

Conceptual Framework Fundamentals.pdf

CONCEPTUAL FRAMEWORK FUNDAMENTALS AND THE REPORTING MODEL

Prepared by:

Conceptual Framework Task Force

March 2015

Comments are requested by August 31, 2015

The Conceptual Framework Task Force encourages
you to respond sooner than August 31, 2015.

Consultation Paper 3

Consultation Paper 3 has been developed by the Public Sector Accounting

Standards Board's (PSAB) Conceptual Framework Task Force. It seeks input from PSAB's stakeholders regarding:

- *A new reporting model to better reflect the accountability objective.*

The proposed reporting model

contains significant changes to

PSAB's existing reporting model.

Consequently, it needs to be considered carefully.

- *Draft principles on public sector characteristics, financial reporting and financial statement objectives, qualitative characteristics, elements, recognition and measurement, as well as presentation and disclosure.*

Project objectives

The objective of this project is to review and amend, if necessary, the concepts underlying financial performance in the public sector conceptual framework in FINANCIAL STATEMENT CONCEPTS, Section PS 1000, and FINANCIAL STATEMENT OBJECTIVES, Section PS 1100 and the reporting model in FINANCIAL STATEMENT PRESENTATION, Section PS 1201.

The project applies to all levels of government as well as government components and organizations that apply the CPA Canada Public Sector Accounting (PSA) Handbook. The project and the conceptual framework focus only on general purpose financial statements.

Reasons for project

A Joint Working Group comprised of selected PSAB members and Deputy Ministers of Finance was established to deal with various concerns expressed by the senior government finance community. A final subgroup report was issued suggesting PSAB review its conceptual framework.

In response, and in formulating its 2010–2013 Strategic Plan, PSAB initially planned its review in conjunction with the work being undertaken by the International Public Sector Accounting Standards Board (IPSASB). However, the senior government finance community expressed concern, indicating that PSAB should be proactive in developing a strong “made-in-Canada” solution. PSAB agreed to revise its 2010–2013 Strategic Plan accordingly, approved a revised project proposal and recruited a task force. In April 2011, the Conceptual Framework Task Force began its review of the conceptual framework focusing primarily on the concepts underlying financial performance for public sector entities.

CONSULTATION PERIOD

March-August 2015

Where are we in the process?

This Consultation Paper is the third document produced by the Task Force. This Consultation Paper, as with the others, represents the views of the Task Force. It is not a “due process” document which requires the approval by PSAB. Consultation Paper 3 highlights many of the principles that will be set out in a future statement of principles for a revised framework and reporting model, and asks for input on them and a proposed reporting model that is built on those principles.

The purpose of the August 2011 Consultation Paper 1, “[Characteristics of Public Sector Entities](#),” was to refine and better describe the characteristics of governments and other public sector entities with the intent that these characteristics would ground the concepts and principles in the PSA Handbook in the realities of the public sector environment.

The October 2012 Consultation Paper 2, “[Measuring Financial Performance in Public Sector Financial Statements](#),” articulates the objective of public sector financial reporting, the primary users of those reports, broad financial reporting accountabilities and more specific financial statement accountabilities. It also asked for stakeholders’ views on three possible reporting model approaches.

A summary of the feedback received from Consultation Papers 1 and 2 can be found on pages 8 and 9.

What are the next steps?

A statement of principles is planned to be issued for 2016. It will take into account input received from the three Consultation Papers and propose a revised conceptual framework and reporting model for public sector entities.

Introduction

The Conceptual Framework Task Force has undertaken a comprehensive review of the concepts that underlie the reporting of financial performance in the general purpose financial statements of public sector entities. Many of its conclusions to date are set out as proposed principles and a proposed reporting model in this Consultation Paper for scrutiny and input by PSAB's stakeholders. Public accountability is the lens through which the proposals in Conceptual Framework Consultation Paper 3 were developed.

Highlights of proposals

1. Revenues and expenses would be categorized in order to provide information about:
 - (a) the net result of services;
 - (b) the aspects of financial results that arise from transactions and events that would be either outside of operations or are not reasonably predictable.
2. New presentation concepts would be included to guide in the preparation of understandable financial statements to meet the accountability objective.
3. An asset and liability model would remain but definitions are proposed to exclude consideration of the expectation of providing future economic benefits to the entity or sacrificing economic resources to others.
4. The revenues and expense definitions include mention of the effect on net assets/liabilities.
5. The use of any attribute other than historical cost, justified at the standards level, would be required.
6. The statement of operations and remeasurement gains and losses would be combined.
7. Unrealized remeasurement gains and losses would be presented separately after net result of services.
8. The presentation of capital transfers would be amended:
 - (a) Specified capital transfers received for using tangible capital assets in the provision of services would be recognized in operating revenue as the liability for the use of the tangible capital asset is settled.
 - (b) Specified capital transfers received for the purpose of acquiring, constructing, developing or bettering a tangible capital asset would be recognized in revenue below net result of services when the liability is settled.
9. The service capacity concept and the reasoning for it will be better explained in the final framework.
10. An amended approved budget could be used by a public sector entity if the government has changed.

11. The flexibility that exists in the current requirements that allowed the actual to budget comparison to be provided in the notes and schedules if the budget reporting entity was different than the entity used for the financial statements would be eliminated.
12. If the reporting entity used for budget purposes is different from that used for financial statements, the statement of comprehensive financial results and change in net debt would provide a note on the face of the statements indicating and explaining why the actual to budget comparison could not be done for a comparable reporting entity.
13. The statement of cash flow would highlight cash available for/required from financing activities.

Your input is requested

The Task Force needs your input on all aspects of Conceptual Framework Consultation Paper 3. This is the final Consultation Paper. Responses to this and the previous Consultation Papers will be carefully analyzed and debated in the development of a statement of principles, which is the next step in the project. You are urged to carefully consider the proposed concepts and their implications on the financial reporting model set out in this Consultation Paper.

Input from individuals, governments and their components and organizations is needed from those who agree with the proposals and from those who do not. The Task Force can form a balanced view of the appropriateness and acceptability of the proposals only if it hears from those who support and those who disagree with the proposals. All comments received will be available on the website shortly after the comment deadline, unless confidentiality is requested. The request for confidentiality must be stated explicitly in the response.

When the input is the collective view formed by a consultative process within an entity, please identify the groups consulted. When relevant, please identify individual views in the response. Such identification will provide context and promote a better understanding of how the proposals are affecting various aspects of a government, government component or government organization.

The Task Force is particularly interested in hearing views on specific questions. However, a response is only valuable if it is accompanied by the reasoning in support of the response. When possible, examples and illustrations should also be provided. When expressing disagreement, please clearly explain the problem and indicate a suggestion, supported by specific reasoning, for alternative wording.

Lastly, the Task Force realizes that it is asking many detailed questions. Given the nature and breadth of issues in the framework, your specific views on many aspects of the Consultation Paper are sought. These views are important input into the development of a statement of principles.

The specific questions being asked are embedded throughout this Consultation Paper in the appropriate places and summarized in Appendix A. Responses need to be supplemented with reasoning for the response and, when practical, illustrations or examples in support of the response.

To be considered, comments must be received by August 31, 2015	• A new response form has been developed to assist PSAB’s stakeholders respond to the questions. Using the new response form instead of the traditional letter or response pdf form will improve comparability among the responses posted on the website and will assist in analyzing responses received. It is a new approach but we urge you to try it as it will positively affect the timeliness and efficiency of the analysis of input received. There is plenty of space for other comments in the new response form and your response can be saved and discussed or amended before submitting it. The questions can be accessed using this new response form link. • Alternatively, you may send comments by email (in Word format to allow for analysis), to: ed.psector@cpacanada.ca. Responses sent in Word format should be addressed to: Tim Beauchamp, Director Public Sector Accounting, CPA Canada, 277 Wellington Street West, Toronto, ON M5V 3H2 • A webinar outlining the proposals set out in this Consultation Paper will also be available on the website during the consultation period.
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Uses of the term “financial”: Financial is used in two senses in the proposals:

- The term is used in front of “statements” and “results” and “position” as a way of identifying that these statements are reporting balances and activities in financial terms and in nominal Canadian dollar amounts (i.e., with no adjustments for the effects of changes in purchasing power).
- The term is also used in front of the word “resources” or “assets” and financial resources/assets are contrasted with “non-financial resources/assets” even though both types of economic resources/assets are reported in “financial” statements. When used in front of “resources/assets”, the term “financial” describes the more liquid nature of the benefits inherent in that type of economic resource/asset and their related flexibility in application. They are financial in the sense that they can normally be applied to settle liabilities or finance future service provision. The benefits inherent in non-financial resources/assets in contrast are more in the nature of service potential and thus can only be applied in future service provision, unless they are identified as for sale and reclassified as financial resources, or sold.

Conceptual Framework Fundamentals and the Reporting Model

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Background

Feedback on previous Consultation Papers

General input received from PSAB's stakeholders on the first two Consultation Papers included the following:

- agreement that public sector entities exist to serve the public;
- positive acknowledgement of the proposed characteristics of public sector entities;
- recognition of the appropriateness of the focus on accountability for the public sector;
- support for the view that information prepared and provided for accountability purposes will also provide information that is useful for decision making;
- agreement that the focus of the project and the framework should be on financial statements; however, it is acknowledged that additional reporting beyond financial statements would be needed to meet the broad accountability objectives of public sector entities;
- an indication that MD&A/FSD&A¹-type reporting needs to be increased in order to improve the understandability of public sector financial reporting;
- agreement that the public and their elected representatives are the primary users of public sector financial statements; and
- an indication that the proposed characteristics are more likely to be met by governments. Government components and organizations may only have some of these characteristics and may also have additional characteristics. A description of these entities should also be included in the characteristics section of the framework.

Key input received from PSAB's stakeholders on the reporting model alternatives in Consultation Paper 2 included the following:

- Out of the three reporting models provided (i.e., the asset and liability model, the revenue and expense model, and the hybrid model) the asset and liability reporting model was endorsed by a majority of respondents because of:
 - o its link to real economic events;
 - o its closeness to business reporting thus improving understandability by PSAB's stakeholders;

¹ "MD&A" means Management Discussion and Analysis. It is a phrase commonly used to describe a type of required narrative reporting in the private sector. "FSD&A" means Financial Statement Discussion and Analysis, a public sector type of optional narrative reporting described in Public Sector Statement of Recommended Practice (SORP) 1, Financial Statement Discussion and Analysis.

- o the strong base that it provides for developing sustainability reporting; and
 - o the fact that a case has not been made regarding the value added by moving to another model.
- However, even some who indicated that they prefer an asset and liability reporting model noted that the asset and liability definitions should allow some deferral/matching, in particular, in relation to transfers received. It should also be noted that the responses at the provincial level were mixed in relation to the reporting model alternatives, while responses at the local and federal levels strongly supported an asset and liability reporting model.
- The current model is not a pure asset and liability model.
 - The revenue and expense model was not endorsed by a majority of respondents for various reasons:
 - o It is difficult to develop a solid, objective basis for deferring inflows and outflows to future periods.
 - o The concept of inter-period equity is difficult to make operational. Only deferrals that meet the definitions of assets and liabilities should be allowed. Assets and liabilities are real economic phenomena. The public only understands real economic phenomena, not accounting creations like deferrals. The public has many assets and liabilities that are similar to those held by public sector entities and so can understand their nature.
 - There was very little support for the hybrid model as it is too complex and would detract from the understandability of the financial statements.

Recommendations of the Joint Working Group

Concerns raised by a Joint Working Group (JWG) comprised of selected PSAB members and deputy ministers of finance were one of the primary reasons that PSAB started its project to review the concepts underlying financial performance in its existing conceptual framework. A final subgroup report recommended that the conceptual framework would be stronger by including the following:

- a statement of the broad conceptually unique features of Canadian governments applicable to all aspects of the standard setting process, in addition to the existing references to uniqueness for reporting purposes;
- a clear definition of government as a socio-economic entity separate from the individuals elected to govern the jurisdiction, which will identify the government as an entity that exists independently and indefinitely;
- a definition of the primary users of the summary financial statements as the public and the legislature acting on their behalf;
- recognition that accounting standards must respond to the information needs of the primary users; and
- a balanced perspective on the importance of the various summary financial statement components required by the standards.

The report also recommended:

- Expansion of the description/definition of liabilities will provide consistency and clarity of presentation of liabilities that are associated with non-exchange transactions, one of the basic unique features of government. In addition, expansion of the description/definition of liabilities will address liabilities associated with exchange transactions that originate from deferred income which are not currently addressed in the PSA Handbook. Alternatively, if these changes cannot be accommodated, new financial statement elements for deferred inflows and outflows (i.e., deferred revenue/expense) should be considered without recording the deferral directly to accumulated surplus/deficit as a means to avoid impacting the statement of operations.
- That the conceptual framework should continue to require that government financial statements are prepared primarily using the historical cost basis of measurement, while recognizing that other bases of measurement are also used, but only in limited circumstances. The conceptual framework would be further strengthened by a requirement to clearly state in any standard (including exposure drafts or other papers for comment) when a departure from this basis of measurement is contemplated, together with clear justification for the departure.

It should be noted that subsequent to the release of the JWG report, standards have been issued about the application of the definition of liability in respect to government transfers.

The Task Force has ensured that the proposals developed to date have considered all of the feedback received as well as the recommendations of the JWG.

Highlights of the fundamentals of the conceptual framework

Below are the highlights of the fundamentals of the conceptual framework, which include the principles that underlie the proposed new reporting model.

NOTE: An introduction to the conceptual framework would be provided in a proposed new Section.

Characteristics of public sector entities (proposed new Section)

1. Public sector entities exist to serve the public. This mandate is the filter through which key characteristics of public sector entities are differentiated from less relevant attributes.
2. The characteristics are:
 - (a) public accountability (including the power to tax, other powers, rights and responsibilities, the importance of the budget, operating and financial frameworks set out in legislation, and debt capacity);
 - (b) multiple public interest objectives (including service provision, resource reallocation, long term stewardship, and peace, order and good government);
 - (c) governance structures (including political dimension to governance, lack of or minimal equity ownership, monopolistic environment, and the Constitutional structure of Canada);
 - (d) the nature of resources; and
 - (e) the significance and volume of non-exchange transactions.
3. Information about the characteristics of government components and government organizations will also be provided.

Major change proposed in comparison to the existing framework: The framework would provide a more complete description of the public sector environment than is accomplished in the existing table of characteristics in Appendix A of FINANCIAL STATEMENT OBJECTIVES, Section PS 1100. Appendix A would be replaced by a proposed new Section.

Implication of the change: A fuller description of the public sector environment will be a touchstone for standard setting. The characteristics have been considered in developing financial statement objectives and the related proposed reporting model. Identification of these characteristics should result in standards that are more tailored to the public sector.

Users and broad objectives of financial reporting (proposed new Section)

4. The primary users of public sector financial reports are the public and their elected representatives.
5. The objective of financial reporting by a public sector entity is to provide information for accountability purposes.
6. The broad financial accountabilities expected to be met by the financial reports of public sector entities are:
 - (a) the extent to which the entity performed in accordance to plan;
 - (b) the state of the financial condition of the entity; and
 - (c) the comprehensive financial performance of the entity.

Major changes proposed in comparison to the existing framework: There would be an increased emphasis on accountability as the primary objective of public sector financial reporting. The public and its elected representatives would be emphasized as the primary users of public sector financial reports in comparison to the existing longer list of users. Broad accountabilities for all financial reporting of a public sector entity would be identified and would set the stage for the more specific financial statement objectives.

Implications of the changes: The accountability objective will have particular effect in the development of the qualitative characteristics, the financial statement indicators and the presentation concepts, all of which would emphasize understandability, reduction of complexity, highlighting of important matters and providing a cohesive, explainable picture of a public sector entity's finances. Thus, the change should have the effect of increasing the accountability value of public sector financial statements, better serving the public interest.

Financial statement foundations and objectives (proposed new Section)

Financial statement foundations

7. Service capacity concept – Public sector entities that apply the PSA Handbook, generally exist to provide services. Measuring service capacity is the basis for assessing financial performance. Service capacity is generally the difference between the value of the assets and liabilities of the entity; it is not limited to the non-financial assets of the entity. Capacity is viewed as a financial phenomenon in the sense that it expresses capacity in monetary terms without any consideration of the productivity of the capacity. The service capacity concept illustrates whether capacity has increased or decreased. Text will be proposed to explain the thinking behind the concept, defined as the capacity to provide services, settle liabilities and finance future services.
8. Unit of measure concept – Public sector financial statements are measured in Canadian dollars with no adjustments made for the effect of a change in the general purchasing power of the currency during the period.

9. Public sector financial statements are prepared using the accrual basis of accounting. The accrual basis of accounting recognizes the effect of transactions and other events in the period in which the transactions and other events occur, regardless of whether there has been a receipt or payment of cash or its equivalent. Accrual accounting recognizes an economic obligation until the term(s) or condition(s) underlying it are partly or wholly satisfied. Accrual accounting recognizes an economic resource until the future service potential or future net cash flows underlying the resource are partly or wholly used or lost.
10. The boundaries of the economic entity being reported on – Accountability can only be served when a complete picture of the entity that is reporting is provided. Financial statements are prepared to report on the finances of an identifiable economic reporting entity, which includes components and organizations controlled by the entity reporting.

Major changes proposed in comparison to the existing framework: The foundations would be better explained; in particular, the reasoning for the service capacity concept and the options considered.

Implications of the changes: There are no implications to highlight.

Financial statement objectives

11. The paper proposes five high-level objectives of financial statements. Financial statements should:

- (a) provide an accounting of the full nature and extent of the resources and financial affairs for which a public sector entity is accountable, including those related to the activities of its components and organizations;
- (b) present information to describe a public sector entity's financial position at the end of the accounting period; such information should be useful in evaluating the entity's accountability for its financial position, including:
 - (i) the entity's ability to finance its activities and to meet its obligations;
 - (ii) the entity's ability to provide future services; and
 - (iii) the entity's service capacity and changes to that service capacity;
- (c) present information to describe the changes in a public sector entity's ability to finance its activities, meet its obligations and provide future services in the accounting period; such information should be useful in evaluating:
 - (i) the sources, allocation and consumption of the entity's economic resources in the accounting period;
 - (ii) the relationship between the use of economic resources to provide services in the period and the inflows of economic resources in the period;

- (iii) the extent to which the results of the period can be attributed to operating activities as contrasted with the effects of unusual events, revaluations or other volatile events;
 - (iv) how the activities of the accounting period have affected the net financial resources/obligations of the entity; and
 - (v) how the entity financed its activities in the accounting period and how it met its cash requirements;
- (d) provide information useful in demonstrating a public sector entity's accountability for the financial affairs and resources for which it is responsible in terms of:
- (i) whether they were administered by the entity in accordance with the limits established by the appropriate legislative authorities; and
 - (ii) how the actual financial performance of the entity in the management of its financial affairs and resources in the accounting period compares to that projected in its fiscal plan; and
- (e) provide information to describe the significant financial risks to which the public sector entity is exposed. Such information would be useful in evaluating the nature and extent of these risks and the entity's accountability for the management of these risks.

Note: At the standards level, objective (a) is dealt with in the requirements of GOVERNMENT REPORTING ENTITY, Section PS 1300. The remaining objectives would be taken into account in the requirements of a revised FINANCIAL STATEMENT PRESENTATION, Section PS 1201.

Major changes proposed in comparison to the existing framework: There would be three changes in the financial statement objectives from those set out in existing FINANCIAL STATEMENT OBJECTIVES, Section PS 1100;

- (a) the addition of a new objective that would require a description of the significant financial risks to which an entity is exposed;
- (b) the addition of a requirement to provide information about the relationship between the decreases of economic resources to provide services in the period and the increases of economic resources in the period, which would translate into a financial reporting requirement for a net result of services subtotal on the statement of comprehensive financial results; and
- (c) the addition of a requirement to provide information about the extent to which the results of the period can be attributed to operating activities as contrasted with the effects of unusual events, revaluations or other volatile events. This change would require the separate reporting of volatile items identified by PSAB from the newly proposed net result of services indicator.

Changes to the reporting model based on these objectives are also proposed. Please see the main body of this paper, which illustrates the proposed new reporting model. The proposed reporting model uses a presentation solution to highlight the net result of services and requires separate reporting of the major items identified as creating volatility in periodic financial results.

Implications of the changes: The additional objective regarding risk disclosures responds to those significant financial risks existing in the economic environment in which public sector entities operate. It was concluded that financial statements that are comprehensive and respond to the accountability objective demand reporting of the significant financial risks to which an entity is exposed. The Task Force does not anticipate new reporting requirements as a result of this additional objective, as reporting on significant financial risks is already a requirement in the existing standards (for example, in FINANCIAL INSTRUMENTS, Section PS 3450). The emphasis on the relationship between the decrease of economic resources to provide services in the period and the increase of economic resources in the period responds to input received on Consultation Paper 2 regarding the need to highlight the net result of services. The implications of the proposals on the reporting model are discussed later in this Consultation Paper.

Question 1: Do you agree with the service capacity concept, as described in paragraph 7?

Question 2: The Task Force is proposing five high-level objectives of financial statements.

- (a) Do you agree with the objective of accounting for the full nature and extent of the resources and financial affairs for which a public sector entity is accountable, as described in paragraph 11(a)?
- (b) Do you agree with the objective of presenting information to describe a public sector entity's financial position at the end of the accounting period, as described in paragraph 11(b)?
- (c) Do you agree with the objective of presenting information to describe the changes in a public sector entity's ability to finance its activities, meet its obligations and provide future services in the accounting period, as described in paragraph 11(c)?
- (d) Do you agree with the objective of providing information that is useful in demonstrating a public sector entity's accountability for the financial affairs and resources for which it is responsible, as described in paragraph 11(d)?
- (e) Do you agree with the objective of providing information to describe the significant financial risks to which a public sector entity is exposed, as described in paragraph 11(e)?

Qualitative characteristics (proposed new Section)

12. The qualitative characteristics of information to be reported in public sector financial statements are:

- (a) relevance (consisting of confirmatory and predictive value and timeliness);
- (b) faithful representation (consisting of completeness, neutrality, freedom from material error and substance over form);
- (c) verifiability;
- (d) comparability; and

(e) understandability (reduction of complexity).

13. Considerations in applying the qualitative characteristics are: benefits versus costs and materiality.

Major changes proposed in comparison to the existing framework:

- Faithful representation would replace reliability as a characteristic. Representational faithfulness is currently identified as a quality of reliability. The main reason for the proposal is that there has been some confusion distinguishing between reliability and verifiability, so it makes sense to more clearly differentiate the intended nature of the characteristics. In proposing the change to faithful representation, it was concluded that it is important to ensure that the concept is clear and distinguishable from other characteristics and that faithful representation provided a better description of the intent of the characteristic than did reliability.
- Because of the proposed accountability objective, an understandability imperative is also proposed. The idea is that accountability cannot be achieved unless the information provided for accountability purposes can be understood.
- Conservatism is removed as an explicit concept but would still play a role in cases of estimation when there is uncertainty and there is a choice between equally possible amounts. In such cases, conservatism would require that there be no deliberate understatement of liabilities or overstatement of assets.
- Materiality is proposed to be added to the benefit/cost comparison as a consideration in applying the qualitative characteristics.

Implications of the changes: The qualitative characteristics would be clarified so that their intent is more transparent and they would be better oriented to the accountability needs of public sector users. The considerations are aimed at ensuring that the practical realities are considered in applying the qualitative characteristics.

Question 3: Do you agree with the proposed change to the qualitative characteristics of replacing reliability with faithful representation?

Question 4: Do you agree that benefits versus costs and materiality should be considerations in applying the qualitative characteristics, as indicated in paragraph 13?

Elements of financial statements (proposed new Section)

14. The elements of financial statements are limited to economic phenomena and changes in them. Identifiable economic phenomena make sense to the public and their elected representatives as they have them too in their own finances (for example houses, mortgages and investments).
15. The elements of financial statements are: assets, liabilities, revenues and expenses.

16. Asset definition – An asset is a present economic resource controlled by an entity as a result of past events that is capable of providing future economic benefits.
17. Liability definition – A liability is a present economic obligation of an entity to others as a result of past events that can result in a future sacrifice of economic resources.
18. Revenues definition – Revenues, including gains, are increases in assets or decreases in liabilities in the accounting period that result in an increase in net assets/liabilities.
19. Expenses definition – Expenses, including losses, are decreases in assets or increases in liabilities in the accounting period that result in a decrease in net assets/liabilities.

Major changes proposed in comparison to the existing framework:

- The asset and liability definitions are proposed to exclude consideration of the expectation of providing future economic benefits to the entity or sacrificing economic resources to others in determining what is an asset or liability. These exclusions would eliminate an existing redundancy between the element definitions and the general recognition criteria. Only the general recognition criteria will consider the expectation of providing future economic benefits or sacrificing economic resources in determining what can be recognized in public sector financial statements.
- The revenues and expenses definitions are proposed to include mention of the effect on net assets/liabilities. Previously, this effect was only recognized in the accompanying guidance, not the definitions; it was concluded that the definitions should stand on their own.

Implications of the changes: Asset and liability definitions would be clearer as they would be focused on the nature and substance of these economic phenomena. They would no longer overlap with the general recognition criteria. The general recognition criteria will now act as the boundaries as to which assets, liabilities, revenues and expenses get recognized in public sector financial statements. There would be no change in what would actually be recognized in the financial statements as there was always redundancy between the asset and liability definitions and the general recognition criteria.

Question 5: Do you agree that the elements of financial statements should be limited to economic phenomena and changes in them, as stated in paragraph 14?

Question 6: Do you agree that the elements of financial statements should be assets, liabilities, revenues and expenses, as stated in paragraph 15?

Question 7: Do you agree with the asset definition, as presented in paragraph 16?

Question 8: Do you agree with the liability definition, as presented in paragraph 17?

Question 9: Do you agree with the revenues definition, as presented in paragraph 18?

Question 10: Do you agree with the expenses definition, as presented in paragraph 19?

Recognition and measurement (proposed new Section)

20. The general recognition criteria are not proposed to be changed. Once it is determined that an item meets the definition of an element, the general recognition criteria would continue to require that the inflow of future economic benefits or outflow of economic resources associated with the item be expected to be realized and that the item can be measured in order for the item to be recognized in financial statements.

21. Derecognition principles are not proposed for inclusion in the framework. These will be considered at the individual standards level.

22. The purpose of financial statements is to demonstrate accountability for the net resources available for service capacity and changes to those resources. Measurement requirements are set out in individual standards. Primarily, historical cost reflects accountability for past performance. Use of any attribute other than historical cost would be justified at the standards level. In the absence of specific guidance, professional judgment is needed to determine the most appropriate measurement attribute given the objectives of financial statements. In public sector financial statements, assets, liabilities, transactions and events are initially recognized at cost, or the amount of cash or cash equivalents paid or received or the fair value ascribed to them. Subsequent to initial recognition, there are circumstances where, for example, a historical cost or fair value attribute is most appropriate for measuring service capacity.

Major changes proposed in comparison to the existing framework: The inclusion of more explanatory information and a requirement that the use of any attribute other than historical cost be justified at the standards level are the main changes proposed.

Implications of the changes: The general recognition criteria will now act as the boundaries as to which assets, liabilities, revenues and expenses get recognized in public sector financial statements.

Question 11: Do you agree that the general recognition criteria should not change, as indicated in paragraph 20?

Question 12: Do you agree that derecognition principles should not be included in the conceptual framework, as indicated in paragraph 21?

Question 13: Do you agree with the measurement attribute, as described in paragraph 22?

Presentation concepts (proposed new Section)

23. The conceptual presentation objective is to present information in the financial statements in a manner that maximizes the accountability value of the financial statements to the public and its elected representatives, and portrays a cohesive financial picture of the activities of a public sector entity. Presentation includes disclosure.
24. The PSA Handbook represents the requirements for all public sector entities that prepare general purpose financial statements. GAAP represents the core accountabilities required of public sector entities that apply the PSA Handbook by the public and their elected representatives. Public sector entities may provide additional presentation and disclosure in the financial statements as long as such information:
- (a) does not conflict with the core requirements;
 - (b) does not confuse, hide or change the meaning of the information included in the financial statements;
 - (c) is consistent with the conceptual framework; and
 - (d) increases the accountability value of the resulting financial statements.
25. Information, including note disclosures, presented in financial statements should:
- (a) provide a cohesive, comprehensive, understandable picture of the financial results and financial position of the entity;
 - (b) provide information at the level of detail appropriate to financial statements;
 - (c) increase the accountability value of the financial statements;
 - (d) prioritize and give higher profile in disclosures to matters of importance that have occurred in the period; and
 - (e) be entity- and period-specific, rather than boilerplate presentations.
26. No one financial statement is more important than any other financial statement. Each financial statement has its own purpose. Notes and schedules have the same significance as information or explanations set forth in the body of the statements themselves. However, disclosure in the notes and schedules to the financial statements should not be used as a substitute for the proper recognition of a transaction.
27. Financial statements should present:
- (a) the substance of transactions and other events;

- (b) information required for the fair presentation of a public sector entity's periodic financial results and financial position;
- (c) information in an understandable manner; and
- (d) information stated as simply as possible while still meeting the qualitative characteristics and the accountability objective.

28. Presentation and disclosure choices should be made within the context of whether they add to the accountability value provided by the set of financial statements. A public sector entity should consider:

- (a) the appropriateness of aggregation/grouping/consolidation of like items for reporting or disclosure purposes and whether such an approach contributes to the understandability of the entity's finances;
- (b) the complexity, uncertainty and risk in identifying the appropriate presentation and disclosure of items, transactions and other events with the emphasis on providing understandable information;
- (c) the timing and frequency of preparation and issuance of financial statements to ensure that information presented in financial statements is meaningful and relevant to users; and
- (d) the need for, nature, extent, organization, value and understandability of all disclosures in the notes and schedules at each reporting date.

Major changes proposed in comparison to the existing framework:

- Some presentation principles that are more conceptual in nature would be moved from existing FINANCIAL STATEMENT PRESENTATION, Section PS 1201, to this proposed new Section. Examples include:
 - o the requirement to present substance over form;
 - o the prohibition against using notes as a substitute for the proper recognition of a transaction;
 - o reporting/disclosing information at the level of detail appropriate to financial statements; and
 - o the requirement to report or disclose any information needed for the fair presentation of an entity's financial results and position.
- New presentation concepts would be included to guide in the preparation of understandable financial statements to meet the accountability objective. Examples include the requirement(s):
 - o for all presentation and related disclosures to provide a cohesive and understandable picture of an entity's finances;
 - o to present information as simply as possible to meet the other requirements;

- o to prioritize matters of importance and use appropriate disclosures for the entity; and
- o to review the financial statement package at each reporting date to ensure that it remains relevant cohesive, comprehensive and understandable.

Implications of the changes: The proposed changes are intended to help explain and operationalize what the accountability objective means for users of the PSA Handbook. They may also help in developing presentation and disclosure requirements at the standards level. Some entities likely already apply principles like those proposed in preparing their financial statements; others may need to institute new practices to ensure that the financial statements are understandable to the public and its elected representatives.

Question 14: Do you agree with the conceptual presentation objective, as described in paragraph 23?

Question 15: Do you agree with the restrictions on information provided supplemental to the core requirements, as listed in paragraph 24?

Question 16: Do you agree with the parameters to be considered in determining what information to include in financial statements, as listed in paragraph 25?

Question 17: Do you agree with the relative equality of the individual financial statements and the notes to the financial statements in meeting the accountability objective, as described in paragraph 26?

Question 18: Do you agree with the basic principles relating to what information financial statements should present, as listed in paragraph 27?

Question 19: Do you agree with the considerations for evaluating presentation and disclosure choices, as listed in paragraph 28?

Features of and basis for reporting model proposals

The Task Force is proposing changes to the core requirements for the public sector financial reporting model. The majority of the proposed changes relate to presentation on the statement of financial performance.

The Task Force has considered the comments received on [Consultation Paper 2](#), the majority of which supported retaining an approach that uses the rigour of asset and liability definitions and changes in assets and liabilities as parameters for calculating financial performance. Thus, the proposed approach balances technical consistency and supportability with changes in how financial performance is presented in order to better explain the dimensions of the financial performance of a public sector entity.

Consultation Paper 3 elaborates on the details of the proposed reporting model highlighting where changes are proposed and their implications. Illustrative financial statements show the features of the proposed reporting model.

FEATURES AND CHANGES		BENEFITS/IMPLICATIONS
Proposed reporting model would require changes in presentation but not in recognition or measurement		Recognition and measurement issues are examined at the standards level, given the uniqueness of each standard.
Number of financial statements reduced to four		- Fewer statements should reduce complexity for users and improve understandability. - There would be fewer reconciliations for users to follow in reading the statements.
Single periodic financial results statement		- One financial results statement means that users would see in one place whether the entity is better or worse off on an overall basis from the activities of the period, but would also be able to evaluate accountability for other aspects of periodic financial performance such as the net result of services and the items affecting volatility of results. - Only the items identified by PSAB would be reported separately from net result of services.
Question 20: Do you agree with combining the statement of operations with the statement of remeasurement gains and losses to make a single periodic financial results statement?		

FEATURES AND CHANGES	BENEFITS/IMPLICATIONS
Proposed statement of comprehensive financial results would present a more nuanced and understandable results story for the period; its focus is not on a single number • “Total revenues less total expenses” would continue to be how the measure of comprehensive financial results for the period is calculated. This difference would continue to represent the change in net assets/liabilities. • However, revenues and expenses would also be categorized on the proposed statement of comprehensive financial results in order to provide information about: - o the net result of services (indicates the extent to which operating revenues were sufficient to cover operating expenses); and - o the aspects of financial results that arise from transactions and events that would be either outside of operations or not reasonably predictable. • Exclusion of unrealized remeasurements from net result of services would continue under the proposed reporting model. This approach is consistent with an accountability objective, which emphasizes accountability for operating performance, highlighting volatile amounts because of the greater uncertainty associated with them. The proposed separate reporting of unrealized remeasurements on the statement of comprehensive financial results highlights them for explanation. • The proposed statement of comprehensive financial results would allow separate reporting of items that are generally not possible to budget for, such as natural disasters and other unusual events. • Guidance will be provided for those items that should be isolated from net result of services, with the expectation that the guidance would include the requirement to properly disclose the rationale for the exclusion.	• Subtotals on the statement of comprehensive financial results would help to better communicate and explain financial results and thus provide better accountability information. • The format would better respond to users’ needs. Users are interested in the net result of services indicator because services are what they expect to receive from the public sector. The public want to understand the extent to which public resources have been used to provide services in the period. • Separately reporting unrealized remeasurements or unusual items allows the entity to explain them to the public. Therefore, the approach should improve the understandability of reported results. This approach would also be more aligned with how public sector entities, particularly governments, budget and manage programs. • This approach continues the existing practice of reporting cost of service information in a manner that facilitates linkage of summary costs to underlying costs for the costing and management of individual programs/services. • Even with subtotals on the statement of comprehensive financial results, the statement would still highlight on an overall basis whether total revenues were sufficient to cover total expenses of the period. • The proposals recognize the reality that it may not be possible to budget for some aspects of financial results, such as unrealized valuation changes and unusual items such as natural disasters. These would be required to be reported separately. Nevertheless, the separate reporting of these

FEATURES AND CHANGES	BENEFITS/IMPLICATIONS
	aspects of financial results for the accounting period would allow for explanation of the actual financial effects of these items and any related budget variances.
Question 21: Do you agree with the proposed statement of comprehensive financial results? Question 22: Do you agree with the segregation of “unusual items” from net result of services? If so, in developing a definition or guidance for “unusual items”, what would the definition or guidance be?	
Unrealized remeasurement gains and losses would not be presented as part of net result of services - Currently, unrealized remeasurement gains and losses are required to be presented in the statement of change in net debt/net financial assets and, thus, are excluded from the operating surplus/deficit. - In the proposed reporting model, unrealized remeasurement gains and losses would be presented separately after net result of services.	- The approach would support the provision of transparent accountability information about significant financial risks taken on by an entity and the effectiveness of its risk management. - The proposed approach would not change the existing financial instrument or foreign currency translation standards except to the extent that unrealized remeasurements are presented on the single comprehensive financial results statement rather than reported on a separate statement.
Question 23: Do you agree that unrealized remeasurement gains and losses should be presented separately from net result of services?	
New rules on the presentation of capital transfers received - Capital transfers received that are stipulated to be used for buying or building a tangible capital asset would be recognized in revenue as the related asset is bought or built and would be reported below the net result of services line. - Capital transfers received for the purpose of acquiring or developing a tangible capital asset for use in providing services for a defined number of years would be recognized in operating revenue as the liability is settled, in accordance with GOVERNMENT TRANSFERS, Section PS 3410.	- Net result of services would not be distorted by capital transfers that are to be used to buy or build a tangible capital asset. - The difference in how these two types of capital transfers are reported on the statement of comprehensive financial results would be set out as a consequential amendment to GOVERNMENT TRANSFERS, Section PS 3410.
Question 24: Do you agree with the proposed presentation for capital transfers received (i.e., capital transfers stipulated to be used for buying or building a tangible capital asset are to be reported below net result of services and capital transfers that are related to the use of the tangible capital asset would be recognized in operating revenue as the liability is settled)?	

FEATURES AND CHANGES	BENEFITS/IMPLICATIONS
Only real economic phenomena and changes in them would be reported Only the substance of economic phenomena (resources and obligations) and changes in them would be recognized in public sector financial statements.	- From an understandability perspective, individuals look at their own finances in terms of economic resources (such as houses) and obligations (such as mortgages, credit cards); so the proposed approach would be more familiar to them and thus, more explainable than one that incorporates accounting deferrals. - This is the same as the current approach in the PSA Handbook.
Proposed approach would set consistent, theoretically supportable boundaries around the items that can be included in periodic financial results - Financial results would only arise from changes in assets and liabilities, and thus, provide rigour for evaluating items being considered for recognition, and consistency in application. - Asset and liability definitions would provide the rigour that establishes boundaries around what can be included in financial results and when. - However, this rigour in what can be included in financial results, and when, would be accompanied by a presentation solution that isolates volatile items from net result of services. Revenues and expenses would be categorized to allow for the calculation of explainable measures that highlight the important financial results dimensions of a public sector entity.	- Measuring comprehensive financial results as the change in net assets/liabilities would provide an anchor to resolving difficult accounting questions and sound financial reporting. - By ensuring that items that do not meet the definitions of assets and liabilities are not recognized on the statement of financial position, this approach would also ensure that only changes in economic phenomena flow through to the statement of comprehensive financial results. - Historical experience suggests that this approach most appropriately anchors the standard-setting process and adds to the credibility of financial reporting by providing the strongest conceptual mapping to the underlying economic reality.
Highlighting cash available for/required from financing activities on the statement of cash flow A subtotal of cash (requirements)/available would be calculated before reporting financing transactions.	This format would allow the amount of cash required from or available for financing activities to be highlighted and, thus, may be more explainable to users.
Question 25: Do you agree with the proposed change made to the statement of cash flow to calculate the subtotal of cash requirements/available before financing transactions?	

FEATURES AND CHANGES	BENEFITS/IMPLICATIONS
The rules regarding the budget numbers to be included in financial statements for purposes of comparing actual to budgeted results are proposed to be tightened in order to emphasize this important part of the accountability cycle. - Guidance will encourage the approved original budget to be on the same accounting basis, for the same entity and to use the same classifications as the financial statements. - At a minimum, a projected statement of comprehensive financial results would be approved as part of the original budget. - Some additional flexibility would be allowed in terms of the budget numbers used for comparison. An amended approved budget is allowed to be used by a public sector entity if the government has changed. An amended budget is differentiated from forecasts updated over the course of the year. - If the budget accounting basis or classification is different than that used in the financial statements, the budget numbers would be restated for purposes of the actual to budget comparison using the financial statement accounting basis and classification. The restatement reconciling back to the numbers in the original approved budget would be disclosed and explained in a note or schedule. - If the reporting entity used for budget purposes is different than that used for financial statements, the statements of comprehensive financial results and change in net debt would provide a note on the face of the statements indicating and explaining why the actual to budget comparison could not be done for a comparable reporting entity.	- The actual to budget comparison in the financial statements would only be provided on the face of the financial statements and not in the notes and schedules to the financial statements. Therefore, it should receive a higher profile. - The resulting accountability information would be more understandable and more clearly link to the fiscal plan. - Reconciliations would be minimized. - The flexibility that exists in the current requirements that allowed the actual to budget comparison to be provided in the notes and schedules if the budget reporting entity was different than the entity used for the financial statements would be eliminated. This flexibility allowed the comparison to be done only for the entity used in the budget. Thus, the actual numbers from the financial statements had to be adjusted and reported in the comparison only for those entities in the budgeted reporting entity. - This proposal would encourage the use of the same reporting entity for financial statements and budgets. - In essence, these proposals encourage budgets to be prepared on an accrual basis for the reporting entity and all entities controlled by a public sector entity. - Accountability is strengthened when actual to budget comparisons are prepared on the same accounting and classification basis and for the same reporting entity.
Question 26: Do you agree with the budget proposals? Question 27: Are there situations, other than a change in government that would support the use of an amended budget?	

FEATURES AND CHANGES	BENEFITS/IMPLICATIONS
Emphasis is on more than a single indicator of results • The current reporting model reports more than one financial results number. But the emphasis of discussion is usually on the annual surplus/deficit from operations. • Net result of services and comprehensive financial results would be indicators on the statement of comprehensive financial results. • The statement of cash flow would highlight cash available for/required from financing activities. • There would be increased emphasis on the budget to actual comparison.	• A single financial results number for a public sector entity may be misleading if it is not put in context. The indicators proposed for the new financial results statement provide some context and allow for a more comprehensive picture of financial results to be presented in one place and explained. • The dimensions of financial results set out in the statement of cash flow provide further useful performance information for accountability purposes that is isolated for explanation. • The budget to actual comparison is an important aspect of variance reporting to further demonstrate accountability.
Question 28: The Task Force has not identified annual surplus/deficit as an indicator. Should annual surplus/deficit be an indicator in the proposed statement of comprehensive financial results? If yes, how should it be defined?	

