition. It is underdeveloped and work on this Section will proceed however decisions need to be made on the above Sections first.

Section 5 Recognition

This Section offers some very preliminary thinking on the issue of recognition and needs to be further developed. It does raise some basic issues related to recognition for your consideration.

There are a number of issues that are being addressed based on the last meeting that will be completed over the summer.

ELEMENTS AND RECOGNITION

Introduction

When the International Public Sector Accounting Standards Board (IPSASB) first initiated its standards-setting program, it determined to start by developing a credible core set of International Public Sector Accounting Standards (IPSASs) that could be adopted by those entities seeking guidance on financial reporting issues. Many concepts, definitions, and principles were considered and embedded in the specific IPSASs as they were developed. To date, however, these concepts, definitions, and principles have not been explicitly identified and explained.

National standards setters in a number of countries have developed conceptual frameworks to respond to the political systems and institutional arrangements in their countries. These frameworks are an important component of the literature of those national standards setters.

The IPSASB is of the view that it is now time to develop an international conceptual framework for general purpose financial reporting (financial reporting) by public sector entities. The IPSASB's Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities (the IPSASB Framework) will establish the concepts that are to be applied in developing IPSASs and other documents that provide guidance on information included in general purpose financial reports (GPFs).

The IPSASB Framework will underpin IPSASs that apply across countries and jurisdictions with different political systems and forms of government. The institutional and administrative arrangements established by the public sector for the delivery of services to constituents can also differ widely from jurisdiction to jurisdiction. The IPSASB Framework will therefore need to recognize the diversity of (a) underlying social and cultural traditions, (b) forms of government, and (c) service delivery mechanisms that exist in the many jurisdictions that may adopt IPSASs.

Many of the IPSASs currently on issue are based on International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB), to the extent that the requirements of those IFRSs are relevant to the public sector. The current IPSASs therefore draw on relevant concepts and definitions in the IASB's "Framework for Preparation and Presentation of Financial Statements" (the IASB Framework), with modifications where necessary to address public sector circumstances.¹

The IASB is currently reviewing its Framework in a joint project with the Financial Accounting Standards Board (FASB) of the USA. The initial focus of the IASB-FASB joint project is on financial reporting by business entities in the private sector. In a later phase of the project, the applicability of the IASB Framework to financial reporting by not-for-profit entities in the private sector and business entities in the public sector will be considered. However, the IASB Framework will not apply to other public sector entities.

¹ Consistent with the IPSASB's IFRS convergence strategy, the accrual IPSASs that are based on International Financial Reporting Standards (IFRSs) reflect the requirements of those IFRSs unless there is a public sector specific reason for a departure.

Given (a) the relationship between the IPSASs currently on issue and the concepts and definitions in IFRSs, and (b) the IPSASB's ongoing IFRS convergence strategy, developments in the IASB Framework are being closely monitored.² The IPSASB Framework will draw on the work of the IASB where it is relevant to the public sector. However, the objective of the IPSASB's project is not simply to interpret the application of the IASB Framework to the public sector, but rather to develop a public sector conceptual framework that makes explicit the concepts, definitions, and principles that underpin the development of IPSASs.

It is intended to develop the IPSASB Framework primarily for public sector entities other than Government Business Enterprises (GBEs). GBEs, which are profit-seeking entities, apply IFRSs issued by the IASB. They are therefore subject to the IASB Framework. However, the performance objectives of GBEs often include both the maximization of profit and the achievement of certain non-profit/social policy objectives imposed on them by governments. In developing the IPSASB Framework and the revised IASB Framework, the IPSASB and the IASB will need to consider whether the social policy/service delivery objectives to which GBEs may be subject will influence (a) the objectives of financial reporting by them, and/or (b) other components of the IPSASB or IASB Framework that applies to them. The IPSASB will consider its work plan and determine whether a separate project to address GBEs should be given priority.

The IPSASB encourages public sector entities to adopt the accrual basis of accounting, but acknowledges that many public sector entities currently adopt the cash basis of accounting (or a near-cash or modified-cash basis). As part of its framework project, the IPSASB will consider the concepts that underpin the cash basis of financial reporting. This will be done at a later stage of the project.

The concepts underlying the statistical financial reporting models, and the potential for convergence with them, will also be considered in developing the IPSASB Framework. The IPSASB is committed to minimizing divergence from the statistical financial reporting models. The extent to which this is achievable will depend on the significance of any differences in the information needs of users of GPFRs and users of statistical reports.

Consultation Papers and Exposure Draft

This project was initiated in 2006 with a project brief that was approved in November 2006. It is a collaborative project that the IPSASB is leading in conjunction with a number of participating national standards setters and similar organizations.

Although the components of the IPSASB Framework are interconnected, the project is being developed in phases, and the IPSASB will issue consultation papers at the conclusion of each phase, followed by an exposure draft of the complete accrual IPSASB

² In July 2006, the IASB issued a Discussion Paper "Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information." An Exposure Draft was issued in May 2008: "Conceptual for Financial Reporting: Chapter 1: The Objective of Financial Reporting (and) Chapter 2: the Qualitative Characteristics and Constraints of Decision-useful Financial Reporting Information." In May 2008, the IASB also issued a Discussion Paper: "Preliminary Views on an improved Conceptual Framework for Financial Reporting – The Reporting Entity."

Framework. This will (a) provide constituents with the opportunity to review and comment on components of the IPSASB Framework as they are developed, as well as the full exposure draft, and (b) allow each stage of project development to be informed by responses to prior consultation papers.

The components of the accrual IPSASB Framework have been grouped, and are being considered in the following sequence:

Phase 1 – the objectives of financial reporting, the scope of financial reporting, the qualitative characteristics of information included in GPFRs, and the reporting entity.

Phase 2 – the definition and recognition of the “elements” that are reported in financial statements.

Phase 3 – consideration of the measurement basis (or bases) that may validly be adopted for the elements that are recognized in the financial statements.

Phase 4 – consideration of concepts that may underpin the cash basis of financial reporting.

More details of each of these phases can be obtained from the project brief that can be found online at www.ipsasb.org.³

³ International Public Sector Accounting Standards Board, Public Sector Conceptual Framework – Project Brief (December 2006). Posted at www.ipsasb.org. Then go to project histories and public sector conceptual framework.

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(TO BE COMPLETED)

THE NEED FOR ELEMENTS AND RECOGNITION CRITERIA

1. Accounting policies and principles are mechanisms for making judgments about what individual transactions and events affect the financial position and performance of an entity at a particular point in time and when those transactions and events should be recorded.
2. Without having a conceptual framework in place, the development of individual standards and other guidance can be susceptible to the current needs of the economic environment and/or the views of individual standard setters at the time. A framework should be designed to establish the basic underlying concepts that will be used to judge individual accounting and other choices faced by standard setters thereby limiting the choices and alternatives that can be considered viable.
3. A conceptual framework is an inter-related system of objectives, definitions and other fundamental assumptions that will provide internal consistency among past, present and future standards and guidance. A conceptual framework provides the foundation for the future development of accounting standards and other guidance and for assessing various accounting choices.
4. Developing a conceptual framework for public sector entities⁴ should be based on the underlying objectives of public sector GPFS. Because the objectives of a business are different than those of a public sector entity, the underlying concepts and assumptions are not necessarily the same as those established for a business.
5. The IASB Framework paragraph 12 notes that the objective of financial statements is to provide information useful for users in making economic decisions. The economic decisions that are taken by users of financial statements are to evaluate the ability of an entity to generate cash and cash equivalents and of the timing and uncertainty of their generation.
6. The IPSASB notes that underlying objectives of public sector entity financial statements are to demonstrate accountability and for making resource allocation, political and social decisions. Accountability is an important objective as governments and other public sector entities raise resources from taxpayers, ratepayers and other resource providers for the use in the provision of public goods and services. These organizations are accountable to those who provide those resources for the use of those resources. The decisions of resources providers, for the most part, are not based on generating a financial return, but based on such issues as the allocation of resources to various goods and services to be provided, voting preferences, choosing a city within which to live or from a business perspective choosing a city to locate their facilities.
7. Because the underlying objectives of public sector GPFS are different than those of a business, there is cause to determine whether the framework used by the IASB is appropriate for public sector entities.

⁴ Public sector entities are defined to mean public sector entities other than Government Business Enterprises.

8. The definitions of the elements are important because they will determine what information is needed to meet the objectives of GPFS. However, questions arise as to which elements should be defined and their specific definitions. Further questions arise from the perspective of which are the most fundamental elements and, as a result, whether certain definitions depend on other definitions. This is sometimes referred to as the conceptual primacy of the elements. Elements are important considerations because they will determine, for example, what is an asset and liability is for the purposes of measuring financial position and what a revenue and expense is for the purpose of measuring financial performance. Elements and their definitions determine what items are considered in the measurements of financial position and performance.
9. Another key aspect relating to elements and their definition is their recognition. Recognition is the process of determining when a transaction or event that meets the definition of an element can be included in the GPFS totals. Under an accrual based model, recognition criteria become important because they reflect the point in time when items are expected to be realized and included in the financial statement totals. Realization⁵ occurs at the point of when the cash, for example, is either paid or received. Accrual accounting records transactions and events, generally prior to their realization or, for example, when cash is received or paid. Recognition criteria could include circumstances where a claim to future cash resources exists and even though its realization is unlikely. Defining the recognition criteria becomes important for assessing when a transaction or event that meets the definition of an element should be included in the GPFS. Recognition is important from the perspective of determining when something that meets the definition of an element is included in the measurement of financial position and performance.
10. Something can meet the definition of an element but not the recognition criteria established and therefore cannot be considered in the measurements of financial position and performance. Alternatively, an item may meet the recognition criteria but not the element definitions.
11. The objective of this paper is to identify and define the elements of general purpose financial statements (GPFS) and provide criteria for recognizing these elements in GPFS. The objectives of GPFS of a public sector entity establish the information needed and useful for accountability and decision-making. Depending upon how the elements and recognition criteria are defined will determine what information is included in the GPFS and what is not. Elements are important because they provide the first step or decision in determining *what* information is presented in the GPFS. The recognition criteria are important because they determine *when* a particular item is recorded.

⁵ Intermediate Accounting, Thomas Beechy and Joan Conrod, McGraw-Hill Ryerson Limited, Second Edition, page 57.

SECTION 1 – BASIS FOR DEFINING ELEMENTS

PURPOSE OF ELEMENTS

12. Users are interested in real economic phenomena. Economic phenomena⁶ are those actual transactions and other events that affect the financial position and financial performance of an entity.
13. The function of general purpose financial statements (GPFS) is the communication of financial information to users in a structured representation of the financial position and financial performance of a public sector entity. Excessive detail, vague or overly technical descriptions, and complex presentation formats result in confusion and misinterpretation. The ability of a user to understand the large number of often complex transactions and other events is enhanced by classifying, characterizing, and presenting financial information clearly, simply and concisely.
14. The purpose of identifying elements of general purpose financial statements (GPFS) is to provide a common and useful starting point for classifying these transactions and other events in a way that will enhance users' understanding of the detailed information contained in an entity's financial reporting system.
15. The ability of a user to understand large numbers of transactions and other events is enhanced when information is aggregated into common classification types that characterize their nature. Elements of financial statements represent the first or primary level of classification of the results of these individual transactions and other events. The individual groupings presented in the GPFS, such as current assets or liabilities, all begin with deciding on what element the transaction or other event is part of, for example, something must meet the overarching definition of an asset before it can meet the definition of an intangible asset.
16. In order to determine which elements are to be defined, a first step is to determine the purpose of elements. This can ultimately lead to which elements are to be defined. In a general sense, the term elements can mean a number of things. Webster's New Ninth Collegiate Dictionary notes that the word *element* when used as a noun means:
 - a constituent part;
 - one of the necessary data or values on which calculations or conclusions are based (2) one of the factors for determining the outcome of a process; and
 - a basic member of a mathematical or logical class or set (4) one of the individual entries in a mathematical matrix or determinant.
17. The "a constituent part" perspective may not provide a clear enough distinction between an element and an item. For example, cash, property, plant and

⁶ IPSASB's Consultation Paper: Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities, paragraph 4.5.

- equipment and investments are constituent parts of assets which could lead one to conclude that these individual parts are elements. In addition, items themselves, such as accounts receivable, can be further broken down as with various types or categories of receivables.
18. Using “a constituent part” as the basis for identifying elements does not appear to provide a clear basis for distinguishing what an element is and what a financial statement item is. It does not appear to provide boundaries for deciding what an element is and what a subclassification of an element is. Taking this approach one might conclude that separate classifications such as those required in IPSAS 1, Presentation of Financial Statements, paragraph 70 “an entity shall present current and non-current assets” may be considered elements.
 19. The “factor for determining an outcome” perspective indicates that an element is something that is needed for determining a final result or outcome. This approach would identify those elements that are needed to make basic calculations such as determining financial position and performance. From this perspective, neither net assets/equity or annual financial performance would be defined as elements as they both represent an “outcome.” For example, net assets/equity is defined as a residual or as the difference between an entity’s assets and liabilities.
 20. However, most standards setters have defined net assets/equity as an element because items included under the heading net assets/equity share certain characteristics that not similar to other elements such as liabilities. They represent, for example, owners who bear the risk of failure and share the successes of the entity. Net assets/equity can be subdivided into various types of items such as contributions from owners and accumulated surpluses/deficits. In both cases, these amounts represent the residual interest. It is due in part because not all increases and decreases in net assets/equity results from the operations of the entity.
 21. The “basic member or logical class” perspective indicates that an element is something that is not a subclassification of something else. Under this approach, elements would be the basic classes or categories of transactions and other events aggregating them according to their shared nature or characteristics. This approach focuses at a higher level by identifying only those fundamental components that are portrayed in financial statements.
 22. If elements are to represent broad classes of things, an issue arises as to how specific one gets. Most agree that account titles, such as cash or property, plant and equipment while having different aspects, share some higher level of characteristics – they are both assets. The items reported within the heading for or broad class of an element do have some common characteristics because they all meet the definition for that element, but these different items have other distinguishing features.⁷

⁷ GASB’s Concepts Statement 4, *Elements of Financial Statements*, paragraph 2

23. Further, most agree that matters of display or presentation are without specific limits and go beyond the meaning of an element. The IASB Framework notes that that income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. Aggregations or combinations of different elements are also a matter of display or presentation.
24. This perspective of an element being a broad class of items is generally consistent with how other standard setters have used the term “elements” in their frameworks:
- (a) Canada’s PSAB *Financial Statements Concepts*: Elements of financial statements are the *basic categories* of items portrayed therein in order meet the objectives of financial statements.
 - (b) IASB’s *Framework*: Financial statements portray the effects of transactions and other events by grouping them into *broad classes*...These broad classes are termed elements...
 - (c) The New Zealand ASRB: Financial reports portray the effects of transactions and other events by grouping them into *broad classes*... These broad classes are termed elements...
 - (d) South Africa’s *Framework for the Preparation and Presentation of Financial Statements*: Financial statements portray the effects of transactions and other events by grouping them into *broad classes*... These broad classes are termed elements...
 - (e) The US’s GASB *Concepts Statement 4*: Elements are the *broad fundamental components* of financial statements.
 - (f) The United Kingdom’s ASB *Statement of Principles*: Elements of financial statements are building blocks with which financial statements are constructed – the *classes of items* that financial statements comprise.

