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Agenda Item

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Date: May 28, 2012
Memo to: Members of the IPSASB
From: Grant Macrae and John Stanford
Subject: Draft Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements

Objective of this Session

1. The objective of this session is to **review** the substance of a preliminary draft of the Phase 2 Exposure Draft of the Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: *Elements and Recognition in Financial Statements*; and **provide** directions for further development.

Agenda Material

2. Agenda material:
 - 4A.1a Core text of preliminary draft of an Exposure Draft of Phase 2 of the Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: *Elements and Recognition in Financial Statements in Financial Statements* (draft Exposure Draft) (The core text).
 - 4A.1b Basis for Conclusions of draft Exposure Draft.
3. Other relevant materials previously distributed:
 - Staff summary and collation of responses received (posted with September 2011 Agenda materials);
 - Overview of responses by geographic location, function and language (posted with September 2011 Agenda materials);
 - A copy of Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities, Consultation Paper: *Elements and Recognition in Financial Statements* (CF-CP2); and
 - A copy of all submissions received.
4. The draft is at an early stage of development and the drafting is likely to have to be improved. However, the draft ED provides the Board with sufficient substantive content to deliberate the key issues and the proposed definitions of elements.

5. Staff acknowledges the commitment and input of the Phase 2 Task Based Group (TBG2). In particular the TBG met over the weekend of May 19th- 20th to consider a draft ED and deliberate key issues, which was very important in the further development of the draft ED.

Background

6. CF–CP2 was issued in December 2010 with a response deadline of June 15th 2011. The responses to CF–CP2 were discussed by the IPSASB at meetings in September 2011, December 2011 and March 2012. CF–CP2 contained 19 specific matters for comment (SMCs). A number of these SMCs contained multiple questions: in total there were 38 questions. All responses to these SMCs have been considered by the IPSASB and directions provided to Staff on the approach to be taken in further progressing this phase of the Framework.

Approach

7. The core text of the draft ED is concise and largely avoids examples. The rationale for the approach, together with some supporting examples, is given in the Basis for Conclusions (BC). Members may wish to have both the core text and the corresponding section of the BC side-by-side when reviewing the agenda material and at the meeting. To assist Members in reviewing and commenting on this material, the draft ED and the BC are provided in separate files.

Key Issues

8. The TBG provided directions to staff for the development of the draft ED. This memorandum does not duplicate the material in the BC. However, because of the view of the TBG that these issues are critical to the overall direction of the ED, the IPSASB's attention is drawn in particular to the following matters:
 - Deferred Inflows and Deferred Outflows.
 - Meaning of Little or No Realistic Alternative to Avoid in Context of Liability Definition.
 - Net Position
 - Recognition.

Deferred Inflows and Deferred Outflows

9. The TBG concluded that deferred inflows and deferred outflows should be defined as separate elements. Section 5 of the ED provides the proposed definitions and commentary on the essential characteristics of the definitions. The rationale for the view that deferred inflows and deferred outflows should be defined, and the approach to the definitions is provided in paragraphs BC39–BC43. The TBG is of the view that defining deferred inflows and deferred outflows as elements is the most transparent and intellectually honest approach to dealing with the characteristics of certain non-exchange financial arrangements, which are either specific to the public sector or much more prevalent than in the private sector. Such arrangements include principally:
 - (a) Involuntary transfers of resources, notably taxation, which may be received prior to the period in which they are intended to finance the provision of goods and services; and
 - (b) Transfers of resources with timing restrictions or expectations and no performance obligations or return obligations.

10. The TBG took the view that because exchange transactions do not lead to the timing issues associated with certain non-exchange transactions, the elements of deferred inflows and deferred outflows should only apply to flows arising from a non-exchange transaction. This should allay the reservations expressed at the last meeting about the possible ambiguities in determining whether the flows from exchange transactions are applicable to the current reporting period. In addition, by ring-fencing the scope of deferred inflows and deferred outflows to non-exchange transactions, the proposed approach avoids the necessity of prohibiting the recognition of deferred inflows and deferred outflows if not specifically required by IPSASs.
11. If the IPSASB does not accept the proposal to treat deferred Inflows and deferred outflows as separate elements, the impact on the ED and the Framework would most likely be one of the following:
- (a) The definition of assets and liabilities would have to be broadened to include flows related to subsequent reporting periods; or
 - (b) A presentational approach along the lines of 'other comprehensive income' in IFRSs would have to be developed and adopted; or
 - (c) Information on non-exchange transactions where the resources provided will be used in a subsequent reporting period, would have to be provided in notes to the financial statements or the Financial Statement Discussion and Analysis (FSDA); or
 - (d) The financial statements would not provide information on non-exchange transactions where the resources provided will be used in another reporting period.
12. Not defining deferred inflows and deferred outflows as separate elements would therefore mean that:
- (a) The definitions of assets and liabilities would be substantially different to those in current usage globally; or
 - (b) The use of a presentational approach would have to be considered on an issue-by-issue basis at the standards level; or
 - (c) The IPSASB would be reconsidering a disclosure approach that has already been rejected on the grounds that "disclosure is not a substitute for recognition"; or
 - (d) The financial statements would not meet the objectives of financial reporting and would not satisfy user needs in this area.