Illustrative financial statements

Statement of Comprehensive Financial Results

Year ended March 31 (\$ thousands)

	Budget ⁷ 20X3	Actual 20X3	Note	Actual 20X2
Operating revenues				
Income or property taxes	8,034	8,628		9,503
Other taxes	2,721	2,976		3,083
Non-renewable resource revenue	660	770		705
Operating transfers	810	840	1	783
Transfers for usage of tangible capital assets	130	130	1	120
Miscellaneous revenues	427	485		465
Net income from government business enterprises	50	525		97
Net investment income (realized)	409	610	3	747
Premiums, permits, fees, fines and licences	581	651		669
Other	100	342		402
	13,922	15,957		16,574
Operating expenses by function				
Health	4,541	4,626	2	4,457
Education	4,329	4,287	2	4,168
Social services	1,654	1,701	2	1,709
Transportation and utilities	626	823	2	807
Agriculture, environment and development	1,706	1,856	2	1,740
Justice	468	487	2	462
Recreation and culture	281	272	2	217
General government	551	627	2	560
Debt servicing costs	93	267	2	183
	14,249	14,946		14,303
Net result of services/programs	(327)	1,011	6	2,271
Transfers for acquisition of tangible capital assets	355	365	1	280
+/- Unusual items	0	(1,000)	5	0
Unrealized remeasurement gains (losses)	0	169	3	(47)
Comprehensive financial results	28	545		2,504
Net assets/(liabilities) at beginning of year	(1,413)	(1,413)	8	(3,917)
Net assets/(liabilities) at end of year	(1,385)	(868)	8	(1,413)

Additional subtotals within the net result of services area are possible. However, public sector entities would need to consider whether further subtotals would improve accountability or impair understandability.

Items identified by PSAB are isolated here.

Question 29: On the statement of comprehensive financial results are there better labels for the indicators (i.e., net result of services) or the statement, which would be more informative or would provide increased understandability? If so, what would they be?

Statement of Financial Position

As at March 31 (\$ thousands)

Financial assets

Cash and cash equivalents	Actual 20X3	Actual 20X2
Accounts and accrued interest receivable	577	1,366
Portfolio investments	1,864	1,708
Derivatives	2,254	1,331
Equity in commercial enterprises	35	0
Loans	331	207
Inventories for resale	4,909	5,659
	109	135
	10,079	10,406

Liabilities

Accounts payable and accrued liabilities		
Derivatives	2,383	2,644
Debt	10	105
Pension liabilities	9,398	9,796
Other accrued liabilities	4,813	4,890
Unearned revenue	1,395	1,510
	308	331
	18,307	19,276
	(8,228)	(8,870)

Net financial assets/(net debt)**8****Non-financial assets**

Tangible capital resources available	14,659	14,430
Less: Accumulated use of tangible capital resources	(7,441)	(7,215)
Tangible capital resources, net	7,218	7,215
Inventories of supplies and prepaid expenses	142	242
	7,360	7,457
	(868)	(1,413)

Net assets/(liabilities)**8**

When negative, this indicator means that future revenues will be needed to pay for past spending. When positive, it means that there are financial resources available to finance future operations.

This indicator represents an accumulation of comprehensive financial results.

Question 30: Do you agree with the change proposed in the statement of financial position to rename the “accumulated surplus/deficit” as “net assets/liabilities”?

Statement of Change in Net Debt

Year ended March 31 (\$ thousands)

	Budget 20X3	Actual 20X3	Actual 20X2
Comprehensive financial results	28	545	2,504
Acquisition of tangible capital assets	(294)	(294)	(250)
Amortization of tangible capital assets	226	226	230
(Gain) / loss on sale of tangible capital assets	0	(5)	(19)
Proceeds on sale of tangible capital assets	0	46	72
Write-downs of tangible capital assets	0	24	44
	(68)	(3)	77
Acquisition of supplies inventories	0	0	(324)
Acquisition of prepaid expense	0	(30)	(20)
Consumption of supplies inventories	0	110	102
Use of prepaid expense	0	20	0
	0	100	(242)
(Increase) / decrease in net debt	(40)	642	2,339
Net debt at beginning of year	(8,870)	(8,870)	(11,209)
Net debt at end of year	(8,910)	(8,228)	(8,870)

Statement of Cash Flow (Indirect Method)

Year ended March 31 (\$ thousands)

The indirect method is used for illustrative purposes only.

Both the indirect and direct method are allowed to report cash flows.

	Actual 20X3	Note	Actual 20X2
Operating transactions			
Comprehensive financial results	545		2,504
Non-cash items including amortization	335		569
Prepaid expenses	(30)		(20)
Change in unearned revenue	(23)		16
Other	(1,073)		(203)
Cash provided by/(applied to) operating transactions	(246)		2,866
Capital transactions			
Capital transfers received	365		280
Proceeds on sale of tangible capital assets	46		72
Cash used to acquire tangible capital assets	(294)		(250)
Cash provided by/(applied to) capital transactions	117		102
Investing transactions			
Proceeds from disposals and redemptions of portfolio investments	262		2,997
Repayment of loans and advances	768		1,129
Portfolio investments	(594)		(4,089)
Loans and advances	(290)		(280)
Other	(17)		(15)
Cash provided by/(applied to) investing transactions	129		(258)
Net cash provided by/(applied to) activities	0	4	2,710
Cash and cash equivalents at beginning of year	1,366	4	1,137
Net cash available for/(required from) financing transactions	1,366	4	3,847
Financing transactions			
Public debt issues	13,970	4	3,694
Public debt retirement	(14,759)	4	(6,175)
Other	0	4	0
Cash provided by/(applied to) financing transactions	(789)	4	(2,481)
Cash and cash equivalents at end of year	577	4	1,366

Explanatory notes:

1 Operating transfers received would be recognized as operating revenue when received, except if they meet the definition of a liability. Large operating transfers received near year end that have stipulations requiring their application to future periods would likely be recognized as liabilities until the stipulations are met. Operating transfers received that are recognized as a liability would be recognized in operating revenue as the liability is settled.

Capital transfers received may be recognized as liabilities until the related asset is bought or built or until the asset is used to provide services as allowed by GOVERNMENT TRANSFERS, Section PS 3410. Capital transfers received that are stipulated to be used for buying or building a tangible capital asset would be recognized in revenue as the related asset is bought or built and would be reported below the net result of services line. Specified capital transfers received for the purpose of acquiring or developing a tangible capital asset for use in providing services for a defined number of years would be recognized in operating revenue as the liability is settled. This proposal is based on the recognition requirements in GOVERNMENT TRANSFERS, Section PS 3410, as they are currently stated. The difference in how these two types of capital transfers are reported on the statement of comprehensive financial results would be set out as a consequential amendment to GOVERNMENT TRANSFERS, Section PS 3410. Thus, net result of services is not distorted by capital transfers that are to be used to buy or build a tangible capital asset.

2 Amortization would be included in operating expenses by function.

3 Net investment income would include realized gains and losses on items (re)measured at fair value. Unrealized remeasurement gains (losses) would include unrealized fair value remeasurements and exchange gains or losses arising prior to settlement. These would be shown separately from recurring, replicable operating results to emphasize the greater degree of uncertainty in these unrealized amounts. No separate statement of remeasurement gains and losses would be prepared. This approach would be a change to the reporting requirements in FINANCIAL STATEMENT PRESENTATION, Section PS 1201, and the presentation requirements in FINANCIAL INSTRUMENTS, Section PS 3450 and FOREIGN CURRENCY TRANSLATION, Section PS 2601, as they relate to the statement of remeasurement gains and losses. Note disclosure would supplement the information reported on the statement of comprehensive financial results, similar to the detail now required to be reported on the statement of remeasurement gains and losses.

In the reporting period that a financial instrument in the fair value category is derecognized, the accumulated unrealized remeasurement gain or loss associated with the derecognized item is reversed and included in net result of services.

With respect to unrealized foreign currency exchange gains and losses, in the period of settlement, the accumulated unrealized foreign currency exchange gains and losses is reversed and included in net result of services.

4 The statement of cash flow would be substantially unchanged, although a subtotal of cash (requirements)/available would be calculated before reporting financing transactions. This format would allow the amount of cash required from or available for financing activities to be highlighted and may be more explainable to users. The proposed presentation would allow the cash flow statement to better reflect funding decisions at a whole of entity level given the focus of the other statements on accrual information.

5 Unusual items, such as natural disasters, would be separately reported from the net result of services/programs. Guidance for identifying items as "unusual" would be provided at the standards level. The statement of principles would propose such guidance in a revised FINANCIAL STATEMENT PRESENTATION, Section PS 1201.

6 Net result of services/programs would be the difference between operating revenues and operating expenses. Operating revenues would be all revenues excluding transfers for acquisition of tangible capital assets, unrealized remeasurement gains and any revenue resulting from unusual items. Operating expenses would be all expenses excluding unrealized remeasurement losses and any expenses related to unusual items. The net result of services indicator is important as it would link to more detailed cost information at the program level. And for those entities that budget and do their appropriations on a full accrual basis, this information would also link to appropriations.

7 **Budget proposals:**

- Budget numbers would continue to be provided in the financial statements for comparison with actual numbers, both on the statement of comprehensive financial results and on the statement of change in net debt.
- The budget proposals recognize the reality that it may not be possible to budget for some aspects of financial results, such as unrealized valuation changes and unusual items.
- Ideally the accounting basis, entity and classification used in an entity's budget would be the same as that used for its financial statements.
- It is possible that an entity might have variances from budget that relate to accounting differences (accounting basis, entity and classification) as well as those that relate to economic and operational differences.
- It is proposed that when the approved original budget and financial statements are prepared on a comparable basis (entity, accounting basis and classification are the same) the actual to budget comparison would be done on the face of the statements of comprehensive financial results and change in net debt.
- If the accounting basis or classification used in the budget is different than that used for the financial statements, the budget amounts would need to be restated and the restated amounts would be identified and reported as such on the face of the

statements of comprehensive financial results and change in net debt. Disclosures would reconcile the restated budget numbers back to those reported in the approved original budget.

- If the reporting entity used for budget purposes is different than that used for the financial statements, the statements of comprehensive financial results and change in net debt would provide a note on the face of the statements indicating and explaining why the budget to actual comparison could not be done.
 - An amended approved budget allowed to be used by a public sector entity if the government changed – the amended budget would be differentiated from forecasts updated over the course of the year.
- 8 Net assets/liabilities would be an indicator calculated as the sum of net financial assets/(net debt) and non-financial (primarily tangible capital) assets. The change in net assets/liabilities would comprise changes in net financial assets/(net debt) and non-financial (primarily tangible capital) assets.
- 9 "Unearned revenue" refers to items that meet the definition of a liability but may commonly be called "deferred revenue". The use of this term does not imply the adoption of deferred inflows and outflows as elements of financial statements. Nor is such terminology reflective of a precedent that items that do not meet the definitions of assets and liabilities can be recognized in public sector financial statements. Examples of items that might fall into a line item such as this include development fees accounted for in accordance with RESTRICTED ASSETS AND REVENUES, Section PS 3100, or government transfers meeting the three characteristics of liabilities in accordance with GOVERNMENT TRANSFERS, Section PS 3410, and LIABILITIES, Section PS 3200. Only items that meet the definition of assets and liabilities are recognized in public sector financial statements.

The Task Force contemplated allowing public sector entities to show the breakdown of net assets/liabilities on the statement of financial position. In order to achieve consistency in the breakdown among similar public sector entities, the Task Force discussed the possibility of providing criteria or a framework for this breakdown. It was concluded that since FUNDS AND RESERVES, PSG-4, permits the disclosure of the breakdown of net assets/liabilities in the notes, that this practice should be continued. This will allow those public sector entities who showed fund balances to continue to show the different funds and reserves they manage in the notes.

Question 31: With respect to the breakdown of net assets/liabilities, do you agree that note disclosure is the most appropriate way to present the categorization of net assets/liabilities?

Endowment contributions and income from endowment investments are not highlighted in the proposed statement of comprehensive financial results. Endowment funds are not highlighted in the statement of financial position and any transactions or events related to endowments are not illustrated on the statements of change in net debt or cash flow. The accounting for endowments funds, endowment contributions, and income from endowment investments are standards level issues that would be contemplated in the future.

General questions to consider

Question 32: The broad financial accountabilities expected to be demonstrated by public sector entities are:

- (a) the extent to which the entity performed in accordance to plan;
- (b) the state of the financial condition of the entity; and
- (c) the comprehensive financial performance of the entity.

Do the financial statements proposed support these broad financial accountabilities?

Question 33: In developing a revised conceptual framework and reporting model, the Task Force believes that the proposals suit the needs of all public sector entities. Are there issues specific to certain types of public sector entities that the Task Force should consider further?

Question 34: The Task Force has developed a reporting model that incorporates a “presentation solution” to better display the result of services and volatility arising from certain government transfers, unexpected events and fair value changes. Do you agree that the reporting model proposed builds in the flexibility that allows public sector entities to “tell their story”?

Question 35: Feedback from previous consultations indicated that MD&A or FSD&A types of reporting needs to be increased in order to improve understandability of public sector financial reporting. FSD&A is a type of optional reporting currently described in SORP 1. SORPs do not form part of GAAP. Should FSD&A type reporting become GAAP?

Question 36: Do you have any other suggestions for how public accountability and understandability can be improved?

Appendix A – Questions on various aspects of Conceptual Framework Consultation Paper 3

Questions relating to the fundamentals of the conceptual framework

1. Do you agree with the service capacity concept, as described in paragraph 7?
2. The Task Force is proposing five high-level objectives of financial statements.
 - (a) Do you agree with the objective of accounting for the full nature and extent of the resources and financial affairs for which a public sector entity is accountable, as described in paragraph 11(a)?
 - (b) Do you agree with the objective of presenting information to describe a public sector entity's financial position at the end of the accounting period, as described in paragraph 11(b)?
 - (c) Do you agree with the objective of presenting information to describe the changes in a public sector entity's ability to finance its activities, meet its obligations and provide future services in the accounting period, as described in paragraph 11(c)?
 - (d) Do you agree with the objective of providing information that is useful in demonstrating a public sector entity's accountability for the financial affairs and resources for which it is responsible, as described in paragraph 11(d)?
 - (e) Do you agree with the objective of providing information to describe the significant financial risks to which a public sector entity is exposed, as described in paragraph 11(e)?
3. Do you agree with the proposed change to the qualitative characteristics of replacing reliability with faithful representation?
4. Do you agree that benefits versus costs and materiality should be considerations in applying the qualitative characteristics, as indicated in paragraph 13?
5. Do you agree that the elements of financial statements should be limited to economic phenomena and changes in them, as stated in paragraph 14?
6. Do you agree that the elements of financial statements should be assets, liabilities, revenues and expenses, as stated in paragraph 15?
7. Do you agree with the asset definition, as presented in paragraph 16?

8. Do you agree with the liability definition, as presented in paragraph 17?
9. Do you agree with the revenues definition, as presented in paragraph 18?
10. Do you agree with the expenses definition, as presented in paragraph 19?
11. Do you agree that the general recognition criteria should not change, as indicated in paragraph 20?
12. Do you agree that derecognition principles should not be included in the conceptual framework, as indicated in paragraph 21?
13. Do you agree with the measurement attribute, as described in paragraph 22?
14. Do you agree with the conceptual presentation objective, as described in paragraph 23?
15. Do you agree with the restrictions on information provided supplemental to the core requirements, as listed in paragraph 24?
16. Do you agree with the parameters to be considered in determining what information to include in financial statements, as listed in paragraph 25?
17. Do you agree with the relative equality of the individual financial statements and the notes to the financial statements in meeting the accountability objective, as described in paragraph 26?
18. Do you agree with the basic principles relating to what information financial statements should present, as listed in paragraph 27?
19. Do you agree with the considerations for evaluating presentation and disclosure choices, as listed in paragraph 28?

Questions relating to the features of the proposed reporting model

20. Do you agree with combining the statement of operations with the statement of remeasurement gains and losses to make a single periodic financial results statement?
21. Do you agree with the proposed statement of comprehensive financial results?
22. Do you agree with the segregation of “unusual items” from net result of services? If so, in developing a definition or guidance for “unusual items”, what would the definition or guidance be?
23. Do you agree that unrealized remeasurement gains and losses should be presented separately from net result of services?

24. Do you agree with the proposed presentation for capital transfers received (i.e., capital transfers stipulated to be used for buying or building a tangible capital asset are to be reported below net result of services and capital transfers that are related to the use of the tangible capital asset would be recognized in operating revenue as the liability is settled)?
25. Do you agree with the proposed change made to the statement of cash flow to calculate the subtotal of cash requirements/available before financing transactions?
26. Do you agree with the budget proposals?
27. Are there situations, other than a change in government that would support the use of an amended budget?
28. The Task Force has not identified annual surplus/deficit as an indicator. Should annual surplus/deficit be an indicator in the proposed statement of comprehensive financial results? If yes, how should it be defined?

Questions pertaining to the illustrative financial statements

29. On the proposed statement of comprehensive financial results, are there better labels for the indicators (i.e., net result of services) or the statement, which would be more informative or would provide increased understandability? If so, what would they be?
30. Do you agree with the change proposed in the statement of financial position to rename the “accumulated surplus/deficit” as “net assets/liabilities”?
31. With respect to the breakdown of net assets/liabilities, do you agree that note disclosure is the most appropriate way to present the categorization of net assets/liabilities?

General questions to consider

32. The broad financial accountabilities expected to be demonstrated by public sector entities are:

- (a) the extent to which the entity performed in accordance to plan;
- (b) the state of the financial condition of the entity; and
- (c) the comprehensive financial performance of the entity.

Do the financial statements proposed support these broad financial accountabilities?

33. In developing a revised conceptual framework and reporting model, the Task Force believes that the proposals suit the needs of all public sector entities. Are there issues specific to certain types of public sector entities that the Task Force should consider further?
34. The Task Force has developed a reporting model that incorporates a “presentation solution” to better display the result of services and volatility arising from certain government transfers, unexpected events and fair value changes. Do you agree that the reporting model proposed builds in the flexibility that allows public sector entities to “tell their story”?
35. Feedback from previous consultations indicated that MD&A or FSD&A types of reporting needs to be increased in order to improve understandability of public sector financial reporting. FSD&A is a type of optional reporting currently described in SORP 1. SORPs do not form part of GAAP. Should FSD&A type reporting become GAAP?
36. Do you have any other suggestions for how public accountability and understandability can be improved?

ED - Conceptual Framework Basis for Conclusion.pdf

May 2015

Basis for Conclusions
Exposure Draft ED/2015/3

Conceptual Framework for Financial Reporting

Comments to be received by 26 October 2015

IASB[®]



**Basis for Conclusions
on the
Exposure Draft *Conceptual Framework
for Financial Reporting***

This Basis for Conclusions accompanies the Exposure Draft *Conceptual Framework for Financial Reporting* (published May 2015; see separate booklet) and is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by **26 October 2015** and should be submitted in writing to the address below, by email to commentletters@ifrs.org or electronically using our 'Comment on a proposal' page.

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Basis for Conclusions on the [draft] *Conceptual Framework for Financial Reporting*

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Introduction

- BCIN.1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) in reaching the conclusions described in the Exposure Draft *Conceptual Framework for Financial Reporting* (the 'Exposure Draft'). Individual IASB members gave greater weight to some factors than to others.

Background

- BCIN.2 The key motivations for the IASB in proposing change to the *Conceptual Framework for Financial Reporting* (the '*Conceptual Framework*') are set out in the Invitation to Comment on the Exposure Draft. The effects of the proposed changes (including transition provisions) are discussed in paragraphs BCE.1–BCE.31.

History of the project

- BCIN.3 In 2004, the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), started a joint project to revise their *Conceptual Frameworks*. In 2010, they issued two chapters of a revised *Conceptual Framework*. These chapters describe the objective of general purpose financial reporting and the qualitative characteristics of useful financial information. They came into effect as soon as they were published and now form part of the IASB's existing *Conceptual Framework*. Chapters 1 and 2 of the Exposure Draft are the chapters published in 2010, with some proposed modifications (see paragraphs BC1.1–BC2.33).
- BCIN.4 In addition to finalising those two chapters, the IASB and the FASB also:
- (a) published a Discussion Paper and then an Exposure Draft on the concept of a reporting entity;
 - (b) discussed the definitions of the elements of financial statements; and
 - (c) discussed and held public round-table meetings about measurement concepts.
- BCIN.5 In 2010, the IASB and the FASB suspended work on the *Conceptual Framework* in order to concentrate on other projects on their agendas.
- BCIN.6 In 2012, following the public consultation on its agenda (the 'Agenda Consultation 2011'), the IASB restarted its *Conceptual Framework* project.
- BCIN.7 In July 2013, the IASB published a Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'Discussion Paper'). Paragraphs BCIN.12–BCIN.21 discuss the responses to the Discussion Paper.

Approach to the project

- BCIN.8 Feedback received from the Agenda Consultation 2011 reinforced the importance of giving priority to this project. Consequently, the IASB decided that it should revise the *Conceptual Framework* without delay. To achieve this, the IASB is building on the existing *Conceptual Framework*—updating it, improving it and filling in gaps instead of fundamentally reconsidering all aspects of the *Conceptual Framework*.
- BCIN.9 Before 2010, the IASB and the FASB had planned to complete the project in eight separate phases. On restarting the project in 2012, the IASB decided not to continue with this phased approach and decided instead to develop a more complete set of proposals for a revised *Conceptual Framework*. The IASB believes that this approach enables it, and interested parties, to see more clearly the links between different aspects of the *Conceptual Framework*.
- BCIN.10 The IASB normally establishes a consultative group for major projects. The IASB is using the Accounting Standards Advisory Forum (ASAF) as its *Conceptual Framework* consultative group. The ASAF is an advisory group to the IASB, consisting of national accounting standard-setters and regional bodies with an interest in financial reporting. Although the IASB is no longer conducting this project as a bilateral joint project with the FASB, the ASAF provides the IASB with multilateral input from a broad range of national standard-setters, including the FASB. The IASB has considered discussions by the ASAF on the following topics related to the *Conceptual Framework*: prudence, stewardship, reliability, complexity, the definition of a liability, the presentation of financial performance, the implications of long-term investment and measurement.
- BCIN.11 The International Public Sector Accounting Standards Board (IPSASB) issued in October 2014 its *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities* (the ‘IPSASB *Conceptual Framework*’). The IASB considered the key similarities and differences between the IPSASB *Conceptual Framework* and the proposals in the Exposure Draft. Some of the differences arise from the different characteristics of public and private sector entities—ie the public sector focus on delivering services to citizens and others whereas the private sector focus on generating cash flows. For other differences, the IASB has rejected alternatives similar to those included in the IPSASB *Conceptual Framework*. An overview of the differences is available in Agenda Paper 10C for the November 2014 IASB meeting which can be found on the IASB’s website: www.ifrs.org.

The Discussion Paper

- BCIN.12 The six-month comment period for the Discussion Paper ended in January 2014. The IASB received over 220 comment letters. In addition, IASB members and staff conducted over 140 outreach meetings, including:
- (a) round-table meetings in London, Toronto, São Paulo and Tokyo.
 - (b) outreach meetings organised by local standard-setters in Asia, Australia, Europe, Latin America, North America and South Africa.
 - (c) discussions with formal advisory bodies to the IASB (the IFRS Advisory Council, the ASAF, the Capital Markets Advisory Committee and the Global Preparers Forum).

- (d) conducted targeted outreach with users of financial statements to discuss topics that are most directly relevant to them. Those discussions focused on the distinction between liabilities and equity, the presentation of profit or loss and other comprehensive income, measurement and issues relating to prudence, reliability and stewardship.

BCIN.13 Nearly all of those who commented on the Discussion Paper supported the decision to update the *Conceptual Framework*. Many expressed the view that a complete, clear and up-to-date *Conceptual Framework* is necessary for the effective development of Standards.

BCIN.14 Some respondents to the Discussion Paper supported the IASB's decision to set a tight timetable for the project, agreeing that this important project should be completed without delay. However, many of those who commented expressed the view that the IASB should spend more time developing robust concepts. A few respondents suggested a phased approach, completing some sections (for example, the definitions of assets, liabilities, equity, income and expenses) in line with the original timetable and undertaking further research on other areas (for example, measurement).

BCIN.15 Because of the concerns about the existing *Conceptual Framework* (see the Summary and Invitation to Comment on the Exposure Draft) and its importance in developing future Standards, the IASB still believes that significant improvements to the existing *Conceptual Framework* should be completed on a timely basis. Hence, the IASB aims to complete the revisions to the *Conceptual Framework* in 2016. To meet this tight but achievable deadline, the IASB is focusing on those changes that will provide clear and significant improvements to the existing *Conceptual Framework*.

BCIN.16 Most respondents to the Discussion Paper expressed support for the IASB's approach to the project and in particular the decisions:

- (a) not to adopt a phased approach to the project; and
- (b) to focus on updating, improving and filling in gaps instead of fundamentally reconsidering all aspects of the *Conceptual Framework*.

Accordingly, the IASB has continued with this approach.

BCIN.17 Some respondents expressed the view that the Discussion Paper was underdeveloped in some areas, for example, the sections on measurement and presentation and disclosure (particularly the presentation of financial performance). The relevant sections of this Basis for Conclusions discuss how the IASB has sought to address these concerns.

BCIN.18 Some respondents expressed the view that the Discussion Paper was not sufficiently aspirational, because in some areas it described the judgements that the IASB will need to make when setting Standards and, in their view, did not examine fundamental concepts. The IASB is of the view that the *Conceptual Framework* should be a practical tool that will help it to develop Standards. A *Conceptual Framework* would not fulfil this role if it merely described concepts

simplistically without explaining the factors that the IASB needs to consider in making judgements when the concepts do not lead to a single answer, or when they lead to conflicting answers.

- BCIN.19 Some respondents stated that the Discussion Paper appeared, in places, to aim to justify existing practice or to justify recent standard-setting decisions by the IASB. That was not the aim of the Discussion Paper and it is not the aim of the Exposure Draft. However, some concepts in recent Standards-level projects reflect the IASB's most developed thinking on these matters, and that thinking also flows into the proposals in the Exposure Draft.
- BCIN.20 Some respondents stated that the Discussion Paper included too much Standards-level detail. In developing the Exposure Draft the IASB has sought to strike a balance between providing high level concepts and providing enough detail for the *Conceptual Framework* to be useful to the IASB and others.
- BCIN.21 Respondents' comments on particular areas of the Discussion Paper are discussed in the relevant sections of this Basis for Conclusions.

Scope

- BCIN.22 Although Chapter 1 describes the objective of financial reporting, most chapters in the Exposure Draft focus on the information provided in financial statements. They do not address other forms of financial reports such as management commentary, interim financial reports, press releases and supplementary material provided for analysis.¹ This reflects the fact that financial statements are a central part of financial reporting and most issues that the IASB addresses involve financial statements. Moreover, addressing other forms of financial reports would have substantially lengthened the time needed to complete the project, thus delaying the improvements it will bring. A few respondents to the Discussion Paper objected to this approach, but most of those who commented on this issue agreed that the *Conceptual Framework* should focus only on financial statements.
- BCIN.23 The IASB considers that concepts relating to the equity method of accounting, and the translation of amounts denominated in foreign currency, would be best dealt with if the IASB were to carry out projects to consider revising Standards on these topics. As part of its research programme, the IASB is at present gathering evidence to help it assess whether to take on projects on these topics.² Consequently, the Exposure Draft does not address them. The absence of a discussion on these topics is not intended to imply any particular approach to them.
- BCIN.24 The existing discussion of capital maintenance is included in the Exposure Draft substantially unchanged (see paragraph BC8.1) and current cost is not discussed in detail as a possible basis for measurement (see paragraph BC6.23). The IASB would consider revising the *Conceptual Framework* discussion of capital

¹ Other Frameworks such as the one developed by the International Integrated Reporting Council discuss other sources of useful information for investors.

² For the IASB to add a project to its active agenda, a formal agenda decision would be required.

maintenance and expanding the discussion of current cost if it were to carry out future work on accounting for high inflation. No such work is currently planned.

- BCIN.25 The Discussion Paper included suggestions on how to distinguish between liabilities and equity. However, some responses to those suggestions raised concerns about the usefulness of the resulting accounting for particular types of claims. Consequently, the IASB decided to further explore how to distinguish between liabilities and equity in its Financial Instruments with Characteristics of Equity research project, so as not to delay other much-needed improvements to the *Conceptual Framework*. Hence, the Exposure Draft does not propose changes to the distinction between liabilities and equity (see paragraphs BC4.93–BC4.103).
- BCIN.26 A number of co-operatives suggested that to deal with their special features, the IASB should develop specific guidance in the *Conceptual Framework*, in particular on the distinction between liabilities and equity. That distinction is now being considered in the research project mentioned in paragraph BCIN.25. Furthermore, the IASB considers that the *Conceptual Framework* should provide concepts with general application and should not provide different or additional concepts for application to particular types of organisations, such as co-operatives.
- BCIN.27 The *International Financial Reporting Standard for Small and Medium-sized Entities* (the ‘IFRS for SMEs’) includes a section on the concepts and basic principles underlying the financial statements of small and medium-sized entities. That section is based on the existing *Conceptual Framework*. The IASB will consider whether it should amend this section of the *IFRS for SMEs* at a future review of the *IFRS for SMEs*, after it has finalised the revised *Conceptual Framework*.

Business activities

- BCIN.28 The Discussion Paper expressed the view that financial statements can be made more relevant if the IASB considers, when it develops or revises particular Standards, how an entity conducts its business activities. It noted that this factor may affect measurement and presentation and disclosure, including whether to include items of income and expenses in profit or loss or in other comprehensive income.
- BCIN.29 Most respondents to the Discussion Paper agreed with those comments on business activities. Some also thought that the IASB should define and use the term ‘business model’ as the label for an overarching concept to be employed throughout the *Conceptual Framework*.
- BCIN.30 Other respondents disagreed that the IASB should place emphasis on the business model. They suggested that referring to the business model could introduce management bias into financial reporting. They advocated a more objective basis to achieve a faithful representation of assets and liabilities, in which neither management’s intentions nor the reporting entity’s business

model affect the measurement of assets or liabilities. In their view, objective measures of assets and liabilities would show clearly the outcome of the reporting entity's business model.

- BCIN.31 Some respondents noted that the term 'business model' is used with different meanings by various organisations, such as the International Integrated Reporting Council, the Enhanced Disclosure Task Force of the Financial Stability Board, the European Financial Reporting Advisory Group and various regulators. They warned that the IASB might cause confusion if it were to use that term with a different meaning. Hence, the IASB has not used that term in the Exposure Draft.
- BCIN.32 In addition, the IASB concluded that the nature of an entity's business activities plays different roles in different aspects of financial reporting.
- BCIN.33 Accordingly, the Exposure Draft does not include a general discussion of the role played in financial reporting by how an entity conducts its business activities. Instead, it discusses how that factor affects:
- (a) the unit of account (see paragraph 4.62(a)(iii));
 - (b) the selection of a measurement basis for an asset or a liability and related income and expenses (see paragraph 6.54(a)); and
 - (c) presentation and disclosure, including whether to include items of income and expenses in other comprehensive income (see paragraphs 6.76–6.77, 7.10 and 7.19).
- BCIN.34 Some respondents thought that how an entity conducts its business activities would also affect the distinction between liabilities and equity and the recognition of assets and liabilities. The IASB did not identify any situations in which consideration of an entity's business activities would be relevant to the recognition of assets and liabilities. As discussed in paragraph BCIN.25, the IASB is performing further research on the distinction between liabilities and equity.

Implications of long-term investment

- BCIN.35 Long-term investment, and long-term financing, is a subject that has attracted a great deal of attention from governments in recent years. Governments have indicated that encouraging long-term investment is one important tool to promote economic growth. Consequently, when developing the Exposure Draft, the IASB considered whether the *Conceptual Framework* will provide the IASB with sufficient and appropriate tools to enable it to consider the following questions when developing new Standards:
- (a) Does the time horizon for investments by a reporting entity have any implications for standard-setting decisions (see paragraphs BCIN.36–BCIN.38)?
 - (b) Do long-term investors in a reporting entity need different information from short-term investors (see paragraphs BCIN.39–BCIN.43)?

Paragraph BCIN.44 comments on the role of accounting standards in relation to promoting long-term investment.

Long-term investment as a business activity

BCIN.36 Some have suggested that the IASB should identify long-term investment as a particular type of business activity (or business model), and develop specific measurement and presentation and disclosure requirements for entities conducting that business activity. Some commentators expressing those views have suggested that:

- (a) entities should not use current value measurements for their long-term investments (and for their liabilities). They should use either cost-based measurements or measurements updated using long-term estimates and determine any impairment loss by using an entity-specific measure (such as value in use), instead of a market-based measure (such as fair value).
- (b) if current value measurements are used, remeasurements should be reported in other comprehensive income (OCI), instead of in the statement of profit or loss. Furthermore, on disposal, the total gain or loss should be reclassified ('recycled') at that date from the accumulated OCI to the statement of profit or loss.

BCIN.37 The Exposure Draft proposes that one factor to be considered when selecting a measurement basis for an asset or a liability (and related income and expenses) is how the asset or the liability contributes to future cash flows. This depends, in part, on the nature of the business activities being conducted. This factor would also be considered in determining whether income and expenses should be included in OCI. The IASB concluded that the discussion on this factor in the Exposure Draft provides sufficient tools to enable the IASB to make appropriate standard-setting decisions if future projects consider:

- (a) how to measure the long-term investments (or liabilities) of entities whose business activities include long-term investment; or
- (b) whether such entities should include changes in the carrying amount of those investments (or liabilities) in the statement of profit or loss or in OCI.³

BCIN.38 For the following reasons, the IASB proposes that the *Conceptual Framework* should not refer explicitly to the business activity of long-term investment:

- (a) referring explicitly to any particular business activity would, inappropriately, embed Standards-level detail in the *Conceptual Framework*.
- (b) the *Conceptual Framework* does not refer to any other particular business activity. It is not obvious why it should refer to this one.

Information needs of long-term investors

BCIN.39 Some commentators have suggested that the *Conceptual Framework* should emphasise the information needs of long-term investors, and that their

³ The IASB has no current project to consider how such entities should measure their long-term investments or their liabilities (other than insurance contract liabilities), nor any project to consider whether they should include remeasurements in the statement of profit or loss or in other comprehensive income (OCI).

information needs may differ from those of short-term investors. These commentators have expressed the view that:

- (a) the IASB focuses too much on the needs of short-term investors.
- (b) the IASB gives too much weight to the needs of potential investors and not enough weight to the needs of existing long-term investors. Those existing investors own the reporting entity and bear the residual risks of ownership. Hence, they need information that helps them to assess management's stewardship of the entity's resources.
- (c) the IASB makes excessive use of current value measurements, particularly market-based current measurements, such as fair value, and those measurements are more relevant to short-term investors than to investors who are interested in long-term value creation.
- (d) excessive use of current value measurements (especially for long-term investments), and recognition of unrealised gains in the statement of profit or loss, may:
 - (i) lead to dividend distributions that are excessive, imprudent, volatile and not in the best interest of long-term investors;
 - (ii) lead to inflated management remuneration; and
 - (iii) encourage short-termist behaviour and financial engineering, and discourage long-term investment.

BCIN.40 For the following reasons, the IASB disagrees with the views expressed in paragraph BCIN.39:

- (a) the IASB does not place more emphasis on the needs of short-term investors than on the needs of long-term investors. Both long-term investors and short-term investors are considered to be primary users of financial statements.
- (b) the *Conceptual Framework* identifies both existing and potential investors as primary users of financial statements. Furthermore, on the basis of extensive discussions with users in this project and many others, the IASB has no reason to think that existing investors need information that differs significantly from the information needed by potential investors. In addition, the changes to the objective of financial reporting proposed in the Exposure Draft clarify the need to provide information that helps investors to assess management's stewardship of the entity's resources (see paragraphs BC1.6–BC1.10).
- (c) when the IASB has decided to require, or permit, current value measurements, that has not been because of a belief that those measurements would be particularly useful to short-term investors. Indeed, when long-term investors do not need the information provided by current value measurements, there is no reason why short-term investors would need that information either. Instead, the IASB's decisions are driven by an assessment of what information is most likely to be useful to all investors. Under the proposals in Chapter 6 of the Exposure Draft, this would continue to be the case.

- (d) in the IASB's view, accounting information (such as reported profit) is not, and should not be, the sole determinant of distributions of dividends and bonuses. Distribution policy is affected by many other factors, such as the entity's financing needs, the risks faced by the entity, legal constraints and (in the case of bonus decisions) remuneration policy and incentive arrangements. These factors are likely to differ by entity, by country and over time. It would be neither desirable nor feasible for the IASB to attempt to factor them into its standard-setting decisions. Paragraph BCIN.44 contains comments on the role of accounting standards and possible effects on particular forms of behaviour.

BCIN.41 For these reasons, the IASB has concluded that the *Conceptual Framework* contains sufficient and appropriate discussion of primary users and their information needs, and on the objective of general purpose financial reporting, to address appropriately the needs of long-term investors.

BCIN.42 If the information needs of short-term investors and long-term investors were different, the IASB would need to decide whether to attempt to meet the needs of both groups, or whether to focus on only one of those groups. The IASB believes that there is no reason why short-term investors would need information that is not also needed by long-term investors.

BCIN.43 Conceivably, long-term investors may need some disclosure that is not also needed by short-term investors; for example, long-term investors may have more extensive needs for information to support decisions to vote on, or otherwise influence, management's actions. However, the IASB concluded that, to help it to identify what disclosures it should require in particular Standards, there is no need to insert in the *Conceptual Framework* a specific reference to the needs of long-term investors. In addition, when the IASB undertakes projects to develop Standards, it routinely seeks input and feedback from investors, including long-term investors, to help ensure that it understands what information they need.

Role of accounting standards

BCIN.44 The IASB wishes to emphasise the role of accounting standards in relation to promoting long-term investment:

- (a) the IASB makes an important contribution to the promotion of long-term investment by producing Standards that are intended to require transparent financial reporting. This is a precondition for the healthy and efficient functioning of capital markets. Transparent financial reporting helps participants in capital markets to make more efficient and informed resource allocation and other economic decisions, and makes investment more attractive to capital providers (investors and lenders). It also provides more useful inputs for an assessment of stewardship.
- (b) it is not the role of accounting standards to encourage or discourage investments that have particular characteristics. Instead, standard-setting decisions (such as which measurement basis to adopt in

particular cases) are driven by the usefulness of the resulting information, so that the information is relevant and is a faithful representation of what it purports to represent.

Chapter 1—The objective of general purpose financial reporting⁴

Introduction

- BC1.1 In 2010, as part of its joint project with the FASB, the IASB issued two chapters of a revised *Conceptual Framework*. These chapters deal with the objective of general purpose financial reporting and the qualitative characteristics of useful financial information.
- BC1.2 When the IASB restarted its work on the *Conceptual Framework* project in 2012, it did not reconsider fundamentally these chapters, noting that they were completed only recently and had been through extensive due process. Some respondents to the Discussion Paper agreed with this approach. However, many respondents stated that the IASB should reconsider one or more aspects of these chapters. In the light of these comments, the IASB discussed whether to make changes in the following areas:
- (a) the objective of general purpose financial reporting:
 - (i) stewardship (see paragraphs BC1.6–BC1.10); and
 - (ii) primary users (see paragraphs BC1.11–BC1.13).
 - (b) the qualitative characteristics of useful financial information:
 - (i) prudence (see paragraphs BC2.1–BC2.17);
 - (ii) substance over form (see paragraphs BC2.18–BC2.20);
 - (iii) reliability (see paragraphs BC2.21–BC2.25);
 - (iv) understandability and the related issue of complexity (see paragraphs BC2.26–BC2.27); and
 - (v) materiality (see paragraphs BC2.28–BC2.31).
- BC1.3 In addition, the IASB proposes a limited number of editorial changes to align the wording in the chapters with the rest of the Exposure Draft including replacement of the phrase ‘has the potential to be’ in paragraph 2.21 (see paragraph BC2.32).
- BC1.4 To help respondents provide comments, the proposed changes are shown in mark-up and the existing Basis for Conclusions on these chapters is included as an appendix to this Basis for Conclusions. The IASB is not requesting comments on other aspects of these chapters and does not expect to make other substantive changes to them.
- BC1.5 The proposed changes to these chapters would make them diverge from the FASB’s Concepts Statement No. 8 *Conceptual Framework for Financial Reporting—Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information*. The IASB thinks that the benefits of its proposed changes outweigh the disadvantages of divergence on the issues affected. The IASB notes that the FASB proposes to

⁴ This Chapter is Chapter 1 of the existing *Conceptual Framework*.

change its definition of materiality and that new definition differs from both the IASB's existing definition and the IASB's proposals discussed in paragraphs BC2.28–BC2.31.

Stewardship (paragraphs 1.3–1.4 and 1.13–1.23)

- BC1.6 In discussing the objective of financial reporting, Chapter 1 notes that users need information to help them assess an entity's prospects for future net cash inflows. The version of Chapter 1 published in 2010 states that part of that information is information about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.⁵ Paragraph BC1.27 of the related Basis for Conclusions (on the existing Chapter 1) makes it clear that this statement is intended to capture the idea that users of financial statements need information to help them assess management's stewardship of the entity's resources. In other words, the IASB considers that providing information to help users assess management's stewardship contributes to meeting the objective of financial reporting. The IASB did not use the term 'stewardship' in the 2010 version of Chapter 1, because it thought that there would be difficulties in translating it into other languages. Instead, the chapter describes what stewardship encapsulates.
- BC1.7 Some respondents to the Discussion Paper stated that it is unnecessary to change the discussion of stewardship in Chapter 1. They feared that giving more prominence to stewardship could lead to competing objectives of financial reporting and could appear to justify introducing inappropriate management bias into recognition and measurement decisions.
- BC1.8 However, many of the respondents who commented on stewardship stated that one of the purposes of financial reporting is to hold management to account. They argued that the existing Chapter 1 gives too little prominence to this notion.
- BC1.9 The IASB noted that many have interpreted Chapter 1 as ignoring the need for information to help users to assess management's stewardship. In addition, although in most cases that information is the same as the information needed to assess the prospects for future net cash inflows to the entity, this may not always be the case. For example, some information about management remuneration or other related party transactions may be important for assessments of stewardship, but arguably may be less important in assessing the prospects for future net cash inflows. Hence, the IASB proposes to make more prominent, within the discussion of the objective of financial reporting, the importance of providing information needed to assess management's stewardship of the entity's resources. The Exposure Draft does this by reintroducing the term stewardship alongside the existing description of what it encapsulates, by moving most of that description from paragraph 1.4 to paragraphs 1.22–1.23 and by referring to stewardship when appropriate in the

⁵ See paragraph 1.4 of the Exposure Draft (paragraph OB4 of the existing *Conceptual Framework*).

rest of the *Conceptual Framework*. The IASB thinks that the clarity provided by using the term stewardship in this way outweighs the translation difficulties identified in 2010.

- BC1.10 For the following reasons, the IASB rejected the idea of identifying the provision of information to help assess management's stewardship as an additional, and equally prominent, objective of financial reporting:
- (a) information about management's stewardship is part of the information used to make decisions about whether to buy, sell or hold an investment (ie resource allocation decisions). For example, information about stewardship would inform a decision to hold an investment (and perhaps improve management) instead of selling it; and
 - (b) introducing an additional primary objective of financial reporting could be confusing.