Do you agree that elements should not be defined based on matters of presentation or display?

Do you agree that elements should be based on broad classes of items?

CHARACTERISTICS OF PUBLIC SECTOR ENTITIES

25. Unlike a public sector entity, the underlying objective of a business is to generate cash. The sale of goods and services takes place in a competitive environment where other entities can influence the success or failure of the business. The business operates to produce income that provides resources to be reinvested in the business, to repay borrowings and allows it to pay dividends to its owners. The financial statements report on the success or failure of that business to generate income. Annual income or loss is a key measure of business performance.

26. Public sector entities, governments in particular, have a different purpose and much broader powers and rights than do businesses. They have the ability to establish and enforce law, regulate the activities of its citizenry and businesses, hold the rights to vast natural resources, provide unique services such as national defense, and many hold heritage items representing the history of the nation. Perhaps the most significant difference lies in the fact that they have the power to tax and, as a result, do not rely on the profitable sale of goods and services to generate the required cash resources.
27. In general, the public and others provide the resources necessary to support the functioning of public sector entities. The provision of resources does not necessarily entitle them to a financial return or to the use of any particular public goods and services. Public sector entities use these resources to provide public goods and services to resource users in terms of things such as transportation and waste disposal and redistribute wealth to meet a variety of social and economic objectives.
28. Public sector entities raise taxes, incur liabilities for various public policy decisions and acquire non-financial assets to provide goods and services to the general public and encourage economic growth, education and to protect the health and welfare of its citizenry, not for the purposes of generating surpluses. The information needed to promote accountability and to aid understanding and assessing public sector entities' financial affairs extends beyond reporting surpluses/deficits.
29. In some cases it may be good public policy to incur deficits rather than surpluses. Reacting to and supporting downturns in the economy or providing assistance for a natural disaster may cause a public sector entity to incur a deficit however the decision to incur those costs may be in the best interests of the overall public. From this perspective, a deficit is not necessarily an indicator of poor performance. In other cases, generating surpluses may also not be a good thing. Taxes raised for the purposes of providing health care may not have been needed as the underlying health program were not completed or incurred. Therefore, the incurrence of a surplus could be caused simply by decreases in expenditures, resulting in lower than expected health care treatment.
30. Because the objectives of public sector entities are focused on the provision of public goods and services, a public sector entity must constantly balance between the ability of the tax base to pay, servicing its debts, the sustainability of the cost, quantity and quality of the goods and services provided, and the condition of its infrastructure to continue to provide goods and services
31. A public sector entity's accountability extends to the stewardship of the resources provided, the allocation and use of those resources, the service delivery choices and activities, the quality and quantity of services and the entity's achievements in meeting its public objectives. Public sector entities are thus held accountable for the choices they have made, and the financial position and performance resulting from those choices, decisions and uses of public resources.
32. Typically, the financial resources required are set out in a budget. The budget is a reflection of the estimates of operating, investing and financing requirements of

- the public sector entity and various policies relating to such things as debt and asset management. A public sector entity's budget is a critical component in its accountability cycle and, generally, held as a standard for measuring subsequent performance. Important accountability information is provided about the budget decisions of a public sector entity when issuing GPFS. GPFS show the effects of those past budgetary decisions on financial position and financial performance.
33. Further, public sector entities provide various programs designed to support the general social structures of the community. For example, many public sector entities provide health, education and welfare benefits including social benefits to the elderly, unemployment insurance schemes and other support mechanisms. Public sector entities pass legislation or regulation setting their policies in place which can include things such hospitalization insurance, old age security and other similar benefits. The extent of these benefits represents a significant draw on future revenue to fund these policies and programs. Understanding the effects of these programs on financial position and performance is also critical for assessing the accountability of a public sector entity and for making decisions about the management of the resources entrusted to that entity.
 34. Another key characteristic of a public sector entity is that its property, plant and equipment, among other similar items, are not acquired for the purposes of generating cash flows, but acquired to provide ongoing public services. For example, some of these items include complex network systems such as water and sewage treatment contributing to health and welfare of the citizens and highways and bridges and transportation systems that contribute to the movement of people, goods and services. These systems have direct affect not only on the local community where they are built in, but also on the overall economy and more generally, to the overall quality of life within nation.
 35. Providing information about them contributes to demonstrating a public sector entity's accountability for and the management of these vast networks of systems. Their benefit lies in their service potential and not cash generation. Understanding the extent of the stock of these resources and the cost of using them in public service provision is a key factor in assessing accountability, demonstrating the effects of past decisions relating to the ongoing maintenance and replacement of these assets, and the overall the financial position and performance of a public sector entity.
 36. Given that a public sector entity levies taxes and raises other revenue to provide its ongoing programs and service its debts, assessing the continuing ability of the tax base to shoulder the fiscal sustainability of a public sector entity's programs, meet its debt obligations, manage the vast networks for public service provision and provide the social benefits under its policies seems paramount.
 37. The financial statements provided should be based on the information that is needed by those who use the financial statements to make such accountability assessments and decisions.

CONCEPTUAL PRIMACY OF THE ELEMENTS

38. Every conceptual structure builds on a concept that has primacy. That is simply another way of saying something must be given meaning before meaning can be attached to other things.⁸ Because financial statements are periodic measures of financial position and performance, the measure of a public sector entity's financial position and performance as at a particular period creates many of the issues facing financial accounting and reporting.

39. There are two views as to the role of accounting in measuring financial position and performance:

(a) To measure an entity's financial position and, through changes in financial position, its financial performance. This is generally called the asset and liability view with assets and liabilities being the primary elements.

- The asset and liability view does not permit items to be included in the determination of financial position that do not meet the definitions of assets and liabilities. Financial performance is measured in terms of assets and liabilities and changes in them.

Some standards setters have defined revenue as increases of benefits or service potential during the reporting period resulting in increases in net assets/equity, other than increases relating to contributions from owners. Similarly, expenses are defined as decreases in benefits or service potential during the reporting period resulting in decreases in net assets/equity, other than decreases relating to distributions to owners. This would indicate that all increases and decreases in net assets/equity, regardless of their nature, are broadly considered revenue and expense unless they are owner transactions. This is an asset and liability view.

(b) To measure an entity's financial position through changes in financial performance. This is generally called the revenue and expense view with revenue and expense being the primary elements.

- The revenue and expense view takes an approach that recognizes revenue and expenses in the periods to which they relate by matching costs incurred with the revenues that they generate or vice versa. Financial position is measured in terms of changes in revenue and expense.

Some standards setters have defined revenue and expense in terms of inflows and outflows that are applicable to the current period. Inflows are generally defined as an acquisition of net assets/equity that is applicable to the current reporting period. An inflow of resources occurring in one period that is applicable to a future period is treated as a deferred item until it is recognized in the appropriate period. In that future period, the inflow would be reported as part of financial performance. Net assets/equity is unaffected as there has been an offsetting decrease in "liabilities" and an increase resulting from financial performance. Outflows are defined as a consumption of net

⁸ Oscar S. Gellein, "Primacy: Assets or income?" in *Research in Accounting Regulation*, vol. 6, edited by Gary John Previtis (Greenwich, Connecticut, JAI Press, 1992), page 198.

assets/equity that is applicable to a current period. An outflow of resources occurring in the one period that is applicable to a future period is treated as a deferred item until it is recognized in the appropriate period. In that future period, the outflow would be treated as part of financial performance. They have the same effect on financial position and performance as do deferred inflows. This is a revenue and expense view.

40. The fundamental difference between the approaches directly affects which elements are defined and how they are defined.

Asset and liability view

41. This approach determines net assets/equity based on the elements of assets and liabilities and would include all changes in those elements to be included in surplus or deficit, except those arising from transactions with owners.
42. The difficulty with this approach is that it introduces gains and losses, such as those arising from peripheral or incidental events and remeasurement gains and losses, into the measurement of surplus/deficit. Given the importance of the budget in the public sector as a key piece of accountability information, making comparisons in the GPFS becomes more than difficult as the budget is unlikely to include estimates regarding unforeseen events or changes in the value of financial instruments.
43. The advantage of this approach is that it includes all changes in assets and liabilities in one statement and produces one “bottom line” for explaining the change in net assets/equity arising from non-owner transactions. It does not require any judgment as to determining which transactions and events that affect financial position are excluded from the financial performance of the reporting public entity. These items, as at the financial reporting date, represent increases or decreases in the net resources of the entity and are, therefore, part of surplus/deficit.
44. In this approach, assets are the primary starting point for determining all of the other elements. Liabilities are defined with reference to being claims on existing or future assets. This approach then uses the definitions of assets and liabilities to determine revenue and expenses.
45. Proponents of this approach note:
- assets and liabilities are fundamental to the entity and should affect all other measurements in the financial statements;
 - financial performance can only be rigorously defined in terms of changes in assets and liabilities, to permit certain changes in assets and liabilities to be excluded from financial performance is a distortion of financial performance;⁹

⁹ FASB Discussion Memorandum, Conceptual Framework for Financial Accounting, December 2, 1976, paragraph 56.

- determining financial performance by relating it to changes in assets and liabilities makes the determination of financial performance more precise and reliable;
 - concern over the prospects of an entity claiming an item to be applicable to a future period for the purposes of smoothing its effects on financial performance over a number of periods;
 - attempts to define revenue and expense independently and as a function of the intent to use an asset, for example, in a future period as the primary foundation of the financial statements, makes assets and liabilities essentially the fallout of the process of matching revenues and expenses; and
 - it is more reflective of the nature of organizations as organizations need resources, either from owners or from operations, to serve as inputs into the provision of goods and services or outputs which can lead to incurrence of liabilities.
46. This approach does permit allocation in certain circumstances. For example, the use of property, plant and equipment to produce potable water is allocated to the period when the asset is used (amortization). However, it is argued that the application of this form of matching that results under accrual accounting was not intended to allow the recognition of items in the statement of financial position that do not meet the definitions of assets or liabilities. From this perspective, inflows of resources that do not meet the definition of a liability are recognized in revenue even though the intent may be to use those resources in a future period.
47. The FASB asked respondents to its Discussion Memorandum to submit precise definitions of revenues and expenses that were wholly or partially independent of assets and liabilities. That no one was able to do that without having to resort to subjective guides, such as proper matching and non-distortion of income, was a significant factor in the ultimate adoption of defining revenues and expenses based on the asset and liability definitions.¹⁰ It was noted that the definitions of revenue and expenses were primarily conventional, not conceptual, and made periodic measurement of financial performance largely a matter of individual judgment and personal opinion. The choice of using the asset and liability definitions as the anchor imposed limits or restraints not only on what can be included in assets and liabilities but also what could be included in financial performance.¹¹

I contend that assets have that primacy. I have not been able to define income without using a term like asset, resources, source of benefits, and so on. In short, meaning can be given to assets without first defining income, but the reverse is not true. That is what I mean by conceptual

¹⁰ Ibid, page 79.

¹¹ Reed K. Storey, Ph.D., CPA and Sylvia Story, MBA, “The Framework of Financial Concepts and Standards”, Financial Accounting Series No. 181-C, Financial Accounting Standards Board, January 1998, page 80.

*primacy of assets. No one has ever been successful in giving meaning to income without first giving meaning to assets.*¹²

48. Proponents of the asset and liability view note that to permit other items to be included or excluded from revenue and expense requires judgments as to when an item should or should not be included in surplus/deficit. They note that unless critical concepts such as matching and non-distortion of surplus/deficit can be precisely defined, surplus/deficit calculations are largely subjective.

49. A strict application of this approach, and excluding transactions with owners, and recognizing that are numerous approaches to the definitions, would lead to elements and definitions based on the following:

- ASSETS – LIABILITIES = NET ASSETS/EQUITY.

Where assets are resources expected to result in an inflow of benefits and liabilities are present obligations expected to result in an outflow of resources.

- REVENUES – EXPENSES = CHANGE IN NET ASSETS/EQUITY OR SURPLUS/DEFICIT

Where revenues, including gains, result from increases in assets or decreases in liabilities, and expenses, including losses, result from decreases in assets or increases in liabilities, both excluding owner transactions.

50. Based on the existing approaches used by other standard setters, including those in the public sector, this is favoured approach. Most revenue and expense definitions are based on changes in assets and liability focusing on resources and obligations to transfers resources.

51. The difficulty with a strict application of this approach is it can, among other things, introduce gains and losses peripheral or incidental to the ongoing normal operations of the entity and those gains and losses associated with market value adjustments into the determination of surplus/deficit. Some argue that these gains and losses detract from understanding the operations of the entity and certain remeasurement gains and losses may never be realized and should therefore be excluded from the calculation. Some feel that this approach does not reflect the long-term and going concern nature of government.

52. Not presuming which elements need to be defined, the definitions of the elements under this view could be:

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.

¹² Oscar S. Gellein, "Primacy: Assets or income?" in *Research in Accounting Regulation*, vol. 6, edited by Gary John Previtis (Greenwich, Connecticut, JAI Press, 1992), page 198.

Net assets/equity is the residual interest in the assets of the entity after deducting all its liabilities.

Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.

Revenue and expense view

53. This approach determines surplus/deficit based on the definitions of revenue and expense and would include all items not meeting these definitions to be included on the statement of financial position.
54. Proponents of this approach note:
- the surplus/deficit is a measure of the entity's and its management's performance and measuring revenue and expenses and the timing of their recognition is the focus of financial accounting.¹³
 - allocating costs and revenues to future periods better reflects the efforts and accomplishments of the period;
 - since revenue and expenses is the key measure of financial performance, net assets/equity is determined as a result of this process;
 - the asset and liability view turns accounting into a valuation process which creates difficulties in determining the most appropriate method of valuation making it difficult to assess the financial performance of an entity; and
 - statement of financial performance articulates changes in the items on the statement of financial position as it includes deferred items, and by doing so reduces volatility in reported financial performance.
55. A deferred outflow of resources can be defined as "a consumption of net assets by the government that is applicable to a future reporting period." The period to which an outflow (or inflow) of resources is applicable is determined using the concept of interperiod equity¹⁴. Interperiod equity is the state in which current period inflows of resources equal current period costs of services. For example, the burden of the cost of services is borne by present-year taxpayers and revenue providers. This burden is not shifted to future-year taxpayers or revenue providers through an increase in the level of borrowing, for example, and accumulated net resources are not used to provide current-period services. Interperiod equity is a relevant metric to assess accountability, rather than a goal that is expected to be

¹³ FASB Discussion Memorandum, Conceptual Framework for Financial Accounting, December 2, 1976, paragraph 39.