Action Requested:

Members are asked to **confirm** that:

- Deferred inflows and deferred outflows should be defined as separate elements;
- An essential characteristic of the elements of deferred inflows and deferred outflows is that the flows giving rise to them must be from non-exchange transactions; and
- The definitions are appropriate.

Little or No Realistic Alternative to Avoid an Outflow of Service Potential or Economic Benefits

13. Section 3 of the ED deals with Liabilities. The approach adopted by the TBG responds to the countervailing views expressed in Düsseldorf that (a) making enforceability an essential characteristic of a liability will not permit entities to recognize as liabilities those obligations where an entity has a past record of honoring similar commitments, which would not be in accordance with the objectives of financial reporting; and (b) the view that constructive obligations have been interpreted in inconsistent and arbitrary ways contrary to the QC of comparability.
14. The TBG concluded that enforceability should not be an essential characteristic of a liability. However, rather than use the term ‘constructive obligation’, the interpretation of which has been problematic for public sector standard setters globally, the TBG considered that the term “social or moral duty or requirement (or obligation)” is more appropriate. A key characteristic of a liability is that the entity has “little or no realistic alternative to avoid an outflow of service potential or economic benefits.”
15. The wide variation in the nature of public sector programs and operations, and the different political and economic circumstances of jurisdictions globally, means that categorical assertions of the circumstances under which social or moral duties or requirements give rise to present obligations are inappropriate. However, as explained in BC32, the TBG proposes the inclusion of rebuttable presumptions that present obligations are extremely unlikely to arise from election promises and, conversely, that where an explicit funding is available and explicitly linked to a social or moral obligation, there is a rebuttable presumption that a present obligation exists. The TBG considers that such rebuttable presumptions will provide useful guidance in assessing whether a social or moral duty or requirement gives rise to a liability.

Action Requested:

Members are asked to **confirm** that:

- Legal (or equivalent) enforceability should not be an essential characteristic of a liability
- The term “social or moral duty or requirement (or obligation)” is more appropriate than constructive obligation and should be used in the Framework; and
- The rebuttable presumptions in paragraph 3.14 of the core text of the Framework are appropriate.

Net Position

16. As a deferred outflow is not an asset and a deferred inflow of resources is not a liability, the TBG took the view that net position rather than net assets is the key residual. Paragraph 1.6 states that net position differs from net assets in that it reflects deferred inflows and deferred outflows. Net position is regarded as a residual amount. Net position is the aggregate of an entity’s assets and deferred outflows less an entity’s liabilities and deferred inflows at the reporting date.

Action Requested:

Members are asked to **confirm** that the inclusion of deferred inflows and deferred outflows as elements means that net position and not net assets/net liabilities, which is the difference between assets and liabilities, is the key residual amount, or provide alternative directions.

Recognition

17. During the development of CF–CP2 there was some discussion whether recognition should be addressed in Phase 2 with an alternative view that it should be dealt with in Phase 3: Measurement. The TBG took the view that existence uncertainty is best addressed in commentary on the definitions of assets and liabilities, because it is an aspect of ‘control’ for assets and is related to the interpretation of ‘little or no realistic alternative to avoid an outflow of service potential or economic benefits’ for liabilities. Therefore paragraph 2.7 addresses existence uncertainty for assets and paragraph 3.15 deals with existence uncertainty for liabilities.
18. Section 7: Recognition currently deals with measurement uncertainty. However, the TBG is of the view that measurement uncertainty should be addressed in Phase 4: Presentation, because, as discussed in paragraph BC48, a decision on whether an item that meets the definition of an element can be measured in a faithfully representative way determines how and whether that item is presented.

Action Requested:

Members are asked to **confirm** that in the context of Recognition:

- Elements uncertainty should be addressed in the context of ‘control’ for assets and in the context of ‘little or no realistic alternative to avoid an outflow of service potential or economic benefits’ for liabilities; and
- Measurement uncertainty should be addressed in Phase 4: Presentation.