Primary users (paragraphs 1.2–1.10)

- BC1.11 Chapter 1 identifies the primary users of financial reports as those existing and potential investors, lenders and other creditors who cannot require entities to provide information directly to them. Some respondents to the Discussion Paper expressed the view that the primary user group is defined too narrowly. They argue that it should be expanded to include, for example, employees, customers, suppliers, regulators and others.
- BC1.12 However, others expressed the view that the primary user group is defined too broadly. They stated that the primary users should be identified as the holders of equity claims against the entity (or perhaps as the holders of the most residual equity claims against the entity). Those with this view believe that those users have different (and perhaps more extensive) information needs than other capital providers because they are exposed to more extensive risks.
- BC1.13 In identifying the objective of financial reporting in 2010, the IASB considered whether the primary user group should be restricted to existing shareholders or expanded to include other users. Respondents to the Discussion Paper raised no new issues that the IASB had not considered when Chapter 1 was originally developed. In addition, as explained in paragraph 1.8 of the Exposure Draft (paragraph OB8 of the existing *Conceptual Framework*), focusing on the common information needs of the primary users does not prevent a reporting entity from including additional information that is most useful to a particular subset of primary users. Consequently, the IASB proposes no changes to the description of the primary user group. (Paragraphs BCIN.35–BCIN.43 discuss whether long-term investors should be identified as a particular type of user with specific information needs.)

Chapter 2—The qualitative characteristics of useful financial information⁶

Prudence (paragraph 2.18)

BC2.1 The *Framework for the Preparation and Presentation of Financial Statements* (the ‘pre-2010 Framework’) stated that financial statements should be neutral; that is, free from bias, and went on to discuss the need for preparers to exercise prudence when preparing financial statements:

Neutrality

36 To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

37 The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.

BC2.2 In developing the existing version of Chapter 3 (corresponding to Chapter 2 of the Exposure Draft), issued in 2010, the IASB removed the reference to prudence, because it was concerned that the term could be interpreted in ways that are inconsistent with neutrality.

BC2.3 The Discussion Paper described the changes made in 2010, and the concerns that some had raised about them.

BC2.4 Some respondents to the Discussion Paper (including some user groups) supported the removal of the reference to prudence from the *Conceptual Framework*. They stated that:

⁶ This chapter is Chapter 3 of the existing *Conceptual Framework*.

- (a) there is no common understanding of what prudence means. Different parties interpret it differently. Consequently, including the word in the *Conceptual Framework* could lead to inconsistent application. Moreover, prudence could be misinterpreted in a way that is inconsistent with neutrality.
- (b) the exercise of prudence, as interpreted by some, leads to greater subjectivity in the financial statements, which can make it difficult to assess an entity's financial performance.

BC2.5 However, many commenting on this issue (including some user groups) expressed the view that a reference to prudence should be reinstated in the *Conceptual Framework*. They gave the following reasons:

- (a) some Standards, both existing and proposed, use accounting treatments that some view as motivated by a desire for prudence. It is therefore important to explain prudence in the *Conceptual Framework* so that it can be applied consistently.
- (b) prudence is needed to counteract management's natural bias towards optimism.
- (c) investors are more concerned about downside risk than upside potential. Prudence helps to address this concern.
- (d) academic research has suggested that some forms of conservatism (a concept often regarded as similar to prudence) have a role to play in financial reporting in some cases. However, there are different views about what forms of conservatism are helpful, when and why.
- (e) the exercise of prudence helps to align the interests of shareholders and managers and can reduce moral hazard.
- (f) the financial crisis has demonstrated the need for prudence when making estimates.

BC2.6 Having considered how interested parties have interpreted the removal of the term 'prudence' in 2010, and the responses to the Discussion Paper, the IASB noted that prudence is a term used by different people to mean different things. In particular:

- (a) some use it to refer to a need to be cautious when making judgements under conditions of uncertainty, but without needing to be more cautious in judgements relating to gains and assets than for those relating to losses and liabilities ('cautious prudence'—see paragraphs BC2.9–BC2.10).
- (b) others use it to refer to a need for asymmetry: losses are recognised at an earlier stage than gains are ('asymmetric prudence'—see paragraphs BC2.11–BC2.15). There is a range of views on how to achieve such asymmetry, and to what extent. For example, some advocate a concept of prudence that would:
 - (i) require more persuasive evidence to support the recognition of gains (or assets) than of losses (or liabilities); or

- (ii) require the selection of measurement bases that include losses at an earlier stage than gains.

BC2.7 An understanding of prudence and its different interpretations is linked to an understanding of the term 'neutrality'. The IASB has identified two aspects of neutrality:

- (a) selection of neutral accounting policies: selecting accounting policies in order to provide relevant information that faithfully represents the items that it purports to depict. A faithful representation requires, among other things, that the depiction is neutral, ie not 'slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users';⁷ and
- (b) neutral application of accounting policies: applying the selected accounting policies in a neutral (unbiased) manner.

BC2.8 The IASB continues to believe that both of these aspects of neutrality make financial information more useful. The relationship between cautious prudence and the neutral application of accounting policies is discussed in paragraphs BC2.9–BC2.10. The relationship between asymmetric prudence and the selection of neutral accounting policies is discussed in paragraphs BC2.11–BC2.15.

Cautious prudence

BC2.9 The IASB considers that prudence (defined as the exercise of caution when making judgements under conditions of uncertainty) can help achieve neutrality in applying accounting policies (the aspect of neutrality described in paragraph BC2.7(b)). Thus, cautious prudence is a factor in giving a faithful representation of assets, liabilities, equity, income and expenses. Setting out that message clearly in the *Conceptual Framework* can be expected to:

- (a) help preparers, auditors and regulators counter a natural bias that management may have towards optimism; for example, it would point to the need to exercise care in selecting the inputs used in estimating a measure that cannot be observed directly; and
- (b) help the IASB to develop rigorous Standards that could counteract any bias by management in applying the reporting entity's accounting policies.

BC2.10 Therefore the IASB, in paragraph 2.18 of the Exposure Draft, proposes to reintroduce the term prudence, defined as cautious prudence, in the *Conceptual Framework*. It notes that the removal of the term prudence in the 2010 revisions led to confusion and perhaps has exacerbated the diversity in usage of this term. People continue to use the term, but do not always say clearly what they mean. In addition, some have claimed that, because the term was removed, financial information prepared using IFRS is not neutral but is in fact imprudent. The IASB thinks that reintroducing the term with a clear explanation that caution works both ways (so that assets and liabilities are neither overstated nor understated) will reduce the confusion.

⁷ See Paragraph 2.17 of the Exposure Draft (paragraph QC14 of the existing *Conceptual Framework*).

Asymmetric prudence

- BC2.11 Some argue that asymmetric prudence is a necessary characteristic of useful financial information and that prudence cannot be consistent with neutrality. The IASB disagrees with this view. However, the IASB also thinks that not all asymmetry is inconsistent with neutrality.
- BC2.12 The selection of neutral accounting policies means selecting accounting policies in a manner that is not intended to increase the probability that financial information will be received favourably or unfavourably by users.
- BC2.13 The selection of neutral accounting policies, contrary to fears sometimes expressed:
- (a) does not require an entity to recognise the value of the entire entity in the statement of financial position. Paragraph 1.7 of the Exposure Draft states that general purpose financial reports are not designed to show the value of a reporting entity.⁸
 - (b) does not require the measurement of all assets and liabilities at a current value. Indeed, the proposals in Chapter 6 of the Exposure Draft would not lead to such a requirement.
 - (c) does not prohibit impairment tests on assets measured at historical cost. Measurement at historical cost (including an impairment test) is consistent with neutrality if that measurement basis is selected without bias; in other words, without slanting, weighting, emphasising, de-emphasising or otherwise manipulating information to increase the probability that it will be received favourably or unfavourably by users.
 - (d) does not require the recognition of all assets and liabilities. Chapter 5 of the Exposure Draft discusses recognition criteria for assets and liabilities.
- BC2.14 Hence, accounting policies that treat gains and losses asymmetrically could be selected in accordance with the proposals in the Exposure Draft if their selection is intended to result in relevant information that faithfully represents what it purports to represent. Such an approach is reflected in many existing Standards, for example IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires different recognition thresholds for contingent liabilities and contingent assets. However, the IASB thinks that the *Conceptual Framework* should not identify asymmetric prudence as a necessary characteristic of useful financial information. In particular, the IASB rejects the following approaches that some argue would follow from a requirement to apply asymmetric prudence in all circumstances:
- (a) prohibiting the recognition of all unrealised gains. In some circumstances, for example, the measurement of many financial instruments, the recognition of unrealised gains is necessary to provide relevant information to users of financial reports.

⁸ Paragraph OB7 of the existing *Conceptual Framework* makes the same statement.

- (b) prohibiting the recognition of unrealised gains not supported by observable market prices. In some circumstances, measuring an asset or a liability at a current value (which may require the recognition of unrealised gains) provides relevant information to users of financial reports even if the current value must be estimated.
- (c) permitting an entity to measure an asset at an amount that is less than an unbiased estimate using the measurement basis selected for that asset or to measure a liability at more than such an amount. Such an approach cannot result in relevant information and cannot provide a faithful representation.

BC2.15 In addition, the IASB notes that if it were to introduce asymmetric prudence, it would need to consider how much bias is appropriate.

Link with other aspects of the 2010 *Conceptual Framework*

BC2.16 Many respondents who commented on the removal of the term prudence from the 2010 *Conceptual Framework* also expressed concerns about the absence of references to stewardship and reliability. They think that an important role for financial reporting is to hold management to account for its stewardship of the entity's resources. They argue that for financial reporting to fulfil this role, financial information needs to be reliable (in the sense of being verifiable and having little measurement uncertainty). They believe that there is a need to counteract a possible bias by management towards optimism (either conscious or unconscious), by exercising prudence to ensure that all losses are recognised and that gains are not recognised without sufficient justification (ie asymmetric prudence). Some of those respondents also expressed concerns about what they perceived was an increasing use of fair value measures. They consider fair value measures, in many cases, to be unverifiable and subject to significant measurement uncertainty (ie they consider fair value measures to be unreliable).

BC2.17 The proposals in the Exposure Draft address these issues, as follows:

- (a) the need for information that can be used to assess stewardship is made more prominent within the discussion of the objective of financial reporting (see paragraphs BC1.6–BC1.10);
- (b) the effect of measurement uncertainty on the relevance of financial information is clarified, both generally (see paragraph BC2.24(b)) and with specific reference to recognition and measurement (see paragraphs BC5.41–BC5.45 and BC6.56–BC6.57), thus addressing some concerns about reliability (see paragraphs BC2.21–BC2.25); and
- (c) the use of fair value is discussed as one possible measurement basis among others within a mixed measurement basis approach (see paragraphs BC6.7–BC6.14).

Substance over form (paragraph 2.14)

BC2.18 The existing *Conceptual Framework* does not include an explicit reference to substance over form. However, the Basis for Conclusions points out that

accounting for something in accordance with its legal form, instead of its economic substance, would not result in a faithful representation.

- BC2.19 Some respondents to the Discussion Paper expressed the view that the *Conceptual Framework* should make explicit reference to substance over form. The IASB agrees that making this statement explicit would add clarity. Consequently, the Exposure Draft proposes that a faithful representation should provide information about the substance of an economic phenomenon instead of merely information about its legal form.
- BC2.20 The IASB believes that reporting something in accordance with its substance, instead of just its legal form, relates to faithful representation for the following reasons:
- (a) accounting for something in accordance with its legal form (even with appropriate disclosures) cannot result in a faithful representation if the economic substance of the item is different; and
 - (b) this is consistent with the pre-2010 *Framework*, which treated substance over form as an aspect of reliability.⁹

Reliability (paragraphs 2.12–2.13)

- BC2.21 The pre-2010 *Framework* stated that:
- (a) one of the two qualitative characteristics of useful financial information is reliability;
 - (b) information is reliable if it is free from material error and bias and can be depended on by users to faithfully represent what it purports to represent; and
 - (c) the characteristics of reliable information are substance over form, neutrality, prudence and completeness.
- BC2.22 In 2010, the label ‘faithful representation’ was applied to the qualitative characteristic previously labelled as ‘reliability’. Thus, financial information is useful, as well as relevant, if it faithfully represents what it purports to represent. The main reason for the change was a lack of a common understanding of the term reliability. In particular, many seemed to equate reliability solely with information being verifiable or free from material error (in other words, having a tolerable level of measurement uncertainty). The term reliability was in fact intended to describe more than just verifiability and freedom from material error.
- BC2.23 Of those respondents to the Discussion Paper who commented on the use of the label faithful representation, many expressed the view that the label reliability should be reinstated in the *Conceptual Framework*. Reasons given included:
- (a) the term reliability is clearer and better understood than the term faithful representation.

⁹ As explained in paragraphs BC2.21–BC2.25, the qualitative characteristic described before 2010 as ‘reliability’ is broadly consistent with what is now called ‘faithful representation’.

- (b) the existing *Conceptual Framework* implies that anything can be faithfully represented if sufficient disclosures are given. Consequently, the qualitative characteristic of faithful representation does not act as an effective filter to identify the types of information that should be included in financial statements. It would allow the recognition of items that cannot be measured reliably.
- (c) the pre-2010 *Framework* acknowledged a trade-off between the qualitative characteristics of relevance and reliability. More relevant information may lack reliability and more reliable information may lack relevance. Some respondents expressed the view that this trade-off is missing in the existing *Conceptual Framework*.
- (d) the idea that financial statements should be credible (that is, that they provide reliable information that users can depend on) is a key concept that should be acknowledged in the *Conceptual Framework*.

BC2.24 The IASB proposes not to reinstate the term reliability as a label for the qualitative characteristic now called faithful representation because:

- (a) as noted in paragraph BC2.22, the decision to change the label from reliability to faithful representation was made to avoid confusion about the meaning of the term reliability. The responses to the Discussion Paper seem to confirm that many respondents equate the word reliability solely with a tolerable level of measurement uncertainty, not with the broader notion described in the pre-2010 *Framework*.
- (b) paragraph QC16 of the existing *Conceptual Framework* already explains the idea that an estimate might not provide relevant information if the level of uncertainty in the estimate is very large. Nevertheless, it is apparent that this idea is not very visible and many readers of the current *Conceptual Framework* seem to overlook it. Accordingly, the IASB is proposing a number of changes intended to make the point more clearly. In particular:
 - (i) paragraphs 2.12–2.13 of the Exposure Draft build on the discussion of measurement uncertainty in paragraph QC16 of the existing *Conceptual Framework*. An example based on paragraph QC16 has been added to paragraph 2.20. As a result of these changes, paragraph QC16 is now largely redundant and has been deleted.
 - (ii) paragraphs 5.20–5.21, BC5.10 and BC5.45 discuss the role of measurement uncertainty in decisions about recognition.
 - (iii) paragraphs 6.55–6.56 and BC6.56–BC6.57 discuss the role of measurement uncertainty in decisions about measurement.
- (c) these changes clarify that the level of measurement uncertainty affects the relevance of an estimate, and that there is a trade-off between the level of measurement uncertainty and other factors that make information relevant. That trade-off is similar to the trade-off previously described as existing between relevance and reliability. For example, one piece of information may be of high interest to users of financial

statements, but subject to high measurement uncertainty. Another piece of information about the same economic phenomenon may be of lower interest to users of financial statements, but subject to lower measurement uncertainty. In such cases, judgement is needed to determine which piece of information is more relevant.

- (d) the enhanced discussion of measurement uncertainty, together with the discussion of the two fundamental qualitative characteristics of useful financial information (relevance and faithful representation), is intended to explain the factors that enable users to rely on financial information to provide a faithful representation of what it purports to depict. In the IASB's view, this makes it unnecessary to reintroduce any further reference to reliability.

BC2.25 Having considered respondents' concerns about measurement uncertainty, the IASB considered whether there were additional issues relating to the term reliability. The IASB noted that there is much in common between the description of reliability in the pre-2010 *Framework* and the description of faithful representation proposed in the Exposure Draft (see Table 2.1). Consequently, it is unclear to the IASB what effect it would have in practice to reinstate the term reliability as a label. Moreover, the IASB believes—for reasons given in paragraph BC2.24—that the term faithful representation describes more clearly what is meant by this qualitative characteristic.

Table 2.1

Pre-2010 Framework Reliability	Proposed in the Exposure Draft Faithful representation
Can be depended on by users to faithfully represent what it purports to represent	Information is useful if it faithfully represents the phenomena that it purports to represent (see paragraph 2.14)
Complete	Complete (see paragraph 2.16)
Neutral	Neutral (see paragraph 2.17)
Free from material error or bias	Free from error and neutral (see paragraphs 2.17 and 2.19)
Substance over form	Substance over form (see paragraph 2.14)
Prudence	Prudence (see paragraph 2.18)

Understandability and complexity (paragraphs 2.33–2.35)

- BC2.26 Chapter 3 of the existing *Conceptual Framework* (Chapter 2 of the Exposure Draft) identifies understandability as an enhancing qualitative characteristic: a characteristic that makes financial information more useful. A few respondents to the Discussion Paper suggested that understandability should be elevated to become a fundamental qualitative characteristic or even to become an objective of financial reporting. However, the IASB proposes not to make such a change. To do so might result in the exclusion of information that is complex but, nevertheless, useful to users of financial statements.
- BC2.27 A few respondents to the Discussion Paper suggested that the *Conceptual Framework* should discuss the sources of complexity in financial reporting and the need to avoid unnecessary complexity when setting Standards. However, the IASB believes that no such discussion is necessary because the existing material on understandability and the cost constraint provide adequate guidance.

Materiality (paragraph 2.11)

- BC2.28 Paragraph QC11 of the existing *Conceptual Framework* (paragraph 2.11 of the Exposure Draft) sets out the concept of materiality as follows:
- Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.
- BC2.29 In addition, IAS 1 *Presentation of Financial Statements* defines 'material' and provides guidance on the application of the concept of materiality.
- BC2.30 The Discussion Paper took the position that the concept of materiality is clearly described in the existing *Conceptual Framework* and did not suggest amending or adding to that description. The Discussion Paper also noted that the IASB is considering, as part of its Disclosure Initiative (see paragraph BC7.2(b)), whether to provide guidance on the application of this concept. Many respondents to the Discussion Paper agreed with this approach.
- BC2.31 Hence, the IASB proposes in the Exposure Draft to make no amendments to the concept of materiality in the *Conceptual Framework*, except to clarify that the users mentioned in the discussion of materiality are the primary users of general purpose financial reports, as described in paragraph 1.5 of the Exposure Draft (paragraph OB5 of the existing *Conceptual Framework*). This clarification would emphasise that decisions about materiality reflect the needs of the primary users, not the needs of any other group. The IASB will consider in the Disclosure Initiative (see paragraph BC7.2(b)) suggestions made by some respondents for amendments to, and clarifications of, the concept of materiality.

Applying the fundamental qualitative characteristics (paragraph 2.21)

- BC2.32 To be consistent with the description of relevance in paragraph 2.6 of the Exposure Draft and to avoid confusion with the use of the term 'potential' in the definition of an economic resource (see paragraph BC4.16), the IASB proposes in paragraph 2.21 to replace the phrase 'has the potential to be' with 'is capable of being'.

The cost constraint on useful financial reporting

- BC2.33 Paragraphs QC35–QC39 of the existing *Conceptual Framework* (paragraphs 2.38–2.42 of the Exposure Draft) include a discussion of cost as a pervasive constraint on the information that can be provided by financial reporting. The cost constraint plays a particularly important role in decisions about the unit of account, recognition, measurement and presentation and disclosure. Accordingly, the Exposure Draft includes further references to the cost constraint in the discussion of those topics.

Chapter 3—Financial statements and the reporting entity

- BC3.1 As explained in paragraph BCIN.22, Chapters 1 and 2 of the Exposure Draft discuss general purpose financial reports. Chapters 3–7 focus on the most important type of general purpose financial reports: financial statements.
- BC3.2 The proposed objective of financial statements is discussed in paragraphs BC7.4–BC7.10.
- BC3.3 Paragraph 3.9 of the Exposure Draft states that financial statements are prepared from the perspective of the entity as a whole, instead of from the perspective of any particular group of investors, lenders or other creditors. This is consistent with the IASB's reasoning in paragraph BC1.8 of the Basis for Conclusions on the existing *Conceptual Framework*. This explains that financial reports should account for the entity, instead of its primary users and their interests in the reporting entity. Taking this perspective does not imply that the IASB thinks that no distinction should be drawn between liabilities and equity. The distinction between liabilities and equity is discussed in paragraphs BC4.93–BC4.103.
- BC3.4 Paragraph 3.10 of the Exposure Draft sets out the going concern assumption, which has been brought forward from the existing *Conceptual Framework*, except that the phrase 'cease trading' replaces the phrase 'curtail materially the scale of its operations'. That change is proposed to align the wording with that used in IAS 1 *Presentation of Financial Statements* and IAS 10 *Events after the Reporting Period*.

The reporting entity (paragraphs 3.11–3.25)

- BC3.5 The existing *Conceptual Framework* does not discuss the following topics, on which the Exposure Draft includes proposals:
- (a) what a reporting entity is; and
 - (b) the boundary of a reporting entity.
- BC3.6 In developing these proposals, the IASB has considered comments received on the Exposure Draft *Conceptual Framework for Financial Reporting—The Reporting Entity* (the 'Reporting Entity Exposure Draft') issued in March 2010 and developed jointly with the FASB.
- BC3.7 The Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* did not include a further discussion of the reporting entity.

The reporting entity (paragraphs 3.11–3.12)

- BC3.8 In the Reporting Entity Exposure Draft, the IASB described a reporting entity and its features:

RE2 A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

RE3 A reporting entity has three features:

- (a) economic activities of an entity are being conducted, have been conducted or will be conducted;
- (b) those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists; and
- (c) financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.

These features are necessary but not always sufficient to identify a reporting entity.

BC3.9 Many respondents to the Reporting Entity Exposure Draft stated that it did not clarify whether entities that met the description of a reporting entity *must*, *should* or *could* prepare general purpose financial reports. As noted by many of these respondents, the IASB has no authority to determine who must or should prepare general purpose financial statements. Accordingly, the Exposure Draft describes a reporting entity as an entity that chooses, or is required, to prepare general purpose financial statements. In addition, the Exposure Draft clarifies that a reporting entity:

- (a) need not be a legal entity;
- (b) can be a portion of an entity; and
- (c) can comprise two or more entities.

Paragraph 3.18 of the Exposure Draft proposes guidance on how to set the boundary of a reporting entity that is not a legal entity.

Boundary of the reporting entity (paragraphs 3.13–3.25)

BC3.10 In the Reporting Entity Exposure Draft, the IASB proposed that the boundary of a reporting entity should be determined by control. Hence, if an entity controls one or more entities, it should present consolidated financial statements in which the assets, liabilities, equity, income, expenses and cash flows of the entity (the parent) and the entities it controls (its subsidiaries) are presented as those of a single unit.

- BC3.11 Most respondents to the Reporting Entity Exposure Draft agreed that an entity controlling one or more entities should prepare consolidated financial statements.
- BC3.12 In the Exposure Draft, the IASB proposes that the boundary of a reporting entity could be determined by:
- (a) direct control only resulting in unconsolidated financial statements;¹⁰ or
 - (b) both direct and indirect control, resulting in consolidated financial statements. The Exposure Draft states that, in general, consolidated financial statements are more likely to provide useful information to users of financial statements than unconsolidated financial statements.
- BC3.13 In the Reporting Entity Exposure Draft, the IASB expressed the view that unconsolidated financial statements may provide useful information if they are presented together with consolidated financial statements.¹¹ However, some respondents suggested that the IASB should permit entities to present their unconsolidated financial statements:
- (a) in a separate document that is different from their consolidated financial statements, possibly issued on a different date; or
 - (b) without preparing accompanying consolidated financial statements at all, as is permitted in some jurisdictions.
- BC3.14 The IASB concluded that unconsolidated financial statements can provide useful information to users of financial statements, but are not a substitute for consolidated financial statements in cases in which Standards require an entity to produce consolidated financial statements. Hence, the IASB proposes that the *Conceptual Framework* should state that:
- (a) a parent may choose, or be required, to prepare unconsolidated financial statements in addition to the consolidated financial statements that it is required to prepare; and
 - (b) if an entity prepares unconsolidated financial statements, those statements need to disclose how users can obtain the consolidated financial statements.
- Hence, the consolidated financial statements need not be presented together with the unconsolidated financial statements.
- BC3.15 The Reporting Entity Exposure Draft also stated that joint control and significant influence do not give rise to control. The IASB still agrees with that conclusion, but sees no need to embed the notions of joint control and significant influence in the *Conceptual Framework*. Hence, the Exposure Draft does not refer to these notions.
- BC3.16 The Reporting Entity Exposure Draft stated that combined financial statements might provide useful information about entities under common control. Many

¹⁰ The Exposure Draft uses the term 'unconsolidated financial statements' instead of the term 'separate financial statements', which is defined in IAS 27 *Separate Financial Statements* to cover specific circumstances.

¹¹ The Reporting Entity Exposure Draft used the term 'parent-only financial statements'.

of those who commented welcomed a discussion of this issue, but disagreed with restricting the preparation of combined financial statements to entities under common control.

- BC3.17 The IASB acknowledges that combined financial statements can provide useful information to users of financial statements in some circumstances. Accordingly, paragraph 3.17 of the Exposure Draft acknowledges the concept of combined financial statements but does not discuss when or how entities could prepare them. The IASB concluded that such discussion would be best developed if the IASB were to undertake a Standards-level project on this subject, instead of in the *Conceptual Framework*.

Chapter 4—The elements of financial statements

Introduction

- BC4.1 The existing *Conceptual Framework* defines the following elements of financial statements:
- (a) an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
 - (b) a liability is a present obligation 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.
 - (c) equity is the residual interest in the assets of the entity after deducting all its liabilities.
 - (d) income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
 - (e) expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

Income and expenses defined in terms of changes in assets and liabilities

- BC4.2 The existing *Conceptual Framework* defines income and expenses in terms of changes in assets and liabilities, and the Discussion Paper indicated that there would be no change to this approach. A few respondents questioned this approach. They argued that this gives undue primacy to the statement of financial position over the statement(s) of financial performance, and does not sufficiently acknowledge the importance of accounting for transactions in the statement(s) of financial performance or of matching income and expenses.
- BC4.3 As explained in paragraphs BCIN.14–BCIN.16, the IASB decided in this project to build on the existing *Conceptual Framework*. Thus, it does not intend to reconsider fundamentally the approach of defining income and expenses in terms of changes in assets and liabilities. Nevertheless, the IASB wishes to emphasise some important points about that approach:
- (a) it is incorrect to assume that the IASB focuses solely or primarily on the statement of financial position. Financial statements are intended to provide information about an entity's financial position and its financial performance. Hence, when making decisions about recognition, measurement and presentation and disclosure, the IASB considers whether the resulting information provides useful information about both an entity's financial position and its financial performance. The

IASB has not designated one type of information (about financial position or about financial performance) as the primary focus of financial reporting.

- (b) information about transactions is relevant to users. Hence, much of financial reporting is currently based on transactions and will continue to be so.
- (c) transactions that result in income and expenses also cause changes in assets and liabilities. Consequently, identifying income and expenses necessarily leads to identifying which assets and liabilities have changed. The IASB and other standard-setters have found over many years that it is more effective, efficient and rigorous to define assets and liabilities first, and to define income and expenses as changes in assets and liabilities, instead of trying to define income and expenses first and then describe assets and liabilities as by-products of the recognition of income and expenses.
- (d) the definitions of an asset and a liability are not merely accounting technicalities. They refer to real economic phenomena (economic resources and obligations to transfer economic resources). A statement of financial position depicting assets, liabilities and equity provides users with more relevant and understandable information about an entity's financial position than does a mere summary of amounts that have arisen as by-products of a matching process. Those amounts do not depict economic phenomena.
- (e) an approach based on matching income and expenses does not define the period to which the income and expenses relate. As explained in paragraph 5.8 of the Exposure Draft, related income and expenses will often be recognised simultaneously because of simultaneous changes in related assets and liabilities. However, an intention to match income and expenses does not justify the recognition of items in the statement of financial position that do not meet the definition of assets or liabilities. That explanation has been brought forward from the existing *Conceptual Framework*.

Definitions—issues common to both assets and liabilities

- BC4.4 The IASB has found the existing definitions of assets and liabilities to be useful for solving many issues in standard-setting. However, confusion can arise because:
- (a) the explicit reference in the definitions of assets and liabilities to the flows of economic benefits blurs the distinction between the resource or obligation and the resulting flows of economic benefits; and
 - (b) some readers interpret the term 'expected' as a probability threshold.
- BC4.5 To address these issues, for the reasons given in paragraphs BC4.7–BC4.22, the IASB proposes the following definitions:
- (a) an asset is a present economic resource controlled by the entity as a result of past events;

- (b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events; and
- (c) an economic resource is a right that has the potential to produce economic benefits.

BC4.6 Proposed supporting guidance for the definition of an asset is discussed in paragraphs BC4.24–BC4.44 and for the definition of a liability in paragraphs BC4.45–BC4.81.

Separate definition of an economic resource (paragraph 4.6)

BC4.7 The main structural change from the existing definitions is the proposal to introduce a separate definition of an economic resource. This repositions the references to future flows of economic benefits so that they appear in the supporting definition of an economic resource, instead of in the definitions of an asset and a liability.

BC4.8 Many respondents to the Discussion Paper agreed with this suggestion. They stated that the proposed definitions were clearer and easier to understand than the existing definitions.

BC4.9 A few respondents to the Discussion Paper stated that there was no need to change the existing definitions. They argued that:

- (a) the existing definitions are well accepted and have not created confusion or major problems for preparers or users;
- (b) the proposed definitions do not differ from the existing definitions sufficiently to warrant the change; and
- (c) readers should be able to understand what an asset or a liability is without having to look up a separate definition of an economic resource.

BC4.10 The IASB still proposes to move the reference to future economic benefits into a supporting definition of ‘economic resource’. Doing so emphasises more clearly that an asset (or a liability) is a resource (or obligation), instead of the ultimate inflow (or outflow) of economic benefits that the resource (or obligation) may produce. This approach also streamlines the definitions and shows more clearly the parallels between assets and liabilities.

Deletion of the notion of an expected flow (paragraphs 4.13–4.16)

BC4.11 The Discussion Paper suggested replacing the notion that an inflow or outflow of resources is expected with the notion that an asset (or a liability) is capable of generating economic benefits (or requiring a transfer of economic resources).

BC4.12 Some respondents stated that the IASB should retain the notion of an expected inflow or outflow of resources. They argued that defining an asset as being ‘capable of producing economic benefits’ results in too broad a definition and the result is not understandable. Users and preparers do not regard an item as an asset if no inflows of economic benefits are expected. Benefits must be reasonably possible. Those respondents argued that the definition in the

Discussion Paper would considerably widen the range of items that will be identified as assets and liabilities. This may lead to:

- (a) pressure to identify every possible asset and liability, imposing a significant operational burden, for little benefit if ultimately the asset or the liability is not recognised or is measured at nil;
- (b) recognition as assets and liabilities of more items that are uncertain, improbable or hard to measure, unless the recognition criteria are made more robust;
- (c) a presumption that, in principle, all assets and liabilities should be recognised even if inflows or outflows are not expected; and
- (d) pressure for irrelevant disclosure about unrecognised assets and liabilities for which inflows or outflows are unlikely.

BC4.13 Some respondents also argued that if the term expected is being interpreted inconsistently or misunderstood, the IASB could clarify how to interpret the term instead of deleting it. Replacing expected with 'capable' merely replaces one difficulty with another. The term capable is equally subjective, may create ambiguity and is not as easily understood.

BC4.14 However, many respondents agreed with the proposal to replace the notion of an expected inflow or outflow of resources. They expressed the following views:

- (a) removal of expected appropriately focuses the definition on the resource. To retain a notion of expected or probable outflows or inflows would exclude many items that are clearly assets and liabilities, such as written and purchased options, stand-ready obligations and insurance contracts.
- (b) the notion of expected flows is unhelpful, because interpretations of this term can vary widely and are often tied to a notion of a threshold level of probability. Uncertainty is best dealt with in recognition criteria or measurement, instead of within the definitions.
- (c) removing the probability criterion would not, as suggested by some, require considerable effort to identify assets and liabilities that will not be recognised. In practice, potential recognition will be in focus from the very beginning.
- (d) a broad definition of an asset may result in the disclosure to users of useful information about items for which recognition is not appropriate.

BC4.15 In the Exposure Draft, the IASB has retained the Discussion Paper's suggestion to delete from the definitions of assets and liabilities the notion that an inflow or outflow is expected. The IASB acknowledges that many respondents have significant concerns about recognising assets or liabilities when the probability of an inflow or outflow of benefits is low, but believes that those concerns are best addressed in recognition, not in the definitions. Paragraphs 5.17–5.19 of the Exposure Draft set out how the recognition criteria would address these concerns.

BC4.16 The Discussion Paper used the term capable. That term is already used in the discussion of relevance in paragraphs QC6–QC7 of the existing *Conceptual Framework* (paragraphs 2.6–2.7 of the Exposure Draft). It would be confusing to

use the term capable with one meaning describing what information is relevant and with a different meaning in defining an economic resource. Hence, the IASB proposes instead to use in the definition of an economic resource the term ‘has the potential to’. That term captures the following points:

- (a) it is not sufficient that the economic benefits may arise in the future. Those economic benefits must arise from some feature that already exists within the economic resource. For example, a purchased option has the potential to produce economic benefits to the holder, but only because the option already contains a term that will permit the holder to exercise the option.
- (b) the definition is not intended to impose a minimum probability threshold. The important thing is that there must be at least one circumstance in which the economic resource will generate economic benefits.

BC4.17 The IASB does not think that eliminating the term ‘expected’ from the definitions and replacing it with the notion of ‘having the potential to produce’ will make the definitions either broader or narrower than the existing definitions. It notes that this approach is consistent with how it has applied the existing definitions in practice for several years.

Past event (paragraphs 4.5 and 4.36–4.39)

BC4.18 The Discussion Paper suggested that:

- (a) the phrase ‘as a result of past events’ should remain in the definitions of an asset and a liability; and
- (b) the word ‘present’ should remain in the definition of a liability and be inserted in the definition of an asset.

BC4.19 Several respondents explicitly supported retaining the reference to past events to emphasise the need to prevent recognition of items that depend largely on the entity’s own future acts, such as the costs of future operations. It also focuses on the need to identify when and how an obligation was incurred, in order to decide how to account appropriately for the asset acquired, or expense incurred, in incurring the obligation. This is consistent with the fact that accounting is largely transaction-based.

BC4.20 Other respondents opposed the reference to past events, arguing that it is redundant. A present asset or liability cannot exist without a past event. Identifying that past event may help to determine how to portray that event in financial statements, but this point could be explained in the supporting guidance instead of in the definitions. Having such a reference in the definition may appear to create a requirement to search for, and identify, the past event. It may also lead to an excessively strict view of what is necessary to constitute a present obligation, and to accounting that some find counterintuitive, such as some of the accounting required by IFRIC 21 *Levies*. Further, it is not clear which past events are sufficient to create an obligation. Moving the focus to the present condition would make the definition easier to apply in practice.

- BC4.21 As discussed in paragraphs BC4.48–BC4.75, the IASB thinks the phrase ‘as a result of past events’ is important to its proposed definition of a liability. In fact, the IASB proposes retaining that phrase in the definitions both of an asset and a liability. By identifying the past event, an entity can determine how best to portray that event in its financial statements; for example, how best to classify and present income, expenses or cash flows arising from that event. The IASB has not identified any significant problems that arise from the inclusion of that phrase in the existing definitions.
- BC4.22 For the same reasons, the IASB also proposes to retain the term ‘present’ in the definition of a liability and add it to the definition of an asset. That addition emphasises the parallels between the two definitions.

Assets

- BC4.23 This section discusses the following aspects of the asset definition:

- (a) economic resources (see paragraphs BC4.24–BC4.28);
- (b) focus on rights (see paragraphs BC4.29–BC4.39); and
- (c) control (see paragraphs BC4.40–BC4.43).

Economic resources (paragraphs 4.6 and 4.13–4.16)

- BC4.24 Paragraphs BC4.7–BC4.10 discuss the proposed separate definition of an economic resource and paragraphs BC4.11–BC4.17 discuss the proposal to remove the notion of expected flows from the definition of an asset.
- BC4.25 The Discussion Paper proposed defining the concept of ‘economic resource’ using the term ‘economic benefits’, but did not define that term. Hence, some respondents argued that the proposed definitions would not enhance clarity or add new insights. However, the IASB notes that the term ‘economic benefits’ already appears in the existing definitions of assets and liabilities and the IASB has identified no major problems caused by its use.
- BC4.26 Other respondents commented that because the definition of an economic resource refers to future economic benefits, an asset should be defined as those future economic benefits, not as the economic resource itself. What gives the resource value is the possibility of future inflows. The IASB noted that although an asset derives its value from its potential to produce future benefits, the thing that the entity controls today is that existing potential, not the future economic benefits. In addition, if an asset were defined as the possible future benefits, it would be unclear:
- (a) whether an asset exists if the possible future benefits are uncertain; and
 - (b) which possible future economic benefits qualify as assets at any given date.
- Consequently, the IASB proposes that the definition of an asset should continue to refer to the (economic) resource, not to the resulting economic benefits.
- BC4.27 Others suggested that the term ‘economic resource’ is too limiting and may indicate only resources that have a market value. These respondents suggested

using the term ‘resource’ instead. The IASB notes that the term ‘economic resource’ is not intended to be limited to resources for which a market currently exists. It covers all resources that have the potential to produce economic benefits. The IASB prefers the term ‘economic resource’ because it helps to emphasise that the resource in question is not, for example, a physical object, but rights over a physical object, as discussed in paragraphs 4.12 and 4.15 of the Exposure Draft.

- BC4.28 Finally, some noted that the IASB’s *Conceptual Framework* is applied in some jurisdictions in the public sector, not-for-profit and non-capital market settings. Consequently, they stated that the definition of an asset should include resources that provide benefits other than cash flows, such as social or environmental services or benefits to the reporting entity, to other parties or to wider society. Similarly, the definition of a liability should include obligations to transfer such benefits, and obligations entered into for prudential or moral purposes, or to meet expectations of a broader group of stakeholders or to maintain public support. However, the IASB focuses currently on for-profit entities. The IASB therefore proposes that the definition of an asset should continue not to refer to resources that provide benefits other than economic benefits.

Focus on rights (paragraphs 4.8–4.12)

- BC4.29 The term ‘resource’ appears in the existing definition of an asset. The Discussion Paper used the amended economic resource term and suggested defining an economic resource (and, hence, an asset) as a right. To illustrate the effect of this change in emphasis, the Discussion Paper suggested that, for a physical object, such as an item of property, plant and equipment, the economic resource is not the underlying object but a right (or a set of rights) to obtain the economic benefits generated by the physical object.
- BC4.30 Respondents who agreed with the Discussion Paper’s proposal to focus on rights suggested that this would confirm a shift away from the traditional notions of accounting for physical objects and towards accounting for different rights that compose economic resources. They expressed the view that this shift would be particularly helpful in addressing the derecognition of components of assets.
- BC4.31 However, some respondents disagreed with the focus on rights and stated that an asset should be defined as a right or resource, not merely as a right. They argued that:
- (a) some assets, for example, tangible assets, are best described as resources instead of rights. The concept of accounting for tangible assets as a set of rights is inconsistent with reality, especially when combined with the idea of ‘unbundling’ rights from an asset.
 - (b) unless the *Conceptual Framework* explains what factors drive the identification of the unit of account, it would be difficult to explain consistently, for a single asset comprising several rights, whether to recognise that single asset as a whole or to recognise some of those rights separately.

- (c) a focus on rights within a larger set of rights would put more pressure on the recognition and derecognition criteria and the unit of account. Entities would need to ask themselves numerous questions in order to determine or deny the existence of new assets and liabilities, without any clear benefit. Indeed, these respondents argued that the rights approach has caused challenges in developing Standards (for example, the current project on leases), and also in applying them, particularly to derecognition (for example, for financial instruments).

BC4.32 In developing the Exposure Draft, the IASB noted that many assets (such as financial assets, a lessee's rights of use of a leased machine, and many intangible assets, such as patents) are rights that are created by contract or law. However, it is equally true that ownership of a physical object arises only because of rights conveyed by law. Furthermore, full legal ownership of a physical asset differs from the right to use an asset for 99 per cent (or 50 per cent or even 1 per cent) of its useful life, but although those rights differ in their extent, they do not differ fundamentally in nature—they are all rights of one kind or another. In addition, because of legal differences or changes, a particular bundle of rights may constitute full legal ownership in one jurisdiction but not in another jurisdiction, or at one date but not at another date.

BC4.33 Hence, the IASB sees no advantage in defining two separate types of asset, one described as a resource (for example, in cases of full legal ownership of a physical object) and the other described as a right (all other rights over all or part of a resource). Nevertheless, the Exposure Draft notes in paragraph 4.12 that describing the set of rights as a physical object will often provide the most concise, clear and understandable information.

Other sources of value

BC4.34 The Discussion Paper's suggested definition of an economic resource included not only 'rights' but also 'other sources of value' that are capable of producing economic benefits. Some respondents commented that the phrase 'other sources of value' does little to place boundaries around the concept of an economic resource and permits wide interpretations in practice.

BC4.35 The IASB included references to 'other sources of value' in the Discussion Paper's definition of an economic resource, because of concerns that the term 'rights' may not capture items, such as know-how, when an entity controls them by having the ability to keep them secret from other parties instead of through legal rights. The IASB thought—and still thinks—that an asset can exist in such cases.

BC4.36 However, the IASB now thinks that the notion of 'other sources of value' is too vague to be useful in a formal definition. Instead it proposes to explain that the notion of a 'right' encompasses not merely legal rights but also access that an entity controls in other ways, for example, by having the ability to keep know-how secret and thus prevent all other parties from directing its use and benefiting from it. The proposed explanation of that concept in the Exposure Draft builds on material that is already in paragraph 4.12 of the existing *Conceptual Framework*.

- BC4.37 Some respondents to the Discussion Paper suggested that the definition of an asset should require assets to be identifiable or separable. Doing so would, in their view, appropriately exclude from the definition of an asset some of the items listed in the Discussion Paper under ‘other sources of value’. For example, IAS 38 *Intangible Assets* requires an intangible asset to be identifiable, so as to distinguish it from goodwill. It states that an asset is identifiable if it is either separable from the entity, or arises from contractual or other legal rights. In the IASB’s view, if an asset is separable, or arises from contractual or other legal rights, it is likely to be easier to identify, measure and describe the asset. This may affect whether or not recognition is appropriate (see paragraph BC5.35). However, the IASB believes that these criteria should not form part of the definition of an asset. Including those criteria would unnecessarily restrict the concept of an asset.