¹⁴ Generally interpreted as taxpayers of future periods should not have to pay for benefits received by those taxpayers of the current period.

- met for any particular period of time. For a deferred outflow of resources, the outflow is applicable to a future reporting period rather than to the current reporting period.
56. For a deferred inflow of resources, the inflow is applicable to a future reporting period rather than to the current reporting period. For example, a local government sells the rights to the estimated sales taxes collections for the next year to a third party in the current period and those sales taxes will be collected by another level of government without any participation by the local government and the sales taxes collected by that other level of government in the next period will be remitted to the third party instead of the local government. The amount received by the local government from the third party in the current period does not meet the definition of a liability. To meet the concept of interperiod equity the amount received would be reported as a deferred inflow (the alternative would be to report two years of sales taxes as revenue in a single period).
57. Interperiod equity is usually explained in the context of laws, such as those requiring balanced budgets and those placing limitations on debt issuance, with the intent of preventing the current generation of citizens from shifting the burden of paying for current-year services to future-year taxpayers. Both the concept of interperiod equity and the traditional matching concept associate accounting events with periods; however, the criteria for associating events with periods and the objectives of the related financial reporting are different. The matching concept attributes costs to the revenues recognized during a period for the purpose of measuring earnings. In contrast, interperiod equity attributes costs of the services to the period in which those services were provided and attributes revenues provided by taxpayers and other revenue providers to the appropriate period for the purpose of assessing whether those revenues were sufficient to finance the costs of providing services during that period.
- I think it is more useful to regard accounting as an allocative process rather than a valuation process, where the primary objective is to fit transactions into the profit and loss accounts of appropriate time periods. The building blocks of such a system are not assets and liabilities, but rather transactions and the cash flows that they entail.¹⁵*
58. Proponents of the revenue and expense view believe that limiting surplus/deficit to changes in assets and liabilities often mismatches revenue and expense and can lead to distortion of the measure of surplus/deficit. They note that it is imperative to exclude those gains and losses caused by random events, such as floods or fires, and those gains and losses resulting from remeasurements of financial instruments cause unnecessary fluctuations in reported surplus/deficit. This issue overshadows the effect of including deferrals in the statement of financial position.
59. A strict application of this approach, and excluding transactions with owners, and recognizing that are numerous approaches to the definitions, could result in basic definitions such as:

¹⁵ Ron Paterson, Accountancy Magazine, October 2003.

- (ASSETS + DEFERRED DEBITS) – (LIABILITIES + DEFERRED CREDITS) = NET ASSETS/EQUITY

Where assets are resources and include certain debits required to be allocated to future periods and liabilities are present obligations and include certain credits to be allocated to future periods.

- (REVENUE +/- DEFERRED INFLOWS) – (EXPENSES +/- DEFERRED OUTFLOWS) = CHANGE IN NET ASSETS/EQUITY OR SURPLUS/DEFICIT

Where revenues are the inflows of resources and expenses are the outflows of resources that are applicable to the current reporting period, both excluding transactions with owners.

60. The difficulty with this approach is that the statement of financial position measures net assets/equity based on the definitions of assets, liabilities, deferred outflows and inflows affecting the measure of financial position. Developing a solid basis for defining deferral definitions would be necessary to prevent their application from being arbitrary leaving the determination of what items can be included in the deferral elements to the standard setter.
61. Not presuming which elements need to be defined, the definitions of the elements under this view could be:

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.

Deferred outflows of resources are a consumption of net assets/equity applicable to a future reporting period

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.

Deferred inflows of resources are an acquisition of net assets/equity applicable to a future reporting period.

Net assets/equity is the residual interest in the assets and deferred outflows of the entity after deducting all its liabilities and deferred inflows.

An inflow of resources is an acquisition of net assets by the government that is applicable to the reporting period, other than inflows relating to contributions from owners.

An outflow of resources is a consumption of net assets by the government that is applicable to the reporting period, other than those relating to distributions to owners.

Change in net assets/equity or revenue and expense

62. The fundamental difference between the two opposing views is the measurement of surplus/deficit.

63. The asset and liability view focuses on changes in existing resources and those obligations to transfer resources to others over the period as the basis for determining financial performance. Financial performance, in a strict application of the concept, would be determined as the total change in net assets/equity regardless of whether they result from all transactions and events or from changes in prices, other than those transactions with owners. Those characteristics of this view have led to criticism by some as they argue that the resulting measure of financial performance does not reflect normal operations and therefore, introduces volatility.
64. Under this view, for example, the change in foreign denominated debt would be treated as a revenue or expense item and considered part of financial performance. Inflows of resources occurring in one period that were not intended to be used until a future period would nonetheless be treated as revenue of the current period unless that inflow resulted in liability. Transfers received that do not result in a liability would be considered revenue of the period. Outflows of resources relating to natural disasters etc. would be treated as expenses of the current period even though revenue has not yet been raised. The focus on resources, such as taxes receivable, investments and property, plant and equipment, and obligations to transfers those resources, such as employee benefits, long-term debt, and social policy obligations that become the primary elements under this approach.
65. In the revenue and expense view financial performance is the result of revenue and expense which can mean that certain transactions and events that are not changes in resources but revenue or expense items to be allocated to future period appear on the statement of financial position. Similarly, revenue and expense can include items that are not changes in resources or obligations to transfer resources, but items allocated to that particular period.
66. Under this view, for example, the change in foreign denominated debt could be treated as a deferred item to be allocated to a future period or to various periods through a method of amortization. Inflows of resources that are applicable to a future period would be treated as a statement of financial position item until those resources are allocated to a period or periods. In some cases, transfers of resources received for the purposes of acquiring property, plant and equipment, for example, would be deferred and amortized over the useful life of the asset even if no liability exists. Outflows of resources relating to natural disasters etc. could be treated as expenses when the related revenue is raised. The focus on revenue, such as taxes of the current period and other resources deemed to applicable to the current period and expenses, such as the provision of a transfer with time requirements applicable to the current period become the primary elements under this approach.
67. The critical decision is whether the basis of the framework should focus on resources (stocks) or on revenue and expense (flows). The view taken directly affects the elements to be defined and the basis for their definition. When considering each view, the decision to adopt one or other should be considered on the objectives and underlying characteristics of a public sector entity.

68. The need to focus on a public sector entity's resources such as its infrastructure available to provide future services, and obligations such as certain social policy obligations, the extent of borrowing, and employee future benefits seems to support taking an asset and liability view. For example, because public sector entities function to provide public goods and services, it could be argued that the focus of the financial statements should be on those resources available to provide those services, obligations to transfer those resources to others and those net resources available to finance future operations. From this point of view, it is important to determine whether the extent of the resources available for future periods or the obligations arising from past periods has improved or deteriorated. Measuring financial performance on this basis provides such an indication. While some argue this is a statement of financial position perspective, it uses the definitions of assets and liabilities as the anchor for determining financial performance.
69. On the other hand, there are certain public sector characteristics that would support taking revenue and expense view. For example, the budget plays a crucial and important role in the accountability cycle of a public sector entity. It is held as a standard against which results are measured. It is the basis upon which taxes are levied and for determining the use of the resources in the planned goods and services that are to be provided. It is argued that a public sector entity should be held to account for its raising of revenue and the uses to which they have been applied which represents the financial performance of the entity. Further, the concept of any one taxpayer paying for the services they receive and not passing on obligations onto future taxpayers and using resources in the period they are intended to be used, should be the measure of financial performance. The revenue and expense view may better align with these features.
70. The tentative decisions in the IASB/FASB convergence project takes an asset and liability view in that it has chosen to define assets and liabilities first.

Which view, the asset and liability view or the revenue and expense view, should serve as the basis for the conceptual framework for public sector financial statements? Please consider the characteristics of public sector entities.

SECTION 2 - REPRESENTATIONS OF FINANCIAL POSITION AND PERFORMANCE

WHICH ELEMENTS TO DEFINE

71. IPSAS 1 paragraph 7, in the accrual accounting definition, notes that elements of financial statements are assets, liabilities, net assets/equity, revenue and expenses. Some standard setters have identified other things that are considered to be elements of financial statements. The following provides a summary comparison of the elements identified by other standards setters and provides the date of issuance of their conceptual frameworks.
72. The resolution of this issue will necessarily depend on the Board’s decision as to the previous question on whether the asset and liability or revenue and expense view is supported.

| | Public sector | | | | | | | Private sector | | | | |
|--|---------------|-----------|------------|-----------|------------|-----------|-----------|----------------|------------|-----------|-----------|-----------|
| | IPSASB | AusASB | CanPSAB | NZASRB | SAfcASB | USFASAB | USGASB | Can ASB | IASB | JpnASB | UKASB | USFASB |
| Elements of financial position and changes in financial position | Dec. 2006 | July 2004 | April 2005 | June 2005 | April 2006 | Dec. 2007 | June 2007 | Dec 1988 | April 2001 | Dec. 2006 | Oct. 1999 | Dec. 1985 |
| Assets | X | X | X | X | X | X | X | X | X | X | X | X |
| Deferred Outflow | | | | | | | X | | | | | |
| Liabilities | X | X | X | X | X | X | X | X | X | X | X | X |
| Deferred Inflow | | | | | | | X | | | | | |
| Equity/ Net Assets | X | X | | X | X | X | X | X | X | X | X | X |
| Contributions from Owners | | | | | | | | | | | X | X |
| Distributions to Owners | | | | | | | | | | | X | X |
| Comprehensive Income | | | | | | | | | X | | | X |
| Revenues/Income | X | X | X | X | X | X | X | X | X | X | | X |
| Gains | | | | | | | | X | | | X | X |
| Expenses | X | X | X | X | X | X | X | X | X | X | | X |
| Losses | | | | | | | | X | | | X | X |
| Financial performance | | | | | | | | | X | | | |

73. While most support the asset and liability approach, all standard setters are faced with alternatives for determining financial performance. A number of standard setters have attempted to reconcile these two views because of their individual effect on financial performance by introducing comprehensive income of allowing entries directly into net assets/equity that are not owner related.
74. The asset and liability view measures net assets/equity as a function of the difference between assets and liabilities, but can introduce certain items, such as

- remeasurements gains and losses on financial instruments, into the measure of financial performance. Financial performance would equate the annual surplus/deficit.
75. On the other hand, the revenue and expense view, for example, would exclude a number of items considered revenue and expense under the asset and liability until a future period. This view argues that financial performance should be based on the “normal” operations of an entity. From this perspective, certain items are deferred onto the statement of financial position and recognized in income over periods of time. Surplus/deficit would equate those revenues and expenses applicable to that period.
76. Most of the standard setters have similar elements for measuring financial position, for example, there is general agreement that assets, liabilities and net assets/equity are elements of GPFS. The issue needing resolution is how financial performance should be measured. Depending on its resolution, elements of financial position can be affected as under the revenue and expense view, deferred items would need to be considered. Furthermore, the elements needed to determine financial performance can be quite different depending on the view taken. For example, taking a strict asset and liability view of financial performance it could be argued that the only elements required are revenue and expenses. Taking a comprehensive income approach or the direct entry to net assets/equity may lead to defining those certain gains and losses outside of “normal” operations.
77. Based on how these individual standards setters have addressed the identification of elements, there are four alternatives (each excluding transactions with owners), each having an effect on which elements would require definition:
- (a) Surplus or deficit is determined directly from changes in assets and liabilities.
 - (b) Comprehensive income determined directly from changes in assets and liabilities. This approach is similar to (a) however, surplus or deficit excludes certain changes displayed in comprehensive income.
 - (c) Surplus or deficit is determined from changes in assets and liabilities but does not articulate all changes in assets and liabilities as certain changes included directly in net/assets/equity.
 - (d) Surplus or deficit articulates changes in financial position and is determined directly from changes in assets plus deferred outflows and liabilities plus deferred inflows.
78. In both the asset and liability and the revenue and expense views and, in addition to the difference in timing of recognition of certain items into financial performance between the two views, there is also controversy in both views surrounding the issues of reporting gains and losses resulting from remeasurements of various assets and liabilities. A strict interpretation of the asset and liability view (alternative (a) below) would include them in surplus/deficit while a strict interpretation of the revenue and expense view (alternative (d) below) would likely defer these items to a future period – likely until they are

realized. Alternatives (b) and (c) are attempts at reconciling those two “end of the spectrum” views.

| Alternative | A | B | C | D |
|--------------------------|-----------------------------------|--|--|---|
| Net assets/equity | Assets minus Liabilities | Assets minus Liabilities | Assets minus Liabilities | Assets minus Liabilities plus deferred outflows minus deferred inflows |
| Surplus or deficit | Changes in Assets and Liabilities | Changes in Assets and Liabilities except certain gains and losses | Changes in Assets and Liabilities except certain gains and losses | Changes in Assets and Liabilities and deferred outflows and deferred inflows |
| Certain gains and losses | | Comprehensive Income | Net Assets/Equity | Deferred outflows and inflows |

Alternative A – Asset and liability approach to financial performance

79. This approach determines net assets/equity on the elements of assets and liabilities and would include all changes in those elements to be included in financial performance, except those arising from:

- transactions with owners;
- those arising from IPSAS 3 – *Accounting Policies, Changes In Accounting Estimates And Errors*.

80. The difficulty with this approach is that it can introduce volatility into the measurement of financial performance by including gains and losses arising outside of normal operations and those that resulting from remeasurement gains and losses. Because the budget to actual comparison is a key component of accountability, variances will arise from these unexpected transactions and events and those changes arising from remeasurements. There is also a view that these amounts would be available for providing goods and services if they are to be considered financial performance.

81. The advantage of this approach is that it includes all changes in assets and liabilities in one statement and produces one bottom line for assessing performance.

82. Under a strict interpretation of this view the elements, as represented in capital letters in the following equations, could be:

$$\text{ASSETS} - \text{LIABILITIES} = \text{Net assets/equity}$$

NET ASSETS/EQUITY = Transactions with owners + financial performance

REVENUE – EXPENSE = Financial performance

Revenue and expense would represent all changes in assets and liabilities and all would be considered part of financial performance.

83. Under this view all changes in assets and liabilities, other than transactions with owners would be considered part of revenue and expense.

Alternative B – Comprehensive income approach to financial performance

84. This approach determines net assets/equity based on the elements of assets and liabilities and would include all changes in them to be included in the financial performance, except those arising from:

- transactions with owners;
- those arising from IPSAS 3 – *Accounting Policies, Changes In Accounting Estimates And Errors*; and
- certain gains and losses arising that are not considered part of surplus/deficit but included in comprehensive income.

85. This is a comprehensive financial performance similar to the above approach where all changes in net assets are displayed on one statement¹⁶ however it would separately display certain gains and losses.

86. This is the approach used in IASB Framework, paragraph 76 and 77 note:

The definition of income (which encompasses both revenue and gains) also includes unrealized gains; for example, those arising on the revaluation of marketable securities and those arising from increases in the carrying value of long-term assets. When gains are recognized in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

The definition of expenses (which encompasses both expenses and losses) also includes unrealized losses, for example, those arising from the effects of increases in the rate of exchange for a foreign currency in respect of the borrowings of an entity in that currency. When losses are recognized in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

87. IAS 1 paragraph 7 defines total comprehensive income as the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. However, IAS 1 permits a second statement to be presented to support the continuing need for displaying “normal” operations from other changes in assets and liabilities. An entity is prohibited from presenting components of income and

¹⁶ IAS 1 permits certain gains and losses to be included on a separate statement of comprehensive income.

- expense (i.e. non-owner changes in equity) in the statement of changes in equity.¹⁷
88. The difficulty with this approach (distinguishing between normal operations or having two separate statements) is that it potentially introduces more than one “bottom line” or two separate statements for measuring financial performance. It raises questions as to which number represents financial performance. Another concern is that certain transactions, such as those related to remeasurements cannot be budgeted for resulting in unbudgeted items when comparing budget-to-actual results; and may not produce a result that is in compliance with budget legislation.
89. The benefits of this approach are that the single statement of comprehensive income measures net assets/equity based on the definitions of assets and liabilities articulates changes in net assets/equity, other than those transactions with owners and provides for different displays of changes in assets and liabilities that are not in the “normal” course of operations. The two statement approach maintains the articulation of changes in net assets/equity resulting from non-owner transactions however users would need to consider both statements.
90. Under this view the elements, as represented in capital letters in the following equations, could be:
- ASSETS – LIABILITIES = Net assets/equity
- NET ASSETS/EQUITY = Transactions with owners + financial performance
- REVENUE – EXPENSE + GAINS – LOSSES = Financial performance
- Revenue and expense could be defined as those resulting from the “normal” operations of the entity. Certain gains and losses would be included in comprehensive income.
91. Under this view the following items, for example, would be not be considered part of revenue and expense but part of comprehensive income:
- revaluations of property, plant and equipment; and
 - gains and losses on certain revaluations of financial instruments.

Alternative C – Net assets/equity approach to financial performance

92. This approach determines net assets/equity based on the elements of assets and liabilities and would include all changes in those elements to be included in financial performance, except those arising from:
- transactions with owners;
 - those arising from IPSAS 3 – *Accounting Policies, Changes In Accounting Estimates And Errors*; and
 - certain gains and losses that are directly entered into net assets/equity.

¹⁷ IAS 1 paragraph BC 53 (July 2008).

93. The existing definitions of the elements of revenue and expense within the IPSAS 1 do not distinguish between revenue and gains; and expenses and losses:

Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows results in an increase in net assets/equity, other than increases relating to contributions from owners.

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumptions of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.

94. However, individual IPSASs note:

- IPSAS 4, *The Effects Of Changes In Foreign Exchange Rates*, paragraph 35 notes:

When a gain or loss on a non-monetary item is recognized directly in net assets/equity, any exchange component of the gain or loss shall be recognized in net assets/equity.

- IPSAS 17, *Property, Plant and Equipment*, notes:

If the carrying amount of a class of assets is increased as a result of revaluation [fair value], the increase shall be directly credited to revaluation surplus. However, the increase shall be recognized in financial performance to the extent that it reverses a revaluation decrease of the same class of assets previously recognized in surplus in deficit.

95. The difficulty with this approach is that the financial performance is not a representation of the changes in assets and liabilities on the statement of financial position. There are certain gains and losses that are excluded from existing revenue and expenses and specifically building criteria for those items that can be directly entered into net assets/equity could be arbitrary.

96. The benefits of this approach are that the statement of financial position measures net assets/equity based on the definitions of assets and liabilities, revaluation adjustments remain outside of the statement of financial performance and budget to actual comparisons are more direct.

97. Under this view the elements, as represented in capital letters in the following equations, could be:

ASSETS – LIABILITIES = Net assets/equity

NET ASSETS/EQUITY = Transactions with owners + financial performance + certain remeasurement gains and losses

(REVENUE + CERTAIN GAINS) – (EXPENSE + CERTAIN LOSSES) = Financial performance

Revenue and expense could be defined as those resulting from the normal operations of the entity or including certain gains and losses. Remeasurements gains and losses may need to be distinguished from those that peripheral or incidental as they are excluded from financial performance.

98. Under this view the following items, for example, would be not be considered part of revenue and expense and debited or credited directly into net assets/equity:
- revaluations of property, plant and equipment; and
 - gains and losses on revaluations of financial instruments.

Alternative D – Deferral approach to financial performance

99. This approach determines net assets/equity based on the elements of assets, deferred outflows, liabilities and deferred inflows and would include all changes in those elements to be included in the elements of the statement of financial performance, except those arising from:
- transactions with owners;
 - those arising from IPSAS 3 – *Accounting Policies, Changes In Accounting Estimates And Errors*;
 - certain revenue, expense, gains and losses that are considered deferred inflows or outflows on the statement of financial position.
100. The difficulty with this approach is that the measurement of net assets/equity is no longer a function of the difference between assets and liabilities as other items are introduced into the determination of net assets/equity.
101. The advantage of this approach is that it excludes these deferred items from classifications of assets and liabilities but provides the necessary information about them. This approach provides for the articulation of surplus and deficit to the change in net assets/equity.
102. Under this view the elements, as represented in capital letters in the following equations, could be:

$$\text{ASSETS} + \text{DEFERRED OUTFLOWS (INCLUDING REMEASUREMENT GAINS)} - \text{LIABILITIES} + \text{DEFERRED INFLOWS (INCLUDING REMEASUREMENT GAINS AND LOSSES)} = \text{Net assets/equity}$$

$$\text{NET ASSETS/EQUITY} = \text{Transactions with owners} + \text{financial performance} + \text{deferred outflows and inflows} + \text{remeasurement gains and losses}$$

$$\begin{aligned} &(\text{REVENUE} + \text{CERTAIN GAINS} + \text{CERTAIN DEFERRED INFLOWS}) - \\ &(\text{EXPENSE} + \text{CERTAIN LOSSES} + \text{CERTAIN DEFERRED OUTFLOWS}) \\ &= \text{Financial performance.} \end{aligned}$$

Alternatively these items could be defined as inflows and outflows applicable to the current reporting period.

103. Under this view the following items, for example, would be not be considered part of revenue and expense until some future period but form part of the changes in net assets/equity:
- deferred inflows and outflows;
 - revaluations of property, plant and equipment;
 - gains and losses arising from translating foreign operations; and

- gains and losses on revaluations of financial instruments.

Summary

104. Any approach other than Alternative A will require some judgment as to which gains and losses are excluded from financial performance. Alternative A simply determines financial performance based on changes in assets and liabilities. It would permit different presentations in the statement financial performance.
105. The similarity between Alternatives A, B and D is that they maintain the articulation of financial performance with the change in net assets/equity.
106. Alternative B, the comprehensive income approach, Alternative C the direct entries into net assets/equity approach are similar in measuring “normal” operations, however, under Alternative C financial performance no longer articulates all changes in net assets/equity, other than transactions with owners.
107. Alternative D, the deferral approach, focuses “normal” operations but includes deferrals in revenue and expense that are applicable to the current period by introducing items into the statement of financial position that are not assets and liabilities.
108. One of the primary criticisms of Alternative B and C is the need to “recycle”¹⁸ certain items into “normal” operations. This need is eliminated with Approach A.
109. The similarity between Alternative A, B and C is that the measurement of net assets/equity is based on changes in assets and liabilities. Alternative D introduces deferrals into the measurement of financial position.
110. Most standard setters today have adopted an asset and liability view for the purposes of determining net assets.

Which basis do you prefer for the purposes of identifying and defining the elements – the strict asset/liability approach, the comprehensive income approach, the net assets/equity approach or the deferral approach?

¹⁸ IAS 1, paragraph BC 70.

SECTION 3 – THE BREADTH OF ELEMENTS

SOURCES OF ASSETS, LIABILITIES, REVENUES, GAINS, EXPENSES, LOSSES

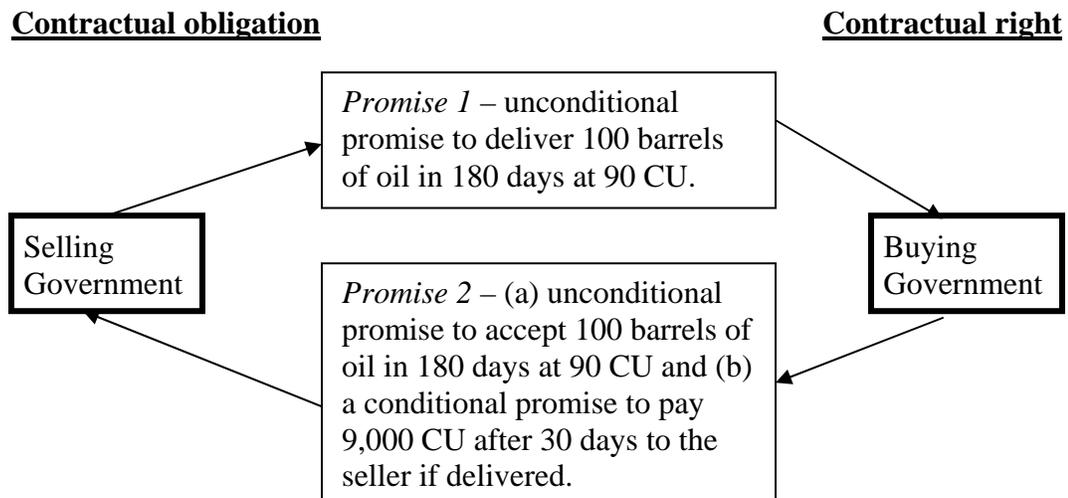
111. The financial position and performance of a public sector entity can be affected by:
- (a) agreements and contracts, including situations where only one party has fulfilled its obligations, where both parties have partially fulfilled their obligations or where the contractual arrangements have a value as a result of changing prices;
 - (b) another government's legislation such as environmental standards or where a government may receive or be entitled to resources as a result of another government's legislation;
 - (c) a government's own legislation giving it rights to sources of resources or obligating the government to a particular course of action; and
 - (d) other facts and circumstances that may lead to economic resources or the obligation to give up economic resources.

Contractual arrangements

112. The clauses in the contract may impose responsibilities on one entity to transfer economic resources (goods and services) and gives rights to the same entity to receive some form of consideration (money or another asset) in return. The position in a contract can change if one of the entities performs. For example, if an entity that is providing the consideration for the goods and services pays in advance, that entity's position in the contract decreases because it no longer has a position in the contract although it may have another asset in the form of a prepaid asset. Alternatively, the other entity could provide the goods and services and once provided the entity no longer has a position in the contract itself, but an asset taking the form of a receivable for the amount of the consideration.
113. In addition, transactions and events can arise based on the individual terms and conditions contained in a contractual arrangement. At any given point in time, the contract itself can be an asset where the transfer of benefits is less than the expected economic benefits to be received in return. Alternatively, the contract can be a liability because the benefits to be transferred exceed the benefits to be received.
114. Analysing the various components of contractual arrangements assists in understanding when a transaction or event might exist that should be considered for inclusion into the financial position and performance. The approach offered by the IASB/FASB project is useful for understanding the various types of promises inherent in a contract and for identifying various aspects associated with those contractual arrangements. It suggests looking at the various aspects of contracts to

determine whether there are unconditional and conditional components to the arrangement.

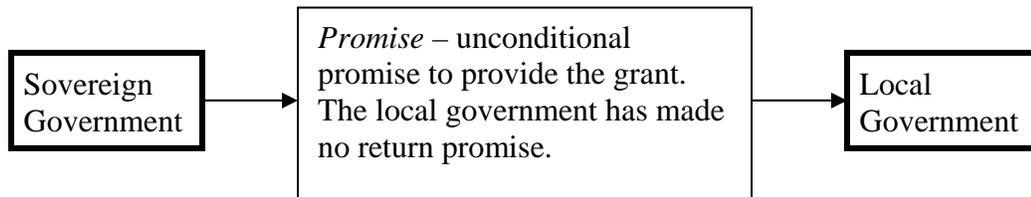
115. Consider a *fixed price contract* between two sovereign governments for the supply and purchase of oil. The contract calls for 100 barrels of oil to be delivered in 180 days at a fixed price of 90 CU (currency units) to be paid 30 days after delivery. A contract is entered into and the seller (promise 1) promises to deliver the oil to the buyer and the buyer (promise 2) agrees to pay 9,000 CU to the seller 30 days after delivery.



116. The contract has two aspects to it – one is that the price is fixed and is not conditional on anything else – it is unconditional. This means that if the price of oil rises above the agreed-upon price of 90 CU per barrel (say 95 CU), the selling government's part of Promise 1 indicates that it has an obligation – that being the difference between what it could have got in 180 days had it not entered into the fixed price contract. From the buying government's perspective it has a resource because the contracted price for the oil is less than the going market rate.
117. The conditional aspect of the contract refers to the actual delivery and acceptance of the oil by the seller and buyer. The buyer's obligation to pay is conditional on the seller delivering the oil. When the oil is delivered, the conditional promise by the buyer to pay 9,000 CU to the seller (Promise 2b) becomes unconditional. After 30 days that unconditional promise is mature. It is useful to note that IAS 39 paragraph 5 indicates that the standard is not applied to those contracts held for the purpose of the receipt and delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage.
118. Consider a simple unconditional grant from one government to another. A sovereign government decides to provide an unconditional grant to a specific local government. It has contracted that it will provide 1,000 CU to that local government to be used for any purpose that the local government chooses.