Rights that all entities have

- BC4.38 The Exposure Draft proposes that if an entity has only the same rights as all other parties, those rights do not create an economic resource for the entity. It could be argued that such rights, for example, a right to access a road network, are, in principle, a resource for the entity. However, including information about them in financial statements is unlikely to be useful, because they do not give the entity access to greater economic benefits than those available to any other entity. Hence, the IASB proposes that they should not be regarded as economic resources for any specific entity.

Rights that are immediately consumed

- BC4.39 Paragraph 4.9 of the Exposure Draft clarifies that goods or services that are received and immediately consumed are momentarily rights to obtain economic benefits until they are consumed, at which point the consumption is recognised as an expense. This is consistent with IFRS 2 *Share-based Payment*, which treats the receipt of employees’ services as an asset that is immediately consumed.

Control (paragraphs 4.17–4.23)

- BC4.40 Both the existing definition of an asset and the definition proposed in the Discussion Paper require the economic resource to be ‘controlled by the entity’. The existing *Conceptual Framework* does not define control. The Discussion Paper proposed adding the following definition:

An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it.

- BC4.41 The following paragraphs discuss:
- (a) risks and rewards of ownership (see paragraphs BC4.42–BC4.43); and
 - (b) other suggested changes (see paragraph BC4.44).

Risks and rewards of ownership

- BC4.42 Some respondents suggested that the definition of an asset should incorporate the notion of exposure to risks and rewards of ownership. The IASB notes that

some recent Standards identify exposure to the risks and rewards of ownership (or, in other words, to variable returns) as an aspect or indicator of control:

- (a) IFRS 10 *Consolidated Financial Statements* states that ‘an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee’.
- (b) IFRS 15 *Revenue from Contracts with Customers* lists indicators of the transfer of control of an asset to a customer. One of the indicators is that ‘the customer has the significant risks and rewards of ownership of the asset’. The Basis for Conclusions accompanying IFRS 15 explains that exposure to the risks and rewards of ownership of an asset may indicate control.

BC4.43 The IASB thinks that it would be helpful for the *Conceptual Framework* to explain in general terms the relationship between control and exposure to risks and rewards of ownership. However, instead of using the term ‘risks and rewards of ownership’, the Exposure Draft uses wording that captures the meaning conveyed by that term, ie ‘exposure to significant variations in the amount of economic benefits’ (see paragraph 4.22 of the Exposure Draft).

Other suggested changes

BC4.44 Respondents suggested other changes to the definition and treatment of control proposed in the Discussion Paper:

- (a) a few respondents questioned whether the definition of an asset needs to include a reference to control. They argued that it is implicit in the definition of a resource as a right that the entity controls the resource. The IASB agrees that this may be implicit but believes that explicitly referring to control is a helpful way of structuring the definition and supporting guidance.
- (b) a few respondents suggested that the requirement for control should be a recognition criterion, instead of part of the definition of an asset. They argued that this approach would separate two questions that are independent of each other (namely: does an asset exist? and to whom does the asset belong?). The IASB does not propose to move the reference to control into the asset recognition criteria, because such a move:
 - (i) would be unlikely to change the population of recognised assets—there are no problems in practice that the IASB would be seeking to address if it made this change; and
 - (ii) would add some complexity to the recognition criteria and might imply a need to identify all possible assets before then using the recognition criteria to eliminate those assets that are not assets of the reporting entity.
- (c) a few respondents suggested that the IASB should amend the definition of control to refer to substantially all the economic benefits. However, the IASB considers that the question of whether to include a threshold such as ‘substantially all’ is a Standards-level decision.

- (d) a few respondents commented that it was not clear whether the definition of control ('the ability to direct the use of ... so as to obtain economic benefits') was intended to be a single criterion or two separate criteria. They suggested amending the definition of control to make it clearer that an entity must have both the ability to direct the use of the economic resource and the right to obtain the benefits from it. The IASB agrees that these are separate criteria. Hence, the Exposure Draft defines control as 'the present ability to direct the use of the economic resource and obtain the benefits that flow from it'.

Liabilities (paragraphs 4.24–4.39)

- BC4.45 The existing *Conceptual Framework* defines a liability as a present obligation 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.
- BC4.46 The Exposure Draft defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events. The main changes from the existing definition are as follows:
- (a) deletion of the reference to an expected outflow of economic benefits. For reasons discussed in paragraphs BC4.11–BC4.17, this is replaced by accompanying guidance that an obligation to transfer an economic resource must have the potential to require the entity to transfer an economic resource to another party (see paragraph 4.27 of the Exposure Draft).
 - (b) replacing the phrase 'resources embodying economic benefits' with the new defined term 'economic resources' (see paragraphs BC4.7–BC4.10).
- BC4.47 Paragraph 4.30 of the Exposure Draft explains that an obligation of an entity to transfer its own equity instruments to another party is not an obligation to transfer an economic resource. This is a consequence of the proposed definition of a liability. The classification of some such obligations is being addressed in the IASB's Financial Instruments with Characteristics of Equity research project (see paragraphs BC4.93–BC4.103).

Present obligation (paragraphs 4.31–4.39)

- BC4.48 In applying the existing definition of a liability, it is generally accepted that one case in which an entity has a present obligation to transfer an economic resource is when the obligation is unconditional and legally enforceable—in such situations, the entity clearly has no ability to avoid the transfer. However, in some situations an entity has some limited ability to avoid a future transfer. Problems have arisen in practice because it is unclear how limited that ability must be for an entity to have a 'present obligation'.
- BC4.49 The Exposure Draft proposes that two conditions must be met for a present obligation to transfer an economic resource to exist:
- (a) the entity has no practical ability to avoid the transfer; and

- (b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

BC4.50 The IASB developed these conditions by considering the problems arising when:

- (a) a requirement already exists for an entity to transfer an economic resource, but the outcome of that requirement is conditional on the entity's own future actions; or
- (b) an entity does not have a legal obligation to transfer an economic resource, but its ability to avoid the transfer is limited by its customary practices, published policies or specific statements (sometimes referred to as constructive obligations).

BC4.51 The Discussion Paper considered those two situations separately. However, some respondents noted that the underlying issues are similar in both situations: the entity has some ability to avoid a transfer, but its ability is constrained. In the Exposure Draft, the two conditions in paragraph BC4.49 form an overarching concept that would apply in all circumstances.

**Obligations conditional on an entity's own actions
(paragraphs 4.32–4.35)**

BC4.52 The definition of a liability in the *Conceptual Framework* has always required a present obligation to be the result of past events.

BC4.53 However, the existing *Conceptual Framework* is unclear about how to identify the past event and whether a past event is sufficient to create an obligation. Questions arise if there has been some event in the past that could result in a transfer of economic resources but the entity still has some ability (at least in theory) to avoid the future transfer; in other words, if the requirement to transfer an economic resource remains conditional on some future action of the entity.

BC4.54 Different Standards have applied different approaches to such situations. For example:

- (a) IAS 37, as it has been interpreted in IFRIC 21, requires that for a present obligation to exist, the entity must have no ability, even in theory, to avoid the future transfer.
- (b) IAS 34 *Interim Financial Statements* addresses lease payments that are contingent on exceeding an annual threshold. It requires a liability to be recognised if the entity has no realistic alternative but to make the future lease payments.
- (c) IAS 19 *Employee Benefits* requires a liability to be recognised for benefits that are conditional on future employment (unvested benefits) if those benefits are given in exchange for service already provided by employees.

BC4.55 The IASB identified these Standards as applying three different views on when a present obligation to transfer an economic resource has arisen:

- (a) View 1—the entity must have no ability to avoid the future transfer.

- (b) View 2—the entity must have no practical ability to avoid the future transfer.
 - (c) View 3—there need be no limits on the entity’s ability to avoid the future transfer. It is sufficient that, as a consequence of a past event, the entity may have to transfer an economic resource if further conditions are met.
- BC4.56 In the Discussion Paper, the IASB tentatively rejected View 1 but did not express a preference between Views 2 and 3.
- BC4.57 A few respondents to the Discussion Paper thought that the definition of a liability should encompass only legally enforceable, unconditional obligations to transfer an economic resource, ie those that the entity has no ability to avoid (View 1). They argued that:
- (a) unless a requirement is unconditional, it is avoidable and not an obligation;
 - (b) applying View 1 would provide useful information about the future outflows that an entity has no ability to avoid; and
 - (c) applying View 1 would enhance comparability, because it uses the clearest, least subjective and most operational criteria.
- BC4.58 However, nearly all respondents commenting on this issue thought that the definition of a liability should encompass both constructive obligations and at least some obligations that are conditional on the entity’s future actions. Most of those respondents favoured a concept that would identify as a liability any obligation to transfer an economic resource that the entity has no practical ability to avoid (View 2). They argued that such a concept would give the most faithful representation (or best report the substance) of the obligations that an entity cannot avoid.
- BC4.59 Some respondents thought that the definition of a liability should encompass all future transfers of economic resources that arise from past events (View 3). They argued that such a concept would ensure that entities report expected expenses in the same period as the past event that caused them. However, against such a concept, some respondents argued that:
- (a) unless a requirement is unconditional, it is avoidable and not an obligation.
 - (b) it could result in the recognition and subsequent derecognition of liabilities that the entity later avoids and so never has to fulfil.
 - (c) it could be difficult to measure liabilities if the entity has the practical ability to avoid them, because the measurement would need to take into account the possibility and economic consequences of the avoiding action. Recognition criteria may be needed to filter out very unlikely, or very uncertain, future transfers. Without such criteria, the accounting would be complex and subjective.
- BC4.60 Some respondents suggested other approaches that incorporate elements of View 2 or View 3, with modifications. Most notably, several respondents suggested a probability threshold: an entity should be regarded as having an obligation if it is probable (or perhaps reasonably certain) that the requirement

will result in the entity transferring an economic resource. They argued that such a threshold would provide the most relevant measure of the expenses in the period.

- BC4.61 The IASB now proposes that the definition of a present obligation should reflect View 2, ie that the entity must have no practical ability to avoid the transfer of an economic resource. The reasons are:
- (a) firstly, the IASB rejected the suggestion (mentioned in paragraph BC4.60) of applying a threshold based on the probability of future outflows. The definition of a liability focuses on a present obligation, for the reason set out in paragraphs BC4.11–BC4.17. Hence, the IASB believes that the supporting guidance should focus on what the entity is able (or not able) to do—not on the likelihood of the possible outcomes.
 - (b) secondly, the IASB continues to reject limiting the definition of a liability to obligations that are legally enforceable and strictly unconditional (View 1). When an entity has no practical ability to avoid transferring an economic resource as a result of a past event, omitting the requirement to make that future transfer from a list of the entity’s obligations would exclude information that many users would find useful. Nearly all respondents to the Discussion Paper agreed that View 1 would define a liability too narrowly.
 - (c) although View 3 may lead to the most complete recognition of expenses in a period, the IASB rejected it because the term ‘obligation’ implies some limit on the entity’s ability to avoid the transfer of an economic resource.
- BC4.62 As noted in paragraphs BC4.52–BC4.53, the existing *Conceptual Framework* requires a present obligation to be the result of past events but does not specify how to identify the event that brings an obligation into existence (sometimes called the ‘obligating event’).
- BC4.63 The IASB observed that some obligations arise in full from a single obligating event, such as receiving goods. Other obligations build up over time from a series of single obligating events, or through a single continuous obligating event, such as conducting a continuous activity. The obligating events that have already occurred determine the extent of the obligation (its quantum). Thus, the IASB proposes in the Exposure Draft to specify that the obligating event is receiving the economic benefits, or conducting the activities, that establish the extent of the entity’s obligation. The IASB noted that establishing the extent of the obligation does not determine what measurement basis should be used for the obligation.
- BC4.64 As explained in paragraphs BC4.18–BC4.22, the IASB proposes to retain the reference to past events in the definition of a liability. If the definition of obligations were limited to encompass only those that are unconditional and legally enforceable (View 1), the explicit reference to a past event would, arguably, have been redundant. However, the IASB proposes a broader approach (View 2). In the IASB’s view, that proposal makes it important to explain as

clearly as possible that, because no obligating event has yet occurred, an entity has no obligation for costs that will arise if it receives benefits, or conducts activities, in the future.

BC4.65 As noted in paragraph BC4.54, existing Standards take different approaches in defining whether an entity has a present obligation when it has a limited ability to avoid a transfer of economic benefits. Consequently, no approach will be consistent with all existing Standards. Applying the proposed approach, the main inconsistency would be between the *Conceptual Framework* and IAS 37 as interpreted by IFRIC 21.¹² The inconsistency would affect, in particular, levies that accumulate over time but are payable only if a further condition is met; for example, if the entity is still operating in the market on a later date. Applying IFRIC 21, liabilities are identified only once all conditions are met. However, applying the proposed approach, liabilities would be identified as arising over time, unless the entity has the practical ability to avoid the remaining conditions (for example, leave the market) without significant business disruption or without economic consequences that would be significantly more adverse than paying the levy. The IASB thinks that it is likely that, in practice, many liabilities for levies would be identified as accruing over time.

BC4.66 Introducing the proposed criteria for identifying a present obligation would not necessarily lead to a change in IAS 37 or IFRIC 21. The *Conceptual Framework* does not override individual Standards, and any decision to amend an existing Standard would require the IASB to go through its normal due process for adding a project to its agenda and developing an Exposure Draft and an amendment.

Constructive obligations (paragraph 4.34)

BC4.67 The existing *Conceptual Framework* states that, in addition to legally enforceable obligations, obligations may arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. IAS 37 defines a constructive obligation as an obligation that derives from an entity's actions where:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

BC4.68 Examples of situations in which it is sometimes argued that a constructive obligation exists are when an employer has an established, informal practice of paying employee bonuses that exceed the contractual entitlement; or when a

¹² Inconsistencies may also arise with the definition of financial liabilities in IAS 32 *Financial Instruments: Presentation* both in relation to the identification of contractual obligations and in the distinction between financial liabilities and equity. The IASB is exploring how to distinguish between liabilities and equity in its Financial Instruments with Characteristics of Equity research project (see paragraph BCIN.25).

mining company has a publicly stated policy of restoring mined land to a similar standard throughout the world, even in countries whose legislation demands lower standards.

- BC4.69 The Discussion Paper suggested that the definition of a liability should encompass both legal and constructive obligations. Nearly all respondents who commented on constructive obligations supported that suggestion. The Exposure Draft addresses constructive obligations in its discussion of whether an entity has the practical ability to avoid a transfer of economic resources. It proposes that obligations can arise from an entity's customary practices, published policies or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. The IASB views this concept as being broadly consistent with the existing IAS 37 definition: another party could validly expect the entity to transfer an economic resource only if the entity has no practical ability to avoid the transfer.

Terminology

- BC4.70 Some respondents to the Discussion Paper suggested that terms such as the following could be easier to interpret than 'no practical ability to avoid':
- (a) 'no realistic alternative'; or
 - (b) 'little or no discretion (in practice) to avoid'.
- BC4.71 The IASB thinks that these two terms have a similar meaning to 'no practical ability to avoid'. However, the IASB proposes the term 'no practical ability to avoid', because it thinks that it most effectively conveys the need to identify what the entity is able to do, instead of what the probable outcome will be. Furthermore, it mirrors the term 'practical ability', which is applied in some existing Standards in assessing whether an entity has control of an asset.
- BC4.72 Many respondents asked for guidance on the meaning of 'no practical ability to avoid'. The IASB acknowledges that applying that concept will require judgement. The IASB will, if necessary, develop guidance on applying that concept to particular cases as it develops specific Standards.

Economic compulsion

- BC4.73 On various occasions, interested parties have suggested that an entity should recognise a liability if it is 'economically compelled' to transfer an economic resource. In the light of those suggestions, some existing Standards state explicitly that 'economic compulsion' is not sufficient to create a present obligation.
- BC4.74 The Exposure Draft does not use the term 'economic compulsion'. In assessing whether it has a liability, an entity would need to consider both criteria listed in paragraph 4.31 of the Exposure Draft.
- BC4.75 The IASB thinks that these criteria make it clear that:
- (a) economic compulsion may be a factor that reduces the entity's practical ability to avoid a future transfer—so it would need to be considered in assessing whether that criterion is met; but

- (b) economic compulsion on its own cannot create a present obligation—there is also the requirement for the obligation to have arisen from a past event (receiving economic benefits, or conducting activities, that establish the extent of the entity's obligation).

An obligation for one party is a right for another party

- BC4.76 Paragraph 4.25 of the Exposure Draft states that if one party has an obligation to transfer an economic resource, it follows that another party (or parties) has a right to receive that economic resource.
- BC4.77 Most respondents did not disagree with a similar suggestion in the Discussion Paper. However, a few respondents questioned whether the counterparty to a constructive or conditional obligation has any asset that it controls if the obligation is not legally enforceable, or is conditional on the reporting entity's own actions. In the IASB's view, the counterparty does control an asset in such cases. According to paragraph 4.21 of the Exposure Draft, 'this aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead [that aspect of control] means that, if the resource produces economic benefits, the entity is the party that will receive them'.
- BC4.78 The IASB thinks that making the general point set out in paragraph 4.25 of the Exposure Draft would help people to apply the definitions (for example, it indicates that the counterparty to a constructive obligation has an asset). A liability necessarily involves an obligation to transfer an economic resource to another party. It follows that the other party must have an asset in the form of the right to receive the economic resource being transferred.
- BC4.79 The relationship does not hold true the other way round. For some assets, such as rights over physical objects, no corresponding liability exists for another party. An asset could be an economic resource that will be used to produce economic benefits, instead of a claim requiring another party to transfer economic resources.
- BC4.80 The Discussion Paper identified environmental obligations as an exception to the general principle that for every obligation, a corresponding resource exists. Some respondents questioned whether this case is an exception. They argued that there is a corresponding asset for society at large. The people living in the area have the right to receive the services required to restore their environment. The IASB agreed with this view, so the Exposure Draft identifies no exception to the general case.

Other guidance on liabilities

- BC4.81 The Exposure Draft proposes to add guidance on some other matters not covered by the existing *Conceptual Framework*:
- (a) that liabilities include performance obligations, such as obligations to provide services (see paragraph 4.28(d) of the Exposure Draft) and obligations to stand ready to transfer an economic resource if a specified future event occurs (see paragraph 4.27 of the Exposure Draft); and

- (b) the role of 'going concern' in assessing whether an entity has a present obligation (see paragraph 4.33 of the Exposure Draft).

Executory contracts (paragraphs 4.40–4.42)

BC4.82 The existing *Conceptual Framework* comments:

- 4.46 ... In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

BC4.83 The Discussion Paper suggested that the IASB could improve the *Conceptual Framework* by clarifying that:

- (a) in principle, a net asset or a net liability arises under an executory contract if the contract is enforceable.
- (b) however, if the contract was priced on arm's length terms, the initial measurement of that contract would typically be zero, because the rights of one party have the same value as its obligations to the other party. Accordingly, usually neither party recognises a net asset or a net liability at contract inception. After contract inception, one or both parties may need to recognise its asset or liability, depending on the measurement basis applied.
- (c) the nature of the purchaser's rights and obligations under an executory contract may depend on the circumstances:
 - (i) in some cases, the purchaser may have a single net right, or a single net obligation, to exchange the underlying asset and the purchase price simultaneously. Often, that net right or net obligation would be measured at zero.
 - (ii) in other cases, the purchaser may have a separate gross right to receive the asset and a separate gross obligation to pay the purchase price. In practice, such rights and obligations are sometimes offset, ie presented as a single net amount.

BC4.84 Respondents who commented on this part of the Discussion Paper generally welcomed the proposal to improve the discussion of the concepts underlying the accounting for executory contracts. However, some respondents thought that the proposed guidance appeared to focus too much on rationalising current practice, and that the underlying concepts would have to be clearer and more fully developed.

BC4.85 The IASB notes that an entity's rights and obligations under an executory contract are highly interdependent:

- (a) the entity's right to receive one resource is conditional on it fulfilling its obligation to transfer the other resource, and its obligation to transfer the other resource is conditional on it receiving the first resource.
 - (b) when the parties perform their obligations, there is only a net inflow or outflow of resources: each party transfers one resource but receives another resource in exchange. This is the case even if the parties perform their obligations at different times: when the first party transfers one resource (the first underlying resource), it simultaneously receives another resource (a right to receive the second underlying resource from the second party).
- BC4.86 In some cases, a court may enforce 'specific performance' of a contract—ie the court may rule that a party in breach of its obligations must perform those obligations instead of paying compensation or penalties. However, even in these cases, the court would not typically enforce performance by one of the parties without also enforcing performance by the other party.
- BC4.87 The IASB therefore concluded that an executory contract contains a right and an obligation to exchange economic resources, instead of a right to receive one economic resource and an obligation to transfer another economic resource.
- BC4.88 The IASB considered whether the right and obligation to exchange economic resources could give rise to both a separate asset (a right to exchange resources, equivalent to a purchased option) and a separate liability (the obligation to exchange resources, equivalent to a written option).
- BC4.89 A purchased option to exchange economic resources gives the holder the right either to make an exchange (for example, if it turns out to be favourable) or to withdraw from the exchange without penalty (for example, if it turns out to be unfavourable). Conversely, the issuer of the written option undertakes the obligation to make the exchange, if the holder exercises its right. However, if an entity is both the holder of an option and the issuer of an option for the same underlying exchange of economic resources, then:
- (a) the entity's right under its purchased option to withdraw from the exchange is negated by its obligation to exchange if the counterparty exercises its right under the entity's written option; and
 - (b) the counterparty's right under the entity's written option to withdraw from the exchange is negated by its obligation to exchange if the entity exercises its right under its purchased option.
- BC4.90 Consequently, if an entity is both the holder of an option and the issuer of an option for the same underlying exchange, then neither party has the right to avoid exchanging economic resources. It follows that for an executory contract, there is only one outcome under the terms of the contract—the exchange will occur. Moreover, the entity's right and obligation to exchange economic resources are so interdependent that they cannot be separated. Hence, the contract cannot be decomposed into more than a single asset or liability. If the exchange is on terms that are favourable, the contract is an asset; if it is on terms that are unfavourable, it is a liability.

BC4.91 Some may ask how this conclusion relates to the treatment of assets and liabilities arising under a lease contract or to trade date accounting for financial assets:

- (a) as explained in the Basis for Conclusions on the 2013 Exposure Draft *Leases*, a lease contract is no longer an executory contract once the lessor has delivered the right-of-use asset to the lessee. The lessor has performed its obligation and the contract is no longer a contract to exchange resources. The lessee controls the right-of-use asset and has a liability for the lease payments.
- (b) IFRS 9 *Financial Instruments* permits 'trade date accounting' for a 'regular way' purchase or sale of a financial asset. This treats the financial asset as having already been delivered at the commitment (trade) date, instead of accounting for the purchase or sale contract as a derivative until settlement. IFRS 9 permits trade date accounting as a simple and practical method of managing and recording transactions that have only a short duration. In other words, its acceptance results from considering the cost constraint, ie from considering the relative costs and benefits of trade date accounting and settlement date accounting (the other permitted treatment). The IASB has no plans to reconsider the use of trade date accounting.

BC4.92 In many cases in current practice, an asset or a liability is not recognised for an executory contract. The IASB expects that this will continue to be the case. The same measurement considerations that apply to all other assets and liabilities (see Chapter 6) apply also to the single asset or liability that arises from an executory contract. When a historical cost measurement is applied to an executory contract, the contract is measured at zero (which has the same practical effect as not recognising the contract) unless it is onerous. For example, the historical cost of an executory contract for the purchase of inventories is zero (assuming no transaction costs) unless the contract is onerous. To achieve consistency with the existing requirements in IAS 2 *Inventories*, that contract would be regarded as onerous if the contractual price payable for the inventory exceeded its net realisable value.

Equity (paragraphs 4.43–4.47)

BC4.93 The existing *Conceptual Framework* defines liabilities and equity. However, existing Standards do not apply the definitions consistently. These inconsistent requirements result in economically similar items being classified differently, with very different accounting outcomes. For example, subsequent changes in the carrying amount of a claim against the entity are income or expenses if the claim is classified as a liability, but are not income or expenses if the claim is classified as equity. In addition, existing Standards generally require more information about items classified as liabilities than about items classified as equity.

BC4.94 The Discussion Paper suggested that the *Conceptual Framework* should:

- (a) retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities; and

- (b) state that the IASB should use the definition of a liability to distinguish liabilities from equity.
- BC4.95 Many respondents to the Discussion Paper supported using the definition of a liability to distinguish liabilities from equity. Others supported different approaches that would:
- (a) eliminate the distinction between liabilities and equity; or
 - (b) define equity directly and introduce a new element of financial statements—claims that are neither liabilities nor equity.
- BC4.96 The inherent limitation of a distinction between liabilities and equity is that it attempts to make a single, binary distinction between claims that have various characteristics in varying degrees. Eliminating the distinction and defining a single element for claims would allow the accounting for each item to be determined individually to depict its specific characteristics. However, the IASB agrees with respondents who stated that, unless all claims are measured directly, any approach would need to identify at least one residual class of claim that would be measured indirectly by reference to the carrying amounts of assets and liabilities. Moreover, it is not possible to measure all claims directly without valuing the entire entity, which goes beyond the stated objective of general purpose financial reports. Thus, dividing claims into at least two categories is unavoidable.
- BC4.97 Defining equity directly and introducing another element (a third class of claim) may better depict claims that have some characteristics of both liabilities and equity. However, introducing another element would make the classification and resulting accounting more complex. In addition, it would be necessary to determine whether changes in this third class of claim should meet the definition of income or expenses. Furthermore, an outcome similar to introducing a new element could be achieved by simply introducing a new subclass within liabilities or equity.
- BC4.98 Thus, the Exposure Draft:
- (a) continues to make a binary distinction between liabilities and equity;
 - (b) continues to define equity as the residual interest in the assets of the entity after deducting all its liabilities; and
 - (c) continues to allow the separate presentation of different classes and categories of equity to provide useful information to users.
- BC4.99 Although they supported using a definition of a liability to distinguish between liabilities and equity, some respondents questioned whether useful information would result from using the definition suggested in the Discussion Paper to classify claims that have characteristics of both liabilities and equity. That definition focused solely on whether the reporting entity has a present obligation to transfer any of its own economic resources. In particular, they questioned whether it would be appropriate to classify:
- (a) as equity, an obligation to deliver a variable number of equity instruments equal to a specified amount (ie when an entity uses its own shares as ‘currency’); and

- (b) as a liability, an obligation to transfer a variable amount of cash or other economic resources equal to the value of an equity instrument.

BC4.100 In addition, the Discussion Paper suggested that, if all claims against an entity meet the proposed definition of a liability, it may be appropriate to treat the most subordinate class of instruments as if it were equity, with suitable disclosure. Some respondents did not support that suggestion. They objected to including in the *Conceptual Framework* such an exception to the definition of a liability. Others, particularly co-operatives and limited liability partnerships that issue puttable or redeemable instruments, supported the suggestion, but opposed describing it as an exception.

BC4.101 The IASB will further explore how to distinguish between liabilities and equity in its Financial Instruments with Characteristics of Equity research project. That research project:

- (a) will consider various approaches to distinguishing between liabilities and equity, including approaches that could require changes to the definitions of a liability or equity in the *Conceptual Framework*. The IASB will use the output from that project when it decides, in due course, whether to add to its active agenda a project to amend the relevant Standards, the *Conceptual Framework*, or both. Any decision to start an active project would require the IASB to go through its normal due process for adding a project to its agenda.
- (b) is unlikely to result in changes to the proposals in the Exposure Draft that focus on identifying whether the reporting entity has a present obligation to transfer an economic resource. Those proposals are not designed to address problems in distinguishing between liabilities and equity.

BC4.102 The Discussion Paper also explored potential enhancements to the statement of changes in equity to illustrate how entities could provide useful information about claims classified as equity, and to emphasise that classifying a claim as a liability is not the only way to provide useful information about that claim.

BC4.103 Many users and other respondents to the Discussion Paper supported the idea of providing additional information on the effects of different classes of equity claim, although not necessarily by enhancing the statement of changes in equity. The Exposure Draft does not propose such enhancements, although the IASB may explore such enhancements as part of its Financial Instruments with Characteristics of Equity research project.

Income and expenses (paragraphs 4.48–4.52)

BC4.104 Paragraphs BC4.2–BC4.3 explain why the IASB proposes to continue with the existing approach of defining income and expenses in terms of changes in assets and liabilities. No major problems have been identified with the definitions of income and expenses. Hence, the only changes proposed are those necessary to make them consistent with the proposed definitions of assets and liabilities.

BC4.105 Much of the discussion of income and expenses in the existing *Conceptual Framework* relates to their presentation and disclosure. Presentation and

disclosure are discussed in Chapter 7 of the Exposure Draft. The rest of the existing discussion refers to various types of income and expenses; for example, revenue, gains and losses. That material has not been included in the Exposure Draft. The IASB thinks that it was originally included to emphasise that income includes revenue and gains and expenses include losses. The IASB thinks that emphasis is now unnecessary and the implication that the *Conceptual Framework* defines subclasses of income and expenses is unhelpful. The IASB does not expect the removal of that material to cause any changes in practice. The terms ‘revenue’, ‘gains’ and ‘losses’ are used in the Exposure Draft only in examples.

Other possible elements

- BC4.106 The Discussion Paper suggested that it may be helpful for the *Conceptual Framework* to define elements for the statement of cash flows and the statement of changes in equity, but did not suggest any wording for the definitions. The elements suggested were:
- (a) in the statement of changes in equity—contributions of equity, distributions of equity and transfers between classes of equity; and
 - (b) in the statement of cash flows—cash inflows (cash receipts) and cash outflows (cash payments).
- BC4.107 Respondents were divided on whether to add such definitions to the *Conceptual Framework*. Those in favour of introducing contributions to equity, distributions of equity and transfers between classes of equity as new elements argued that:
- (a) the existing definitions of income and expenses refer to changes in assets and liabilities, excluding those resulting from contributions from equity participants and distributions to equity participants. It may be confusing, and arguably is conceptually inconsistent, to define one type of movement as an element if that definition refers to another type of movement that is not identified explicitly as an element.
 - (b) there is lack of clarity about the distinction between income (expenses) and contributions (distributions). Explicit clarification in the *Conceptual Framework* may help.
 - (c) defining these items as elements is consistent with the FASB’s *Conceptual Framework*.
- BC4.108 The arguments against are:
- (a) it may be difficult to create a clear definition without making significant amendments to the definitions of income and expenses.
 - (b) the absence of a definition of contributions of equity and distributions of equity has not caused major problems.
 - (c) the Discussion Paper suggested making the statement of changes in equity more prominent. Defining these elements was one part of this suggestion. However, the Exposure Draft does not include that suggestion (see paragraph BC4.103). Thus, defining contributions and distributions of equity may not provide great benefits.

BC4.109 The key argument in favour of defining elements for the cash flow statement is that it would emphasise the importance of cash flow information. The arguments against doing so are that:

- (a) defining elements of cash flows may have unintended consequences and would not solve any known practical problem.
- (b) defining elements of cash flows would imply that all entities should produce a statement of cash flows. Some argue that, as currently structured, cash flow statements do not provide useful information in the case of financial institutions. The IASB is researching the use of the statement of cash flows. Until that research is complete, it would be premature to consider whether to define elements for cash flow statements.
- (c) the most obvious definitions of elements of cash flows may imply a preference for the direct method. It would not be appropriate to embed such a preference in the *Conceptual Framework* without conducting further research. (The IASB has no current plans to consider the introduction of a requirement for a direct cash flow statement.)

BC4.110 The IASB concluded that the disadvantages of defining elements for the statement of changes in equity and the statement of cash flows outweigh the advantages and, hence, proposes no such definitions.

Reporting the substance of contractual rights and obligations (paragraphs 4.53–4.56)

BC4.111 As explained in paragraphs BC2.18–BC2.20, the Exposure Draft proposes that, to provide a faithful representation of an economic phenomenon, an entity should report the substance of that phenomenon, not merely its legal form. The Exposure Draft also proposes concepts for reporting the substance of contractual rights and obligations. Those concepts already underlie requirements and guidance in several Standards. The IASB thinks that including the underlying concepts in the *Conceptual Framework* would help to ensure that these concepts are applied more consistently. The concepts proposed in the Exposure Draft are the same as those proposed in the Discussion Paper. Most responses on this matter supported the proposal to include concepts and agreed with the specific concepts proposed.

Unit of account (paragraphs 4.57–4.63)

BC4.112 The unit of account is the group of rights, the group of obligations or the group of rights and obligations to which recognition and measurement requirements are applied.

BC4.113 The Discussion Paper suggested that selecting a unit of account would be a Standards-level decision, not a decision that can be resolved conceptually for a broad range of Standards.

- BC4.114 Many of those respondents who commented on this issue stated that they agreed that the selection of a unit of account should be a Standards-level decision. However, some respondents stated that the *Conceptual Framework* should provide more detailed discussion on this topic.
- BC4.115 Having considered the comments from respondents, the IASB continues to believe that selecting a unit of account should be a Standards-level decision. The unit of account is driven by decisions about recognition and measurement: those decisions are made in developing Standards and, hence, so will be the decision about the unit of account. The IASB has included in the Exposure Draft a discussion on the issue, including examples of possible units of account and the factors that could determine which unit of account to use. The IASB proposes not to rank the factors by priority, because their relative importance depends on the specific features of the item that the entity is accounting for. No single ranking could determine the most useful unit of account consistently for a broad range of Standards.
- BC4.116 Selecting a unit of account is not the same issue as:
- (a) determining that an executory contract creates a single asset or liability. In an executory contract, the right to exchange and the obligation to exchange are not separable (see paragraphs BC4.82–BC4.92) and, hence, they cannot form separate units of account.
 - (b) offsetting. The question of offsetting arises after recognition and measurement have been applied to identified units of account for both an asset and a liability.

Chapter 5—Recognition and derecognition

Recognition process (paragraphs 5.2–5.8)

BC5.1 The existing *Conceptual Framework* defines recognition as follows:

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 4.38 [of the existing *Conceptual Framework*]. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals.¹³

BC5.2 There are three minor problems with this existing definition:

- (a) most items are depicted by including them in line items, not by depicting them individually.
- (b) the cross-reference to the recognition criteria is unnecessary. It also means that the definition would not be met if recognition criteria in a particular Standard are inconsistent with the recognition criteria in the *Conceptual Framework*.
- (c) the terminology is out of date. For example, it refers to the balance sheet instead of the statement of financial position.

BC5.3 To address these minor points, the Exposure Draft adapts the existing definition to read as follows:

Recognition is the process of capturing, for inclusion in the statement of financial position or statement(s) of financial performance, an item that meets the definition of an element. It involves depicting the item (either alone or as part of a line item) in words and by a monetary amount, and including that amount in the relevant statement.

BC5.4 The IASB also proposes to explain in the *Conceptual Framework* how recognition links the statement of financial position and the statement(s) of financial performance.

Recognition criteria (paragraphs 5.9–5.24)

Existing requirements

BC5.5 The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an item that meets the definition of an element if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be measured with reliability.

BC5.6 In addition, as with all other aspects of the existing *Conceptual Framework*, the cost constraint applies. Thus, an asset or a liability is not recognised if the benefits of recognition do not justify the costs.

¹³ See paragraph 4.37 of the existing *Conceptual Framework*.

- BC5.7 The existing criteria have caused some problems, which are discussed in the following paragraphs.

Problems with probability criterion

- BC5.8 Some existing Standards do not apply a probability recognition criterion, for example, IFRS 9 *Financial Instruments*. Those that do apply such a criterion use different probability thresholds. These include 'probable', 'more likely than not', 'virtually certain' and 'reasonably possible'. The use of the different terms indicates a lack of consistency in the meaning attached at the Standards-level to the term probable used in the *Conceptual Framework*.
- BC5.9 Some have argued that a probability recognition criterion could prevent the recognition of some financial instruments, for example, derivatives. Moreover, it could sometimes result in a gain being recognised for a transaction when no economic gain has occurred. For example, suppose that, in exchange for receiving cash, an entity incurs a liability to pay a fixed amount if some unlikely event occurs in the future. If an outflow of economic benefits is not considered probable, the entity will recognise an immediate gain when it receives the cash.

Problems with reliable measurement criterion

- BC5.10 Using reliable measurement as a criterion could be confusing because reliability is not identified as a qualitative characteristic (see paragraphs BC2.21–BC2.25). In practice, the criterion seems to have been interpreted as relating to measurement uncertainty. Hence, a broadly similar result can be achieved by acknowledging that, in some cases, the level of measurement uncertainty can affect the relevance of the information provided by recognising a particular asset or liability (see paragraphs BC5.41–BC5.45).

Approach in the Discussion Paper

- BC5.11 The Discussion Paper suggested that the discussion of whether to recognise an asset or a liability should refer directly to the qualitative characteristics of useful financial information. Accordingly, an entity would recognise all its assets and liabilities, unless the IASB decides when developing a particular Standard that an entity need not, or should not, recognise an asset or a liability because:
- (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant or is not sufficiently relevant to justify the cost; or
 - (b) no measure of the asset (or the liability) would result in a faithful representation both of the asset (or the liability) and of the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.
- BC5.12 The Discussion Paper also suggested that the *Conceptual Framework* should list the following indicators explaining when recognition may produce information that does not possess those qualitative characteristics:
- (a) if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate;

- (b) if an asset (or a liability) exists, but there is only a low probability that an inflow (or outflow) of economic benefits will result;
- (c) if identifying a resource or obligation is unusually difficult;
- (d) if measuring a resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured; and
- (e) if recognising an asset (in particular, internally generated goodwill) is not necessary to meet the objective of financial reporting.

Responses to the Discussion Paper

- BC5.13 Some respondents believed that the suggestions in the Discussion Paper were intended to increase the range of assets and liabilities recognised and expressed concerns about that outcome. However, in developing the Discussion Paper, and subsequently the Exposure Draft, the IASB's aim has been solely to develop tools that enable it to take decisions based on a more coherent set of principles, which result in useful information. The IASB has not had, and does not have, an objective of either increasing or decreasing the range of assets and liabilities recognised, although the proposed guidance on the definition of a liability might broaden slightly the population of items identified as meeting that definition.
- BC5.14 With regard to the overall direction, some respondents favoured recognising all, or almost all, assets and liabilities:
- (a) a few respondents suggested that an entity should recognise all its assets and liabilities, with no exceptions. They argued that this would promote completeness, comparability, consistency and conceptual integrity in financial reporting.
 - (b) a few other respondents suggested that the *Conceptual Framework* should not provide for departures from the general principle that an entity should recognise all assets and liabilities. If limited exceptions are needed, they could be developed in particular Standards by referring to the qualitative characteristics of useful financial information.
 - (c) some respondents suggested that the *Conceptual Framework* should establish a rebuttable presumption that all assets and liabilities should be recognised. They indicated that recognition would generally result in the most relevant information.
- BC5.15 However, most respondents believed that it is neither relevant nor feasible for an entity to recognise all of its assets and liabilities and that the *Conceptual Framework* should acknowledge this:
- (a) some respondents felt that recognition should occur only when there is clear evidence that it provides a relevant and faithful representation. The concerns of those respondents centred on particular items, such as some litigation liabilities and some intangible assets, for which they viewed recognition as inappropriate. They also expressed a wish to avoid any requirements that could result in a time-consuming and costly search to identify all possible assets and liabilities.

- (b) others argued that the *Conceptual Framework* should provide criteria for when to recognise assets and liabilities, because:
 - (i) delegating these decisions to specific Standards may lead to inconsistencies between Standards and create rules instead of principles.
 - (ii) such criteria would assist preparers and others who need guidance to help them decide when to recognise an asset or a liability that no Standard covers. The use of these criteria by parties other than the IASB should cause no concerns, because the *Conceptual Framework* does not override recognition criteria in Standards.

BC5.16 The IASB concluded that the *Conceptual Framework* should take an even-handed approach to recognition, with neither:

- (a) a presumption that all assets and liabilities should be recognised; nor
- (b) a presumption that assets and liabilities should be recognised only if they meet stringent criteria.

Instead, the *Conceptual Framework* should simply set out criteria based on the qualitative characteristics and describe the factors that drive recognition decisions.

BC5.17 Many respondents to the Discussion Paper agreed that:

- (a) the approach to recognition should refer to relevance and faithful representation;
- (b) the *Conceptual Framework* should acknowledge that significant uncertainty and significant measurement difficulties may undermine relevance and make it difficult to provide a faithful representation; and
- (c) the cost constraint should play a role in recognition decisions.

BC5.18 Respondents who commented on recognition were evenly divided on how best to refer to relevance and faithful representation and how best to acknowledge the effects of significant uncertainty and significant measurement difficulties:

- (a) some favoured retaining one or both of probability and reliability of measurement as explicit recognition criteria. They argued that such criteria are suitable filters to be used in practice for identifying cases in which recognition is not likely to provide information that possesses the qualitative characteristics of useful financial information. There were considerably more requests to retain an explicit probability criterion than requests to retain an explicit reliability criterion.
- (b) others favoured the approach suggested by the Discussion Paper, namely to refer more directly to the qualitative characteristics and supplement this by guidance.

BC5.19 Proponents of using probability and reliability as practical filters argued that these criteria would be clearer, more robust and less judgemental than the

approach suggested in the Discussion Paper. Some feared that the lack of robust criteria would result in broader, and excessive, recognition of assets and liabilities.

- BC5.20 The IASB continues to think that referring directly to the qualitative characteristics of useful financial information is appropriate. Basing recognition criteria on the qualitative characteristics should result in useful information. Nevertheless, the IASB thinks that merely referring directly to the qualitative characteristics, without providing supporting guidance, could lead to inconsistent recognition decisions at the Standards level.
- BC5.21 Paragraph 5.9 of the Exposure Draft sets out the IASB's proposed recognition criteria, which refer to:
- (a) relevance (see paragraphs BC5.22–BC5.45);
 - (b) faithful representation (see paragraphs BC5.46–BC5.47); and
 - (c) the cost constraint (see paragraph BC5.48).

Relevance (paragraphs 5.13–5.21)

- BC5.22 The guidance supporting the proposed recognition criteria lists the following indicators to help in identifying some of the cases when recognising an asset or a liability may not provide users of financial statements with relevant information:
- (a) if it is uncertain whether the asset exists, or is separable from goodwill, or whether a liability exists (see paragraphs BC5.25–BC5.35);
 - (b) if an asset or a liability exists, but there is only a low probability that an inflow or outflow of economic benefits will result (see paragraphs BC5.36–BC5.40); or
 - (c) if a measurement of an asset or a liability is available (or can be obtained) but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available or can be obtained (see paragraphs BC5.41–BC5.45).