Contractual obligation

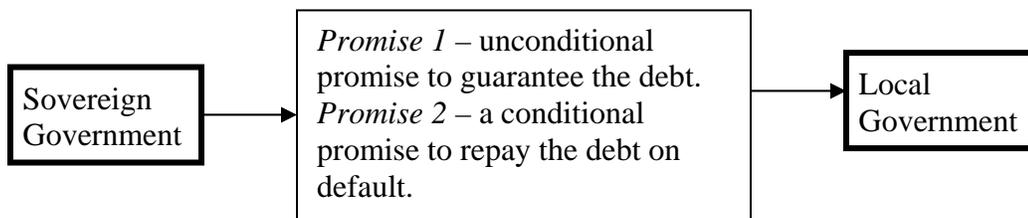
Contractual right



119. In this example, the sovereign government has made an unconditional promise to provide the funding to the local government. From the local government’s perspective, it has made no promise other than to accept the funding. Nevertheless, a transaction or event may have occurred that needs to be considered.
120. In another example, consider a loan guarantee made between a sovereign government and a local government. The local government has issued 1,000 CU of debentures. The sovereign government has issued a guarantee on that debt providing the local government with an advantage in terms of issuing the debt.

Contractual obligation

Contractual right



121. In this situation, the sovereign government has made an unconditional promise to “stand ready” to pay the debt if the local government defaults. Nevertheless, the sovereign government may have created a transaction or event because it has agreed to stand ready to pay. What the examples show is that contracts themselves can include items to be considered such as unconditional promises.

Do you agree that financial position and performance can change based on the terms and conditions contained in the contracts themselves?

Do you agree that standing ready to repay another entity’s debt can result in changes in financial position and performance?

Legislation and sovereign rights

122. Under their Acts or other legislative frameworks sovereign governments and public sector entity’s are given vast responsibilities, powers and hold rights to certain things like the electro-magnetic spectrum, mineral rights, licenses, permits

- and the ability to tax. Unlike contracts or other binding agreements, legislation is different because an entity does not explicitly agree to perform for another party.
123. Legislation and sovereign rights can establish assets, liabilities, revenues and expenses of an entity due to:
- another public sector entity's legislation such as environmental responsibilities and standards to be maintained;
 - the entity's own legislation regarding things like transfer payments and social security benefits; and
 - the holding of rights that can be sold or exercised such as permits and the ability to tax.
124. By operating in a jurisdiction that has legislative requirements, an entity is subject to the law. That means an entity can be affected if they and transaction or event that triggers the legislative provisions – such as the earning of personal income and the need to pay taxes. In other cases, legislative provisions can be triggered if another event occurs. For example, environmental legislative standards can, when an entity exceeds those standards, create an obligation for that entity. In addition, the legislation of another entity can create a responsibility to make a transfer or a right to receive a transfer.
125. An entity's own legislation can create a framework with similar responsibilities and rights that occur under another entity's legislation. Legislative provisions can result in an entity having to transfer resources to third parties such as arrangements to cost share certain programs with other entities, the provision of social benefits to its citizenry and responsibilities for the ongoing provision of goods and services such as health.
126. The rights and ability to tax also create assets, liabilities, revenue and expenses for a public sector entity. Fines and penalties levied can create assets, the sale of rights to access mineral deposits or radio waves or permits to drive vehicles can also result in assets and liabilities.
127. Alternatively, a sovereign right to tax may not be an asset as the right may exist, however there is no future economic benefit until the levying of taxes occurs. While the government retains and controls the right to levy taxes creating a future benefit, the asset may not presently exist until the government exercises its right to levy those taxes.

Do you think that the holding of the right to tax gives rise to an asset?

Other types of arrangements

128. Assets, liabilities, revenue and expense can also arise from other promises made by a government beyond those in written or oral contracts. For example, an announcement of government transfer program where the government has identified and indicated an amount to be paid to individual local governments can be a promise made in the same sense as a contractual arrangement.

129. In some, but not all countries there are legal doctrines that address these kinds of promises. For example, promissory estoppel¹⁹ is a legal principle that a promise or assurance made without consideration may nonetheless be enforced to prevent injustice:
- (a) if the promisor should have reasonably expected the promisee to rely on the promise; and
 - (b) if the promisee did actually rely on the promise to his or her detriment.²⁰
130. The IASB, IPSASB, the FASB, the Canadian AcSB and PSAB, GASB and others have explicitly referred to these types of assets and liabilities as those countries have legal doctrines that refer to estoppel in terms of *constructive obligations*.
131. *Constructive obligations* are generally described as being “created, inferred or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by the government.” The IASB does not use the same wording, but the intent appears the same “obligations also arise, however, from normal business practice, custom.”²¹ Similar wording can be found in the South Africa, Framework for the Preparation and Presentation of Financial Statements, paragraph 80. The UK ASB Statement of Principles 4.27 acknowledges that these obligations are to be considered. The GASB, Concepts Statement 4, also acknowledges these obligations in paragraphs 19 and 57.
132. A public sector entity may have acknowledged, through a published policy or past practice that it will accept certain responsibilities and those affected by that policy or practice have a valid expectation that the government will in fact discharge those responsibilities. An example of a constructive right and obligation could be where an entity has chosen in the past to provide pension or other benefits to its employees but there is no formal contract.
133. The recipients, who have a valid expectation that the entity will fulfil its responsibilities, on the other hand, may an asset.

Do you think the element definitions should be broad enough to include constructive obligations and rights?

134. *Equitable obligations* are generally described in accounting as emanating from “ethical or moral constraints rather than from rules of common or statute law, that is, from a duty to another entity to do that which an ordinary conscience and sense of justice would seem fair, just and right – to do what one ought to do rather what one is legally obligated to do.”²² These could assets, liabilities, revenue and expenses arising from environmental responsibilities relating to the ongoing health and welfare of the community even though there may be no environmental standard in place.

¹⁹ It is acknowledged that this legal doctrine may not be prevalent in all jurisdictions.

²⁰ Black’s Law Dictionary, Eight Edition, 2004, Thompson West, St. Paul Minnesota, USA.

²¹ IASB Framework, paragraph 60.

²² FASB, CON 6, paragraph 40.

135. The existing IASB Framework does not use the same wording, but the intent appears the same “obligations also arise, however, from a desire to maintain good business relations or act in an equitable manner.”²³ Australia also has a doctrine of equitable estoppel which can give rise to these types of assets and liabilities.²⁴
136. The IASB/FASB work is considering excluding these ethical and moral obligations from the definitions of liability. For example a public sector entity may feel morally obligated to clean an environmental issue for the purposes of protecting the health and safety of its citizens. The issue becomes whether there can be sufficient rigour established as to when these types ethic and moral obligations becomes liabilities.

Do you think these ethical and moral items should be included within the definitions of the elements?

Business risk

137. The IPSASB and IASB do not provide a definition of business operating risk. This operating risk can be related to unexpected things such as contamination of the water or blood supply which represent the ongoing conduct of activities of the entity.
138. Statistical methodologies could be employed to determined the chance of such an event happening. For example, if there is a history or chance of the blood supply being contaminated, the history or chance could be used to determine if a liability should be recognized in the financial statements.

Do you think that the element definitions should be broad enough to consider these types of risks?

²³ IASB Framework, paragraph 60.

²⁴ A complete review of legal doctrines was not undertaken – only a small sampling.

SECTION 4 - ELEMENTS

139. The following sections in this paper are preliminary writings and have been based on the existing definitions offered by the IPSASB. Decisions relating to the foregoing will directly affect which elements are defined and how they are defined.

ASSET DEFINITION ALTERNATIVES

140. Regardless of whether one takes an asset and liability view or a revenue and expense view the common characteristic possessed by assets is service potential or future economic benefits. The service potential of future economic benefit embodied in all assets represents the potential to contribute directly or indirectly, to the provision of goods and services or to the flow of cash and cash equivalents to the entity. Generally, assets results from owner contributions, ongoing operations of the entity, gains and losses, and liabilities resulting from borrowing. All items called assets share a common characteristic – they represent the stock of items that embody a capability to provide goods and services to generate cash and cash equivalents.
141. There are three key issues related to relating to the definition of an asset: what the asset actually is; is the asset a resource or an economic resource; and how those assets should be linked to the entity.

What the asset is

142. IPSAS 1:

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.

143. This definition focuses on the asset being the resource that is controlled.
144. Others have taken a different view and indicate that it is the future economic benefits associated with the resource that is the asset. They define the asset as the probable future economic benefits obtained or controlled by the entity or the rights or other access to the future economic benefits controlled by the entity.

Assets are rights or other access to future economic benefits controlled by an entity²⁵

145. The UK focuses their definition on the rights to the future economic benefit associated with the asset. This view indicates that the asset is not the item of property itself but instead the asset represents the underlying ability to obtain, through rights or other means of accessing the future economic benefits from the resource itself. From this perspective, it is the right to obtain future economic benefits embedded in the resource that is the asset.
146. These rights can be derived from legal ownership of the resource or can arise without having legal ownership. Leases are a good example of agreements where

²⁵ Refer to the UK ASB Statement of Principles for Financial Reporting, Asset definition.

- two different entities have access to different rights that arise in assets on both entities' financial statements. The entity leasing the asset has a right to the future economic benefits embodied in the asset while the lessor has a right to future lease payments and any residual value.
147. However, a government is the holder of many rights to future economic benefits that it controls. The sovereign right to tax provides the government with access to future economic benefits. It clearly controls those rights and can limit access to those rights by others.
148. This approach focuses on the inflow of resources to the entity in terms of an entity having a controlled access to that inflow.
- Assets as the resource
149. Some argue that the right or other access to the future economic benefit is not the asset. While an entity has the right or other access to a benefit and controls those rights or the access, the benefit arising from those rights arise because there is a resource that the entity controls. For example, rights to cash resulting from the distribution of water are controlled by the government, however, it is the facility itself that treats and distributes the water that is the resource that gives rise to future benefits. Without the treatment and distribution facility there are no future economic benefits that be obtained. While future economic benefits are a fundamental characteristic of an asset, those benefits cannot exist without the resource.
150. From the perspective of lease agreement, it is argued that it is the resource is the promise that gives rise to the various benefits associated with. For example, the entity leasing assets has a right to access the use of the resource for its own purposes. On the other hand, the lessor enjoys a right to a cash inflow as a result of leasing the resource.
151. Those that focus on the resource as the asset indicate that it is the resource itself that results in future benefits or service potential. The IPSASB, IASB, Canada (both private and public sectors), FASAB, GASB, AASB, German ASB, NZ ASRB, Japan ASB and South African ASB all agree that the asset is the resource that gives rise to a future benefit and not the benefit associated with the asset. They argue that the asset is the “stock” or the resource itself, and not the “flow” of benefits or the rights or other access to the future benefit. They argue that whether the resource will actually result in an inflow of future benefits is an issue separate from the resource itself.
152. The IASB definition of an asset also focuses on the asset being the stock or the resource that gives rise to a benefit. The IASB/FASB convergence project also is focussing on the asset being the resource rather than benefit associated with the asset.

Linking the asset to the entity

153. One approach is to define assets without providing guidance on why the asset is of the entity. The advantage of this approach is that it defines assets generally

leading first to identifying all possible assets then applying guidance to determine when it is of that entity's asset. Determining who the asset belongs to could be left to the supporting guidance or contained in the recognition criteria.

Assets are resources.

154. The problem with this approach is that there can be many assets that the entity does not know of or may cause confusion due to knowing of an asset but it is not of the entity. For example, a private hospital owns medical equipment that are assets, but that equipment does not belong to the government as they belong to the private hospital. Providing a link in the definition may be more efficient and easier to understand.
155. To link the asset to the entity, one approach is to introduce the phrase "of an entity." This would indicate that at a minimum, the resource needs to belong to the entity.

Assets are resources of an entity.

156. While this links the asset to the entity it forces the reader into further research to better understand what is meant by "of an entity." In other words, when reading just the definition, it answers the question of what is an asset but it fails to respond to how or why it is an asset "of an entity."
157. The supporting text could describe how the asset is "of the entity." It avoids the reader having to struggle with various terms, such as control, in the definition itself. The major disadvantage of this approach is that readers could apply their own meaning of "of an entity" and not refer to the additional guidance. This view was not supported by the IASB/FASB board members as it was felt to be too brief.
158. Another approach is to focus on the legal title or ownership of the asset. An asset would have to be owned in order appear on an entity's GPFS. This alternative provides a legal basis for deciding when the asset belongs to the entity.

Assets are resources owned by an entity.

159. Because a leased asset under a finance lease is not owned by the lessee, it would be excluded from the definition of an asset. Alternatively, because it is owned by the lessor, it would still be considered as that entity's asset. Basing the determination of whether the asset is of the entity on legal form appears too narrow and may not result in a faithful representation of the resources of the entity.
160. IPSAS 13, *Leases*, paragraph 13 offers an alternative to consider:

A lease is classified as a finance lease if it transfers substantially all of the risks and rewards incidental to ownership.
161. Under this alternative, an asset would be determined to be of the entity when the entity is exposed to the operating risk, demand risk, business risk, and construction risk, for example. Rewards may be represented by the expectation of service potential or profitable operation over the asset's economic life and of gain from appreciation on the value or realization of a residual value. This approach

captures assets that are not legally owned by the entity but includes those that are being used by the entity to provide goods and services.

Assets are resources of an entity when it is exposed to the risks and rewards associated with the asset.

162. It does require, however, an entity to dissect certain arrangements for the purposes of identifying the individual risk and rewards to make a determination of whether the asset is of the entity. It requires that an entity make an assessment of all of the related factors to determine whether the asset is of the entity. It could result in range of possibilities given the varying degrees of risks and rewards associated with the asset.

163. The IPSASB, IASB, PSAB, Canadian ASB, FASAB, GASB, AASB, NZ ASRB, German ASB, Japanese ASB and SA ASB definitions link the asset to the entity using the concept of control.

Assets are resources controlled by an entity.

164. IFRIC 4, *Determining whether an Arrangement contains a Lease*, paragraph 9, provides a rationale for using a control approach for leases as it argues that:

An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset.

165. If a lessee has the right to control the use of the asset, it would be recognized by the lessee as its asset. IFRIC 4 provides additional guidance on when control exists by referring to factors such as having the ability or right to operate the asset and the ability or right to control physical access to the underlying asset.

166. IFRIC 12, *Service Concession Arrangements*, paragraph 11, notes:

Infrastructure within the scope of this Interpretation shall not be recognized as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on behalf of the grantor [public sector entity] in accordance with the terms of the contract.

167. From this perspective, it does not matter who holds title to the asset, what is important is who can control its use.

168. While the use of control is widely accepted among standard setters, there are issues with the concept of control in the public sector. The difficulty with applying the concept of control is set out in IPSAS 23, *Revenue From Non-Exchange Transactions (Taxes and Transfers)* paragraph 32,:

In the public sector, governments exercise a regulatory role over certain activities, for example, financial institutions or pension funds. This regulatory role does not necessarily mean that such regulated items meet the definition of an asset of the government, or satisfy the criteria for recognition criteria as an asset in the general purpose financial statements of the government that regulates those assets.

169. IPSAS 6, *Consolidated and Separate Financial Statements*, paragraph 37 (a) also supports this view regarding the distinction between regulation and control:

The meaning of control does not extend to the power of the legislature to establish the regulatory framework within which entities operate and to impose condition or sanctions on their operations. Such power does not constitute control by a public sector entity of the assets deployed these entities.

170. IPSAS 6 provides an example where a pollution control authority may have the power to close down the operations of another entity that is not complying with environmental legislation however that power does not constitute control over that entity's assets.

171. Another approach to consider the UK ASB's definition of an asset that provides the link to the asset as being "the rights or other access to future economic benefits."

Assets are present economic resources to which an entity has a right or other access.

172. As a starting point, rights appear to express the association of the entity to the economic resource better than control. For example an entity has rights to the shares representing its investment in the government business enterprise. The entity's access to the economic resource is by way of its rights to the shares representing its investment. While the individual assets of the government business enterprises are not owned in title by the government, the government does have access to the underlying assets of the government business enterprise.

173. Similarly, an entity might enter into a contract whereby it agrees to purchase a building at a future date. In this example, the purchaser has the rights to any price appreciation on the building, but does not have rights to the building itself, or to the management of the building, until the date of ownership change – the entity does not *control* the building, but it does have a right to any price appreciation.

174. However, focusing on contractual or legal "rights" alone could limit or restrict assets to those that are legally enforceable. The capacity of an entity to have a right to the asset normally stems from legal rights and may be evidenced by ownership through title or other mechanisms. For example, a central government agency may be responsible for the acquisition of military equipment and hold title to it. However, the department of national defence is the organization that has access to the service potential embodied in the asset. From this perspective, the asset would be of the department of national defence.

175. This addresses the concern with leased capital assets but it could result in a definition of an asset that is too broad. For example, an entity has access to fibre optic cable but that cable is not an asset of the entity. Further, the general public has access to many public sector assets, such as a museum, but those assets do not belong to them.

176. Simply including "access" to link an asset to an entity is too broad. For example, a library or museum provides public access to the resource but those items are not

assets of the general public. While the general public may have access to a road, their access is no different from the access enjoyed by others. However, a government has access because it can choose to close the road for purposes of repair and maintenance, alter the direction of the road or completely remove the road from service.

LIABILITY DEFINITION ALTERNATIVES

177. Regardless of whether one takes an asset and liability view or a revenue and expense view the common characteristic possessed by all liabilities is that they represent claims by others on the existing or future assets of the entity. The fundamental characteristic of a liability is that it is an obligation of the entity, a duty or responsibility to transfer assets at a particular point in time to use assets in a particular manner. Generally, liabilities result from obligations arising from financing transactions such as borrowing and from ongoing operations of an entity, such as those for employee benefits. All of these obligations share a common characteristic in that they result in an entity transferring existing or future assets or providing services to another entity.
178. There two key issues relating to the definition of a liability: what the liability actually is and how liabilities should be linked to the entity.

What the liability is

179. IPSAS 1:
Liabilities are present obligations of the entity arising from past event, the settlement of which is expected to result in an outflow from the entity of resources embodying future economic benefits or service potential.
180. The IASB and IPSASB both take the view that the liability is the obligation that results in an outflow of resources. They argue that there must be an obligation first before it can result in an outflow of resources.
181. Those that focus on the *obligation* being the liability indicate that it is the obligation that *results* in the sacrifice of economic benefits. The IPSASB, IASB, Canada (both private and public sectors) FASAB, GASB, UK ASB, AASB, German ASB, Japan ASB, NZ ASRB, South Africa ASB agree.
182. The IASB currently defines a liability as a stock or obligation. The IASB/FASB convergence project is also focussing on the liability being the obligation rather than the sacrifice of economic benefit.
183. The FASB has taken a different view and indicate that it is the probable future sacrifice of economic benefits associated with the obligation that is the liability. Even though the definition in FASB CON 6, paragraph 35 focuses on the probable sacrifices of economic benefits as the liability, it notes specifically that they arise from present obligations.²⁶

²⁶ Obligations in the definition are broader than legal obligations. It is used with usual meaning to refer to duties imposed legally or socially; to that which one is bound by contract, promise or moral

184. This view could result in liabilities being recorded that are not obligations to other entities. While FASB's CON 6 language, when taken as a whole, would not permit liabilities that are not obligations, the language and focus of the liability definition remains. CON 6 paragraph 200 notes that an entity must be obligated to sacrifice its assets in the future – that is it must be bound by a duty or responsibility to transfer assets or provide services to one or more entities. That paragraph goes on to note that not all probable sacrifices of assets are liabilities. An entity's need to replace merchandise sold or raw materials or equipment used up, no matter how pressing, does not by itself constitute a liability of the entity because no obligation to another entity is present.
185. This approach focuses on the outflow of resources from the entity in terms of the entity being obligated to transfer or use resources.

Linking liabilities to the entity

186. One approach is to define liabilities without providing guidance on why the liability is of the entity. The advantage of this approach is that defines liabilities generally and could leave the determination of why it is "of the entity" to supporting guidance. Guidance on what a present obligation is could be defined based on the nature of the obligations. For example, the remaining approaches focus on particular aspects of liability. Depending the appropriate choice as to the scope of liabilities, the supporting guidance could be designed to address these issues. This would result in:

Liabilities are present obligations.

187. As with the asset definition, without providing a link to the entity, the entity would first need to determine all obligations, then it would need to apply some supporting guidance to determine when it is of the entity. Linking the obligation to the entity within the definition is useful as there can be many obligations that the entity is not aware of and providing the link makes the definition more efficient and easier to understand.
188. To link the liability to the entity, one approach is to introduce the phrase "of the entity." This would indicate that at a minimum, the liability needs to belong to the entity. This is the approach currently taken IPSAS 1.

Liabilities are present obligations of an entity.

189. While this links the liability to the entity it still forces the reader into further research to better understand what is meant by "of the entity." In other words, when reading the just the definition, it answers the question of what is a liability but fails to respond to how or why it is a liability "of the entity."
190. The IPSASB, IASB, PSAB, Canadian ASB, FASAB, GASB, UK ASB, AASB, NZ ASRB and SA ASB definitions include the phrases of the entity, of a government, of the federal government, of a particular entity, that the entity and

responsibility, and so forth, It includes equitable and constructive obligations as well as legal obligations.

- that the reporting entity controls. All of these phrases are attempts at linking the liability to a particular entity.
191. The benefit of linking the liability to the entity in the definition itself would require that both aspects i.e., the obligation and the link to the entity need to be present to determine which liabilities belong to the entity. For an entity to report a liability there must be a present economic obligation and it must be that entity's obligation. For example, an account payable is a present promise to pay cash and it is that entity's obligation.
 192. One approach to clarify how the obligation is linked to the entity is to limit obligations to those that are contractually based. This approach would include obligations under contracts that would include those related to obligations such as accounts payable, borrowing and financial instruments.
 193. Many obligations arise from exchange transactions that are contractually based with other parties to acquire the funds, goods, and services needed for the entity to operate. For example, borrowing cash requires an entity to repay the amount borrowed; acquiring assets on credit obligates an entity to pay for them; using employees' knowledge, skills, time, and efforts obligates an entity to pay for their use, often including non-payroll benefits. Guaranteeing debt of others would require a government to stand ready to pay cash to the borrower or repay the debt directly. These contractual obligations are usually documented, including identifying the entity that is required to bear the economic obligation. For example, in a construction contract to build a new water treatment facility, the contract will usually specify the names of the parties to the contract and other terms. It would require that other party to be identified.

*Liabilities are present obligations of an entity
as a result of contractual arrangements.*

194. However, this approach would exclude those obligations arising from constructive and equitable obligations, such as employee benefit programs where there is no contract in place. Lawsuits and other items such as environmental liabilities may be excluded. Non-contractual, informal practices, such as those that could be related to non-vesting employee benefits would be excluded. Further it would exclude a number of obligations associated with social policy schemes as there may be no legal contract established.
195. Another approach is to consider that obligations must be enforceable against the entity by someone or something outside of the entity. In other words it is only those obligations that another party could force the entity to fulfil, otherwise satisfy or settle. However, the identity of the other party need not be known to obligate the entity before the time of settlement. For example, while a government may have an environmental liability, as the obligation is enforceable under legislation, the identity of a contractor, who will be hired to carry out the work, may not be known.

Liabilities are present obligations of an entity that are enforceable.

196. Enforceable obligations include those that are established by contract or otherwise imposed, 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 or equitable estoppel. Such doctrines can be considered part of law and thus, are also enforceable. 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 if they are supported by courts of equity.
197. This approach places a legal focus on the definition of an obligation but broadens it beyond just contracts and agreements. This is similar in nature to IPSAS 19, Provisions, Contingent Liabilities and Contingent Assets, paragraph 18 that defines legal obligations as those obligations derived from:
- (a) a contract (through implicit or explicit terms);
 - (b) legislation; or
 - (c) other operation of law.
198. The approach would include those obligations arising under legal doctrines of promissory and equitable estoppel. However, where such doctrines do not exist, items not meeting the definition of an enforceable obligation may not liabilities. For example, an entity may have created an obligation by paying year-end bonuses even though they are not contractually bound to do so and has no policy in place so cannot be forced to make these payments. It can refuse to pay even though it risks substantial employee-relations problems.
199. Some obligations of the entity arise from constructive obligations. A constructive obligation might be created, inferred, or construed from the facts in a particular situation, rather than contracted by agreement with another entity or imposed by government. For example, an entity might have a history of paying employee pension benefits even though there is no specified contractual agreement to do so and the entity has not announced a policy to do so. Nonetheless, a court could construe that practice to have created a legally enforceable obligation.
200. From this perspective, enforceable would mean that a:
- (a) *Separate party* is involved. 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 a separate party to enforce the consequences.
201. So long as others can require the entity to take one or the other action, the entity has an obligation. Obligations that cannot 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. However, an arbitrator in a wage settlement situation can impose and enforce requirements upon both the employees and the entity itself.
202. In some cases, there may be no legal or equivalent requirement to clean-up certain abandoned mines sites. An entity that chooses to clean up these sites because it feels compelled to do so, would not qualify as a liability because no external party can force the entity to clean up those sites. The entity doing the clean up maintains discretion as to whether or not to do it, in this or a subsequent period. This differs from a legal compulsion which emanates from forces external to the entity. Moral compulsion is an internal compulsion. Economic compulsion refers to an entity doing what is in its own best interests. This differs from legal compulsion as it too emanates from internal rather than external forces.
203. The advantage of this approach, recognizing that statutes and regulations may differ from country to country, is that it provides a solid basis for deciding when an obligation exists.
204. Another approach is to define liabilities based on the nature of announcement or commitments made by the entity in a budget or speech for example.
205. This approach would include those enforceable obligations that arise from contracts and agreements and those constructive obligations that arise in environments where there is a legal framework or other mechanism in place to force the entity into a particular action. However, it would also include those things made where there may not be a framework in place (legal or otherwise) that call the entity into action. So long as there has been a valid expectation raised in the recipient leaving the entity no realistic alternative to withdraw from the promise. This would include, for example, obligations arising from where an entity has an established policy of funding natural disasters or makes a promise of relief to the victims of the disaster. While there may not be a compulsion to act, these policies may leave a government no realistic opportunity to withdraw.

OTHER CHANGES TO THE ASSET AND LIABILITY DEFINITIONS FOR CONSIDERATION

206. The amended definitions above do not seem to provide sufficient guidance in the definitions as to what resources and obligations are assets and liabilities and why they are assets and liabilities of the entity. Two improvements being considered by in the IASB/FASB project are:
- (a) removing past events from the definitions; and
 - (c) removing “expected to flow from the definitions.

Removing “past events” from the definitions

207. While an observed transaction or other event might provide a signal that an asset or liability exists, it is not a fundamental characteristic of either element and the failure to observe a past event does not negate that an asset or liability exists. The inclusion of the notion of control in the asset definition and the present obligation

- in the liability may nullify the need to include a reference to past events. Something must have happened to give control or create an obligation. The main purpose of including this aspect into the definition was to exclude future assets or liabilities from meeting the definitions.
208. 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 transaction or event was (how the arose should not be at question).
 - (c) The inability to identify a past transaction or event may lead to non-recognition of an asset or liability.
209. Using the term “*future*” resource/obligation is not appropriate as it introduces the possibility of accruing future assets such as tax revenues and future liabilities such as ongoing program commitments. While a government may have the power to tax, until it exercises its authority to do so, it cannot have an asset.²⁷ At the same time, while a government may have a future commitment to provide education or purchase a new fire truck, until it provides that service or acquires that fire truck it does not have a liability for them.
210. Inserting the word “*present*” before resource in the asset definition would require that the resource must be available as at the reporting date emphasizing that it cannot be a resource that will arise until the future or one that existed in the past but is no longer available at the reporting date. In addition, the current IPSASB definitions, while the intent is the same, do not parallel each other. For example the liability definition refers to a “*present*” obligation and the asset definition does not. Assets only refer to past events, which, for all intents and purposes was intended to mean that it presently exists. Inserting the word “*present*” before resource can accomplish the same thing and result in parallel approach to the liabilities definition.
211. The phrase “*past event*” in the definition of an asset and liability becomes redundant as it implies that a present resource or obligation exists. This does not preclude including additional guidance relating to what is meant by “*present*.” Supporting text could include:
- Financial reports are prepared as of a particular date. Users of financial reports are interested in assets and liabilities that exist at that point in time. The definition of an asset and a liability requires that the resource and the obligation presently exist at the financial statement date.
- This means that the asset must be accessible at the financial statement date. Often an entity obtains assets by purchasing or producing them, but other transactions or events may give rise to assets. The means of acquiring an asset does not affect whether something meets the definition of an asset (that is, the history of how the asset arose, or of how the entity obtained the asset,

²⁷ IPSASB ED, INTANGIBLE ASSETS, paragraph 1.

does not matter), although it might provide evidence to help in the assessment as to whether the entity has an asset and what is the nature of the asset.