Those indicators cover some (but not necessarily all) cases in which the recognition criteria in the existing *Conceptual Framework* might have led to a conclusion that a flow is not probable or that reliable measurement is not possible.

- BC5.23 The indicators are derived from indicators suggested by the Discussion Paper (see paragraph BC5.12). Some respondents stated that:
- (a) it would be useful to explain how the qualitative characteristics might be applied in recognition, but that indicators are not necessary to achieve this.
 - (b) the indicators, and supporting examples illustrating how the indicators might be applied, do not provide concepts. The *Conceptual Framework* should contain clear concepts.
- BC5.24 Other respondents stated that such indicators are essential to make the recognition criteria sufficiently robust. The IASB continues to agree with that

view. However, to avoid providing Standards-level detail, the IASB has deleted the specific examples that the Discussion Paper had provided as illustrations of how the indicators might be applied.

Existence uncertainty (paragraphs 5.15–5.16)

- BC5.25 The definitions of assets and liabilities allow for uncertainty about whether the inflows or outflows of economic benefits will ultimately occur (see paragraphs BC4.11–BC4.17). But there could also be uncertainty over the existence of an asset or a liability.
- BC5.26 Feedback on the Discussion Paper’s discussion on existence uncertainty focused on:
- (a) whether to distinguish existence uncertainty from outcome uncertainty (see paragraphs BC5.27–BC5.31); and
 - (b) whether the *Conceptual Framework* should address existence uncertainty (see paragraphs BC5.32–BC5.34).
- BC5.27 Several respondents commented explicitly that it is useful to differentiate between existence uncertainty and outcome uncertainty. Doing so would clarify how to deal with both types of uncertainty.
- BC5.28 Other respondents stated that it can be difficult to distinguish the two types of uncertainty. They often occur together and hence need to be dealt with together.
- BC5.29 In the IASB’s view, it is helpful to distinguish existence uncertainty from outcome uncertainty. Making this distinction makes it easier to decide what information is most likely to be relevant to users of financial information and how to provide the most faithful and understandable representation of that information. Outcome uncertainty affects many assets and liabilities. Although outcome uncertainty does not always cause measurement uncertainty, it may sometimes contribute to measurement uncertainty. It could therefore affect decisions about recognition and the selection of a measurement basis. Existence uncertainty, on the other hand, may be a separate factor to consider for decisions about recognition.
- BC5.30 The Discussion Paper stated that existence uncertainty is rare. Several respondents disagreed with this statement. They supplied the following examples of existence uncertainty:
- (a) litigation. Several respondents feared that if the *Conceptual Framework* does not retain a probability threshold that could apply for existence uncertainty, this may lead to the inappropriate recognition of liabilities for actual or potential claims under lawsuits.
 - (b) constructive obligations, because there is no contract or legislation that establishes the liability.
 - (c) cases in which there is some doubt whether an entity controls a resource.
 - (d) items acquired or incurred in non-monetary exchange transactions.

- BC5.31 Although the vast majority of assets and liabilities are not typically subject to existence uncertainty, the IASB agrees that existence uncertainty is not rare so that statement is not included in the Exposure Draft.
- BC5.32 Several respondents agreed with the suggestion in the Discussion Paper that the *Conceptual Framework* should not set a probability threshold for cases in which it is uncertain whether an asset or a liability exists. The IASB could decide how to deal with that uncertainty when the IASB develops or revises a Standard on that type of asset or liability.
- BC5.33 Some respondents disagreed, stating that the *Conceptual Framework* should explain explicitly how to approach recognition when asset or liability existence is uncertain. They argued that:
- (a) deciding how to deal with existence uncertainty should be principle-based and should not vary by transaction. Dealing with existence uncertainty in individual Standards could lead to an unnecessary proliferation of Standards and inconsistencies.
 - (b) preparers need guidance for assets and liabilities that no Standard covers.
- BC5.34 The Exposure Draft lists uncertainty over whether an asset or a liability exists as one of the indicators that may lead to a conclusion that recognition of that asset or liability may not produce relevant information. The IASB believes that it would not be useful to provide more detailed guidance on how to address existence uncertainty, because the relevant factors are likely to depend very much on particular circumstances.

Separability from goodwill

- BC5.35 The Discussion Paper stated that, because the recognition of internally generated goodwill would require a valuation of the entity as a whole, its recognition is unnecessary to meet the objective of financial reporting. Although the IASB continues to believe that this statement is valid, the Exposure Draft does not include this case as an indicator that recognition might not result in relevant information. The IASB agrees with those respondents who argued that such an indicator is not useful because it applies only to internally generated goodwill. However, the IASB concluded that difficulty in assessing whether an asset exists separately from the business as a whole (that is whether there is an asset distinct from goodwill) is a factor that could indicate that recognition of the asset would not provide relevant information.

Low probability of a flow of economic benefits

- BC5.36 As noted, the existing *Conceptual Framework* includes a probability-based recognition criterion. The Discussion Paper suggested that this should be removed and many respondents agreed. They argued that:
- (a) it would not be possible to construct probability thresholds that result in useful information for all types of assets and liabilities. The *Conceptual Framework* should not include probability thresholds, but should give guidance on how to construct probability thresholds and recognition

criteria at a Standards level. This guidance could explain when recognition is unlikely to be appropriate and how uncertainty affects relevance and reliability.

- (b) many uncertainties relate to measurement and can be dealt with by choosing an appropriate measurement basis.
- (c) a probability threshold has a disproportionate effect when an item crosses the threshold. The economic change that causes the item to cross the threshold may be small, but the resulting accounting effect could be large.
- (d) any thresholds set by the IASB will prevent management from considering carefully how to present relevant information. Management should apply materiality and a higher threshold for recognising assets than for liabilities.

BC5.37 Many other respondents argued that the recognition criteria should continue to refer to probability. They argued that:

- (a) probability has a significant effect on whether information is capable of faithful representation and also on whether it is relevant. The probability criterion provides a practical and inexpensive way to filter out assets and liabilities with low probability, which are not relevant to users and are costly for preparers to identify and measure.
- (b) recognising assets and liabilities that have a low probability of generating inflows or outflows of economic benefits would:
 - (i) produce information that is not relevant to users and is complex and hard to understand. For example, it could result in a multitude of items being recognised at small amounts or lead to frequent reversals in subsequent periods when the inflow or outflow does not occur.
 - (ii) require costly, and perhaps complex systems, involve significant management time and judgement and lead to an endless search for potential rights and obligations.
 - (iii) lead to wider, and excessive, use of measurements based on expected value techniques, and of fair value measurements. Disclosures are sometimes more useful than a measure that uses weighted averages or fair value. Such measures provide an illusion of 'precision' that does not exist.
 - (iv) intensify measurement problems, because measurement may be sensitive to small changes in probability estimates.
- (c) retaining a probability threshold within the recognition criteria in the *Conceptual Framework* may lead to more consistent recognition decisions in Standards.
- (d) the Discussion Paper overstates the range of assets and liabilities that would be filtered from recognition by the existing probable criterion. For example, for an obligation to provide a service of standing ready to meet any insurance or warranty claim by a customer, the economic

resource transferred is the service provided, not the payment or receipt of cash that may or may not occur ultimately.

BC5.38 Some respondents suggested applying a probability filter for some assets or liabilities, but not for all. For example:

- (a) a probability filter may be necessary for non-financial assets with uncertain benefits, such as patents and research and development. For these items, it is doubtful whether multiplying the estimated chance of success by the estimated pay-off would provide a meaningful figure or more reliable information than providing information in the notes. Moreover, for these items, it may not be possible to make reasonable estimates of the probabilities of each outcome. On the other hand, a probability filter could inappropriately exclude assets such as options or other financial instruments for which a market price is available or for which well-developed measurement models exist.
- (b) in considering whether to use a probability filter in a particular case, relevant factors could include whether there is a large number of similar objects (for example, product warranties) or a single object (for example, a single large lawsuit) and the uncertainty in the probability amount of each outcome.
- (c) it is not reasonable to remove the probability requirement from the recognition criteria simply to permit the recognition of some financial instruments. In such cases, it is only necessary to stipulate an exception for particular financial instruments in a particular Standard.

BC5.39 The IASB acknowledges that a probability threshold could be a practical way to filter out assets and liabilities whose recognition would not provide relevant information. However, an explicit, specified probability threshold is not sufficiently aligned with the concept (relevance) that it is supposed to achieve. Too many assets and liabilities would not be recognised when recognition would have provided relevant information. The IASB also noted that the measure of any recognised asset or liability with a low probability of an inflow or outflow would be likely to reflect that low probability—it is unlikely that a required measurement basis would reflect only the maximum inflow or outflow.

BC5.40 Hence, the Exposure Draft does not propose a specific probability threshold. Instead, low probability is noted in the Exposure Draft as an indicator that recognition may sometimes not provide relevant information, for reasons discussed in paragraphs 5.17–5.19 of the Exposure Draft.

Measurement uncertainty and reliability

BC5.41 The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an asset or a liability only if it has a cost or value that can be measured with reliability.

BC5.42 As previously noted, the Discussion Paper suggested that reliability should no longer be a recognition criterion. Many respondents did not comment explicitly on reliability. However, some respondents explicitly opposed the retention of reliable measurement as a recognition criterion. They felt that it may

inappropriately preclude the recognition of some assets and liabilities that are subject to considerable measurement uncertainty, such as pension liabilities and insurance liabilities.

BC5.43 In contrast, other respondents suggested retaining reliability of measurement as an explicit recognition criterion. They provided the following arguments, which focused on cases of high measurement uncertainty:

- (a) including unreliable estimates would obscure financial performance, confuse users, undermine their trust in financial statements and pollute the whole communication process, even if estimation uncertainty is disclosed in footnotes. Disclosures cannot compensate for large margins of errors in measurement. Moreover, disclosures about estimation uncertainty would contribute to disclosure overload.
- (b) some elements of reliability exist in relevance and faithful representation. However, reliability would provide a more understandable and operational basis for determining whether assets and liabilities should be recognised.
- (c) reliability is as important as relevance, and there is a trade-off between them. Consequently, if relevance is used as a recognition filter, then so should be reliability. Reliable information may not always be relevant, and relevant information may not always be reliable.
- (d) reliability is a key element of faithful representation. No measure will result in a faithful representation if it is not capable of reliable measurement.
- (e) recognition of items measured with a high degree of estimation uncertainty adds costs and complexity for preparers and results in information that is difficult to audit.
- (f) if reliability is replaced as a recognition criterion by faithful representation (defined as complete, neutral and free from error), anything could be recognised. This is because any estimate, however uncertain, could be faithfully represented if supported by sufficient disclosure about the estimation process.
- (g) although the *Conceptual Framework* no longer defines reliability as a qualitative characteristic, there is no reason why the recognition criteria cannot still use that term.

BC5.44 The IASB proposes in the Exposure Draft not to retain reliability as a recognition criterion, because:

- (a) the concerns expressed by some respondents about the removal of 'reliability' as a recognition criterion appear to relate mainly to concerns about measurement uncertainty. Paragraph QC16 of the existing *Conceptual Framework* already captures the idea that an estimate might not provide relevant information if the level of uncertainty in the estimate is too high. The IASB proposes to make this idea more visible (see paragraphs 2.12–2.13 and BC2.21–BC2.25). The IASB also proposes that measurement uncertainty should be discussed as an indicator that recognition may not provide relevant information.

- (b) the former notion of a trade-off between relevance and reliability still exists, but is now captured by a trade-off within relevance itself. As explained in paragraphs 2.13 and BC2.24(c), there is sometimes a trade-off between measurement uncertainty (which is a factor that affects relevance) and other factors that also affect relevance.

BC5.45 Some respondents to the Discussion Paper suggested that more measurement uncertainty is tolerable when recognising expenses than when recognising income. They described this as an application of asymmetric prudence (applying the terminology in paragraph BC2.6), not cautious prudence. The IASB thinks that the level of measurement uncertainty that makes a measure lose relevance depends on the circumstances and can be determined only when developing specific Standards. Hence, the *Conceptual Framework* neither requires nor prohibits a symmetrical approach that would set the same level of measurement uncertainty as being tolerable for the recognition of both income and expenses.

Faithful representation (paragraphs 5.22–5.23)

BC5.46 The Discussion Paper suggested that faithful representation could be used as a recognition criterion (see paragraph BC5.11). A few respondents commented on this:

- (a) the recognition criteria need not refer separately to faithful representation. There are no circumstances when recognising an asset or a liability would provide information that is relevant but yet could not result in a faithful representation of that asset or liability and of changes in that asset or liability, given adequate disclosure.
- (b) if measurement uncertainty is part of relevance, not of faithful representation, it is not clear what faithful representation means. The Discussion Paper included no examples of measurements that are not faithful representations of assets or changes in assets.
- (c) the Discussion Paper suggested that one case in which information is not relevant (or does not give a faithful representation of what it is trying to depict) is if it is incomplete or hard to understand; for example, if related assets and liabilities are not recognised. The answer is to produce complete information in an understandable form, not to omit the item.

BC5.47 The IASB continues to think that faithful representation is a necessary factor to consider when deciding whether to recognise an element. In particular, problems may arise in giving a faithful representation of a transaction or other event when some of the assets or liabilities affected by the transaction or other event are not recognised. Partial recognition of the effects of the transaction or other event (ie the effect only on the recognised assets and liabilities) may give a misleading depiction of the effect of the transaction.

Cost constraint (paragraph 5.24)

BC5.48 Paragraph BC2.33 explains why there is an explicit reference to the cost constraint in the chapter on recognition.

Derecognition (paragraphs 5.25–5.36)

- BC5.49 The existing *Conceptual Framework* does not define derecognition, nor does it describe when derecognition should occur. Because there is no agreed conceptual approach to derecognition, different Standards have adopted different approaches.
- BC5.50 The IASB suggested in the Discussion Paper, and proposes again now in the Exposure Draft, that accounting requirements for derecognition should aim to represent faithfully both:
- (a) the assets and the liabilities retained after the transaction or other event that led to the derecognition; and
 - (b) the changes in the assets and the liabilities as a result of the transaction or other event.
- BC5.51 Achieving that twin aim is straightforward if an entity disposes of an entire asset or an entire liability and retains no exposure to that asset or liability, but can be more difficult if an entity disposes of only part of an asset or a liability or retains some exposure.
- BC5.52 The following two examples illustrate some difficulties that can arise. In both examples, derecognising the asset would result in accounting that faithfully represents any asset or liability retained. However, it may sometimes misrepresent the extent of the changes in the entity's financial position:
- (a) sale of receivables with recourse—suppose that an entity sells some receivables to another party, but guarantees the third party against any credit losses it may incur on the receivables. If the entity derecognises the receivables and recognises its obligation under the guarantee as a liability, that may significantly reduce the total assets and total liabilities recognised in the statement of financial position, even though the credit risk is unchanged.
 - (b) sale and repurchase agreement—suppose that an entity sells an asset and at the same time contracts to buy it back at a fixed price. Derecognising the asset could suggest that the entity's asset mix has changed significantly, even though the change is only temporary and will be reversed. In addition, if the asset is measured on a historical cost basis, derecognising the asset would lead to the recognition of income and expenses at the time of the original sale, and then a corresponding increase or decrease in the carrying amount of the asset when the repurchase is completed.
- BC5.53 In the Discussion Paper, the IASB discussed two approaches to derecognition when the entity retains a component of the asset or the liability:
- (a) a control approach—derecognition is simply the mirror image of recognition. Thus, an entity would derecognise an asset or a liability when it no longer meets the criteria for recognition (or no longer exists, or is no longer an asset or a liability of the entity).

- (b) a risks-and-rewards approach—an entity would continue to recognise an asset or a liability until the entity is no longer exposed to most of the risks and rewards generated by that asset or liability. This would apply even if the remaining asset (or liability) would not qualify for recognition if acquired (or incurred) separately at the date when the entity disposed of the other components.
- BC5.54 The IASB concluded in the Discussion Paper that neither approach would necessarily produce the most useful information in all circumstances. Instead, the IASB suggested that:
- (a) an entity would, in most cases, achieve the twin aim described in paragraph BC5.50 by derecognising an asset or a liability when it no longer meets the recognition criteria (or no longer exists, or is no longer an asset or a liability of the entity); but
 - (b) if the entity retains a component of the asset or the liability, the IASB should determine, when developing particular Standards, how the entity would best portray the changes that resulted from the transaction. The Discussion Paper suggested that possible approaches for this could include:
 - (i) enhanced disclosure;
 - (ii) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or
 - (iii) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.
- BC5.55 Views of the respondents to the Discussion Paper were mixed. Some respondents favoured the control approach (possibly including risks and rewards as an indicator of control). Other respondents favoured the risks-and-rewards approach. Yet other respondents stated that the *Conceptual Framework* should discuss both approaches, including the relative merits of the approaches, and indicate when each should be used.
- BC5.56 The IASB noted that it is possible to resolve some, but not all, apparent conflicts between the control approach and the risks-and-rewards approach by considering:
- (a) whether a transferee acquires an asset as a principal or as an agent; and
 - (b) the fact that, in some cases, continuing exposure to variations in benefits (sometimes known as exposure to the significant risks and rewards of ownership) is an indicator of continuing control.
- BC5.57 In the IASB's view, the control approach focuses more on the aim mentioned in paragraph BC5.50(a) and the risks-and-rewards approach focuses more on the aim mentioned in paragraph BC5.50(b). The difficulties that the IASB has encountered in practice have arisen when those two aims conflict. The IASB views both aims as valid. Accordingly, the Exposure Draft does not advocate using the control approach or the risk-and-rewards approach in all

circumstances. Instead, the Exposure Draft describes the alternatives available and discusses what factors the IASB would need to consider when developing particular Standards.

- BC5.58 The Discussion Paper also discussed factors that the IASB should consider in deciding which approach to use when derecognition occurs: partial derecognition (derecognise the transferred component and continue to recognise the retained component) or full derecognition (derecognise the entire asset or liability and recognise the retained component as a new asset or liability). The Exposure Draft does not discuss this aspect of derecognition, because it is closely linked to issues of determining the unit of account and selecting the measurement basis for the retained component.

Modification of contracts (5.33–5.36)

- BC5.59 The Discussion Paper did not discuss how modifications of contracts would affect decisions about derecognition. As requested by some respondents to the Discussion Paper, the Exposure Draft proposes some guidance on this topic. The guidance is consistent with the sections in the Exposure Draft on the unit of account and on reporting the substance of contractual rights and obligations.

Chapter 6—Measurement

- BC6.1 The existing *Conceptual Framework* provides very little guidance on measurement. The Discussion Paper discussed:
- (a) how the objective of financial reporting and qualitative characteristics of useful financial information influence measurement requirements;
 - (b) three categories of measurement bases; and
 - (c) how to identify an appropriate measurement basis and the implications of the proposed approach for particular types of assets and liabilities.
- BC6.2 Many respondents agreed with the overall approach to measurement suggested in the Discussion Paper. Their comments on particular aspects of that approach are discussed in the following paragraphs. However, some respondents suggested that the IASB should undertake further research on measurement and either:
- (a) delay issuing a revised *Conceptual Framework* until that research is completed;
 - (b) issue a revised *Conceptual Framework* without a measurement section; or
 - (c) develop high level interim guidance on measurement for use until rigorous concepts and principles can be developed.
- BC6.3 The lack of guidance on measurement is a serious gap in the existing *Conceptual Framework* and many respondents to the Discussion Paper broadly supported the suggested approach to measurement. Moreover, the IASB believes that it is not necessary or appropriate to delay all or part of the *Conceptual Framework* to undertake more research on measurement. The IASB also does not support the idea of issuing high level interim guidance. High level guidance may not be sufficient to help the IASB develop measurement requirements and could be in place for a long time.
- BC6.4 Some respondents expressed the view that the measurement section of the Discussion Paper contained too much Standards-level detail. The IASB agrees with them and has removed some of that detail.
- BC6.5 Accordingly, Chapter 6 of the Exposure Draft focuses on:
- (a) measurement bases, the information they provide and their advantages and disadvantages (paragraphs BC6.15–BC6.37); and
 - (b) the factors to consider when selecting a measurement basis (paragraphs BC6.41–BC6.68).
- BC6.6 Paragraphs BC6.7–BC6.14 discuss the mixed measurement basis approach proposed in the Exposure Draft.

Mixed measurement basis (paragraph 6.3)

- BC6.7 When developing both the Discussion Paper and the Exposure Draft, the IASB considered whether the *Conceptual Framework* should advocate a single or default measurement basis. The main advantages of a single measurement basis are:

- (a) the amounts included in the financial statements can be more meaningfully added, subtracted and compared; and
 - (b) a single measurement basis makes the financial statements less complex and, arguably, more understandable.
- BC6.8 However, the Discussion Paper suggested that a single measurement basis for all assets, liabilities, income and expenses may not always provide the most relevant information to users of financial statements. Hence, the Discussion Paper suggested that the *Conceptual Framework* should adopt a mixed measurement basis approach.
- BC6.9 Nearly all respondents to the Discussion Paper who commented on this issue agreed that a single measurement basis for all assets, liabilities, income and expenses may not provide the most relevant information to users of financial statements.
- BC6.10 A few respondents disagreed with the suggestion to adopt a mixed measurement basis approach and proposed one of the following as a single or default measurement basis:
- (a) historical cost;
 - (b) fair value;
 - (c) current entry value (such as current cost, see paragraph BC6.18(a)); or
 - (d) deprival (relief) value (see paragraph BC6.18(c)).
- BC6.11 One respondent suggested that a single measurement basis could be derived if the IASB identified an ideal concept of wealth that would meet the information needs of users of financial statements.
- BC6.12 Most of the respondents who suggested the use of a single measurement basis conceded that this could not be achieved in practice, at least in the short term. However, they expressed the view that the *Conceptual Framework* should aspire to a single measurement basis and that the IASB should be required to explain any decisions not to use that measurement basis.
- BC6.13 When developing the Exposure Draft, the IASB noted that different information, derived from different measurement bases, may be relevant to users of financial statements in different circumstances. In addition, in particular circumstances, particular measurement bases may be:
- (a) easier to understand and implement;
 - (b) more verifiable, less prone to error or subject to less measurement uncertainty; or
 - (c) less costly to implement.
- BC6.14 Hence, the IASB has concluded that consideration of the objective of financial statements, the qualitative characteristics of useful information and the cost constraint is likely to result in the selection of different measurement bases for different assets and liabilities.

Measurement bases and the information they provide (paragraphs 6.4–6.47)

- BC6.15 The Discussion Paper grouped measures into three categories:
- (a) cost-based measures;
 - (b) current market prices including fair value; and
 - (c) other cash-flow-based measures.
- BC6.16 A few respondents to the Discussion Paper stated that they found the discussion of the three different categories of measures to be confusing. In particular, it was not always clear how a particular measurement basis would be categorised. Other respondents suggested that the *Conceptual Framework* should identify only two measurement categories: cost-based measures and current measures. Cash-flow-based measures would then be identified as techniques used in estimating either a cost-based measure or a current measure.
- BC6.17 The IASB agrees that:
- (a) the discussion would be clearer if measurement bases were characterised as either historical cost measurement bases or current value measurement bases. Hence, the Exposure Draft describes these two categories of measurement basis. Paragraphs BC6.19–BC6.23 discuss historical cost and paragraphs BC6.24–BC6.30 discuss current value measurement bases.
 - (b) cash-flow-based measurement techniques are generally used to estimate the measure of an asset or a liability on a defined measurement basis. Consequently, the Exposure Draft does not identify those techniques as a separate category of measurement basis. Paragraphs BC6.31–BC6.33 discuss those techniques.
- BC6.18 A few respondents to the Discussion Paper stated that the discussion of measurement bases should include more about the following areas:
- (a) the use of entry and exit values. The IASB rejected the idea of categorising measurement bases according to whether they provide information about the inputs to an entity's business activities (ie entry values such as historical cost and current cost) or information about the outputs from an entity's business activities (ie exit values such as fair value, value in use and fulfilment value). The IASB thinks that there is often little difference between entry and exit values in the same market, except for transaction costs, which are discussed in paragraphs BC6.34–BC6.37.
 - (b) the use of entity-specific values and market values. The Exposure Draft identifies, where relevant, measurement bases as entity-specific values or market values and discusses the different information that they provide.
 - (c) the role of deprival (relief) value as a measurement basis. The deprival (relief) value of an asset (liability) is the loss (benefit) that an entity would suffer (enjoy) if it were deprived (relieved) of the asset (liability) being measured. The IASB discussed the use of deprival (relief) value. However,

the IASB did not include a discussion of this approach to measurement in the Exposure Draft, because it is more complex than other measurement bases and is not well accepted in some jurisdictions. Hence, the IASB thinks that it is unlikely to use this approach when developing new Standards.

- (d) the treatment of transaction costs. The proposed guidance on this topic is discussed in paragraphs BC6.34–BC6.37.

Historical cost

- BC6.19 The Exposure Draft identifies historical cost measures as measures that provide monetary information about assets, liabilities, income and expenses using information from the past transaction or event that created them.
- BC6.20 The Exposure Draft explains that historical cost is initially the value of all the costs incurred to acquire or construct an asset, or the value of the net consideration received to take on a liability. Whether that initial value is fair value, or some other value, will be a Standards-level decision.
- BC6.21 In response to comments from some respondents to the Discussion Paper, the IASB expanded the description of historical cost for non-financial assets and non-financial liabilities. In particular, the Exposure Draft explains that the historical cost:
 - (a) of assets is decreased as the asset is consumed (depreciation or amortisation) or if it becomes impaired; and
 - (b) of liabilities is decreased as they are fulfilled and increased if they become so onerous that the historical consideration is no longer sufficient to depict the requirement to fulfil the liability.
- BC6.22 The amortised cost basis of measurement for financial assets and financial liabilities combines information about the historical yield of financial assets and financial liabilities with updated estimates of cash flows. The Exposure Draft categorises the amortised cost basis of measurement for financial assets and financial liabilities as a historical cost measurement basis. This reflects the fact that the amortised cost of financial assets and financial liabilities is not adjusted to reflect subsequent changes in prices.
- BC6.23 Paragraph 6.18 of the Exposure Draft contains a brief discussion of current cost as a measurement basis. The IASB noted that a detailed discussion of current cost would be unnecessary because the IASB would be unlikely to consider selecting current cost as a measurement basis when developing future Standards.

Current value

- BC6.24 The Exposure Draft identifies current measurement bases as measures that provide monetary information about assets, liabilities, income and expenses, using information that is updated to reflect conditions at the measurement date. It goes on to describe fair value, value in use (for assets) and fulfilment value (for liabilities) as examples of current measurement bases.

- BC6.25 The description of fair value in the Exposure Draft is consistent with its description in IFRS 13 *Fair Value Measurement*. The descriptions of value in use and fulfilment value are derived from the definition of entity-specific current value in IAS 16 *Property, Plant and Equipment*, which is the most explicit of the various definitions of entity-specific value in existing Standards.
- BC6.26 In existing Standards, value in use is used only in determining whether an asset measured at historical cost is impaired. Within that context, when an impairment loss has been recognised on an asset, the carrying amount of the asset equals the part of historical cost that is currently recoverable. Nevertheless, the IASB proposes in the Exposure Draft to describe value in use as a separate measurement basis because:
- (a) although value in use is used in determining recoverable historical cost, it differs conceptually from historical cost; and
 - (b) there may be situations in the future when the IASB decides that an entity should measure an asset using an entity-specific current value (ie value in use) instead of fair value.
- BC6.27 The Exposure Draft explains that value in use and fulfilment value reflect the same factors in their measurement as fair value, but base those factors on entity-specific assumptions instead of assumptions by market participants.
- BC6.28 Hence, value in use and fulfilment value reflect the price for bearing the uncertainty inherent in the cash flows (ie a risk premium). Including such a risk premium produces information that can be relevant, because it reflects the economic difference between items that are subject to different degrees of uncertainty. For example, the inclusion of a risk premium is already implicit in the way in which value in use is described in IAS 36 *Impairment of Assets*.¹⁴
- BC6.29 The Exposure Draft states that, to provide the most useful information, value in use and fulfilment value may need to be customised. In particular, the Exposure Draft notes that fulfilment value for liabilities may need to be customised so that the measure does not reflect the possibility of non-performance by the reporting entity. The IASB has found in many projects that the information provided by including non-performance risk is thought by many to be counterintuitive and not relevant. In addition, including in the measure of a liability the effect of a change in the entity's own non-performance risk may not faithfully represent the effect of the event that causes the change, because that event will probably also affect unrecognised assets (for example, unrecognised goodwill). Hence, although conceptually fulfilment value would reflect the risk of non-performance by the reporting entity, the IASB thinks that it might set Standards that would not require such risks to be reflected in an entity-specific measurement basis for a liability.
- BC6.30 The Exposure Draft does not describe the following current measurement bases:¹⁵

¹⁴ See paragraphs 55–56, A1 and A15–A21 of IAS 36.

¹⁵ The decision not to include in the Exposure Draft a detailed discussion of current cost is described in paragraph BC6.23.

- (a) net realisable value. Net realisable value depicts the estimated consideration from the sale of the asset adjusted for the estimated costs of sale. The IASB believes it is unnecessary to describe net realisable value separately, because it is simply a current measure for assets that has been reduced to reflect the estimated costs of sale.
- (b) cost of release. Cost of release depicts the estimated cost (including transaction costs) of obtaining release from a liability by negotiation with the counterparty. Because it is relatively unusual for entities to obtain release from liabilities, instead of fulfilling them, the IASB believes that it is unlikely that it would use this measurement basis.

Cash-flow-based measurement techniques (paragraphs 6.5 and A1–A10)

- BC6.31 As explained in paragraph BC6.17(b), cash-flow-based measurement techniques are techniques used in applying a defined measurement basis. The Exposure Draft includes a brief discussion of these techniques in Appendix A.
- BC6.32 The Discussion Paper discussed factors to consider when developing cash-flow-based measures. A few respondents suggested expanding this discussion to provide the IASB with more guidance on:
- (a) the use and determination of discount rates. As part of its research programme, the IASB is at present gathering evidence to help it assess whether to take on a project to develop guidance on the use and determination of discount rates.¹⁶
 - (b) whether the effect of changes in own credit risk should be included in a cash-flow-based measure (see paragraph BC6.29).
 - (c) approaches to dealing with uncertain cash flows (for example, using the mean, median or mode of a cash flow distribution, and the inclusion and calculation of a risk adjustment). Paragraphs A6–A10 of the Exposure Draft include a discussion of these approaches.
- BC6.33 The Exposure Draft notes that cash-flow-based measurement techniques can be used to customise measurement bases. Customising measurement bases could result in more relevant information for users of financial statements, but the resulting information may also be more difficult for users to understand. Hence, if the IASB decides to use a customised measurement basis, the Basis for Conclusions on the relevant Standard will explain the reasons for that decision.

Transaction costs (paragraphs 6.7–6.9, 6.26 and 6.37–6.38)

- BC6.34 Transaction costs can arise both when an asset (liability) is acquired (incurred) and when an asset (liability) is realised (settled or transferred). Defining which costs are transaction costs is beyond the scope of the *Conceptual Framework*. They are normally defined in particular Standards as incremental costs (other than the transaction price) that would not have been incurred if the particular asset (or liability) being measured had not been acquired (incurred) or realised

¹⁶ For the IASB to add a project to its active agenda, a formal agenda decision would be required.

(transferred or settled). The IASB frequently discusses the treatment of transaction costs when it discusses the measurement requirements for new or revised Standards. Consequently, the Exposure Draft proposes guidance on the treatment of transaction costs.

- BC6.35 Transaction costs incurred in acquiring an asset or taking on a liability are a feature of the original transaction in which the asset was acquired or the liability was incurred. Hence:
- (a) the cost of an asset or a liability reflects (among other things) the transaction costs of acquiring the asset or incurring the liability. Although the transaction costs are not part of the transaction price, the asset could not have been acquired or the liability incurred without incurring those transaction costs.
 - (b) if a measure is intended to depict the fair value, fulfilment value or value in use of an asset or a liability, the measure would not reflect those transaction costs. Those costs do not affect the current value of that asset or liability.
- BC6.36 Transaction costs that would be incurred in realising an asset, or settling or transferring a liability, are a feature of a possible future transaction. Hence:
- (a) because value in use depicts the present value of the cash flows that are estimated to arise from the continued use of the asset and from its disposal at the end of its useful life, estimated transaction costs on that disposal are deducted in arriving at those cash flows. Similarly, because fulfilment value depicts the present value of the cash flows needed to fulfil a liability, the transaction costs (if any) of fulfilment are included in those cash flows. As implied by their definitions, both value in use and fulfilment value reflect the present value of those cash flows.
 - (b) it would be inconsistent with historical cost measurement to reduce (increase) the cost-based measure of an asset (liability) to reflect transaction costs that will arise only if a future transaction occurs (historical cost uses information about past transactions). However, the transaction costs that would be incurred in realising an asset (or settling or transferring a liability) may become relevant in determining whether the asset is impaired (or whether the liability has become onerous) or in determining the residual value of an asset for depreciation purposes.
- BC6.37 A fair value measure depicts the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Because the costs to sell an asset (or transfer a liability) are not part of the price of the asset (or liability) that is being sold or transferred, they are not included in a fair value measure. However, this does not preclude the IASB from deciding that an entity should measure an asset at fair value less costs to sell (or a liability at fair value plus costs of transfer).

Objective of measurement (paragraphs 6.2 and 6.49)

- BC6.38 The Discussion Paper suggested that the objective of measurement is to contribute to the faithful representation of relevant information about:

- (a) the resources of the entity, claims against the entity and changes in resources and claims; and
 - (b) how efficiently and effectively the entity's management and governing body have discharged their responsibilities to use the entity's resources.
- BC6.39 Although many respondents to the Discussion Paper agreed with that suggested objective, some stated that it simply repeats the objective of financial reporting and the qualitative characteristics of useful information. Consequently, these respondents believe that the suggested objective would not provide useful guidance to the IASB in setting measurement requirements.
- BC6.40 The IASB agrees with these comments, but believes that it is important to provide a link between measurement and the objective of financial reporting. Hence, the Exposure Draft does not define an objective for measurement. Instead, it describes the measurement process (see paragraph 6.2 of the Exposure Draft) and the factors to consider when selecting a measurement basis in order to contribute to the overall objective of financial reporting (see paragraph 6.49 of the Exposure Draft).

Factors to consider when selecting a measurement basis (paragraphs 6.48–6.73)

- BC6.41 In order to meet the objective of financial reporting, information provided by a particular measurement basis must be useful to users of financial statements. A measurement basis achieves this if it provides information that is relevant and faithfully represents what it purports to represent. In addition, the selected measurement basis needs to provide information that is, as far as possible, comparable, verifiable, timely and understandable. The Exposure Draft discusses how these factors affect the selection of a measurement basis.
- BC6.42 Paragraph BC2.33 explains why there is an explicit reference to the cost constraint in the chapter on measurement.

Relevance

- BC6.43 The Exposure Draft discusses a number of factors that can affect the relevance of the information provided by a particular measurement basis:
- (a) effect on both the statement of financial position and the statement(s) of financial performance (see paragraph BC6.44);
 - (b) contribution to future cash flows (see paragraphs BC6.45–BC6.49);
 - (c) an entity's business activities (see paragraphs BC6.50–BC6.53);
 - (d) characteristics of an asset or a liability (see paragraphs BC6.54–BC6.55); and
 - (e) measurement uncertainty (see paragraphs BC6.56–BC6.57).

Effect on both the statement of financial position and the statement(s) of financial performance

- BC6.44 The Discussion Paper stated that selecting a measurement basis by considering the information that would be included in either the statement of financial

position alone or the statement(s) of financial performance alone will not usually produce the most relevant information for users of financial statements. Most respondents to the Discussion Paper agreed with this suggestion. However, some suggested that the IASB should give more weight to the effect that a particular measure would have on the statement(s) of financial performance. Nevertheless, the IASB believes that the relative importance of the information produced in the statement of financial position and the statement(s) of financial performance will depend on the circumstances. Hence, the Exposure Draft carries forward the suggestion made in the Discussion Paper unchanged.

Contribution to future cash flows

- BC6.45 The Discussion Paper suggested that the relevance of a particular measure will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement basis:
- (a) for a particular asset should depend on how that asset contributes to future cash flows; and
 - (b) for a particular liability should depend on how the entity will settle or fulfil that liability.
- BC6.46 A few respondents disagreed with this suggestion, arguing that the IASB should adopt a single or ideal measurement basis (see paragraphs BC6.7–BC6.14). However, most of those who commented agreed with this suggestion.
- BC6.47 The IASB continues to believe that the amounts included in the financial statements can be more relevant if the way in which an asset or a liability contributes to future cash flows is considered when selecting a measurement basis. Hence, this suggestion has been retained.
- BC6.48 Some respondents disagreed with referring to how investors, creditors and other lenders are likely to assess how a type of asset or liability will contribute to future cash flows. They stated that preparers are unlikely to know what assessments users would make and that investors, creditors and other lenders do not have the information to assess how an asset or a liability will contribute to future cash flows. The IASB agrees with those comments. Consequently, the IASB has removed the reference to the assessments of investors, creditors and other lenders.
- BC6.49 Respondents expressed concerns that the Discussion Paper contained too much Standards-level detail on the implications for subsequent measurement of how an asset or a liability contributes to future cash flows. In response, the IASB has removed much of that discussion.

An entity's business activities

- BC6.50 The IASB considers that the way in which an asset or a liability contributes to future cash flows depends, in part, on the nature of the business activities being conducted. For example:
- (a) non-financial assets can be sold as inventory, leased to another entity or used in the entity's business;

- (b) financial assets can be held to collect cash flows or be sold;
 - (c) a non-financial institution will normally repay its financial liabilities in accordance with their contractual terms instead of seeking to transfer them to a third party;
 - (d) a financial institution is likely to seek a net cash settlement of a commodity contract (by closing out the contract) instead of receiving, and paying for, the underlying commodity; and
 - (e) a provider of services will normally fulfil its performance obligations by providing services instead of seeking release from the contract from its customer and instead of transferring the obligation to a third party.
- BC6.51 Some respondents to the Discussion Paper feared that inconsistencies and subjectivity could result if the nature of the business activities were to be considered when selecting a measurement basis. However, the IASB believes that:
- (a) measuring in the same way assets (or liabilities) that contribute to cash flows differently could reduce comparability by making things that are different appear the same.¹⁷
 - (b) in many cases, the nature of the business activities is a matter of fact instead of an opinion or management intent. When this is not the case, the IASB will need to consider how to address any subjectivity.
- BC6.52 The Exposure Draft, therefore, states that how an asset or a liability contributes to future cash flows will depend, in part, on the nature of the business activities being conducted.
- BC6.53 Some respondents to the Discussion Paper argued that the IASB should identify long-term investment as a particular type of business activity and develop specific measurement requirements for entities conducting that business activity. However, the IASB believes that the *Conceptual Framework* need not (and should not) refer explicitly to any particular business activity, such as long-term investment, for the reasons set out in paragraphs BCIN.35–BCIN.38.

Characteristics of an asset or a liability

- BC6.54 The Discussion Paper suggested that for some financial assets and financial liabilities (for example, derivatives), selecting a measurement basis by considering how the asset or the liability contributes to future cash flows may not provide information that is useful in assessing prospects for future cash flows. Instead, the characteristics of the asset or liability would be a key factor in selecting a measurement basis. The Discussion Paper went on to describe when cost-based information may not be useful in the case of financial assets that are held for collection or financial liabilities that are fulfilled in accordance with their terms. Although many respondents to the Discussion Paper agreed with these suggestions, some expressed the view that these were Standards-level conclusions.

¹⁷ Paragraph QC23 of the *Conceptual Framework* (paragraph 2.26 of the Exposure Draft) states: 'Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different.'

- BC6.55 The IASB acknowledges that the suggestion in the Discussion Paper was phrased in a way that made it look like a Standards-level decision. However, the IASB believes that underpinning the suggestion is an important idea that the characteristics of an asset or a liability are one of the factors that need to be considered when selecting a measurement basis. One example of that factor is the nature or extent of the variability in the item's cash flows or the sensitivity of the item's value to changes in market factors or to other risks inherent in the item.

Measurement uncertainty

- BC6.56 Some respondents to the Discussion Paper suggested that one factor to be considered in selecting a measurement basis is the degree of measurement uncertainty associated with each measurement basis. Some respondents use the term 'reliability' to describe that factor. For reasons noted in paragraphs BC2.21–BC2.25, the IASB proposes not to reintroduce the term reliability to describe that factor. However, paragraph 2.13 of the Exposure Draft states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may have little relevance, even if the estimate is properly described and disclosed. Consequently, the IASB believes that the level of uncertainty associated with the measurement of an item should be considered when assessing whether a particular measurement basis provides relevant information. However, it is only one of the factors that should be considered in that assessment. Sometimes a measure with a high degree of uncertainty provides the most relevant information about an item. For example, this may be the case with many financial instruments for which prices are not observable.
- BC6.57 Some respondents to the Discussion Paper stated that applying prudence as they understand the term would imply that the tolerable level of measurement uncertainty would be greater for liabilities than for assets (see paragraphs BC2.1–BC2.15). The IASB thinks that the level of measurement uncertainty that makes information lack relevance depends on the circumstances and can only be decided when developing particular Standards. Hence, the *Conceptual Framework* neither requires nor prohibits setting different levels of tolerable measurement uncertainty for assets and liabilities.

Faithful representation (paragraphs 6.57–6.58)

- BC6.58 The Discussion Paper suggested that:
- (a) although a faithful representation is free from error, that does not mean that measures must be perfectly accurate in all respects; and
 - (b) when deciding whether a particular measure faithfully represents an entity's financial position and financial performance, it may be necessary to consider how best to portray any link between items.
- BC6.59 Few respondents to the Discussion Paper commented on these suggestions. The IASB still supports these suggestions and has carried them forward to the Exposure Draft.

- BC6.60 A few respondents objected to the statement in the Discussion Paper that an estimate of an unobservable price can be a faithful representation if adequate disclosures are made. They agreed that an estimate of an unobservable price could be a faithful representation of that estimate. However, they argued that, if the uncertainties associated with an estimate are too large, the estimate cannot be a faithful representation of the item itself. The IASB thinks that these concerns are addressed, at least in part, by:
- (a) the statement in paragraph 2.20 of the Exposure Draft (paragraph QC17 of the existing *Conceptual Framework*) that, to be useful, information must be both relevant and faithfully represented; and
 - (b) the discussion of the role of measurement uncertainty in selecting a measurement basis (see paragraphs BC6.56–BC6.57).

Enhancing qualitative characteristics (paragraphs 6.59–6.63)

- BC6.61 The existing *Conceptual Framework* identifies four ‘enhancing qualitative characteristics’ that make financial information more useful: comparability, verifiability, timeliness and understandability.
- BC6.62 The Discussion Paper suggested that the understandability of financial statements could be enhanced if the number of different measurement bases used is limited to the smallest number necessary to provide relevant information. Many of those who commented agreed with this suggestion. However, some respondents disagreed, stating that there should not be an artificial limit on the number of measurement bases used. In their view, a different measurement basis should be selected if it will provide relevant information to the users of financial statements.
- BC6.63 It was not the IASB’s intention to impose an artificial limit on the number of measurement bases used. A different measurement basis should be used if it will provide the most relevant information to users of financial statements. Hence, the IASB has replaced the statement that the number of different measurement bases used should be limited to the smallest number necessary with a discussion (in paragraph 6.62 of the Exposure Draft) on the advantages and disadvantages of introducing new or different measurement bases.
- BC6.64 The Discussion Paper also suggested that the understandability of financial statements would be enhanced by avoiding unnecessary changes in measurement bases and by explaining necessary changes. Most respondents who commented agreed with this suggestion. The Exposure Draft retains that discussion and clarifies that avoiding unnecessary measurement changes does not preclude:
- (a) current values being used as a deemed cost on initial measurement (see paragraph 6.11 of the Exposure Draft); or
 - (b) a change in measurement basis to enhance the relevance of the information provided (see paragraph 6.63 of the Exposure Draft).

BC6.65 The Discussion Paper also discussed the implications of the enhancing qualitative characteristics of timeliness, verifiability and comparability for measurement. Few respondents commented on this discussion. Those commenting suggested that:

- (a) verifiability has a significant role to play in the selection of a measurement basis; and
- (b) comparability could be enhanced by removing the ability for preparers to choose between measurement bases.

BC6.66 The IASB believes that the discussion of verifiability in the Discussion Paper appropriately reflected the importance of verifiability as one of the factors that should be considered when selecting a measurement basis. In addition, paragraph 2.28 of the Exposure Draft (paragraph QC25 of the existing *Conceptual Framework*) already acknowledges that permitting alternative accounting methods for the same economic phenomenon diminishes comparability. Consequently, the Exposure Draft includes the discussion of verifiability and comparability suggested in the Discussion Paper, largely unchanged. The IASB considers that the enhancing qualitative characteristic of timeliness has few implications for the selection of a measurement basis.

Factors to consider on initial recognition (paragraphs 6.64–6.73)

BC6.67 The Discussion Paper included a discussion on factors to consider when deciding how to measure an asset or a liability on initial recognition. Few respondents commented on that discussion. However, a few stated that the discussion was too prescriptive for the *Conceptual Framework*. In response, the IASB has shortened that discussion and removed some Standards-level detail.

More than one relevant measurement basis (paragraphs 6.74–6.77)

BC6.68 The IASB considers that, in some cases, consideration of the objective of financial reporting, and of the qualitative characteristics of useful financial information, will indicate that using more than one measurement basis for the same item in the same financial statements could provide useful information to the users of financial statements. Hence, the Exposure Draft discusses how information about more than one measurement basis could be provided.

Measurement of equity (paragraphs 6.78–6.80)

BC6.69 Although total equity is not measured directly, the IASB considers that, in order to provide useful information, it may be necessary to measure directly individual classes or categories of equity. Hence, the Exposure Draft discusses this notion.

Chapter 7—Presentation and disclosure

Introduction

- BC7.1 Presentation and disclosure are not addressed in the existing *Conceptual Framework*. Respondents to the Agenda Consultation 2011 identified presentation and disclosure as a priority topic. A particular issue identified was providing information about an entity's financial performance, including the use of other comprehensive income (OCI).
- BC7.2 In response to that feedback:
- (a) the Exposure Draft proposes:
 - (i) high level concepts that describe what information is included in financial statements (see paragraphs 7.2–7.7) and how that information should be presented and disclosed (see paragraphs 7.8–7.18). Those concepts would guide the IASB in setting presentation and disclosure requirements in Standards and would guide entities in providing information in financial statements.
 - (ii) guidance on reporting financial performance, including the use of OCI (see paragraphs 7.19–7.27);
 - (b) the IASB is undertaking:
 - (i) a Disclosure Initiative, a collection of implementation and research projects aimed at improving disclosure in IFRS financial reporting. In the Disclosure Initiative, the IASB will seek to provide additional specific guidance to support the application of the presentation and disclosure concepts proposed in the Exposure Draft.
 - (ii) a research project to explore whether to add to its agenda a project on performance reporting.
- BC7.3 The following paragraphs discuss:
- (a) objective and scope of financial statements (see paragraphs BC7.4–BC7.16);
 - (b) presentation and disclosure as communication tools (see paragraphs BC7.17–BC7.23); and
 - (c) information about financial performance (see paragraphs BC7.26–BC7.57).

Objective and scope of financial statements (paragraphs 7.2–7.7)

- BC7.4 The Discussion Paper suggested introducing in the *Conceptual Framework* the term 'primary financial statements' to collectively refer to:
- (a) the statement of financial position;
 - (b) the statement(s) of financial performance;

- (c) the statement of changes in equity; and
- (d) the statement of cash flows.

- BC7.5 The Discussion Paper also suggested setting out in the *Conceptual Framework* separate objectives for the identified primary financial statements and the notes to the financial statements. However, the Exposure Draft does not identify primary financial statements nor does it propose separate objectives for the individual statements within the financial statements or the notes to the financial statements. The IASB considers that such definitions and objectives are best considered in the Performance Reporting project and the Disclosure Initiative.
- BC7.6 However, the IASB considers that setting out an objective for the financial statements as a whole would clarify their scope and, hence, clarify the boundary between financial statements and other forms of financial reports, such as management commentary.
- BC7.7 The IASB proposes, for use in the *Conceptual Framework*, an adapted and updated version of the objective of financial statements set out in IAS 1 *Presentation of Financial Statements*. Paragraph 9 of IAS 1 states:
- Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. To meet this objective ...
- BC7.8 The proposed objective of financial statements is set out in paragraph 3.4 of the Exposure Draft. It differs from the objective in IAS 1 in the following ways:
- (a) in order to provide a link to the elements of financial statements, the objective in the Exposure Draft refers to:
 - (i) assets, liabilities and equity instead of the financial position; and
 - (ii) income and expenses instead of financial performance.
 - (b) the objective in the Exposure Draft does not refer to providing information about cash flows. Although information about cash and cash flows is important to users of financial statements, cash flows are not identified as separate elements of financial statements in the *Conceptual Framework*.
 - (c) the objective in the Exposure Draft describes what makes information useful to users of financial statements (ie the information needs to be useful in assessing prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's resources).
- BC7.9 Paragraphs 7.2–7.7 of the Exposure Draft summarise the types of information that financial statements normally include. However, the Exposure Draft does not include more detailed examples of the types of disclosures, such as roll-forwards and reconciliations. Although the Discussion Paper discussed such

examples, a discussion of such disclosures is too detailed for the *Conceptual Framework*. Instead, the IASB will explore disclosure of this type in its Disclosure Initiative.

- BC7.10 The Discussion Paper suggested that the objectives of presentation and disclosure do not include providing information that enables a user of financial statements to recalculate the amounts recognised in the primary financial statements. A few respondents did not support this suggestion. They argued that such information could be useful in making economic decisions. However, the IASB believes that the Disclosure Initiative would be the best place to discuss whether providing such information is necessary to meet the objective of financial statements. Hence, the Exposure Draft does not comment on this aspect of presentation and disclosure.

Information about risks (paragraph 7.3(a))

- BC7.11 The Exposure Draft proposes that financial statements should provide information about the nature of recognised and unrecognised items that meet the definition of an element and about the risks arising from them. Some respondents to the Discussion Paper expressed a concern that the term 'risk' is not defined. Hence, 'information about risks' could be understood to include almost any type of information, including information that could be best placed outside the financial statements. For example, some argued that the information about how an entity manages risk belongs outside the financial statements.
- BC7.12 However, the IASB noted that information about the risks associated with an entity's existing assets and liabilities is likely to be useful in assessing the entity's ability to generate cash flows and also in assessing management's stewardship of the entity's resources. Thus, this information contributes to meeting the objective of financial statements.

Forward-looking information (paragraphs 7.4–7.6)

- BC7.13 The Discussion Paper proposed that forward-looking information should be required in financial statements only if it provides relevant information about the assets and the liabilities that existed at the end of, or during, the reporting period. Other types of relevant forward-looking information could be presented outside the financial statements.
- BC7.14 Some respondents to the Discussion Paper argued that the suggested description of forward-looking information that should be included in the financial statements is too narrow and could result in excluding useful information. For example, they argued that this description could exclude from the financial statements information about some types of non-adjusting events, as defined in IAS 10 *Events after the Reporting Period*.
- BC7.15 Other respondents also expressed a concern about the suggested description of the types of forward-looking information that could be included in the financial statements. They stated that the description would be too broad.
- BC7.16 The IASB continues to believe that financial statements should focus on providing information about an entity's assets, liabilities and equity that existed

at the end of, or during, the period and income and expenses for the reporting period. However, it also notes that information about transactions or events that have occurred after the end of the reporting period (including the non-adjusting events identified in IAS 10) is not forward-looking information. It is information about events that have occurred. Thus, paragraph 7.6 of the Exposure Draft states that it may be necessary to provide such information to meet the proposed objective of financial statements.

Presentation and disclosure as communication tools (paragraphs 7.8–7.18)

- BC7.17 The Discussion Paper included a discussion of classification, aggregation and offsetting in financial statements. The IASB received little specific feedback on this discussion. Hence, the IASB has included an updated discussion of these issues in the Exposure Draft.
- BC7.18 The Discussion Paper described presentation and disclosure as the mechanisms by which a reporting entity communicates information about its financial position and financial performance to users of financial statements. To help make that communication more effective, the Discussion Paper suggested:
- (a) that each Standard that sets out presentation and disclosure requirements should have a clear objective that would guide entities in determining how best to provide information in the financial statements; and
 - (b) specific communication principles that the IASB should consider when it sets presentation and disclosure requirements in Standards.
- BC7.19 Many respondents who commented on the communication principles agreed with including those principles in the *Conceptual Framework*. However, some respondents suggested that some or all of the communication principles suggested in the Discussion Paper would be better placed in a Standard, such as IAS 1.
- BC7.20 The feedback received on the communication principles suggested in the Discussion Paper is generally consistent with the feedback from the IASB's Discussion Forum on Financial Reporting Disclosure, held in January 2013. Participants in that forum, including investors and preparers, agreed that financial reports are an important communication tool that should enable preparers 'to tell the story' and investors 'to hear the story'.
- BC7.21 Consequently, the IASB proposes that the *Conceptual Framework* should:
- (a) discuss how presentation and disclosure contributes to effective communication (see paragraphs 7.8–7.15 of the Exposure Draft);
 - (b) include an explicit reference to the cost constraint in the chapter on presentation and disclosure (see paragraph BC2.33);
 - (c) explain how presentation and disclosure objectives in Standards help entities to communicate information effectively and efficiently (see paragraphs 7.16–7.17 of the Exposure Draft); and

- (d) specify presentation and disclosure principles that facilitate effective communication of useful financial information (see paragraph 7.18 of the Exposure Draft).
- BC7.22 Some of the communication principles suggested in the Discussion Paper focus more on the preparation of the financial statements than on the underlying concepts. Accordingly, the IASB proposes to include in the *Conceptual Framework* communication principles that describe the underlying concepts and to explore whether to provide additional guidance in the Disclosure Initiative.

Financial statements in an electronic format

- BC7.23 The Discussion Paper suggested that, when developing presentation and disclosure requirements, the IASB may need to consider the impact of technology and to support advances in its application and wider use. The IASB received little specific feedback on that suggestion. However, as suggested by many of those who did comment on this topic, the IASB has not included such a discussion in the Exposure Draft.

Information about financial performance (paragraphs 7.19–7.27)

Terminology

- BC7.24 The Exposure Draft uses the term ‘statement(s) of financial performance’ to refer to the combination of the statement of profit or loss and the statement of other comprehensive income.¹⁸ The Exposure Draft uses this term because it is consistent with the term ‘statement of financial position’ that is used in existing Standards and is clearer than the term ‘comprehensive income’.
- BC7.25 Existing Standards use the term ‘other comprehensive income’ to refer to income and expenses recognised outside the statement of profit or loss. Feedback on the Discussion Paper suggested that this term is not particularly descriptive or well understood, particularly by investors. Nonetheless, the IASB considers that avoiding the use of the term or using a different term to refer to income and expenses recognised outside profit or loss could be confusing. Hence, the Exposure Draft refers to ‘other comprehensive income’.

Discussion Paper

- BC7.26 The Discussion Paper:
- (a) discussed principles that could be used to determine whether income and expenses should be included in the statement of profit or loss or in other comprehensive income (‘OCI’). In particular the Discussion Paper suggested that:
 - (i) income and expenses included in the statement of profit or loss provide the primary source of information about the return that an entity has made on its economic resources in a period; and

¹⁸ The Exposure Draft does not specify whether the statement(s) of financial performance comprise a single statement or two statements.

- (ii) all income and expenses should be included in the statement of profit or loss unless including an item in OCI enhances the relevance of the statement of profit or loss for that period.
 - (b) suggested that the *Conceptual Framework* should permit or require at least some OCI items to be reclassified (recycled) from OCI to profit or loss.
 - (c) suggested that the *Conceptual Framework* should require a total or subtotal for profit or loss.
- BC7.27 In addition, the Discussion Paper discussed an alternative approach whereby:
- (a) income and expenses included in OCI would not be recycled to the statement of profit or loss;
 - (b) the *Conceptual Framework* would not require a total or subtotal for profit or loss; and
 - (c) the *Conceptual Framework* would not describe which items of income and expenses should be included in the statement of profit or loss.

Feedback on the Discussion Paper

- BC7.28 Some respondents to the Discussion Paper agreed with the proposal to address the reporting of income and expenses in the statement of profit or loss, and OCI, in the *Conceptual Framework*. However, others stated that it is more appropriate to address those topics in Standards.
- BC7.29 Respondents also expressed mixed views on most of the proposals on the reporting of income and expenses in the statement of profit or loss and OCI. Some respondents supported more extensive use of OCI whereas others advocated less use of OCI. Some respondents supported subsequent recycling of some, or all, income and expenses included in OCI to the statement of profit or loss. However, their views varied on which items should be recycled and on when those items should be recycled to the statement of profit or loss. Other respondents opposed recycling in principle.
- BC7.30 Regardless of their views on the types of income and expenses that should be included in OCI and on recycling, most respondents agreed that the *Conceptual Framework* should refer to a total or subtotal for profit or loss. The few respondents who disagreed with requiring such a total or subtotal instead advocated a single statement of performance that would not draw a line between profit or loss and OCI (ie they favoured the alternative approach described in paragraph BC7.27).
- BC7.31 Many respondents stated that the use of profit or loss and OCI requires further thought and analysis. Some urged the IASB either to define financial performance or OCI or to define, or directly describe, profit or loss and its purpose. Other respondents acknowledged the difficulty of developing such definitions and pointed out that decades of research and numerous attempts at producing such definitions have not yielded a satisfactory result. Only a few respondents suggested how the IASB might approach developing such definitions. Most of those suggestions did not extend beyond the approaches already considered and rejected by the IASB in developing the Discussion Paper. A few respondents proposed variations of those approaches or new approaches.

For example, one respondent suggested describing profit or loss as an all-inclusive measure of irreversible outcomes. These suggestions were considered by the IASB as part of the feedback on the Discussion Paper.

- BC7.32 Views expressed by investors and analysts were also mixed and were generally consistent with other feedback received. In addition, many investors and analysts made the following comments:
- (a) there are many facets to an entity's performance and no single performance number would be suitable for all users' needs;
 - (b) the use of OCI and of recycling are not well understood by the user community and OCI is not looked at by many users; and
 - (c) users need transparency and meaningful disaggregation of information in financial statements, including the appropriate use of totals and subtotals, regardless of whether OCI exists as a separate category.

Approach to reporting financial performance

- BC7.33 Having considered the feedback received on the Discussion Paper, the IASB discussed whether to explore the use of the statement of profit or loss and OCI in a separate research project instead of providing guidance in the *Conceptual Framework*. However, the IASB concluded that conceptual guidance on this issue is urgently needed.
- BC7.34 The IASB noted that respondents to the Discussion Paper and others have consistently asked the IASB to define, or better describe, profit or loss or OCI or to define financial performance. However, the IASB's previous work on presentation and disclosure, as well as its work in developing the Discussion Paper, has shown that no single characteristic can be used to separate items of income and expenses usefully into two clear-cut categories, with all items within one category sharing the same characteristic. For example, many items currently included in OCI are remeasurements of assets or liabilities expected to be held for a long period. However, some such remeasurements are currently included in the statement of profit or loss. Feedback from users suggests that there is little appetite for including those particular remeasurements in OCI. The conclusion that income and expenses cannot be divided consistently into two categories in a manner that would provide useful information is also consistent with the idea that there are many facets of an entity's financial performance (see paragraph BC7.32).
- BC7.35 In addition, in developing proposals for the use of OCI, the IASB has considered the current and proposed use of OCI in Standards. The IASB notes that whereas each use of OCI has an explanation, there is no single conceptual basis that underlies all of those cases.
- BC7.36 Accordingly, the IASB decided that it is not feasible or appropriate to attempt to define, or precisely describe, in the *Conceptual Framework* when an item of income or expenses should be included in the statement of profit or loss or OCI. Instead, the IASB proposes to include in the *Conceptual Framework* high level guidance on this topic and on subsequent reclassification.

- BC7.37 In developing the Exposure Draft, the IASB built on the high level principles discussed in the Discussion Paper (see paragraph BC7.26). However, it did not develop further the more specific suggestions in the Discussion Paper on the types of income and expenses that could be included in OCI and the related approaches to recycling. Respondents did not generally find those more specific suggestions helpful as a way of analysing this topic.

Describing the statement of profit or loss (paragraphs 7.19–7.22)

- BC7.38 The Exposure Draft proposes that the *Conceptual Framework* should:
- (a) describe the statement of profit or loss as the primary source of information about an entity's financial performance for the period;
 - (b) require a total or subtotal for profit or loss; and
 - (c) state explicitly that the purpose of the statement of profit or loss is to both:
 - (i) depict the return that an entity has made on its economic resources during the period; and
 - (ii) provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources.
- The IASB thinks that it is important to emphasise this dual purpose of the statement of profit or loss to prevent excessive focus on one purpose over another.
- BC7.39 Describing the statement of profit or loss in this way would reflect the feedback from some respondents who argued that profit or loss is the primary measure of performance and, for that reason, its prominence should be established in the *Conceptual Framework*. The IASB noted that such a description would also be consistent with how the statement of profit or loss is used in practice. That is, many users incorporate the total or subtotal for profit or loss in their analysis, either as a starting point or as the main indicator of an entity's financial performance.
- BC7.40 On the other hand, the Exposure Draft emphasises that the statement of profit or loss is not the only source of information about an entity's financial performance for the period. An in-depth understanding of performance requires an analysis of all recognised income and expenses (including income and expenses included in OCI), as well as other information included in the financial statements.
- BC7.41 The IASB acknowledges that merely describing the statement of profit or loss would be unlikely to satisfy those who asked for a definition of 'profit or loss'. However, as discussed in paragraphs BC7.34–BC7.36, the IASB did not think that a robust and appropriate definition of profit or loss would be feasible for the *Conceptual Framework*.

Presumption of inclusion in the statement of profit or loss (paragraph 7.23)

- BC7.42 If the statement of profit or loss is the primary source of information about an entity's financial performance for the period, it follows that excluding income and expenses from that statement without compelling reasons could undermine the usefulness of that statement. That is, the statement of profit or loss should be as inclusive as possible.
- BC7.43 Accordingly, the Exposure Draft includes a presumption that income and expenses will be included in the statement of profit or loss. Only in limited circumstances could the IASB require, or permit, income and expenses (or a component of income and expenses) to be excluded from the statement of profit or loss and, hence, be included in OCI. Those circumstances would be when the IASB concludes that doing so would enhance the relevance of the information in the statement of profit or loss for the period.
- BC7.44 Only the IASB when setting Standards would be able to rebut the presumption that an item of income or expenses should be reported in the statement of profit or loss. Preparers would not be able to rebut that presumption, because IAS 1 prohibits the inclusion of items of income and expenses in OCI when no Standard permits or requires this.

Types of income and expenses (paragraphs 7.23–7.24)

- BC7.45 The IASB discussed whether the *Conceptual Framework* should require the following types of income and expenses to be included in the statement of profit or loss:
- (a) income and expenses arising on initial recognition of an asset or a liability;
 - (b) income and expenses arising on assets and liabilities measured at historical cost;
 - (c) the following types of income and expenses arising on assets and liabilities carried at current values:
 - (i) consumption of the economic resource that constitutes the asset (depreciation or amortisation);
 - (ii) accrual of interest, accretion of a discount or amortisation of a premium on acquisition; or
 - (iii) impairment of assets or increases in the carrying amount of liabilities that have become onerous.
 - (d) dividend income.
- BC7.46 The IASB considers that a detailed list would be inappropriate in the *Conceptual Framework*. However, the IASB noted that the items listed in paragraph BC7.45 relate to transactions and events of the period, such as consumption of an asset or interest income and expenses, but not to other changes in the value of assets and liabilities. Classifying income and expenses arising from transactions and events separately from changes in value can provide useful information.

BC7.47 Hence, consistently with the suggestions in the Discussion Paper, the IASB proposes to specify that only income and expenses related to changes in current value measures of assets and liabilities (remeasurements), or components of such income and expenses, could be included in OCI. Income and expenses related to changes in a historical cost measure of assets and liabilities would need to be included in the statement of profit or loss. Likewise, if an asset or a liability is being measured on a current value basis, but components of income and expenses of the type that would arise if the asset or liability were measured at historical cost are identified separately, those components would need to be included in the statement of profit or loss. This is because excluding such items from the statement of profit or loss would not enhance the confirmatory or predictive value of the information included there. Table 6.1, following paragraph 6.47 of the Exposure Draft, sets out the types of income and expenses that arise under a historical cost basis.

BC7.48 Recognising some items of income and expenses in the statement of profit or loss, and some items in OCI, is a particular case of classification, namely classification between two separate statements (or, within a single statement between profit or loss and OCI). As stated in paragraph 7.11 of the Exposure Draft, separate classification is appropriate when the components have such different characteristics that classifying them separately would enhance the relevance and understandability of financial information. Paragraph 7.10 notes that such characteristics include, but are not limited to, the role (function) of the item within the business activities conducted by the entity and how it is measured.

Use of more than one measurement basis (paragraph 7.25)

BC7.49 One example of when components of income and expenses will be included in OCI is when the IASB selects a current measurement basis for an asset or a liability in the statement of financial position and selects a second measurement basis for determining the related income and expenses in the statement of profit or loss (a 'dual measurement' approach). When such an approach is used:

- (a) the current measurement basis is used in the statement of financial position.
- (b) the income and expenses included in the statement of profit or loss are determined by measuring the asset or the liability on the second measurement basis.
- (c) the cumulative amount of that income or expense is the same as if the second measurement basis had also been used in the statement of financial position. Thus, the cumulative amount of income and expenses included in other comprehensive income equals the difference between the two measures of the asset or the liability.
- (d) the measure of the asset or the liability on the second measurement basis needs to have an independent meaning and not be a mere accumulation of amounts included in the statement of profit or loss.

BC7.50 For example:

- (a) measuring a financial asset at fair value in the statement of financial position and related income and expenses at historical cost in the statement of profit or loss is a case of dual measurement.
- (b) but the treatment of a pension liability applying IAS 19 *Employee Benefits* is not a case of dual measurement. This is because the income and expenses included in the statement of profit or loss in each period reflect assumptions (including discount rates) for that period. Thus, the cumulative amounts included in that statement reflect different assumptions (including discount rates) for each period. Those cumulative amounts correspond to a measure for the pension liability that has no independent meaning and can be described only as the accumulation of the amounts included in the statement of profit or loss.

Reclassifying items into the statement of profit or loss (paragraphs 7.26–7.27)

- BC7.51 The IASB considered whether items of income and expenses included in OCI should be subsequently reclassified into the statement of profit or loss. Such reclassification is often described as recycling.
- BC7.52 When the dual measurement approach described in paragraph BC7.49 is used, reclassification of the cumulative amount included in OCI over the holding period of the asset or the liability is a necessary consequence of that approach. This is because the income or expenses included in profit or loss on derecognition of the asset or the liability (for example, on sale) include any income or expenses relating to the asset or the liability that have not already been included in the statement of profit or loss. Hence, any income and expenses previously included in OCI will, unless they have already reversed, now be included in profit or loss.
- BC7.53 However, when income and expenses are included in OCI in cases other than dual measurement, such reclassification is not a necessary consequence of the approach adopted.
- BC7.54 If the amounts included in the statement of profit or loss are the primary source of information about an entity's financial performance for the period, it follows that the cumulative amounts included over time in that statement should also be as complete as possible. Hence, no income and expenses should be excluded from the statement of profit or loss permanently, unless there is a compelling reason to do so.
- BC7.55 Accordingly, the IASB proposes to include in the *Conceptual Framework* a presumption that income and expenses included in OCI must subsequently be reclassified to the statement of profit or loss. Reclassification takes place in the period when including the income and expenses in the statement of profit or loss enhances the relevance of the information included in that statement for that period.
- BC7.56 However, in some cases, reclassifying the income and expenses to the statement of profit or loss might not enhance the relevance of the information in that statement in any period. Thus, there would be no appropriate basis for reclassification. In such cases, the presumption of reclassification can be

rebutted because reclassification could occur only on an arbitrary basis, which would not provide useful information. The absence of an appropriate basis for reclassification may be an indication that this particular item of income and expenses should not be included in OCI in the first place.

- BC7.57 The IASB does not propose to include in the *Conceptual Framework* specific guidance on when reclassification may be appropriate. The IASB expects to take that decision when developing individual Standards.

Chapter 8—Concepts of capital and capital maintenance

- BC8.1 The material in Chapter 8 is carried forward unchanged from the existing *Conceptual Framework*, except for a limited number of editorial changes (see paragraph BCIN.24).

Effects of the proposed changes to the *Conceptual Framework*

- BCE.1 The Invitation to Comment on the Exposure Draft discusses the effects of the proposed changes to the *Conceptual Framework*. The following paragraphs discuss:
- (a) inconsistencies with existing Standards (see paragraphs BCE.2–BCE.24); and
 - (b) transition and effective date (see paragraphs BCE.25–BCE.31).

Inconsistencies with existing Standards

- BCE.2 Some respondents to the Discussion Paper suggested that the IASB should undertake a review of existing Standards to identify any inconsistencies with the proposals for a revised *Conceptual Framework*. They stated that such a review would enable them to better understand the implications of the proposals.
- BCE.3 The IASB reviewed existing and proposed Standards, other than those to be superseded before the revised *Conceptual Framework* becomes effective.
- BCE.4 In doing this, the IASB has not attempted to predict what judgements it would now make if it were to set requirements in existing Standards applying the concepts proposed in the Exposure Draft for:
- (a) judgements on recognition and measurement requirements; and
 - (b) reclassification to the statement of profit or loss of income and expenses included in OCI in an earlier period.
- BCE.5 In addition, the IASB has not identified the following requirements as being inconsistent with the proposals for the *Conceptual Framework*:
- (a) requirements that, although consistent with the concepts now proposed, are currently explained using different concepts in the Basis for Conclusions; and
 - (b) requirements that seem to have been driven by cost-benefit considerations (ie the cost constraint).
- BCE.6 Paragraphs BCE.7–BCE.11 discuss the main inconsistencies between existing Standards and the proposed *Conceptual Framework* that were identified in the course of the review. Paragraphs BCE.12–BCE.21 discuss minor inconsistencies that would arise from the proposed changes to the *Conceptual Framework*. Paragraphs BCE.22–BCE.24 explain that some existing inconsistencies would be eliminated by the newly proposed concepts.

Main inconsistencies

IAS 32 *Financial Instruments: Presentation*

- BCE.7 Some of the classification requirements of IAS 32 *Financial Instruments: Presentation* are inconsistent with both the existing *Conceptual Framework*'s definitions and the proposed definitions of liability and equity. In particular, these inconsistencies arise from:

- (a) the share-settlement clauses of the definitions of financial assets and financial liabilities. Situations to which these clauses apply include, for financial liabilities:
 - (i) a non-derivative for which the entity is, or may be, obliged to deliver a variable number of the entity's own equity instruments; and
 - (ii) a derivative that will, or may, be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.¹⁹

These instruments are classified as liabilities even though obligations that an entity must settle, or may have the right to settle, by issuing its own equity instruments, do not meet either the existing or the proposed *Conceptual Framework's* definition of a liability.

- (b) the exceptions for puttable instruments contained in paragraphs 16A–16D of IAS 32. These result in some financial instruments being classified as equity, even though they meet the *Conceptual Framework's* definition of a liability.

BCE.8 As discussed in paragraphs BC4.93–BC4.103, the IASB proposes not to make changes in this area at this stage. The IASB will further explore how to distinguish liabilities from equity claims, including consideration of whether to add to its agenda a project to amend the definitions of a liability and equity, in its Financial Instruments with Characteristics of Equity research project.²⁰

IFRIC 21 *Levies*

BCE.9 As discussed in paragraph BC4.65, the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as interpreted in IFRIC 21 *Levies* are inconsistent with the proposed new concepts for identifying liabilities.

BCE.10 An entity must often conduct a series of activities before it is required to pay a levy. IFRIC 21 identifies the last event in the series as the event that gives rise to a liability. The IFRS Interpretations Committee ('the Interpretations Committee') concluded that, because economic compulsion does not create a present obligation, earlier events in the series do not give rise to a liability even if the entity would have to take unrealistic actions to avoid the obligations. In contrast, applying the IASB's proposed guidance on a present obligation, an entity would identify a liability when the entity has no practical ability to avoid a transfer of economic benefits and the obligation has arisen from past events; in other words, the entity has received benefits or conducted activities that establish the extent of the obligation. Accordingly, a liability for some levies could be identified earlier by applying the *Conceptual Framework* proposals than by applying IFRIC 21.

¹⁹ See paragraph 11 of IAS 32.

²⁰ For the IASB to add a project to its active agenda, a formal agenda decision would be required.

- BCE.11 The IASB is considering, as part of its research agenda, whether it should take on an active project to consider amending aspects of IAS 37.²¹ That research will take into account the inconsistencies between IFRIC 21 and the proposed new concepts for identifying present obligations.

Minor inconsistencies

Quotes of existing definitions

- BCE.12 Some existing Standards quote existing *Conceptual Framework* definitions:
- (a) IAS 37 quotes the existing definition of a liability; and
 - (b) IAS 38 *Intangible Assets* quotes the existing definition of an asset.
- BCE.13 The implications for IAS 37 are discussed in paragraph BCE.11. The IASB is not proposing to update the quotation in IAS 38 at this time. It has considered possible implications for this Standard of the proposed changes in the definitions of assets and concluded that the changes would not cause any practical problems in applying the Standard. The IASB's aim in revising the definitions in the *Conceptual Framework* was to provide more clarity, not to fundamentally change the way in which the definitions are applied in any existing Standard.

Presentation and disclosure

- BCE.14 In the Exposure Draft, the IASB notes the benefits of including a specific presentation and disclosure objective in a Standard (see paragraph 7.16 of the Exposure Draft). Recent Standards already include an objective for disclosure requirements. However, many older Standards do not contain such an objective.
- BCE.15 The Exposure Draft proposes that financial statements should include forward-looking information only if it provides relevant information about the assets and liabilities that existed at the end of, or during, the period (see paragraph 7.4 of the Exposure Draft). IAS 19 *Employee Benefits* requires entities to disclose expected contributions to the defined benefit or the defined contribution plan for the next annual reporting period. This requirement is arguably inconsistent with the approach to forward-looking information proposed in the Exposure Draft.
- BCE.16 The IASB proposes not to address these inconsistencies in the *Conceptual Framework* project. A review of disclosure requirements in existing Standards to identify and assess redundancies, conflicts and duplication is included in the Disclosure Initiative (see paragraph BC7.2(b)).

Faithful representation vs reliability

- BCE.17 In existing Standards the term 'reliability' is used in two different ways:
- (a) to mean that the level of measurement uncertainty associated with an item is tolerable. This use of the word is consistent with the recognition criteria in the existing *Conceptual Framework* (an item that meets the

21 For the IASB to add a project to its active agenda, a formal agenda decision would be required.

definition of an element is recognised only if it is probable that there will be a flow of economic benefits and it has a cost or value that can be measured with reliability).

- (b) in a broader sense, as a qualitative characteristic explained in the pre-2010 *Framework* as encompassing freedom from error, neutrality, prudence, completeness and substance over form.

BCE.18 The IASB proposes not to reinstate the term reliability as a label for the qualitative characteristic now called 'faithful representation'. However, it considers that there is much in common between the qualitative characteristics of reliability (pre-2010 *Framework*) and the description of faithful representation proposed in the Exposure Draft (see paragraphs BC2.21–BC2.25).

BCE.19 The IASB considered whether to replace the term reliability with the term faithful representation in the Standards that refer to reliability as a qualitative characteristic. However, the IASB concluded that until it completes the revised *Conceptual Framework*, it would be premature to consider whether to propose such amendments. Similarly, it would be premature to consider whether to propose replacing the term reliability in the Standards that use the term to refer to a tolerable level of measurement uncertainty.

IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

BCE.20 Two existing Standards—IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*—rely directly on the guidance in the *Conceptual Framework* and act as a direct link between the Standards and the *Conceptual Framework*. IAS 1 prescribes the basis for preparation of general purpose financial statements. It requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*, to achieve fair presentation in financial statements. IAS 8 provides guidance to help entities develop and apply accounting policies when there are no specifically applicable Standards.

BCE.21 The guidance in these Standards is based on the qualitative characteristics described in the *Conceptual Framework* and, hence, the concepts in the *Conceptual Framework* are essential to the application of these Standards. When the revised *Conceptual Framework* is finalised, the IASB will consider whether to develop proposals to amend IAS 1 and IAS 8 to reflect the revised *Conceptual Framework*.

Existing inconsistencies

BCE.22 Some existing inconsistencies between the Standards and the existing *Conceptual Framework* would be eliminated by the proposals in the Exposure Draft.

BCE.23 For example, the existing *Conceptual Framework* specifies that an asset or a liability should be recognised only if it is probable that future economic benefits will flow to or from the entity. The IASB has not applied this recognition criterion in some Standards—it decided that recognition of some assets and liabilities (such as some derivatives) meets the objectives of financial reporting

irrespective of the likelihood of future cash flows. Such requirements are inconsistent with the existing *Conceptual Framework* recognition criteria, but are possible outcomes of the proposed new *Conceptual Framework* recognition criteria. (As noted in paragraph BCE.4, the IASB has not attempted to predict what judgements it would now make if it were to set requirements in existing Standards applying the concepts now proposed.)

- BCE.24 The IASB emphasises that its intention in this project is to provide a coherent basis for developing future Standards, not to eliminate existing inconsistencies. In fact, as discussed in paragraphs BCE.7–BCE.21, the IASB acknowledges that the proposals in the Exposure Draft would create some new inconsistencies. Nevertheless, some concepts in recent Standards-level projects reflect the IASB's most developed thinking on these matters, and that thinking also flows into the proposals in the Exposure Draft. It is not the IASB's intention to legitimise existing Standards or practice.

Transition and effective date

- BCE.25 As noted in the Discussion Paper, the IASB will start using the revised *Conceptual Framework* immediately once it is published. The revised *Conceptual Framework* will supersede the previous version.
- BCE.26 Some respondents asked the IASB to provide transition guidance for:
- (a) the Interpretations Committee to help it interpret Standards developed under an earlier version of the *Conceptual Framework*; and
 - (b) entities that develop and apply an accounting policy in accordance with the *Conceptual Framework* when no Standard applies to a particular transaction or when they have to choose between accounting policy options permitted by a Standard.
- BCE.27 The IASB concluded that there is no need to include in the revised *Conceptual Framework* any transition guidance for the Interpretations Committee. To avoid having several co-existing versions of the *Conceptual Framework*, the Interpretations Committee will start using the revised *Conceptual Framework* immediately after it is published. When the Interpretations Committee is faced with inconsistencies between a Standard (including those developed on the basis of the existing *Conceptual Framework*) and the concepts in the revised *Conceptual Framework*, it is required by the *IASB and IFRS Interpretations Committee Due Process Handbook* to refer the issue to the IASB.²²
- BCE.28 The IASB considered how entities should account for changes in accounting policies resulting from the revision of the *Conceptual Framework*. In particular, the IASB discussed:
- (a) whether to allow entities not to change their existing accounting policy. It rejected this approach because it could result in financial statements prepared on the basis of concepts that were inconsistent with the revised *Conceptual Framework*.

²² See paragraph 7.8 of the *IASB and IFRS Interpretations Committee Due Process Handbook*.

- (b) whether to require prospective application of the revised *Conceptual Framework*. It rejected this approach because it would compromise the comparability of financial statements.
- BCE.29 Consequently, the IASB proposes that entities should account for any changes in accounting policy arising from an application of the revised *Conceptual Framework* retrospectively in accordance with IAS 8, subject to the impracticability provisions set out in that Standard.
- BCE.30 To avoid having several co-existing versions of the *Conceptual Framework*, the IASB proposes replacing references to the *Framework for the Preparation and Presentation of Financial Statements* in existing Standards with references to the *Conceptual Framework for Financial Reporting*. To achieve this, the IASB has issued a separate Exposure Draft *Updating References to the Conceptual Framework*.
- BCE.31 The replacement of those references within two Standards—IAS 1 and IAS 8—will achieve transition to the revised *Conceptual Framework* for entities that use the *Conceptual Framework* to develop accounting policies. The two Standards will set the effective date for the paragraphs containing those references. The IASB proposes to set an effective date that will allow a transition period of approximately 18 months between the issue of the revised *Conceptual Framework* and its effective date for entities. This would allow entities time to review the effects of the revised concepts on their accounting policies and prepare for retrospective application of the changes. In addition, the IASB proposes to permit early application for entities that would not find it difficult to start applying the revised *Conceptual Framework* immediately.

Appendix

This appendix reproduces the Basis for Conclusions on Chapter 1: *The objective of general purpose financial reporting* and Chapter 3: *Qualitative characteristics of useful financial information* of the existing *Conceptual Framework*.

The Exposure Draft proposes a number of changes to these Chapters (including renumbering Chapter 3 as Chapter 2). These changes are discussed in paragraphs BC1.1–BC2.33 of the Basis for Conclusions on the Exposure Draft.

Footnotes have been added to this appendix to enable readers to better understand how the changes proposed in the Exposure Draft affect the decisions made when these Chapters were originally developed.

Basis for Conclusions on Chapter 1: *The objective of general purpose financial reporting*

This Basis for Conclusions accompanies, but is not part of, Chapter 1.

Introduction

- BC1.1 This Basis for Conclusions summarises considerations of the International Accounting Standards Board in reaching the conclusions in Chapter 1 *The objective of general purpose financial reporting*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.
- BC1.2 The Board developed this chapter jointly with the US Financial Accounting Standards Board (FASB). Consequently, this Basis for Conclusions also includes some references to the FASB's literature.

Background

- BC1.3 The Board began the process of developing the objective of financial reporting by reviewing its own framework and concepts as well as those of other standard-setters. In July 2006 the Board published for public comment a discussion paper on this topic. That same paper was also published by the FASB. The Board and the FASB received 179 responses. In its redeliberations of the issues on this topic, the Board considered all of the comments received and information gained from other outreach initiatives. In May 2008 the Board and the FASB jointly published an exposure draft. The boards received 142 responses. The Board reconsidered all of the issues on this topic. This document is the result of those reconsiderations.

General purpose financial reporting

- BC1.4 Consistently with the Board's responsibilities, the *Conceptual Framework* establishes an objective of financial reporting and not just of financial statements. Financial statements are a central part of financial reporting, and most of the issues that the Board addresses involve financial statements. Although the scope of FASB Concepts Statement No. 1 *Objectives of Financial*

Reporting by Business Enterprises was financial reporting, the other FASB concepts statements focused on financial statements. The scope of the Board's *Framework for the Preparation and Presentation of Financial Statements*, which was published by the Board's predecessor body in 1989 (hereinafter called *Framework* (1989)), dealt with financial statements only. Therefore, for both boards the scope of the *Conceptual Framework* is broader.²³

- BC1.5 Some constituents suggested that advances in technology may make general purpose financial reporting obsolete. New technologies, for example the use of eXtensible Business Reporting Language (XBRL), may make it practicable in the future for reporting entities either to prepare or to make available the information necessary for different users to assemble different financial reports to meet their individual information needs.
- BC1.6 To provide different reports for different users, or to make available all of the information that users would need to assemble their own custom-designed reports, would be expensive. Requiring users of financial information to assemble their own reports might also be unreasonable, because many users would need to have a greater understanding of accounting than they have now. Therefore, the Board concluded that for now a general purpose financial report is still the most efficient and effective way to meet the information needs of a variety of users.
- BC1.7 In the discussion paper, the Board used the term *general purpose external financial reporting*. External was intended to convey that internal users such as management were not the intended beneficiaries for general purpose financial reporting as established by the Board. During redeliberations, the Board concluded that this term was redundant. Therefore, Chapter 1 uses *general purpose financial reporting*.

Financial reporting of the reporting entity

- BC1.8 Some respondents to the exposure draft said that the reporting entity is not separate from its equity investors or a subset of those equity investors. This view has its roots in the days when most businesses were sole proprietorships and partnerships that were managed by their owners who had unlimited liability for the debts incurred in the course of the business. Over time, the separation between businesses and their owners has grown. The vast majority of today's businesses have legal substance separate from their owners by virtue of their legal form of organisation, numerous investors with limited legal liability and professional managers separate from the owners. Consequently, the Board concluded that financial reports should reflect that separation by accounting for the entity (and its economic resources and claims) rather than its primary users and their interests in the reporting entity.²⁴

²³ Note for readers of the Exposure Draft: with the exception of Chapters 1 and 2, the Exposure Draft *Conceptual Framework for Financial Reporting* focuses on financial statements instead of financial reports (see paragraph BCIN.22).

²⁴ Note for readers of the Exposure Draft: Chapter 3 of the Exposure Draft *Conceptual Framework for Financial Reporting* discusses the reporting entity and the perspective of financial statements (see paragraphs BC3.9–BC3.22).