Expected future transactions or other future events do not give rise to assets today. An intention to purchase inventory does not meet the definition of an asset. Equipment that an entity plans or budgets to acquire next year does not make that equipment an asset today.

This means that a liability must have already arisen at the financial statement date. Often an entity incurs liabilities when it receives purchased assets or services, but other transactions or events may give rise to liabilities. The means of incurring a liability does not affect whether something meets the definition of a liability (that is, the history of how the liability arose, or of how the entity incurred the liability, does not matter), although it might provide evidence to help in the assessment as to whether the entity has a liability and what is the nature of the liability.

Expectations alone of future transactions or other events do not result in liabilities today. An intention to, or budgeting for the, purchase of an asset is not a present resource or obligation today. The intention to fund, or budgeting for the funding of, a future expenditure does not result in a present resource or obligation of the entity. For example, services to be rendered by employees next year do not result in liabilities today as nothing is owed in regards to expected future services.

Removing “expected to flow” from the definitions

212. Both of the existing IASB and IPSASB definitions of an asset and liability make reference to the phrase benefits “are expected to flow”. The concept of “expected to flow” (inbound or outbound) is included in many element definitions, albeit using different phraseology. However, for some it is unclear what is meant by expected to flow. This phrase reflects a concern that without including it in the definitions, many would not record assets or liabilities *unless it was certain* that the economic benefits would flow (either inward or outward). On the other hand, without it, some could argue that all assets and liabilities should be recognized even if there is expectation as to a flow of resources.
213. “Probable” 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. Similar concerns have resulted in the inclusion of *expected* in the IASB definition.
214. Some think that unless there is a high likelihood of economic benefits flowing in or out of the entity, the asset or liability definition is not met. To avoid this continued misinterpretation, the IASB/FASB proposed working definition of an asset and a liability exclude reference to the expected inflow or outflow of benefit from the definitions. They argue that it is preferable that this “expectation” be

- built into the recognition criteria rather than being built directly into the definitions themselves.²⁸
215. This was the most favoured improvement by the IASB/FASB in the proposed working definitions when they consulted on the definition from December 2006 to March 2007.
216. Further the phrases from which future economic benefits or service potential are expected to flow to the entity and the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential have another effect on the definitions of assets and liabilities. Including these phrases in the definitions is designed to put limits on the extent to which assets and liabilities would be considered in the financial statements. In other words, it would only be those assets where there is an expectation of an inflow or those liabilities where there was an expectation of an outflow that would be recognized.
217. A view of the IASB/FASB was that keeping these phrases in the definitions made it less clear what an asset and liability is and questioned whether the inclusion of these phrases were addressing issues of recognition and narrowing the definitions of assets and liabilities. As well, the phrases tended to overburden and confuse both the definitions of asset and liability.
218. Some argue that leaving these phrases in the definitions themselves adds a level of complexity to the definitions from the perspective that is attempting not only to define what an asset is but also when it is recognized in financial statements. They say that the definition of the element should remain pure and the supporting guidance for the element could contain the necessary guidance. They add that including this uncertainty in the definitions makes applying the definitions more troublesome to apply.
219. Others think, however, that including this information in the supporting guidance would make this important consideration less prominent and therefore, may not be considered in the determination of what is recognized in the GPFS. Others are of the view that this is not a matter for the definition itself. They note that an asset, for example, is a resource and determining when to include that item in the GPFS totals is a separate matter. They indicate that this issue can be dealt with outside of the element definitions and placed into supporting guidance or the recognition criteria.

NET ASSETS/EQUITY

220. The traditional accounting equation is $ASSETS - LIABILITIES = EQUITY$. Accounting has focused on defining the substance of a liability rather than trying to define both liabilities and equity. Attempts to define both liabilities and net assets/equity, can lead to mezzanine items that appear to be neither liabilities nor equities. From this perspective, the definition of net/assets equity is dependent

²⁸ IASB/FASB Conceptual Framework, Elements & Recognition – Asset & Liability Definitions, August 20, 2008, pre-ballot draft

- upon, the result or outcome of the difference between assets and liabilities and not independent of those things.
221. Ownership interest would indicate a claim to net assets that has no priority over any other claim if the entity was to liquidate and has no upper or lower limit on the amount except to the extent of the remaining assets available. However, under current GAAP there are several levels of residual interest that can be included in “net assets/equity” – common shareholders, preferred shareholders²⁹ and other equity financial instruments.³⁰
222. Even though the “net assets/equity” section can be subdivided into owners’ equity, capital maintenance adjustments, and any other subclassifications it does not make net assets/equity anything more than a residual resulting from the difference between assets and liabilities. That is not to say that these items are not important components of net assets/equity and may need individual definitions. However, this is not unlike the need for individual definitions for various types of assets such as financial or tangible capital assets.
223. FASB CON 6.213 notes:
- Equity in a business enterprise is the ownership interest, and its amount is the cumulative result of investments by owners, comprehensive income, and distributions to owners. That characteristic, coupled with the characteristics that liabilities have priority claim over ownership interest as claims against the enterprise’s assets, make equity not determinable independently of assets and liabilities. Although equity can be described in various ways, and different recognition and measurement procedures can affect its amount, equity always equals net assets (assets minus liabilities). That is why it is a residual interest.*
224. Net assets/equity is the residual interest in the assets after deducting liabilities. The fundamental characteristic of net assets/equity is that it represents the net resources available to the entity for use as a result of the entity’s ongoing operations or from net contributions from its owners. Unlike liabilities, which are non-discretionary transfers or use of economic benefits, there is no obligation on the entity to transfer resources to owners or use net assets/equity in a particular manner. The distinction between liabilities and residual interest is highly significant. Creditors have the ability to insist that a transfer of economic benefit or service potential is made to them regardless of the circumstances.³¹
225. Similar to assets and liabilities, net assets/equity can be subclassified into various components or items that share a common characteristic, but individually they may have other distinguishing characteristics. IPSAS 1. 97 notes:
- In some cases, there may be a minority interest in the net assets/equity of entity. For example, at whole-of-government level, the economic entity may include a GBE that has been partially privatized. Accordingly, there may be*

²⁹ See IPSAS 6, Consolidated and Separate Financial Statements, paragraph 57.

³⁰ See IAS 32, Financial Instruments: Presentation.

³¹ South African Accounting Standards Board Framework, paragraph .92

private shareholders who have a financial interest in the net assets/equity of the entity.

226. Net assets/equity represents a stock of economic resources that have different economic characteristics from those things that result from the ongoing operations of an entity. It represents the net stocks of resources and the accumulated net flows of resources available to the entity.
227. Contributions from and distributions to owners result in changes to net assets/equity which have not arisen from ongoing operations of the entity. They represent a portion of the net assets/equity that is available to the entity for use in the provision of goods and services by the entity. While they may share individual characteristics from other items in the net assets/equity element, they remain a subclassification of the net resources available to the entity.
228. While net assets/equity may be a representation of a residual interest, there are views that support net assets/equity as an element of financial statements. Some indicate that it is element because it is not a subset of any other element and it has different characteristics than the other elements. For example, owner contributions are not liabilities or revenue. Others note that the individual components of net assets/equity (owner transactions, surpluses or deficits, revaluation reserves) all share the same fundamental characteristics of net assets/equity so net assets/equity is the overarching classification not unlike assets or liabilities.
229. Some argue that because there is need to determine whether there has been a return on capital invested or a return of capital invested, there is a need to define the owners' contributions and distribution to owners separately. Others note that net assets/equity is an element because it serves as the point of articulation between the financial performance of the entity and those changes in net assets/equity items that are not included in financial performance.
230. Another view argues that assets are the cornerstone of an entity's financial position is that liabilities and owners' interests represent different types of claims of those resources. Owners' interests represent the community's collective investment in the entity's capacity to provide goods and services and other benefits to that community.

REVENUE AND EXPENSES

Revenues, gains, expenses, and losses

231. Revenues (for this purpose meant to include gains) has a distinct economic characteristic as they represent those inflows of resources, actual or expected, that have resulted from the entity's ongoing operations and other events. Revenue, generally, can arise from inflows or enhancements of assets or settlement of its liabilities, from delivering goods and services, or in the case of a public sector entity the levying of various taxes and fines and penalties. Revenue is different from liabilities as there is no outside third party claim and different from owner contributions as they represent the inflows of resources. Revenue items all share a

common characteristic in that they are inflows of resources that increase net assets/equity and not from a contribution from owner.

232. Expenses (for this purpose meant to include losses) have a distinct economic characteristic as they represent outflows of resources, actual or expected, that have resulted from the entity’s ongoing operations and other events. Expenses, generally, can arise from outflows or use of assets or incurrences of liabilities from the process of producing goods or providing services, or in the case of a public sector the redistribution of wealth. Expenses are different from assets as there is no future economic benefit embodied in them and different from distributions to owners as the distributions as they represent outflows of resources to others than the owners. Expense items all share a common economic characteristic in that they represent an outflow of resources that decrease net assets/equity through the ongoing operations of the entity and not from distributions to owners.
233. The definitions of elements directly affect financial performance. They determine whether an item should be recognized as an asset or liability, a net assets/equity item or part of financial performance.
234. All of the standard setters have identified assets, liabilities, net assets/equity (PSAB excepted), revenue and expenses as the core elements that need definition. However, a number of other standards have identified other things as elements. For example, defining gains and losses separately from revenue and expenses; comprehensive income, and financial performance. While elements are broad classes of items there does not appear to be agreement on which elements should be defined.
235. The following provides the views of those standard setters in the public sector.

| Table 2 | Revenue/Gains | Expenses/Losses |
|--------------|---|---|
| Aus ASB | The definition of income encompasses both revenue and gains. | The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. |
| Can PSAB | The definition of revenue encompasses both revenue and gains. | The definition of expenses encompasses both expenses and losses. |
| NZ ASRB | The definition of income encompasses both revenue and gains. | The definition of expenses encompasses losses. |
| S Africa ASB | The definition of revenue encompasses both revenue and gains. | The definition of expenses encompasses losses as well as those expenses that arise in the course of the operating activities of the entity. |
| US FASAB | The definition of revenue in this Statement includes items that might be reported as gains. | The definition of expense, in this Statement includes items that might be reported as losses. |

236. South Africa's ASB notes:

Gains represent increases in economic benefits or service potential and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this framework.

Losses represent decreases in economic benefits or service potential and as such, they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this framework.

237. The need to separately define gains and losses from revenue and expenses is a matter of display that attempts to present those transactions and events that arise in normal course of operations from those that are peripheral or incidental.

238. Further, there can be difficulties in identifying the differences between a peripheral item (gain or loss) and one that exists as a result of normal operating activities. FASB's Concepts Statement 6 explains that while revenues and gains, and expenses and losses, share the same economic characteristics within each of those two groups of items, they were defined largely for reasons of display:

Distinctions between revenues and gains and expenses and losses in a particular entity depend to a significant extent on the nature of the entity, its operations, and its other activities. Items that are revenues for one kind of entity may be gains for another, and items that are losses for one kind of entity may be expenses for another.

239. Expenditures incurred resulting from a hurricane or a forest fire, for example, may be treated as a loss in one country and an expense in another that is susceptible to hurricanes or fires. Since a primary purpose of distinguishing gains and losses from revenue and expenses is to make displays that convey different information about performance, these distinctions are principally matters of display.

240. The private sector also shares this view that gains and losses share the same fundamental economic characteristics with revenue and expenses (increases or decreases in net assets/equity):

Can ACSB: Gains are increases in equity/net assets from peripheral or incidental transactions and events affecting an entity and from all other transactions, events and circumstances affecting the entity except those that result from revenues or equity/net assets contributions. Losses are decreases in equity/net assets from peripheral or incidental transactions and events affecting an entity and from all other transactions, events and circumstances affecting the entity except those that result from expenses or distributions of equity/net assets.

FASB CON 6: Gains are increases in equity...except those that result from revenues or investment by owners. Losses are decreases in equity...except those that result from expenses or distributions to owners.

UK ASB: Gains are increases in ownership interest not resulting from contributions to owners. Losses are decreases in ownership interest not resulting from distributions to owners.

241. However, because in some instances it is useful presentation to separate gains and losses, such as those that might arise on the sale of a piece of property, it is useful to provide definitions of these items. IPSAS 1 does not currently provide these definitions as they included in the related elements. The public sector standard setters have not offered individual definitions of these items in the Conceptual Frameworks. However, two of the private sector standards setters (FASB and the Can. AcSB) have. They have generally defined gains and losses that have been realized have generally been defined as:

Gains are increases in net assets/equity from peripheral or incidental transactions affecting an entity and from all other events and circumstances affecting the entity except those that result from revenue or investments by owners.

Losses are decreases in net assets/equity from peripheral or incidental transactions affecting an entity and from all other events and circumstances affecting the entity except those that result from expenses or distributions to owners.

242. Using element definitions to make distinctions of display, which are without specific limits, goes beyond the “broad classes” notion as used in both the IASB’s Framework and the existing IPSASB’s definitions.

REVENUE AND EXPENSE DEFINITION ALTERNATIVES

243. The IPSAS definitions are:

Revenue is the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.

244. The definitions should parallel each other as close as possible:

Revenue is the gross increase in economic benefits or service potential during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets/equity, other than those relating to contributions from owners.

Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.

245. There are a number of existing IPSASs that require or permit netting of certain expenses against revenue or revenue against certain expenses. For example,

- expenses related to a provision that is recognized in accordance with IPSAS 19 and reimbursed under a contractual arrangement may be netted against the reimbursement. Other examples include trade discounts and volume rebates and gains and losses on foreign currency exchange. These standards level decisions do not appear to follow the basic definition of revenue yet, in some cases, it makes sense to net the effect, for example, when there is a legal right of offset.
246. If this point of view is taken:
- Revenues are increases in economic benefits or service potential during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets/equity, other than those relating to contributions from owners.*
- Expenses are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.*
247. Further, gains and losses are not elements in and of themselves, the notion of gains and losses can be built into the definitions of revenues and expenses:
- Revenues, including gains, are increases in economic benefits or service potential during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in net assets/equity, other than those relating to contributions from owners.*
- Expenses, including losses, are decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.*
248. The IASB Framework, PSAB, FASAB, UK ASB, AASB, NZASRB and SA ASB all indicate that the definition of revenues includes gains. The same standard setters agree that the definition of expenses includes losses. They point out that gains and losses are considered subsets of revenues and expenses, rather than distinct elements, just as capital assets and financial assets are considered a subset of assets, and that gains are no different in nature [increases in economic resources] than revenues and the same for losses and expenses.
249. In addition, the proposed definition of assets focuses on resources and not economic benefits. The existing definitions focus on the benefits or service potential flowing into or out of the entity.