Primary users

- BC1.9 The objective of financial reporting in paragraph OB2 refers to existing and potential investors, lenders and other creditors. The description of the primary users in paragraph OB5 refers to existing and potential investors, lenders and other creditors who cannot require reporting entities to provide information directly to them. Paragraph OB10 states that ‘regulators and members of the public other than investors, lenders and other creditors’ may find information in general purpose financial reports useful but clearly states that those are not the parties to whom general purpose financial reports are primarily directed.
- BC1.10 Paragraph 9 of the *Framework* (1989) stated that users included ‘present and potential investors, employees, lenders, suppliers and other trade creditors’ (and later added advisers in the discussion of investors’ needs), all of which are intended to be encompassed by the phrase in paragraph OB2. Paragraph 9 of the *Framework* (1989) also included a list of other potential users such as customers, governments and their agencies, and the public, which is similar to the list in paragraph OB10 of those who may be interested in financial reports but are not primary users.
- BC1.11 Paragraph 10 of the *Framework* (1989) stated that ‘as investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy’, which might have been read to narrow the focus to investors only. However, paragraph 12 explicitly stated that the objective of financial statements is to provide information ‘that is useful to a wide range of users in making economic decisions.’ Thus, the *Framework* (1989) focused on investors’ needs as representative of the needs of a wide range of users but did not explicitly identify a group of primary users.
- BC1.12 FASB Concepts Statement 1 referred to ‘present and potential investors and creditors and other users in making rational investment, credit, and similar decisions’ (paragraph 34). It also stated that ‘major groups of investors are equity securityholders and debt securityholders’ and ‘major groups of creditors are suppliers of goods and services who extend credit, customers and employees with claims, lending institutions, individual lenders, and debt securityholders’ (paragraph 35). One difference in emphasis from the *Framework* (1989), which emphasised providers of risk capital, is that Concepts Statement 1 referred to ‘both those who desire safety of investment and those who are willing to accept risk to obtain high rates of return’ (paragraph 35). However, like the *Framework* (1989), Concepts Statement 1 stated that the terms investors and creditors ‘also may comprehend security analysts and advisors, brokers, lawyers, regulatory agencies, and others who advise or represent the interests of investors and creditors or who otherwise are interested in how investors and creditors are faring’ (paragraph 35).
- BC1.13 Paragraphs OB3, OB5 and OB10 differ from the *Framework* (1989) and Concepts Statement 1 for two reasons—to eliminate differences between the *Framework* and Concepts Statement 1 and to be more direct by focusing on users making decisions about providing resources (but not to exclude advisers). The reasons are discussed in paragraphs BC1.15–BC1.24.

Should there be a primary user group?

- BC1.14 The discussion paper and the exposure draft proposed identifying a group of primary users of financial reports. Some respondents to the exposure draft said that other users who have not provided, and are not considering providing, resources to the entity, use financial reports for a variety of reasons. The Board sympathised with their information needs but concluded that without a defined group of primary users, the *Conceptual Framework* would risk becoming unduly abstract or vague.

Why are existing and potential investors, lenders and other creditors considered the primary users?

- BC1.15 Some respondents to the discussion paper and the exposure draft suggested that the primary user group should be limited to existing shareholders or the controlling entity's majority shareholders. Others said that the primary users should be existing shareholders and creditors, and that financial reports should focus on their needs.
- BC1.16 The reasons why the Board concluded that the primary user group should be the existing and potential investors, lenders and other creditors of a reporting entity are:
- (a) Existing and potential investors, lenders and other creditors have the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly.
 - (b) The Board's and the FASB's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors but also potential investors and existing and potential lenders and other creditors.
 - (c) Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.
- BC1.17 Some respondents expressed the view that the specified primary user group was too broad and that it would result in too much information in the financial reports. However, *too much* is a subjective judgement. In developing financial reporting requirements that meet the objective of financial reporting, the boards will rely on the qualitative characteristics of, and the cost constraint on, useful financial information to provide discipline to avoid providing too much information.²⁵

²⁵ Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* includes an additional discussion of primary users (see paragraphs BCIN.35–BCIN.43 and BC1.11–BC1.13).

Should there be a hierarchy of users?

- BC1.18 Some respondents to the exposure draft who supported the composition of the primary user group also recommended that the Board should establish a hierarchy of primary users because investors, lenders and other creditors have different information needs. However, the Board observed that individual users may have information needs and desires that are different from, and possibly conflict with, those of other users with the same type of interest in the reporting entity. General purpose financial reports are intended to provide common information to users and cannot accommodate every request for information. The Board will seek the information set that is intended to meet the needs of the maximum number of users in cost-beneficial ways.

Information needs of other users who are not within the primary user group

Management's information needs

- BC1.19 Some constituents questioned the interaction between general purpose financial reporting and management's needs. The Board stated that some of the information directed to the primary users is likely to meet some of management's needs but not all of them. However, management has the ability to access additional financial information, and consequently, general purpose financial reporting need not be explicitly directed to management.

Regulators' information needs

- BC1.20 Some constituents said that maintaining financial stability in capital markets (the stability of a country's or region's economy or financial systems) should be an objective of financial reporting. They stated that financial reporting should focus on the needs of regulators and fiscal policy decision-makers who are responsible for maintaining financial stability.
- BC1.21 Other constituents opposed establishing an objective to maintain financial stability. They said that financial statements should present the economic reality of the reporting entity with as little bias as possible, but that such a presentation is not necessarily inconsistent with a financial stability objective. By presenting economic reality, financial statements could lead to more informed decision-making and thereby support financial stability even if that is not the primary aim.²⁶
- BC1.22 However, advocates of a financial stability objective had a different outcome in mind. They did not encourage the Board to require reporting entities to provide information for use by regulators and fiscal policy decision-makers. Instead, they recommended that the Board consider the consequences of new financial reporting standards for the stability of the world's economies and financial

²⁶ One group expressing that view was the Financial Crisis Advisory Group (FCAG). The FCAG comprised approximately 20 senior leaders with broad experience in international financial markets and an interest in the transparency of financial reporting information. The FCAG was formed in 2009 to advise the Board and the FASB about the standard-setting implications of the financial crisis and of potential changes in the global regulatory environment.

systems and, at least at times, assign greater weight to that objective than to the information needs of investors, lenders and other creditors.

- BC1.23 The Board acknowledged that the interests of investors, lenders and other creditors often overlap with those of regulators. However, expanding the objective of financial reporting to include maintaining financial stability could at times create conflicts between the objectives that the Board is not well-equipped to resolve. For example, some may take the view that the best way to maintain financial stability is to require entities not to report, or to delay reporting, some changes in asset or liability values. That requirement would almost certainly result in depriving investors, lenders and other creditors of information that they need. The only way to avoid conflicts would be to eliminate or de-emphasise the existing objective of providing information to investors, lenders and other creditors. The Board concluded that eliminating that objective would be inconsistent with its basic mission, which is to serve the information needs of participants in capital markets. The Board also noted that providing relevant and faithfully represented financial information can improve users' confidence in the information, and thus contribute to promoting financial stability.

Usefulness for making decisions

- BC1.24 Both the Board's and the FASB's previous frameworks focused on providing information that is useful in making economic decisions as the fundamental objective of financial reporting. Those frameworks also stated that financial information that is useful in making economic decisions would also be helpful in assessing how management has fulfilled its stewardship responsibility.
- BC1.25 The discussion paper that led to Chapter 1 stated that the objective of financial reporting should focus on resource allocation decisions. Although most respondents to the discussion paper agreed that providing useful information for decision-making was the appropriate objective, they said that investors, lenders and other creditors make other decisions that are aided by financial reporting information in addition to resource allocation decisions. For example, shareholders who vote on whether to retain directors or replace them, and on how members of management should be remunerated for their services, need information on which to base their decisions. Shareholders' decision-making process may include evaluating how management of the entity performed against management in competing entities in similar circumstances.
- BC1.26 The Board agreed with these respondents and noted that, in most cases, information designed for resource allocation decisions would also be useful for assessing management's performance. Therefore, in the exposure draft leading to Chapter 1, the Board proposed that the objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential investors, lenders and other creditors in making decisions in their capacity as capital providers. The exposure draft also described the role financial statements can have in supporting decisions related to the stewardship of an entity's resources.

- BC1.27 The exposure draft discussed the *Objective of Financial Reporting* and *Decision-usefulness* in separate sections. The Board combined those two sections in Chapter 1 because usefulness in making decisions is the objective of financial reporting. Consequently, both sections addressed the same points and provided more detail than was necessary. Combining those two sections resulted in eliminating the separate subsections on usefulness in assessing cash flow prospects and usefulness in assessing stewardship. The Board did not intend to imply that assessing prospects for future cash flow or assessing the quality of management's stewardship is more important than the other. Both are important for making decisions about providing resources to an entity, and information about stewardship is also important for resource providers who have the ability to vote on, or otherwise influence, management's actions.
- BC1.28 The Board decided not to use the term *stewardship* in the chapter because there would be difficulties in translating it into other languages. Instead, the Board described what stewardship encapsulates. Accordingly, the objective of financial reporting acknowledges that users make resource allocation decisions as well as decisions as to whether management has made efficient and effective use of the resources provided.²⁷

The objective of financial reporting for different types of entities

- BC1.29 The Board also considered whether the objective of general purpose financial reporting should differ for different types of entities. Possibilities include:
- (a) smaller entities versus larger entities;
 - (b) entities with listed (publicly traded) debt or equity financial instruments versus those without such instruments; and
 - (c) closely held entities versus those with widely dispersed ownership.
- BC1.30 External users of financial reporting have similar objectives, irrespective of the type of entities in which they invest. Therefore, the Board concluded that the objective of general purpose financial reports is the same for all entities. However, cost constraints and differences in activities among entities may sometimes lead the Board to permit or require differences in reporting for different types of entities.

²⁷ Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to increase the prominence of stewardship within the overall objective of financial reporting (see paragraphs 1.3–1.4, 1.15, 1.20 and 1.22–1.23 of the Exposure Draft and paragraphs BC1.6–BC1.10 of the related Basis for Conclusions).

Information about a reporting entity's resources, claims against the entity and changes in resources and claims

The significance of information about financial performance

- BC1.31 A long-standing assertion by many constituents is that a reporting entity's financial performance as represented by comprehensive income and its components is the most important information.²⁸ Concepts Statement 1 (paragraph 43) stated:

The primary focus of financial reporting is information about an enterprise's performance provided by measures of comprehensive income and its components. Investors, creditors, and others who are concerned with assessing the prospects for enterprise net cash inflows are especially interested in that information.

In contrast, the *Framework* (1989) considered information on the reporting entity's financial position and financial performance of equal importance.

- BC1.32 To be useful for decision-making, financial reports must provide information about a reporting entity's economic resources and claims, and the change during a period in economic resources and claims. A reporting entity cannot provide reasonably complete information about its financial performance (as represented by comprehensive income, profit or loss or other similar terms) without identifying and measuring its economic resources and the claims. Consequently, the Board concluded that to designate one type of information as the primary focus of financial reporting would be inappropriate.
- BC1.33 In discussing the financial position of an entity, the exposure draft referred to *economic resources and claims on them*. The chapter uses the phrase *economic resources of the reporting entity and the claims against the reporting entity* (see paragraph OB12). The reason for the change is that in many cases, claims against an entity are not claims on specific resources. In addition, many claims will be satisfied using resources that will result from future net cash inflows. Thus, while all claims are claims against the entity, not all are claims against the entity's existing resources.

Financial position and solvency

- BC1.34 Some constituents have suggested that the main purpose of the statement of financial position should be to provide information that helps assess the reporting entity's solvency. The question is not whether information provided in the financial reports should be helpful in assessing solvency; clearly, it should. Assessing solvency is of interest to investors, lenders and other creditors, and the objective of general purpose financial reporting is to provide information that is useful to them for making decisions.
- BC1.35 However, some have suggested that the statement of financial position should be directed towards the information needs of lenders, other creditors and

²⁸ Concepts Statement 1 referred to *earnings and its components*. However, FASB Concepts Statement No. 6 *Elements of Financial Statements* substituted the term *comprehensive income* for the term *earnings*. The latter term is reserved for a component of comprehensive income.

regulators, possibly to the detriment of investors and other users. To do so would be inconsistent with the objective of serving the common information needs of the primary user group. Therefore, the Board rejected the notion of directing the statement of financial position (or any other particular financial statement) towards the needs of a particular subset of users.

...

Chapter 3: Qualitative characteristics of useful financial information

This Basis for Conclusions accompanies, but is not part of, Chapter 3.

Introduction

- BC3.1 This Basis for Conclusions summarises considerations of the Board in reaching the conclusions in Chapter 3 *Qualitative characteristics of useful financial information*. It includes reasons for accepting some alternatives and rejecting others. Individual Board members gave greater weight to some factors than to others.
- BC3.2 The Board developed the chapter jointly with the US Financial Accounting Standards Board (FASB). Consequently, this Basis for Conclusions also includes some references to the FASB's literature.

Background

- BC3.3 The Board began the process of developing the qualitative characteristics of useful financial information by reviewing its own framework and concepts as well as those of other standard-setters. In July 2006 the Board published for public comment a discussion paper on this topic. That same paper was also published by the FASB. The Board and the FASB received 179 responses. In its redeliberations of the issues on this topic, the Board considered all of the comments received and information gained from other outreach initiatives. In May 2008 the Board and the FASB jointly published an exposure draft. The boards received 142 responses. The Board reconsidered all of the issues. This document is the result of those reconsiderations.

The objective of financial reporting and the qualitative characteristics of useful financial information

- BC3.4 Alternatives are available for all aspects of financial reporting, including recognition, derecognition, measurement, classification, presentation and disclosure. When developing financial reporting standards, the Board will choose the alternative that goes furthest towards achieving the objective of financial reporting. Providers of financial information will also have to choose among the alternatives if there are no applicable standards available, or if application of a particular standard requires judgements or options, to achieve the objective of financial reporting.
- BC3.5 Chapter 1 specifies that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions

about providing resources to the entity. The decision-makers on which this *Conceptual Framework* focuses are existing and potential investors, lenders and other creditors.

- BC3.6 That objective by itself leaves a great deal to judgement and provides little guidance on how to exercise that judgement. Chapter 3 describes the first step in making the judgements needed to apply that objective. It identifies and describes the qualitative characteristics that financial information should have if it is to meet the objective of financial reporting. It also discusses cost, which is a pervasive constraint on financial reporting.
- BC3.7 Subsequent chapters will use the qualitative characteristics to help guide choices about recognition, measurement and the other aspects of financial reporting.

Fundamental and enhancing qualitative characteristics

- BC3.8 Chapter 3 distinguishes between the fundamental qualitative characteristics that are the most critical and the enhancing qualitative characteristics that are less critical but still highly desirable. The discussion paper did not explicitly distinguish between those qualitative characteristics. The Board made the distinction later because of confusion among respondents to the discussion paper about how the qualitative characteristics relate to each other.
- BC3.9 Some respondents to the exposure draft stated that all of the qualitative characteristics should be considered equal, and that the distinction between fundamental and enhancing qualitative characteristics was arbitrary. Others said that the most important qualitative characteristic differs depending on the circumstances; therefore, differentiating qualitative characteristics was not appropriate.
- BC3.10 The Board does not agree that the distinction is arbitrary. Financial information without the two fundamental qualitative characteristics of relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable. However, financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Fundamental qualitative characteristics

Relevance

- BC3.11 It is self-evident that financial information is useful for making a decision only if it is capable of making a difference in that decision. *Relevance* is the term used in the *Conceptual Framework* to describe that capability. It is a fundamental qualitative characteristic of useful financial information.
- BC3.12 The definition of relevance in the *Conceptual Framework* is consistent with the definition in FASB Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information*. The *Framework* (1989) definition of relevance was that information is relevant only if it actually makes a difference in users' decisions. However, users consider a variety of information from many sources, and the extent to which a

decision is affected by information about a particular economic phenomenon is difficult, if not impossible, to determine, even after the fact.

- BC3.13 In contrast, whether information is *capable* of making a difference in a decision (relevance as defined in the *Conceptual Framework*) can be determined. One of the primary purposes of publishing exposure drafts and other due process documents is to seek the views of users on whether information that would be required by proposed financial reporting standards is capable of making a difference in their decisions. The Board also assesses relevance by meeting users to discuss proposed standards, potential agenda decisions, effects on reported information of applying recently implemented standards and other matters.

Predictive and confirmatory value

- BC3.14 Many decisions by investors, lenders and other creditors are based on implicit or explicit predictions about the amount and timing of the return on an equity investment, loan or other credit instrument. Consequently, information is capable of making a difference in one of those decisions only if it will help users to make new predictions, confirm or correct prior predictions or both (which is the definition of predictive or confirmatory value).
- BC3.15 The *Framework* (1989) identified predictive value and confirmatory value as components of relevance, and Concepts Statement 2 referred to predictive value and feedback value. The Board concluded that confirmatory value and feedback value were intended to have the same meaning. The Board and the FASB agreed that both boards would use the same term (confirmatory value) to avoid giving the impression that the two frameworks were intended to be different.

The difference between predictive value and related statistical terms

- BC3.16 Predictive value, as used in the *Conceptual Framework*, is not the same as predictability and persistence as used in statistics. Information has predictive value if it can be used in making predictions about the eventual outcomes of past or current events. In contrast, statisticians use predictability to refer to the accuracy with which it is possible to foretell the next number in a series and persistence to refer to the tendency of a series of numbers to continue to change as it has changed in the past.

Materiality

- BC3.17 Concepts Statement 2 and the *Framework* (1989) discussed materiality and defined it similarly. Concepts Statement 2 described materiality as a constraint on financial reporting that can be considered only together with the qualitative characteristics, especially relevance and faithful representation. The *Framework* (1989), on the other hand, discussed materiality as an aspect of relevance and did not indicate that materiality has a role in relation to the other qualitative characteristics.
- BC3.18 The discussion paper and the exposure draft proposed that materiality is a pervasive constraint in financial reporting because it is pertinent to all of the qualitative characteristics. However, some respondents to the exposure draft agreed that although materiality is pervasive, it is not a constraint on a

reporting entity's ability to report information. Rather, materiality is an aspect of relevance, because immaterial information does not affect a user's decision. Furthermore, a standard-setter does not consider materiality when developing standards because it is an entity-specific consideration. The boards agreed with those views and concluded that materiality is an aspect of relevance that applies at the individual entity level.²⁹

Faithful representation

- BC3.19 The discussion of faithful representation in Chapter 3 differs from that in the previous frameworks in two significant ways. First, it uses the term *faithful representation* instead of the term *reliability*. Second, substance over form, prudence (conservatism) and verifiability, which were aspects of reliability in Concepts Statement 2 or the *Framework* (1989), are not considered aspects of faithful representation. Substance over form and prudence were removed for the reasons described in paragraphs BC3.26–BC3.29. Verifiability is now described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic (see paragraphs 3.34–3.36).

Replacement of the term reliability

- BC3.20 Concepts Statement 2 and the *Framework* (1989) used the term *reliability* to describe what is now called faithful representation.
- BC3.21 Concepts Statement 2 listed representational faithfulness, verifiability and neutrality as aspects of reliability and discussed completeness as part of representational faithfulness.
- BC3.22 The *Framework* (1989) said:
- Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.
- The *Framework* (1989) also discussed substance over form, neutrality, prudence and completeness as aspects of faithful representation.
- BC3.23 Unfortunately, neither framework clearly conveyed the meaning of reliability. The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some focused on *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision.
- BC3.24 Because attempts to explain what reliability was intended to mean in this context have proved unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term *faithful representation*, the faithful depiction in financial reports of economic phenomena, was the result of that search. That term encompasses the main characteristics that the previous frameworks included as aspects of reliability.

²⁹ Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to clarify that the reference to users in the discussion of materiality is to the primary users of general purpose financial reports (see paragraph 2.11 of the Exposure Draft and paragraphs BC2.28–BC2.31 of the related Basis for Conclusions).

- BC3.25 Many respondents to the discussion paper and the exposure draft opposed the Board's preliminary decision to replace *reliability* with *faithful representation*. Some said that the Board could have better explained what reliable means rather than replacing the term. However, many respondents who made those comments assigned a different meaning to reliability from what the Board meant. In particular, many respondents' descriptions of reliability more closely resembled the Board's notion of verifiability than its notion of reliability. Those comments led the Board to affirm its decision to replace the term *reliability* with *faithful representation*.³⁰

Substance over form

- BC3.26 Substance over form is not considered a separate component of faithful representation because it would be redundant. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation.³¹

Prudence (conservatism) and neutrality

- BC3.27 Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality. Some respondents to the discussion paper and exposure draft disagreed with that view. They said that the framework should include conservatism, prudence or both. They said that bias should not always be assumed to be undesirable, especially in circumstances when bias, in their view, produces information that is more relevant to some users.
- BC3.28 Deliberately reflecting conservative estimates of assets, liabilities, income or equity has sometimes been considered desirable to counteract the effects of some management estimates that have been perceived as excessively optimistic. However, even with the prohibitions against deliberate misstatement that appear in the existing frameworks, an admonition to be prudent is likely to lead to a bias. Understating assets or overstating liabilities in one period frequently leads to overstating financial performance in later periods—a result that cannot be described as prudent or neutral.³²

30 Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* explains why the IASB reaffirmed its 2010 decision not to use the term 'reliability' as a label for the qualitative characteristic called 'faithful representation'. In addition, the Exposure Draft proposes to clarify how measurement uncertainty affects the relevance of an estimate (see paragraphs 2.12–2.13 of the Exposure Draft and paragraphs BC2.21–BC2.25 of the related Basis for Conclusions).

31 Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to make an explicit reference to substance over form in the discussion of faithful representation (see paragraph 2.14 of the Exposure Draft and paragraphs BC2.18–BC2.20 of the related Basis for Conclusions).

32 Note for readers of the Exposure Draft: the Exposure Draft *Conceptual Framework for Financial Reporting* proposes to reintroduce a reference to prudence in the *Conceptual Framework* and describe prudence as the exercise of caution when making judgements under conditions of uncertainty (see paragraph 2.18 of the Exposure Draft and paragraphs BC2.1–BC2.17 of the related Basis for Conclusions).

- BC3.29 Other respondents to the exposure draft said that neutrality is impossible to achieve. In their view, relevant information must have purpose, and information with a purpose is not neutral. In other words, because financial reporting is a tool to influence decision-making, it cannot be neutral. Obviously, reported financial information is expected to influence the actions of users of that information, and the mere fact that many users take similar actions on the basis of reported information does not demonstrate a lack of neutrality. The Board does not attempt to encourage or predict specific actions of users. If financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral.

Can faithful representation be empirically measured?

- BC3.30 Empirical accounting researchers have accumulated considerable evidence supporting relevant and faithfully represented financial information through correlation with changes in the market prices of entities' equity or debt instruments. However, such studies have not provided techniques for empirically measuring faithful representation apart from relevance.
- BC3.31 Both previous frameworks discussed the desirability of providing statistical information about how faithfully a financial measure is represented. That would not be unprecedented. Other statistical information is sometimes reflected in financial reports. For example, some entities disclose value at risk from derivative financial instruments and similar positions. The Board expects that the use of statistical concepts for financial reporting in some situations will continue to be important. Unfortunately, the boards have not identified any way to quantify the faithfulness of the representations in a financial report.

Enhancing qualitative characteristics

Comparability

- BC3.32 Comparability was an important concept in both the *Framework* (1989) and Concepts Statement 2, but the two previous frameworks disagreed on its importance. The *Framework* (1989) stated that comparability is as important as relevance and faithful representation.³³ Concepts Statement 2 described comparability as a quality of the relationship between two or more pieces of information that, although important, is secondary to relevance and faithful representation.
- BC3.33 Relevant and faithfully represented information is most useful if it can be readily compared with similar information reported by other entities and by the same entity in other periods. One of the most important reasons that financial reporting standards are needed is to increase the comparability of reported financial information. However, even if it is not readily comparable, relevant and faithfully represented information is still useful. Comparable information, however, is not useful if it is not relevant and may mislead if it is not faithfully

³³ The term *reliability* was used instead of *faithful representation*, but the meaning was intended to be similar.

represented. Therefore, *comparability* is considered an enhancing qualitative characteristic instead of a fundamental qualitative characteristic.

Verifiability

- BC3.34 Verifiable information can be used with confidence. Lack of verifiability does not necessarily render information useless, but users are likely to be more cautious because there is a greater risk that the information does not faithfully represent what it purports to represent.
- BC3.35 The *Framework* (1989) did not explicitly include verifiability as an aspect of reliability, but Concepts Statement 2 did. However, the two frameworks are not as different as it might appear because the definition of reliability in the *Framework* (1989) contained the phrase *and can be depended upon by users*, which implies that users need assurance on the information.
- BC3.36 The discussion paper stated that reported financial information should be verifiable to assure users that it is free from material error and bias and can be depended on to represent what it purports to represent. Therefore, verifiability was considered an aspect of faithful representation. Some respondents pointed out that including verifiability as an aspect of faithful representation could result in excluding information that is not readily verifiable. Those respondents recognised that many forward-looking estimates that are very important in providing relevant financial information (for example, expected cash flows, useful lives and salvage values) cannot be directly verified. However, excluding information about those estimates would make the financial reports much less useful. The Board agreed and repositioned verifiability as an enhancing qualitative characteristic, very desirable but not necessarily required.

Timeliness

- BC3.37 The *Framework* (1989) discussed timeliness as a constraint that could rob information of relevance. Concepts Statement 2 described timeliness as an aspect of relevance. However, the substance of timeliness as discussed in the two previous frameworks was essentially the same.
- BC3.38 The discussion paper described timeliness as an aspect of relevance. However, some respondents pointed out that timeliness is not part of relevance in the same sense that predictive and confirmatory value are. The Board was persuaded that timeliness is different from the other components of relevance.
- BC3.39 Timeliness is very desirable, but it is not as critical as relevance and faithful representation. Timely information is useful only if it is relevant and faithfully represented. In contrast, relevant and faithfully represented information may still be useful (especially for confirmatory purposes) even if it is not reported in as timely a manner as would be desirable.

Understandability

- BC3.40 Both the *Framework* (1989) and Concepts Statement 2 included understandability, a qualitative characteristic that enables users to comprehend the information and therefore make it useful for making decisions. Both frameworks also similarly described that for financial information to be understandable, users

should have a reasonable degree of financial knowledge and a willingness to study the information with reasonable diligence.

- BC3.41 Despite those discussions of understandability and users' responsibilities for understanding financial reports, misunderstanding persists. For example, some have expressed the view that a new accounting method should not be implemented because some users might not understand it, even though the new accounting method would result in reporting financial information that is useful for decision-making. They imply that understandability is more important than relevance.
- BC3.42 If understandability considerations were fundamental, it might be appropriate to avoid reporting information about very complicated things even if the information is relevant and faithfully represented. Classifying understandability as an enhancing qualitative characteristic is intended to indicate that information that is difficult to understand should be presented and explained as clearly as possible.³⁴
- BC3.43 To clarify another frequently misunderstood point, the *Conceptual Framework* explains that users are responsible for *actually* studying reported financial information with reasonable diligence rather than only being *willing* to do so (which was the statement in the previous frameworks). In addition, the *Conceptual Framework* states that users may need to seek the aid of advisers to understand economic phenomena that are particularly complex.

Qualitative characteristics not included

- BC3.44 *Transparency, high quality, internal consistency, true and fair view or fair presentation and credibility* have been suggested as desirable qualitative characteristics of financial information. However, transparency, high quality, internal consistency, true and fair view or fair presentation are different words to describe information that has the qualitative characteristics of relevance and representational faithfulness enhanced by comparability, verifiability, timeliness and understandability. Credibility is similar but also implies trustworthiness of a reporting entity's management.
- BC3.45 Interested parties sometimes suggested other criteria for standard-setting decisions, and the Board has at times cited some of those criteria as part of the rationale for some decisions. Those criteria include simplicity, operability, practicability or practicality, and acceptability.
- BC3.46 Those criteria are not qualitative characteristics. Instead, they are part of the overall weighing of benefits and costs of providing useful financial information. For example, a simpler method may be less costly to apply than a more complex method. In some circumstances, a simpler method may result in information that is essentially the same as, but somewhat less precise than, information produced by a more complex method. In that situation, a standard-setter would

³⁴ Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* explains why the IASB reaffirmed its 2010 decision not to elevate understandability from an enhancing qualitative characteristic to a fundamental qualitative characteristic (see paragraphs BC2.26–BC2.27).

include the decrease in faithful representation and the decrease in implementation cost in weighing benefits against costs.

The cost constraint on useful financial reporting

- BC3.47 Cost is a pervasive constraint that standard-setters, as well as providers and users of financial information, should keep in mind when considering the benefits of a possible new financial reporting requirement.³⁵ Cost is not a qualitative characteristic of information. It is a characteristic of the process used to provide the information.
- BC3.48 The Board has attempted and continues to attempt to develop more structured methods of obtaining information about the cost of gathering and processing the information that proposed standards would require entities to provide. The primary method used is to request interested parties, sometimes formally (such as by field tests and questionnaires), to submit cost and benefit information for a specific proposal that is quantified to the extent feasible. Those requests have resulted in helpful information and have led directly to changes to proposed requirements to reduce the costs without significantly reducing the related benefits.

³⁵ Note for readers of the Exposure Draft: the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting* notes that the cost constraint plays a particularly important role in some aspects of financial reporting and hence the Exposure Draft includes a discussion of the cost constraint in those areas (see paragraph BC2.33).

Alternative views on the *Conceptual Framework Exposure Draft*

- AV1 Mr Cooper, Mr Finnegan and Ms Lloyd voted against the publication of the Exposure Draft:
- (a) Mr Cooper and Mr Finnegan voted against the publication for the reasons given in paragraphs AV2–AV7;
 - (b) Ms Lloyd and Mr Finnegan voted against publication for the reasons given in paragraphs AV8–AV14; and
 - (c) Mr Finnegan also voted against publication for the reasons given in paragraphs AV15–AV34.

Alternative view of Stephen Cooper and Patrick Finnegan

- AV2 Mr Cooper and Mr Finnegan voted against the publication of the Exposure Draft because they do not believe that Chapter 7 of the proposed *Conceptual Framework* provides an adequate basis for the IASB to make decisions about the presentation of income and expenses, and in particular on what amounts should be reported in OCI and whether and when they should be subsequently reclassified to profit or loss (recycled). They consider that the Exposure Draft represents a missed opportunity to identify a conceptual basis for the use of OCI, with the IASB effectively being in no better position than it is now in determining how it should be used. Mr Cooper and Mr Finnegan also disagree with the combination of a lack of discipline in the use of OCI with the rebuttable presumption that items are reclassified to profit and loss. They are concerned that this would lead to the use of an arbitrary basis for the reclassification of some OCI amounts.
- AV3 Mr Cooper and Mr Finnegan agree that performance reporting, the presentation of different types of income and expenses and the use of OCI are key issues in financial reporting and that it is important that the *Conceptual Framework* provides a foundation for related Standards-level decisions. However, they believe that the proposals in the Exposure Draft lack that conceptual basis. Identifying the statement of profit or loss as the primary source of information about financial performance, but without actually defining financial performance or specifying the characteristics of income and expenses that require their presentation in OCI, will leave the IASB in effectively the same position that it is now. In addition, the approach to recycling provides little guidance, because there are no specific reasons presented that would rebut the presumption that recycling takes place (other than the reference to relevance).
- AV4 Mr Cooper and Mr Finnegan think that the conceptual foundation for performance reporting should be based on principles of separate presentation of income and expenses with different characteristics, including, for example, different degrees of persistence and different predictive values, and principles of disaggregation or splitting of items of income and expenses to highlight components that have different characteristics. In general, such disaggregation should be done within profit or loss, either on the face of the statement or in the

notes. However, Mr Cooper and Mr Finnegan acknowledge that there may be some circumstances in which disaggregation may be best done by recognising some components of income and expenses in OCI and not in profit or loss. Nevertheless, they believe that the *Conceptual Framework* should restrict the use of this approach (unless the IASB chooses to depart from the *Conceptual Framework*) more than the Exposure Draft proposes.

- AV5 Mr Cooper and Mr Finnegan think that the principle governing the disaggregation of a component of income or expenses referred to in paragraph AV4 should result in an amount recognised outside profit or loss, but only if doing so enhances the relevance of the information in the statement of profit or loss in that reporting period. Moreover, they think that this must also hold true for all other periods that may be affected, including periods covered by any potential recycling, and also in aggregate over several periods, including the life of the transaction concerned. To achieve this, the basis of disaggregation should result in a net zero accumulated amount in OCI over the life of a transaction or in aggregate over the life of economically linked transactions. If the cumulative amount in OCI is not zero, then the relevance of the information in the statement of profit or loss is reduced on a cumulative basis, because some items of income and expenses would be entirely omitted from the statement of profit or loss and so the depiction of financial performance in that statement would not be complete. They also believe that the principle they outline would obviate the need to consider explicit reclassification of OCI items (because the disaggregation should naturally result in zero cumulative OCI over the life of the relevant transactions) and would therefore remove a source of complexity and confusion for users of financial statements.
- AV6 Mr Cooper and Mr Finnegan consider that this principle would, in effect, restrict the use of OCI to a limited number of cases in which either (1) a different measurement basis (which, as noted in paragraph BC7.49, should be a meaningful measure and not just an accumulation of amounts recognised in the statement of profit or loss) is judged appropriate for measuring income and expenses in profit or loss, compared with that best suited to the measurement of the asset or the liability in the statement of financial position; or (2) there is a mismatch in the recognition basis for different but economically related transactions. These are two of the three situations for use of OCI envisaged in the Discussion Paper. Mr Cooper and Mr Finnegan believe that further work to develop a conceptual basis for OCI should have built on these.
- AV7 Mr Cooper and Mr Finnegan think that the proposals in the Exposure Draft would likely result in a much wider use of OCI than they have outlined in paragraphs AV5–AV6. For these additional items it is proposed that there should be a presumption that reclassification (recycling) takes place. Mr Cooper and Mr Finnegan consider that if the IASB does decide that remeasurements other than those described in paragraph AV6 can be presented in OCI, they should not be subsequently reclassified. To do so would create items in profit or loss that do not meet the definition of income and expenses, that are confusing for investors and that distort profit or loss in the period of reclassification. As a result, Mr Cooper and Mr Finnegan think that these other remeasurements are best

dealt with in profit or loss, with appropriate presentation to emphasise their different characteristics, and not in OCI.

Alternative view of Suzanne Lloyd and Patrick Finnegan

- AV8 Ms Lloyd and Mr Finnegan voted against the publication of the Exposure Draft because they disagree with the limited nature of the changes proposed to the definition of a liability (see paragraphs BCIN.25 and BC4.93–BC4.103). Ms Lloyd and Mr Finnegan agree that the definition of a liability should be used to distinguish between liabilities and equity. However, Ms Lloyd and Mr Finnegan believe that the IASB should have more fully considered changes to the definition of a liability to address the classification of claims against an entity as liabilities or equity. Ms Lloyd and Mr Finnegan think that the Exposure Draft should have included either:
- (a) the IASB's conclusion that the definition of a liability that is being proposed is suitable for distinguishing between liabilities and equity; or
 - (b) additional changes to the definition of a liability that would make it suitable for such a purpose.
- AV9 The objective of the *Conceptual Framework* project is to improve financial reporting by providing a more complete, clear and updated set of concepts. Ms Lloyd and Mr Finnegan believe that the distinction between liabilities and equity is an issue that:
- (a) is not adequately addressed or explained in the current *Conceptual Framework*; and
 - (b) is fundamental to reporting the effects of financial instruments with characteristics of both debt and equity.
- AV10 Ms Lloyd and Mr Finnegan believe that the lack of adequate concepts in the current *Conceptual Framework* is evidenced both by inconsistent application of the existing definitions of equity and liability in Standards and in inconsistencies between these definitions in the *Conceptual Framework* and in Standards. In particular, this is the case for more complex financial instruments that have characteristics of both liabilities and equity. For example, the classification of a financial instrument differs between IFRS 2 *Share-based Payments* and IAS 32 *Financial Instruments: Presentation* if the entity has an obligation to deliver a variable number of equity instruments equal to a specified amount (ie if it uses its own shares as 'currency' to settle the instrument). IAS 32 also includes a limited-scope exception from the definition of a liability for some puttable instruments that represent a residual interest in the entity.
- AV11 As a result of responses to the recent financial crisis and to continuing financial innovation, increasingly complex financial instruments with characteristics of both debt and equity have been, and are continuing to be, created. Ms Lloyd and Mr Finnegan believe that there is a need to more fully consider how to classify such financial instruments to meet the information needs of investors, lenders and other creditors and to consider whether the existing definitions of equity and liability meet those information needs. Ms Lloyd and Mr Finnegan acknowledge that additional information can be provided through alternative

presentation and disclosure requirements, and welcome further development of such requirements. However, Ms Lloyd and Mr Finnegan believe that the classification of claims as liabilities or equity has a fundamental effect on the reporting of an entity's financial position and financial performance. For financial performance in particular, classification is particularly important, because the definitions of income and expenses only include changes in claims if they are classified as liabilities.

- AV12 Ms Lloyd and Mr Finnegan believe the *Conceptual Framework's* definition of a liability and, as a consequence, of equity, need to be reconsidered in the light of these issues. In particular, Ms Lloyd and Mr Finnegan believe that the *Conceptual Framework* should more fully address whether and why the definition of a liability should or should not include:
- (a) an obligation to deliver a variable number of equity instruments equal to a specified amount (ie when an entity uses its own shares as 'currency'); and
 - (b) an obligation to transfer a variable amount of cash or other economic resources equal to the value of an equity instrument.
- AV13 Ms Lloyd and Mr Finnegan therefore disagree with the decision not to address the distinction between liabilities and equity in the Exposure Draft. They believe that, in failing to consider this, a fundamental conceptual issue for the classification of financial instruments is not addressed. Without reconsidering this distinction, including the effect on an entity's financial performance, Ms Lloyd and Mr Finnegan believe that the *Conceptual Framework* will fail to achieve the stated objective of 'assist[ing] the IASB to develop the Standards' when the issues at the Standards level relate to financial instruments that have characteristics of both liabilities and equity.
- AV14 Ms Lloyd and Mr Finnegan acknowledge that the IASB has decided to consider the distinction between liabilities and equity in the Financial Instruments with Characteristics of Equity research project. However, the *Conceptual Framework* is intended to provide a basis for developing and revising Standards and Ms Lloyd and Mr Finnegan therefore believe that this analysis is better placed in the *Conceptual Framework* project. The research project is primarily a Standards-level project. A Standards-level project should ideally be based on applying or making considered departures from the *Conceptual Framework*, instead of being used to develop concepts that may subsequently be considered as changes to the *Conceptual Framework*. In addition, Ms Lloyd and Mr Finnegan believe that it will be more difficult to consider fundamental changes to the distinction between liabilities and equity in the research project than in the *Conceptual Framework* project. This is because the *Conceptual Framework* project will not necessarily result in subsequent changes at a Standards level and the research project is largely intended to focus on current application questions that have arisen in relation to IAS 32. Thus, by undertaking the analysis of the distinction between liabilities and equity in the *Conceptual Framework* project, it could be more aspirational and have a broader focus. Ms Lloyd and Mr Finnegan are also concerned that by considering this issue within the context of the research project, there will be a detrimental effect on the timeliness with which the IASB

will be able to consider potential revisions or interpretations of existing Standards that deal with the distinction between liabilities and equity.

Alternative view of Patrick Finnegan

- AV15 In addition to the reasons outlined above, Mr Finnegan voted against the publication of the Exposure Draft because he:
- (a) disagrees with the decision to reintroduce an explicit reference to the notion of prudence in the *Conceptual Framework*;
 - (b) disagrees with the discussion of historical cost and current value measurement; and
 - (c) believes that the IASB has both a duty and an opportunity to spend more time developing concepts in the areas of:
 - (i) reporting financial performance; and
 - (ii) presentation and disclosure.

Prudence

- AV16 Mr Finnegan disagrees with the decision to reintroduce an explicit reference to the notion of prudence in the *Conceptual Framework* to support the meaning of neutrality, ie a lack of bias in the selection or presentation of financial information. He believes that financial information possessing the characteristic of neutrality is already free from bias. Mr Finnegan thinks that if prudence is included in the *Conceptual Framework* or any Standard, it would introduce bias and would create confusion in the minds of many preparers about whether or how it should be applied. Even though the Exposure Draft attempts to make it clear that prudence is consistent with neutrality, Mr Finnegan disagrees that prudence (the exercise of caution) is consistent with neutrality. He believes the use of that term within the *Conceptual Framework* could result in:
- (a) Standards designed to produce weighted outcomes.
 - (b) preparers being cautious by understating assets and overstating liabilities or being cautious in communicating bad news and hence overstating assets and understating liabilities. Such actions have the potential to confuse investors and lower their confidence in financial reporting.

Measurement

- AV17 The Exposure Draft describes two principal categories of measurement bases—historical cost and current value—along with the perceived advantages and disadvantages of both. Mr Finnegan disagrees with those descriptions and believes that the application of such guidance will lead to a biased selection of the use of historical cost over current value. Mr Finnegan believes:
- (a) current value information will always be more relevant than historical cost information (see paragraphs AV18–AV19);

- (b) current value information maximises the enhancing qualitative characteristics to a greater extent compared with historical cost information and is not inherently more costly than historical cost information (see paragraphs AV20–AV22); and
- (c) the Exposure Draft’s proposed approach to guiding the selection of a measurement basis:
 - (i) is flawed (see paragraph AV23);
 - (ii) will perpetuate the variety of measurement bases in current IFRS, to the detriment of investors (see paragraphs AV24–AV25); and
 - (iii) creates a bias for the use of historical cost measurement (see paragraph AV26).

Relevance

- AV18 Mr Finnegan believes that current value measurement reflects the most relevant information about an asset or a liability and, hence, should have primacy in the statement of financial position and the statement(s) of financial performance. That belief is based on the view, and is supported by empirical evidence, that the changes in variables included in current values, such as changes in interest rates, price of credit and other market variables, result in information with greater predictive value compared with historical cost measures that do not include such changes.
- AV19 Chapter 1 of the *Conceptual Framework* states that to make decisions about providing resources to an entity, users of financial statements assess both the prospects for future net cash inflows to an entity and also management’s stewardship of the entity’s resources. To do this, they need measures of assets, liabilities, income and expenses that capture the amount, timing and uncertainty of those net cash inflows. Current value measures do that more effectively than historical cost measures. Moreover, the use of historical cost provides more motivation and opportunity to manipulate profit or loss by realising income or expenses when desired compared with current value measurement.