ELEMENTS – OTHER DEFINITIONS TO CONSIDER

Comprehensive income

250. FASB CON 6, ELEMENTS OF FINANCIAL STATEMENTS, notes:

Comprehensive income is the change in equity of a business enterprise during a period from transactions and other events and circumstances from

nonowner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

251. The fundamental purpose of comprehensive income is to present the total change in assets and liabilities arising from operations that are not attributable to transactions with owners.
252. Under a historic cost model, for the most part, gains and losses were typically not recognized until they were realized with general exceptions for items such as valuation allowances and impairments. The introduction of other, subsequent revaluations such as those for financial instruments has raised issues with the definitions of the elements. Because of the effects of introducing certain revaluations into the statement of financial position, the changes result in increases or decreases to assets and liabilities not attributable to transactions with owners.
253. While the various sources of comprehensive income revenue, gains, expenses and losses, all represent changes in net assets/equity, presenting them differently provides other information useful for various decisions. Comprehensive income allows for a distinction to be made between those items that are central to an entity's ongoing operations from those things that are peripheral or incidental to those operations.
254. Comprehensive income can be derived from simply subtracting opening net assets/equity from closing net assets/equity after removing the effects of transactions with owners. Comprehensive income attempts to provide a further explanation of how and what caused the changes in net assets/equity. It provides a presentation that separates ongoing operations from gains and losses as well as other presentations that provide useful information by combining revenue and expense, for example, in different ways.
255. Making distinctions between comprehensive income and financial performance is a matter of display. Both of these items are components of changes in assets and liabilities that do not result from transactions with owners. Nevertheless, the items included in comprehensive income and financial performance all share the common characteristic of increases or decreases in assets and liabilities other than those transactions and events arising from those with owners.
256. However, because some gains and losses are recognized as part of financial performance and other not recognized in financial performance immediately, there maybe a need to separately define the nature gains and losses individually based on their characteristics. These gains and losses are not peripheral or incidental in their nature.
257. IPSAS 1 paragraph 101 notes:

Other Standards deal with items that may meet the definitions of revenue or expenses set out in this IPSAS but are usually excluded from financial performance. Examples include revaluation surpluses (see IPSAS 17), particular gains and losses arising on translating the financial statements of a foreign operation (see IPSAS 4) and gains and losses on remeasuring available-for-sale financial assets (guidance on measurement of financial

assets can be found in the relevant international or national accounting standard dealing with the measurement of financial instruments).

258. From the above, it does not appear to be possible to generically define those gains and losses that are not part of financial performance without creating a list of those items that are included in surplus and deficit and those that are not..

Capital maintenance adjustments

259. The purposes of this Consultation Paper is not to debate the most appropriate measurement attribute, as this will be dealt with in another phase of the Conceptual Framework Papers.
260. A concept of capital maintenance or cost recovery is necessary for determining whether there has been a return of owner investment (capital) or a return on owner investment. Only those net inflows that are greater than the amount needed to maintain the invested amount is considered a return on capital. For example, dividends paid out in excess of accumulated earnings would be considered a return of capital. Capital is synonymous with the net assets/equity of the entity.
261. Many GPFS have been prepared using primarily a historical basis of accounting. GPFS that are prepared on a historical cost basis do not account for the changes in prices related to specific assets or liabilities. Price changes are called, in some jurisdictions, revaluation adjustments or in others, holding gains and losses. When these changes are introduced into the GPFS, the related increases or decreases in the assets and liabilities must be accounted for. These price changes are accounted for differently depending which of the two concepts of capital maintenance is applied.³²
262. One approach, referred to as the “financial capital maintenance concept”, would account for revaluation adjustments in comprehensive as holding gains and losses and, therefore, included in the determination of a return on capital. This concept is based on measuring capital in terms of money. The capital to be maintained may be conceived of a simply the monetary value of net resources, with the value determined in accordance with whatever basis is used for valuing the assets and liabilities of the entity (historical cost, current cost, net realizable value etc.) On this basis any changes in the asset and liability values, other than those arising from transactions with owners, whether they result from productive activities or holding gains and losses, form part of comprehensive income³³.
263. The term comprehensive was used rather than financial performance. Nevertheless, under this concept these valuation changes are considered part of financial performance.

³² It is acknowledged that there is another concept of capital maintenance which considers earning power as the capital to be maintained. It proposes that the capital to be maintained is the entity capacity to generate an appropriate return. Since public sector entities are designed to generate a return on capital, this concept has not been considered. Please see Accounting Standards in Evolution, Ross Skinner and J. Alex Milburn, Prentice Hall, Toronto, 2001, page 538.

³³ Accounting Standards in Evolution, Ross M. Skinner and J. Alex Milburn, Second Edition Prentice Hall, Toronto, Canada, page 538.

264. Because money values change under hyperinflationary economies, (see IPSAS 10, *Financial Reporting in Hyperinflationary Economies*), there is another concept of financial capital maintenance. The capital to be maintained maybe conceived of in terms of the purchasing power of the monetary net assets, where changes in purchasing power are measured by reference to a general price level index. On this basis, any changes in asset and liability values, other than those arising from transactions with owners, form part of comprehensive income³⁴.
265. The IASB, Framework, paragraph 104, defines financial capital maintenance as:
- Under this concept a profit is earned only if the financial (or money) amount of the net assets/equity at the beginning of the period, after excluding distributions to and contributions from owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of purchasing power.*
266. Alternatively, there is a view that these adjustments should not form part of financial performance, but instead be recognized directly as capital or equity adjustments – not included in the return on capital. This approach is referred to as the “physical capital maintenance concept.”
267. Choosing an underlying concept can affect the measurement of financial performance. FASB CON 6.71 notes:
- Under the physical capital concept, those changes would be recognized but called “capital maintenance adjustments” and would be included directly in [net assets] equity and would not be included in the return on capital [financial performance].*
268. The IASB’s Framework paragraph 81 notes that revaluations gives rise to increases or decreases in equity, and while these increase or decreases meet the definitions of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Paragraph 110 goes on to note that:
- This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time it is not the intention of the Board of IASC to prescribe a particular model other than in exceptional circumstances, such as for those entities reporting in the currency of a hyperinflationary economy.*
269. Under the physical capital maintenance concept, the capital to be maintained may be conceived of as the productive capacity of an entity’s physical resources, with the value determined in accordance replacement cost basis. On this basis any changes in the physical resource values, form part of an equity adjustment. Any excess or revenue over related expenses on a replacement cost basis is considered in comprehensive income³⁵.
270. The IASB, Framework, paragraph 104, defines physical capital maintenance as:

³⁴ Ibid.

³⁵ Ibid.

Under this concept a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

Contributions from and Distributions to Owners

271. IPSAS 1, currently defines these terms as:

Contribution from owners means future economic benefits or service potential that has been contributed to the entity by parties external to the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets/equity of the entity, which:

- (a) Conveys entitlement both to distributions of future of economic benefits or service potential by the entity during its life, such distributions being at the discretion of the owners or their representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or
- (b) Can be sold, exchanged, transferred or redeemed.

Distributions to owners means future economic benefits or service potential distributed by the entity to all or some of its owners, either as a return on investment or as a return of investment.

272. This aspect should be considered when assessing the definitions of elements.

SECTION 5 - RECOGNITION

UNCERTAINTY

273. Element definitions are designed as the first screening of the types of items that can be considered for inclusion into the GPFS. If the item does not meet one of those definitions it cannot be considered in the GPFS. If the item meets one of those definitions it should be considered in the GPFS. The definitions of the elements provide the starting point for determining what is included in the GPFS.
274. Uncertainty results from situations where it may difficult to ascertain whether an item meets the test of an element. A thing must exist before it can be recognized. There are two questions that must be addressed: is there an item that needs to be considered; and does that item qualify as an element. Uncertainty about each of these aspects is usually referred to as element uncertainty.
275. Uncertainties about the existence of things such as property, plant and equipment are generally easier to address than other events such as those related to contingent liabilities. However, in existing standards, the issues of existence uncertainty are dealt with differently depending on whether it relates to an asset or a liability.
276. IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 41 notes:
- Contingent assets are not recognized in financial statements since this may result in the recognition of revenue that may never be realized. However, when the realization of revenue is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.*
277. IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets* paragraph 24 (a) notes;
- Where it is more likely than not that a present obligation exists at the reporting date, the entity recognizes a provision (if the recognition criteria are met).*
278. IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, takes the same approach.
279. Addressing uncertainty is a major issue if GPFS are to provide a faithful representation of the transactions and other events they purport to provide. In some cases, there may be uncertainty as to whether a transaction or event that meets the element definitions will give rise to an inflow or outflow of economic resource, for example, some accounts receivable may need to be written off as a bad debt or a loan payable may be forgiven.
280. At the conceptual level, some of these uncertainties, to a certain degree, have been dealt with directly in the definitions of the elements themselves. For example, assets have been defined as:

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.

281. For example, there are two things in the definition that affect which resources should be included in the GPFS. The first indicates that the asset should be controlled and the second indicates that there should be an expectation of a future economic benefit or service potential flowing to the entity. Once uncertainties about these two items can be resolved, then the resource can be considered an asset of the entity. The difficulty is determining when these things are met in order for an item to qualify as an asset (future benefits and control).³⁶
282. The UK's, Interpretation for Public Benefit Entities, June 2007 notes that if a transaction or event has created a new asset or liability or added to an existing asset or liability, that effect will be recognized if sufficient evidence exists that a new asset or liability has been created or that there has been an addition to an existing asset or liability.
283. Recognition is the process of including or recording an item into GPFS. It consists of both the narrative description of the item (cash, accounts receivable etc) and the amount of the item to be included in the GPFS totals.
284. Recognition not only involves recording an item at the time of acquisition or otherwise, it also includes subsequent changes in the amount and those changes that occur that will result in the removal of the item from the GPFS totals. Recognition does not mean disclosure in the notes to the financial statements.
285. Recognition is usually determined from two aspects: that there is probability of benefits flowing into or out of the entity and a reasonable estimate of the amount involved can be measured reliably.
286. Recognizing an item too early can result in overstating assets and liabilities. Recognizing an item too late can result in understating assets and liabilities. Further, it may be only in the future that one is able to determine that item recognized as an expense should have been recognized as an asset or an item recognized as a liability should have been recognized as a revenue, as for example, the creditor chose to forgive the obligation.

PROBABILITY OF BENEFITS

287. The IPSASB does not currently provide recognition criteria with IPSAS 1. The IASB provides such guidance:

An item that meets the definition of an element should be recognized if it is probable that any future economic benefits associated with the item will flow to or from the entity.

288. One alternative to consider is whether the recognition criteria should be based on a strict interpretation – for example the benefits must be virtually certain to flow.

³⁶ FASB, Recognition in Financial Statements: Underlying Concepts and Practical Conventions, Todd Johnston and Reed Storey 1982, page 77.

It has the advantage of reducing the level of judgement required surrounding the recognition of items.

Items are recognized in the financial statements when it is virtually certain that the entity will receive resources or give up resources.

289. Including virtually certain would exclude a number of liabilities that are recognized now. For example, unless it was virtually certain that a lawsuit was going to be settled against the entity, the amount would not be recognized. This is perhaps the simplest and easiest to apply approach. Those assets and liabilities that are not virtually certain would not meet the test of being an asset or liability. However, this approach may result in relevant information being excluded from recognition. For example, some tax revenue may not be virtually certain that it is going to be collected and therefore, would not be included in the GPFS. This approach is a very conservative view of recognition, for example:

290. Alternatively, if the recognition was based on a “more likely than not” criterion it provides a way for the preparer of the GPFS to assess all of the facts surrounding the item to determine whether it is more likely than not that an item exists and should be recognized.

291. This could result in additional assets being recognized in the GPFS than there are now. Those contingent assets that are excluded from recognition now until it is virtually certain that inflows will be realized would now form part of the measurements in the GPFS. Those less than likely would be excluded. It does however focus on making a determination of the series of facts and surrounding circumstances to decide. It may be a more neutral assessment than the “virtually certain” approach.

Items are recognized in the financial statements when it is more likely than not that the entity will receive resources or give up resources.

292. Finally, the recognition could take a more inclusive approach to assets and liabilities. Anything that meets the tests of being an element would be recognized when there is a possibility that resources will flow into or out of the entity. This would include those items now excluded where the possibility of inflow or outflow is only remote. As long as there is a possibility for an inflow or outflow the item would be recognized.

Items are recognized in the financial statements when it is possible that the entity will receive resources or give up resources.

293. This could result in certain liabilities being included in the GPFS totals even though the possibility is remote. For example, if a water supply has been tainted, this approach could lead one to conclude that if there was simply a possibility of an outflow of resources, a liability would be established.

RELIABILITY OF MEASUREMENT

294. The second criterion for recognition of an item into the GPFS is that the item possesses a cost or other measure that can be measured with reliability. In many cases these costs must be estimated. Part of the measurement process includes

- using management's best estimates based on assumptions that reflect the most probable set of economic conditions and planned courses of action.
295. There is a degree of uncertainty associated with the measurement of many amounts recognized or disclosed in the financial statements. In many cases, however, such uncertainty is not material. A decision about whether measurement uncertainty has a material effect on the financial statements is a matter of professional judgment. Management would consider information such as the range of reasonably possible amounts, whether the amount could change by a material amount; the impact of other reasonably possible amounts on the resources, obligations and net assets; and the possible timing of the impact. A judgment about materiality of measurement uncertainty would be made considering the effect that a different reasonably possible amount would have on the financial statements.
 296. The estimation of the amount of an item may be based on information that provides a range of amounts. When a particular amount within such a range appears to be a better estimate than any other, that amount would be used. When uncertainty exists, estimates used would attempt to ensure that assets, revenues and gains are not overstated and that liabilities, expenses and losses are not understated. Estimates of the financial effect are determined using professional judgment, supplemented by experience of similar transactions and, in some cases, reports from independent experts. Estimates should include any additional evidence provided by subsequent events occurring after the reporting date.
 297. As a result of the estimation process, an entity would be able to determine a range of reasonably possible amounts in accordance with assumptions that are realistic, supportable, internally consistent, and consistent with planned courses of action. The range of reasonably possible amounts would exclude amounts at the outer edges of possibility since such amounts, while possible, are considered to be outside the best estimate range. Relevant information available to the government to develop a reasonable range includes past experience, precedents, and opportunities to reach alternative arrangements.
 298. Disclosure of the extent and/or range of reasonably possible amounts or the effect of a change in the underlying assumptions used to estimate the amount would be provided unless it would have a significant adverse effect on the outcome.