Enhancing qualitative characteristics and cost

- AV20 Mr Finnegan believes that current value information maximises the qualitative characteristics of comparability, timeliness and understandability to a greater extent than does historical cost information, and is at least as verifiable as historical cost information. In addition, he does not believe that historical cost measures are in many situations simpler and less expensive to provide than information using current measurement bases, as asserted in paragraph 6.15 of the Exposure Draft.
- AV21 Mr Finnegan observes that both historical cost and current value measures are often based on market values at initial recognition. Consequently, at initial recognition, both historical cost and current values will be equally verifiable for a particular item, depending on whether verification is a direct observation or an indirect verification through an estimation technique. However, following initial recognition, historical cost requires preparers to make a number of

subjective judgements that are involved in the process of estimating useful lives, salvage values or impairment. These judgements are no more verifiable than the estimates of current values. Furthermore, the process of including such judgements can make historical cost measures complex and difficult to understand; for example, amortised cost as required under IFRS 9 *Financial Instruments*.

- AV22 When making comparisons between companies, historical cost amounts are rarely, if ever, comparable because they are recognised and adjusted at different dates, including some dates in the distant past. This can significantly distort the carrying amounts of the assets and the timing of the recognition of income and expenses from these assets. Collectively, this can significantly distort the reporting of real economic margins of an entity.

Selection of a measurement basis

- AV23 One of the criteria proposed in the Exposure Draft for consideration when selecting a measurement basis deals with the characteristics of an asset or a liability; for example, the nature or extent of the expected variability of an asset or a liability's cash flows or the sensitivity of the value of an asset or a liability to changes in market forces. This criterion will not meet the objectives of financial reporting consistently because even a simple asset, for example, a government bond, may experience significant negative changes in value, which cannot be foreseen by management. In such circumstances, historical cost measurement would significantly overstate an entity's financial position, solvency and liquidity until management decides whether and by how much the asset has been impaired.
- AV24 Another factor in selecting a measurement basis is how an asset or a liability contributes to future cash flows, which, in turn, depends in part on the nature of the business activities conducted by the entity. Mr Finnegan thinks this factor allows management intent to affect measurement. He thinks that how management intends to use an asset or realise its value may be inconsistent and be an unreliable indicator of the prospects of future net cash flows. Management's intentions about the way it intends to realise value are not static. Determining measurement attributes based on such intentions and assumptions introduces the potential for management bias, which can cause financial information to be less relevant and less faithfully represented compared to when it is consistently measured at current value.
- AV25 Furthermore, there are numerous possible outcomes to the application of historical cost measurement. For example, the use of historical cost as described in the Exposure Draft can result in amounts for assets that reflect the effects of different estimates of consumption, different estimates of cash flows, different discount rates or different estimates of impairment. If this much judgement is warranted, it should focus instead on current value estimates.
- AV26 The use of current value measures is linked to the presentation of income and expenses (see paragraphs AV29–AV33). Mr Finnegan thinks that the rebuttable presumption that changes in current value measure must be recognised in profit or loss unless they do not enhance the relevance of the information in profit or loss will create a barrier to the use of current value measure.

Summary of views on measurement

- AV27 Mr Finnegan accepts that IASB members and many stakeholders believe that both historical cost measurement and current value measurement have a predictive ability and value relevance for investors. He acknowledges that there are circumstances in which the use of historical cost measurement would produce a result that would be materially consistent with the result produced by the use of current value measurement. For example, this would be the case when assets are consumed or converted to cash shortly after being recognised. However, Mr Finnegan believes that current value measures would be more relevant for financial statement analysis and that financial statement analysis would be easier for users if all assets and liabilities were measured using a consistent approach. Moreover, he also believes that the debate about whether historical cost provides more relevant information, that is, information less subject to measurement uncertainty compared to current value, is unlikely to be resolved on the basis of the way in which the revised *Conceptual Framework* is drafted.
- AV28 Mr Finnegan is also concerned that many of the decisions regarding how to subsequently measure an asset or a liability after initial recognition derive from trying to deal with the concern about volatility in reported profit or loss, and are not based on whether the measure provides information with the qualitative characteristics as proposed in the *Conceptual Framework*. The fact is that economic volatility exists in business and managers regularly make decisions to engage in transactions that subject their businesses to this volatility. If this is the case, then Mr Finnegan believes that it seems entirely appropriate to report that volatility in the financial statements.

Reporting financial performance

- AV29 Mr Finnegan believes that the principal challenge to using current value measurement more widely and consistently across IFRS is the concern raised by some stakeholders that its use will create volatility in reported profit or loss and, as a result, profit or loss will be less reliable. That concern has been raised during the IASB's deliberations in such areas as accounting for post-employment benefits, financial instruments, liabilities and equity, insurance contracts, revenue recognition and biological assets.
- AV30 Mr Finnegan believes that the root of the debate between historical cost and current value lies in the existing focus of preparers and users on the use of a single statistic—profit or loss—to reflect performance for that period. When profit or loss is measured using current values, or even a mix of current values and historical costs, as proposed in the Exposure Draft, opponents of current value measurement argue that it results in financial performance that is less reliable and predictable than historical cost measurement. Mr Finnegan believes that in the Exposure Draft the IASB is not advancing the concepts needed to improve the quality of financial information for investors.
- AV31 Mr Finnegan believes that the current impasse on the use of current value or historical cost could be better addressed if the Exposure Draft more clearly defined the purpose and use of other comprehensive income. As discussed in paragraph BC7.1, respondents to the IASB's Agenda Consultation 2011 identified

the reporting of financial performance, including the use of OCI and reclassification of items from OCI, as a priority topic that the IASB should address.

- AV32 According to paragraph 1.15 of the Exposure Draft (paragraph OB15 of the existing *Conceptual Framework*), changes in a reporting entity's economic resources and claims are a result of that entity's financial performance and other events and transactions such as issuing debt or equity instruments. Mr Finnegan believes that this statement implies that financial performance must be evaluated as including all changes in the total net assets, exclusive of transactions with holders of equity claims. Without greater clarity about why and how other comprehensive income is used, the emphasis on profit or loss as a primary source of information about performance has the potential to create a confusing picture of performance for investors.
- AV33 As stated, Mr Finnegan believes that investors need to receive timely information about the changes in recognised assets and liabilities measured at current value. He believes that presentation through the use of OCI is an effective (albeit not necessarily an optimal) means of delivering such information, which the IASB has used in many areas. The IASB's current and proposed use of OCI has been primarily to report unrealised gains or losses resulting from remeasurements of assets and liabilities that were measured at fair value or other current value in the statement of financial position. Mr Finnegan believes that this provides useful information and communicates information about the characteristics of assets and liabilities in a more objective and timely way compared to the use of historical cost supplemented by the disclosure of current value information (see paragraphs 6.74–6.77 of the Exposure Draft).

Presentation and disclosure

- AV34 Mr Finnegan believes the Exposure Draft's discussion of principles for presentation and disclosure should be changed as follows to address two critical areas of financial reporting that require improvement:
- (a) *disaggregation*—Mr Finnegan believes that the *Conceptual Framework* should discuss the usefulness of financial information from the perspective of disaggregated information, not aggregated information. The financial statements issued by most entities report information that summarises a large volume of detail, as noted by paragraph 7.15 of the Exposure Draft. Such summarised information cannot provide the essential information necessary for an investor's understanding of financial performance (or financial position). Moreover, a significant amount of effort is expended by investors when analysing and using financial statements to identify, adjust and possibly remove amounts of income and expenses from reported financial performance to estimate 'sustainable' or 'normalised' performance. Mr Finnegan believes that, to address investors' needs, the *Conceptual Framework* should emphasise the importance of providing information in a way that highlights the effects of different economic attributes, different measurement bases and different trends. In particular, the *Conceptual Framework* should establish principles that would result in Standards specifying appropriate levels of

disaggregation, with clear links between amounts recognised in the statements of financial position and financial performance and amounts presented and disclosed elsewhere in the financial statements.

- (b) *relationships between assets, liabilities, income and expenses with cash flows*—Mr Finnegan believes that the disclosure principles in the *Conceptual Framework* should set an objective for all Standards to include a requirement for the disclosure of entity-specific information that shows or explains changes in assets and liabilities attributable to cash and non-cash changes for all assets and liabilities presented in the statement of financial position. One way of achieving this disclosure objective would be to provide reconciliations for all assets and liabilities, but the simple disclosure of cash and non-cash changes could also satisfy the objective. This would address the frequently heard call for improving the quality (or relevance) of disclosures in financial statements.

Table of Concordance

This table shows how the contents of the *Conceptual Framework for Financial Reporting* (2010) and the Exposure Draft *Conceptual Framework for Financial Reporting* correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

<i>Conceptual Framework</i> (2010) paragraphs	Exposure Draft paragraphs
Introduction	Introduction
OB1–OB3 (Chapter 1)	1.1–1.3
OB4	1.4, 1.22–1.23
OB5–OB21	1.5–1.21
QC1–QC11 (Chapter 3)	2.1–2.11
QC12–QC15	2.14–2.17, 2.19
QC16–QC17	2.12–2.13, 2.20
QC18–QC39	2.21–2.42
4.1	3.10
4.2	4.2–4.3
4.3	7.10
4.4	4.3–4.4
4.5	5.7, 5.17–5.19
4.6	4.53–4.56
4.7	None
4.8–4.14	4.5–4.23
4.15–4.19	4.24–4.39
4.20–4.23	4.43–4.47
4.24	4.3, 7.22
4.25–4.35	4.48–4.52
4.36	8.10
4.37–4.53	5.1–5.24
4.46	4.40–4.42
4.54–4.56	6.1–6.80
4.57–4.65	8.1–8.9

continued...

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<i>Conceptual Framework (2010)</i> paragraphs	Exposure Draft paragraphs
None	2.18, 3.1–3.9, 3.11–3.25, 4.1, 4.57–4.63, 5.25–5.36, 7.1–7.9, 7.11–7.21, 7.23–7.27, A1–A9

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IFRIC INTERPRETATION 14

IAS 19 — the limit on a defined benefit asset, minimum funding requirements and their interaction

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References

- IAS 1 *Presentation of Financial Statements*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 19 *Employee Benefits* (as amended in 2011)
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Background

- Paragraph 64 of IAS 19 limits the measurement of a net defined benefit asset to the lower of the surplus in the defined benefit plan and the asset ceiling. Paragraph 8 of IAS 19 defines the asset ceiling as 'the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan'. Questions have arisen about when refunds or reductions in future contributions should be regarded as available, particularly when a minimum funding requirement exists.
- Minimum funding requirements exist in many countries to improve the security of the post-employment benefit promise made to members of an employee benefit plan. Such requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period. Therefore, a minimum funding requirement may limit the ability of the entity to reduce future contributions.
- Further, the limit on the measurement of a defined benefit asset may cause a minimum funding requirement to be onerous. Normally, a requirement to make contributions to a plan would not affect the measurement of the defined benefit asset or liability. This is because the contributions, once paid, will become plan assets and so the additional net liability is nil. However, a minimum funding requirement may give rise to a liability if the required contributions will not be available to the entity once they have been paid.
- 3A In November 2009 the International Accounting Standards Board amended IFRIC 14 to remove an unintended consequence arising from the treatment of prepayments of future contributions in some circumstances when there is a minimum funding requirement.

Scope

- This Interpretation applies to all post-employment defined benefits and other long-term employee defined benefits.
- For the purpose of this Interpretation, minimum funding requirements are any requirements to fund a post-employment or other long-term defined benefit plan.

Issues

- The issues addressed in this Interpretation are:

- (a) when refunds or reductions in future contributions should be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19.
- (b) how a minimum funding requirement might affect the availability of reductions in future contributions.
- (c) when a minimum funding requirement might give rise to a liability.

Consensus

Availability of a refund or reduction in future contributions

- 7 An entity shall determine the availability of a refund or a reduction in future contributions in accordance with the terms and conditions of the plan and any statutory requirements in the jurisdiction of the plan.
- 8 An economic benefit, in the form of a refund or a reduction in future contributions, is available if the entity can realise it at some point during the life of the plan or when the plan liabilities are settled. In particular, such an economic benefit may be available even if it is not realisable immediately at the end of the reporting period.
- 9 The economic benefit available does not depend on how the entity intends to use the surplus. An entity shall determine the maximum economic benefit that is available from refunds, reductions in future contributions or a combination of both. An entity shall not recognise economic benefits from a combination of refunds and reductions in future contributions based on assumptions that are mutually exclusive.
- 10 In accordance with IAS 1, the entity shall disclose information about the key sources of estimation uncertainty at the end of the reporting period that have a significant risk of causing a material adjustment to the carrying amount of the net asset or liability recognised in the statement of financial position. This might include disclosure of any restrictions on the current realisability of the surplus or disclosure of the basis used to determine the amount of the economic benefit available.

The economic benefit available as a refund

The right to a refund

- 11 A refund is available to an entity only if the entity has an unconditional right to a refund:
- (a) during the life of the plan, without assuming that the plan liabilities must be settled in order to obtain the refund (eg in some jurisdictions, the entity may have a right to a refund during the life of the plan, irrespective of whether the plan liabilities are settled); or
 - (b) assuming the gradual settlement of the plan liabilities over time until all members have left the plan; or
 - (c) assuming the full settlement of the plan liabilities in a single event (ie as a plan wind-up).

An unconditional right to a refund can exist whatever the funding level of a plan at the end of the reporting period.

- 12 If the entity's right to a refund of a surplus depends on the occurrence or non-occurrence of one or more uncertain future events not wholly within its control, the entity does not have an unconditional right and shall not recognise an asset.

Measurement of the economic benefit

- 13 An entity shall measure the economic benefit available as a refund as the amount of the surplus at the end of the reporting period (being the fair value of the plan assets less the present value of the defined benefit obligation) that the entity has a right to receive as a refund, less any associated costs. For instance, if a refund would be subject to a tax other than income tax, an entity shall measure the amount of the refund net of the tax.
- 14 In measuring the amount of a refund available when the plan is wound up (paragraph 11(c)), an entity shall include the costs to the plan of settling the plan liabilities and making the refund. For example, an entity shall deduct professional fees if these are paid by the plan rather than the entity, and the costs of any insurance premiums that may be required to secure the liability on wind-up.
- 15 If the amount of a refund is determined as the full amount or a proportion of the surplus, rather than a fixed amount, an entity shall make no adjustment for the time value of money, even if the refund is realisable only at a future date.

The economic benefit available as a contribution reduction

- 16 If there is no minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions is the future service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity. The future service cost to the entity excludes amounts that will be borne by employees.
- 17 An entity shall determine the future service costs using assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period as determined by IAS 19. Therefore, an entity shall assume no change to the benefits to be provided by a plan in the future until the plan is amended and shall assume a stable workforce in the future unless the entity makes a reduction in the number of employees covered by the plan. In the latter case, the assumption about the future workforce shall include the reduction.

The effect of a minimum funding requirement on the economic benefit available as a reduction in future contributions

- 18 An entity shall analyse any minimum funding requirement at a given date into contributions that are required to cover (a) any existing shortfall for past service on the minimum funding basis and (b) future service.
- 19 Contributions to cover any existing shortfall on the minimum funding basis in respect of services already received do not affect future contributions for future service. They may give rise to a liability in accordance with paragraphs 23–26.
- 20 If there is a minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions is the sum of:
- (a) any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (ie paid the amount before being required to do so); and
 - (b) the estimated future service cost in each period in accordance with paragraphs 16 and 17, less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in (a).
- 21 An entity shall estimate the future minimum funding requirement contributions for future service taking into account the effect of any existing surplus determined using the minimum funding basis but excluding the prepayment described in paragraph 20(a). An entity shall use assumptions consistent with the minimum funding basis and, for any factors not specified by that basis, assumptions consistent with those used to determine the defined benefit obligation and with the situation that exists at the end of the reporting period as determined by IAS 19. The estimate shall include any changes expected as a result of the entity paying the minimum contributions when they are due. However, the estimate shall not include the effect of expected changes in the terms and conditions of the minimum funding basis that are not substantively enacted or contractually agreed at the end of the reporting period.
- 22 When an entity determines the amount described in paragraph 20(b), if the future minimum funding requirement contributions for future service exceed the future IAS 19 service cost in any given period, that excess reduces the amount of the economic benefit available as a reduction in future contributions. However, the amount described in paragraph 20(b) can never be less than zero.

When a minimum funding requirement may give rise to a liability

- 23 If an entity has an obligation under a minimum funding requirement to pay contributions to cover an existing shortfall on the minimum funding basis in respect of services already received, the entity shall determine whether the contributions payable will be available as a refund or reduction in future contributions after they are paid into the plan.
- 24 To the extent that the contributions payable will not be available after they are paid into the plan, the entity shall recognise a liability when the obligation arises. The liability shall reduce the net defined benefit asset or increase the net defined benefit liability so that no gain or loss is expected to result from applying paragraph 64 of IAS 19 when the contributions are paid.
- 25–26 [Deleted]

Effective date

- 27 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2008. Earlier application is permitted.
- 27A IAS 1 (as revised in 2007) amended the terminology used throughout IFRSs. In addition it amended paragraph 26. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies IAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 27B *Prepayments of a Minimum Funding Requirement* added paragraph 3A and amended paragraphs 16–18 and 20–22. An entity shall apply those amendments for annual periods beginning on or after 1 January 2011. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.
- 27C IAS 19 (as amended in 2011) amended paragraphs 1, 6, 17 and 24 and deleted paragraphs 25 and 26. An entity shall apply those amendments when it applies IAS 19 (as amended in 2011).

Transition

- 28 An entity shall apply this Interpretation from the beginning of the first period presented in the first financial statements to which the Interpretation applies. An entity shall recognise any initial adjustment arising from the application of this Interpretation in retained earnings at the beginning of that period.
- 29 An entity shall apply the amendments in paragraphs 3A, 16–18 and 20–22 from the beginning of the earliest comparative period presented in the first financial statements in which the entity applies this Interpretation. If the entity had previously applied this Interpretation before it applies the amendments, it shall recognise the adjustment resulting from the application of the amendments in retained earnings at the beginning of the earliest comparative period presented.
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SECTION PS 1000

financial statement concepts

SUPPLEMENT

This supplement sets out the previous wording of paragraphs that have been amended substantially or deleted as a consequence of approving ASSETS, Section PS 3210.

.36 Assets have three essential characteristics:

- (a) they embody a future benefit that involves a capacity, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services;
- (b) the government can control access to the benefit; and
- (c) the transaction or event giving rise to the government's control of the benefit has already occurred.

.38 For an asset to be a government's asset, that government must control the future economic benefit associated with the asset to the extent that it can benefit directly from the asset and generally can deny or regulate access to that benefit by others. For example, the direct benefits of education and health care programs accrue to and are controlled by the individuals who are educated or treated and healed. Therefore, the costs of such programs, which are often called "investments", are excluded from being assets of the government.

This supplement sets out the previous wording of paragraphs that have been amended substantially as a consequence of approving FINANCIAL INSTRUMENTS, Section PS 3450.

.34 The elements of government financial statements include: assets (both financial and non-financial), liabilities, revenues, and expenses. Revenues and expenses, and therefore operating results for an accounting period, result only from changes in assets and liabilities. Operating results, which are described as the surplus or deficit for the accounting period, are determined as a measure of the change in net economic resources for an entity for a period and, except in specific circumstances, articulate that change (economic, financial and non-financial resources are defined in FINANCIAL STATEMENT OBJECTIVES, Section PS 1100). Specific circumstances affecting net economic resources that are excluded from operations are identified in individual Sections of the PSA Handbook, for example ACCOUNTING CHANGES, Section PS 2120. Definitions of the elements that together comprise operating results, revenues and expenses, are derived from the definitions of assets and liabilities.

.40 A financial asset is any asset that is:

- (a) cash;
- (b) a realizable asset that is convertible to cash;
- (c) a contractual right to receive cash or another financial asset from another party;
- (d) a temporary or portfolio investment;
- (e) an investment in a government business enterprise or government business partnership;
- (f) a financial claim on an outside organization or individual; or
- (g) an inventory or item for sale that meets the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1200.051.

Note: Refer also to Handbook Revisions Release no. 34 (June 2011) for a complete listing of amendments related to the issuance of FINANCIAL INSTRUMENTS, Section PS 3450.

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public sector accounting standards

concepts & principles

Sections PS 1000 — PS 1300

SECTION PS 1000

financial statement concepts



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PURPOSE AND SCOPE

.01 This Section describes the concepts underlying the development and use of accounting principles in government financial statements. Such financial statements are designed to meet the common information needs of external users of financial information about a government.

.02 "Financial statements" refers to the summary financial statements published by a government that report on the financial position and changes in financial position of the government reporting entity. Financial statements include the notes and schedules supporting the statements. "Government" refers to the elected and appointed policy-makers and administrators who together perform the executive function and are the preparers of financial statements.

.03 This Section is to be used by preparers and auditors of financial statements in exercising their professional judgment as to the application of generally accepted accounting principles and in establishing accounting policies in areas in which accounting principles are developing.

.04 This Section does not establish standards for particular measurement or disclosure issues. Nothing in the Section overrides any specific standard in another Section of the CPA Canada Public Sector Accounting Handbook. The Public Sector Accounting Board (the Board) will review any inconsistency between this Section and another Section when that other Section is re-examined.

.05 Financial reporting and accounting standards are evolutionary and are revised to reflect changes in conditions. Standards are the concepts, conventions and postulates that provide principles to measure, recognize, present and disclose the financial information considered necessary for accountability and useful for decision making. In government standards, the unique characteristics of government (see Appendix A to FINANCIAL STATEMENT OBJECTIVES, Section PS 1100) are a primary consideration in setting the parameters of the government reporting model.

.06 Standards generally do not prescribe format, ordering of financial statements or financial statement elements, or terminology except as required to meet the measurement and presentation requirements of the standards. Standards do, however, specify what measure(s) must be reported on a statement, and the calculation of those measures may demand a certain ordering of the financial statement elements reported. In all other aspects, preparers of government financial statements use professional judgment to design financial statements tailored to their users' needs.

CONTEXT OF GOVERNMENT FINANCIAL STATEMENTS

.07 *A government financial report should present information that is useful in evaluating the government's financial condition at the end of the accounting period and its financial performance during the accounting period. Government financial statements are a fundamental component of a government financial report.* [APRIL 2005]

.08 The financial position of a government as measured in the financial statements is only one factor in determining the financial condition of a government. Financial condition is a broad, complex concept with both short- and long-term implications that describes a government's financial health in the context of the overall economic and financial environment. Nevertheless, financial statements provide information that is critical to evaluating the financial condition of the government, and they form the cornerstone of a government financial report.

.09 The changes in the government's financial position presented in the financial statements are essential factors in assessing the financial performance of the government in the accounting period. They are, however, not the sole measures of government financial performance in the period. Additional financial performance information that draws on information external to the financial statements supplements and adds further depth to the picture of financial performance illustrated in the financial statements.

.10 The complex nature of government, its myriad of objectives and its public accountability requires multi-faceted reporting. Accordingly, total government reporting envisions a multidimensional accountability report comprising: a financial report that includes government financial statements; other information about a government's financial condition, and supplementary financial performance information; as well as non-financial information.

.11 All governments in Canada publish financial statements that display their financial position and the changes in financial position in the period. These financial statements are general purpose statements that serve, to the extent possible, the needs of a variety of users. Such statements are commonly required by law, audited and issued annually and, while most often addressed to legislatures or councils, are available to all interested parties.

.12 Financial statements cannot be expected to fulfill all of the users' needs served by a government's financial reporting system. Governments produce many kinds of financial reports in addition to financial statements. For example, there are reports prepared by individual entities to comply with legislation; there are reports to measure and report on the performance of individual funds, programs and activities; and there are special purpose reports designed to meet particular needs of specific users. In addition, governments set out their fiscal plan in budgets and estimates of expenses or expenditures. Some information, such as related performance information and narrative explanations, can only be provided in other financial reports or as supplementary information to the financial statements themselves. Thus, certain information is better provided, or can only be provided, by financial reports other than financial statements.

.13 Nevertheless, financial statements are a central feature of government financial reporting. They serve as a means by which a government provides an accounting of its administration of public financial affairs and resources. These financial statements are a principal means of communicating financial information to those not involved in the government's financial administration and present aggregated information capable of integration with other financial statements, schedules and reports provided by the government. Because of this key role, the objectives of government financial statements (see FINANCIAL STATEMENT OBJECTIVES, Section PS 1100) are a significant factor in the selection of accounting policies used in government financial reporting and in the determination of information required from the accounting system.

USERS AND USER INFORMATION NEEDS

.14 Government financial statements serve the interests of a variety of users: the public, legislators, councillors, investors, analysts and other governments.

.15 Legislatures, councils and governments are accountable to the public, who provide the revenues and resources necessary for government operations, who receive government services and who are the beneficial owners of the public money and property for which legislatures, councils and governments are responsible. The public is comprised of groups with a variety of interests and views.

.16 As elected representatives of the public, legislators and councillors are primary users of government financial statements. They grant authority to the government to administer public resources and financial affairs, and hold the government accountable for its financial administration.

.17 Investors in government securities and enterprises provide financial resources. Government has an interest in providing information useful to them in evaluating its ability to finance its activities and to meet its liabilities and contractual obligations. Economic and financial analysts serve legislators and councillors, investors and other interested parties. They use financial statements and other information to analyze and evaluate financial issues.

.18 Users are interested in the state of a government's finances, its financial viability both in the short and long term, its revenues and financing sources, the allocation and use of its economic resources, the nature and extent of its economic activities and the quality of its financial management. In particular, government financial statements need to report the information required by users to help them make assessments and judgments concerning government financial operations and management.

.19 More specifically, users look to financial statements to provide information about:

- (a) the sources and types of government revenues;
- (b) the allocation and use of economic resources;
- (c) the cost of goods and services provided in the accounting period;
- (d) the extent to which the costs of the period were met by the revenues of the period;
- (e) the government's financial position;
- (f) the stock, allocation and use of non-financial resources;
- (g) the extent to which revenues were sufficient to meet expenditures;
- (h) how the government financed its activities and how it met its cash requirements;
- (i) actual results of activities of the period in comparison with those originally planned and those of past periods; and
- (j) whether public economic resources were managed in accordance with legislative authorities.

.20 Information in financial statements may be used for a number of diverse purposes depending on the interests of the users. For example, information presented in the financial statements, when used with other information, is useful in gaining an understanding of and assessing:

- (a) a government's ability to meet its financial obligations, both short- and long-term;
- (b) a government's ability to maintain the level and quality of its services and to finance new programs;
- (c) future tax and other revenue requirements;
- (d) government spending priorities;
- (e) the impact of government economic activities on the economy; and
- (f) the performance of government in managing the economic resources for which it is responsible.

FINANCIAL STATEMENT OBJECTIVES

.21 The information needed to aid understanding and assessments of government financial operations and to promote accountability extends beyond reporting surpluses and deficits. A government's financial statements must provide information that describes liabilities and financial assets, its non-financial assets that are available for use in providing future services, the cost of using its economic resources in the delivery of services, as well as information about investing and financing activities and potential assets and liabilities. Further, this information needs to highlight measures (for example, net debt and net economic resources) that help users assess whether the government's financial position has improved or deteriorated and explain the changes in financial position. The information reported in financial statements must also reflect the full nature and extent of the government's resources, obligations and financial affairs. The objectives of government financial statements are outlined in FINANCIAL STATEMENT OBJECTIVES, Section PS 1100, and are consistent with the financial statement concepts of this Section.

BENEFIT VERSUS COST CONSTRAINT

.22 The benefits expected to arise from providing information in financial statements should exceed the cost of doing so. This constraint also applies to the development of accounting standards by the Board. It is also a consideration when preparing financial statements in accordance with those standards (for example, in considering disclosure of information beyond that required by the standards). The Board recognizes that the benefits and costs may accrue to different parties and that the evaluation of the nature and amount of benefits and costs is substantially a judgmental process.

QUALITATIVE CHARACTERISTICS

.23 The function of financial statements is the communication of information to users. To fulfill this function effectively, the information must be relevant and reliable, and communicated in a manner that best facilitates its use.

.24 *Financial statements should communicate information that is relevant to the needs of those for whom the statements are prepared, reliable, comparable, understandable and clearly presented in a manner that maximizes its usefulness.* [APRIL 2005]

.25 Financial statements provide evidence of accountability and report information required by users to help them make assessments and judgments concerning government financial operations and management. To adequately serve these needs in a manner that maximizes its usefulness, information in financial statements must possess certain basic qualities. These qualities are essential to the utility of government financial statements. The information required to meet the objectives of government financial statements needs to embody these essential characteristics.

Relevance

.26 For the information provided in financial statements to be useful, it must be relevant to the decisions made by users and for assessing accountability. Information is relevant by its nature when it can influence the decisions of users by helping them evaluate the financial impact or potential financial impact of past, present or future transactions and events or confirm, or correct, previous evaluations. For the information in government financial statements to be relevant to the needs of users, it must also be of a nature, and presented in a manner, that helps users assess the accountability of the government for its administration of public resources and financial affairs.

.27 Financial statements are not intended to provide all of the information necessary to users for decision making or for assessing government accountability. Nevertheless, they provide a fundamental component of the information needed for such purposes.

.28 Relevance is achieved through information that has predictive, feedback and accountability value, and is timely.

(a) **Predictive value and feedback value**

Information that helps users to predict a government's future financial results and cash flows has predictive value. Although the data provided in financial statements will not normally be a prediction in itself, it may be useful in making predictions. The predictive value of the statement of operations, for example, is enhanced if abnormal items are separately disclosed. Information that confirms or corrects previous predictions has feedback value. Information often has both predictive value and feedback value.

(b) **Accountability value**

Information that helps users assess a government's stewardship of the resources entrusted to it, including how resources have been applied and consumed in providing services, has accountability value. Information in government financial statements must be presented in a manner that assists in discharging this accountability. To provide accountability value, financial statements should reflect the nature and dimensions of financial position and performance that are characteristic of and appropriate to the unique nature of government. Accountability value is enhanced when financial statements identify the financial objectives and targets normally established by formal process and measure actual achievements against those financial objectives and targets. The accountability value of the information in the financial statements is also enhanced when the financial and non-financial performance information disclosed elsewhere in the Public Accounts, annual report or other report of the government can be related to the information in financial statements.

(c) **Timeliness**

Information should be timely. Financial statements issued long after the end of the fiscal period are of historical interest only. For information to be useful for decision making and accountability, the decision maker or stakeholder must receive it before it loses its capacity to influence decisions. The usefulness of information for decision making and assessing accountability declines as time elapses.

Reliability

.29 Information should be reliable. Inaccurate, inappropriate or incomplete information, or information that is biased or does not faithfully represent what it purports to represent, will inhibit rather than enhance understanding, evaluation and decision making by users and adversely affect the accountability provided by the financial statements to stakeholders. Reliable information has the following characteristics.

(a) **Representational faithfulness**

Representational faithfulness is achieved when transactions and events affecting the entity are presented in financial statements in a manner that is in agreement with the actual underlying transactions and events. Thus, transactions and events are accounted for and presented in a manner that conveys their substance rather than necessarily their legal or other form. The substance of transactions and events may not always be consistent with that apparent from their legal or other form. To determine the substance of a transaction or event, it may be necessary to consider a group of related knowledgeable and independent observers would concur that it is in agreement with the actual underlying transaction or event with a reasonable degree of precision.

(b) **Completeness**

Information is complete when none of the data necessary to achieve representational faithfulness is lacking. Completeness of disclosure means providing sufficient information about transactions, circumstances or events of such size, nature or incidence that their disclosure is necessary to understand the government's finances. In assessing the degree of completeness of the information provided in financial statements, the benefit / cost constraint in paragraph PS 1000.22 and the qualitative characteristics trade-off described in paragraph PS 1000.32 would be considered. Reliability implies completeness of information, at least within the bounds of what is material and feasible, considering the cost. An omission can rob information of its claim to neutrality if the omission is material and is intended to induce or inhibit some particular mode of behaviour.

(c) **Neutrality**

Information is neutral when it is free from bias that would lead users towards making decisions that are influenced by the way the information is measured or presented. Bias in measurement occurs when a measure tends to consistently overstate or understate the items being measured. In the selection of accounting principles, bias may occur when the selection is made with the interests of particular users or with particular economic or political objectives in mind. Financial statements that do not include everything necessary for faithful

representation of transactions and events affecting the entity would be incomplete and, therefore, potentially biased.

Neutrality does not mean "without purpose", nor does it mean that accounting should be without influence on human behaviour. Accounting information cannot avoid affecting behaviour, nor should it. It is, above all, the predetermination of a desired result, and the consequential selection of information to induce that result, that negates neutrality in accounting. To be neutral, accounting information must report economic activity as faithfully as possible, without colouring the image it communicates for the purpose of influencing behaviour in some particular direction.

(d) Conservatism

The application of conservatism in making judgments under conditions of uncertainty affects the neutrality of financial statements in an acceptable manner. When uncertainty exists, estimates of a conservative nature attempt to ensure that assets, revenues and gains are not overstated and, conversely, that liabilities, expenses and losses are not understated. Conservatism does not, however, encompass the deliberate understatement of assets and revenues or the deliberate overstatement of liabilities and expenses.

(e) Verifiability

The financial statement representation of a transaction or event is verifiable if knowledgeable and independent observers would concur that it is in agreement with the actual underlying transaction or event with a reasonable degree of precision. Verifiability focuses on the correct application of a basis of measurement rather than its appropriateness.

Comparability

.30 Comparability is a characteristic of the relationship between two pieces of information rather than of a particular piece of information by itself. It enables users to identify similarities in and differences between the information provided by two sets of financial statements. Uniformity in application of principles is important when comparing the financial statements of two different entities. Consistency in application is important when comparing the financial statements of the same entity over two periods or at two different points in time. Consistency helps prevent misconceptions that might result from the application of different accounting policies in different periods. When a change in accounting policy is deemed to be appropriate, disclosure of the effects of the change is necessary to maintain comparability.

Understandability and clear presentation

.31 Information should be understandable and clearly presented. Excessive detail, vague or overly technical descriptions, and complex presentation formats result in confusion and misinterpretation. Users need information presented clearly and simply. For the information provided in financial statements to be useful, it must be capable of being understood by users. Users are assumed to have a reasonable understanding of economic activities and accounting, together with a willingness to study the information with reasonable diligence.

Qualitative characteristics trade-off

.32 In practice, a trade-off between qualitative characteristics is often necessary, particularly between relevance and reliability. For example, there is often a trade-off between the timeliness of producing financial statements and the reliability of the information reported in the statements. There may also be a trade-off between the accountability value of information and the level of detail appropriate to the financial statements, as well as the cost of providing it. As described in paragraph PS 1000.12, some information may be better provided by other reports in the government's reporting system. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objectives of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

ELEMENTS OF FINANCIAL STATEMENTS

.33 Elements of financial statements are the basic categories of items portrayed therein in order to meet the objectives of financial statements. There are two types of elements: those that describe the economic (financial and non-financial) resources, obligations and accumulated surplus or deficit of a government at a point in time, and those that describe changes in economic resources, obligations and accumulated surplus or deficit over a period of time. Notes to financial statements, which are useful for the purpose of clarification or further explanation of the items in financial statements, while an integral part of financial statements, are not considered to be an element.

.34 The elements of government financial statements include: assets (both financial and non-financial), liabilities, revenues, and expenses. Revenues and expenses and, therefore, operating results for an accounting period, result only from changes in assets and liabilities. Operating results, when taken together with amounts reported in the statement of remeasurement gains and losses, account for the change in net economic resources for an entity for a period and, except in specific circumstances, articulate that change (economic, financial and non-financial resources are defined in FINANCIAL STATEMENT OBJECTIVES, Section PS 1100). Specific circumstances affecting net economic resources that are excluded from operations are identified in individual Sections of the PSA Handbook, for example ACCOUNTING CHANGES, Section PS 2120. Definitions of the elements that together comprise operating results, revenues and expenses, are derived from the definitions of assets and liabilities. [Former paragraph PS 1000.34 retained in Archived Pronouncements.]

.35 **Assets** are economic resources controlled by a government as a result of past transactions or events and from which future economic benefits are expected to be obtained.

.36 Assets have three essential characteristics:

- (a) they embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows;
- (b) the public sector entity can control the economic resource and access to the future economic benefits; and
- (c) the transaction or event giving rise to the public sector entity's control has already occurred. [Former paragraph PS 1000.36 retained in Archived Pronouncements.]

.37 An item is not an asset of a government if it lacks one or more of the essential characteristics listed in the preceding paragraph. Thus, for example, an item does not qualify as an asset of a government if the item involves:

- (a) no future economic benefit;
- (b) future economic benefit, but the government cannot obtain it; or
- (c) future economic benefit that the government may obtain, but the events or circumstances that give the government control of the benefit have not yet occurred.

(paragraph PS 1000.38 deleted) [Former paragraph PS 1000.38 retained in Archived Pronouncements.]

.39 **Financial assets** are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations.

.40 A financial asset is any asset that is:

- (a) cash;
- (b) a realizable asset that is convertible to cash;
- (c) a contractual right to receive cash or another financial asset from another party;
- (d) a contractual right to exchange financial instruments with another party under conditions that are potentially favourable to the government;
- (e) an equity instrument of another entity;
- (f) an investment in a government business enterprise or government business partnership;
- (g) a financial claim on an outside organization or individual; or
- (h) an inventory or item for sale that meets the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1201.055. [Former paragraph PS 1000.40 retained in Archived Pronouncements.]

.41 Non-financial assets include tangible capital assets, and other assets such as prepaid expenses and inventories of supplies.

.42 **Non-financial assets** are acquired, constructed or developed assets that do not normally provide resources to discharge existing liabilities, but instead:

- (a) are normally employed to deliver government services;
- (b) may be consumed in the normal course of operations; and
- (c) are not for sale in the normal course of operations.

.43 **Tangible capital assets** are non-financial assets 1 having physical substance that:

- (a) are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance or repair of other tangible capital assets;
- (b) have useful economic lives extending beyond an accounting period;
- (c) are to be used on a continuing basis; and
- (d) are not for sale in the ordinary course of operations.

.44 **Liabilities** are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits.

.45 Liabilities have three essential characteristics:

- (a) they embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;
- (b) the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and
- (c) the transactions or events obligating the government have already occurred.

.46 **Revenues**, including gains, are increases in economic resources, either by way of increases of assets or decreases of liabilities, resulting from the operations, transactions and events of the accounting period.

.47 Revenues, other than gains, can arise from: taxation; the sale of goods; the rendering of services; the use by others of government economic resources yielding rent, interest, royalties or dividends; or receiving contributions such as

grants, donations and bequests. Revenues do not include borrowings, such as proceeds from debt issues or transfers from other governmental units in the government reporting entity or amounts collected on behalf of others.

.48 Gains can arise from peripheral or incidental transactions and events affecting a government. Such transactions and events include the disposition of assets purchased for use and not for resale, and the liquidation or refinancing of debt.

.49 **Expenses**, including losses, are decreases in economic resources, either by way of decreases in assets or increases in liabilities, resulting from the operations, transactions and events of the accounting period.

.50 Expenses include the cost of economic resources consumed in and identifiable with the operations of the accounting period. For example, the cost of tangible capital assets is amortized to expenses as the assets are used in delivering government programs (see TANGIBLE CAPITAL ASSETS, Section PS 3150). Expenses do not include debt repayments or transfers to other governmental units in the government reporting entity.

.51 Losses can arise from peripheral or incidental transactions and events affecting a government. Such transactions and events include the disposition of assets purchased for use and not for resale, and the liquidation or refinancing of debt.

RECOGNITION

.52 Recognition is the process of including an item in the financial statements of an entity. Recognition consists of the addition of the amount involved into item totals on a financial statement together with a narrative description of the item (for example, receivables, user fees, grants) in a statement. Similar items may be grouped together in the financial statements for the purpose of presentation.

.53 Recognition means inclusion of an item within one or more individual statements and does not mean disclosure in the notes to the financial statements. Notes either provide further details about items recognized in the financial statements, or provide information about items that do not meet the criteria for recognition and thus are not recognized in the financial statements.

.54 The recognition criteria below provide general guidance on when an item is recognized in the financial statements. Whether a particular item is recognized or not will require the application of professional judgment in considering whether the specific circumstances meet the recognition criteria.

.55 The recognition criteria are as follows:

- (a) the item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved; and
- (b) for an item that involves obtaining or giving up future economic benefits, it is expected that such benefits will be obtained or given up.

.56 It is possible that an item will meet the definition of an element but still not be recognized in the financial statements because it is not expected that future economic benefits will be obtained or given up or because a reasonable estimate cannot be made of the amount involved. It may be appropriate to provide information about items that do not meet the recognition criteria in notes to the financial statements. "Expected" is used with its usual general meaning and refers to that which can reasonably be anticipated, contemplated or believed on the basis of available evidence or logic but is neither certain nor proved. The use of the word in the recognition criteria is intended to acknowledge that economic activities occur in an environment characterized by uncertainty. It is not intended to accommodate the recognition of items that do not meet the definition of one of the elements of financial statements. By implication, recognition would, therefore, not be appropriate without the occurrence of a past transaction or economic event that gives rise to an asset, liability, revenue or expense as defined in this Section.

.57 Purchased natural resources and Crown lands are recognized in government financial statements. However, when natural resources and Crown lands have been inherited by the government in right of the Crown and have not been purchased, they are not given accounting recognition as assets in government financial statements. These items are not recognized as assets because the costs, benefits and economic value of such items cannot be reasonably and verifiably quantified using existing methods. Similarly, art and historic treasures are also not recognized as assets.

.58 In the absence of appropriate public sector recognition and measurement criteria for intangibles, all intangibles, including those that have been purchased, developed, constructed or inherited in right of the Crown, are not recognized as assets in government financial statements. The intangible often called "human capital" that embodies the talent or intellectual capital of government employees is not recognized as an asset under existing accounting principles.

.59 Items recognized in government financial statements are accounted for in accordance with the accrual basis of accounting. The accrual basis of accounting recognizes the effect of transactions and events in the period in which the transactions and events occur, regardless of whether there has been a receipt or payment of cash or its equivalent. Accrual accounting recognizes a liability until the obligation or condition(s) underlying the liability is partly or wholly satisfied. Accrual accounting recognizes an asset until the future economic benefit underlying the asset is partly or wholly used or lost.

MEASUREMENT

.60 Measurement is the process of determining the amount at which an item is recognized in the financial statements. There are a number of bases on which an amount can be measured. Government financial statements are, however, prepared primarily using the historical cost basis of measurement, whereby transactions and events are recognized in financial statements at the amount of cash or cash equivalents paid or received or the fair value ascribed to them when they took place. Other bases of measurement are also used, but only in limited circumstances.

(a) Replacement cost is the amount that would be needed currently to acquire an equivalent asset. This may be used, for example, when inventories are valued at the lower of historical cost and replacement cost.

(b) Realizable value is the amount that would be received by selling an asset. This may be used, for example, to value portfolio investments. Market value may be used to estimate realizable value when a market for an asset exists.

.61 Present value is the discounted amount of future cash flows expected to be received from an asset or required to settle a liability. Present value is not a basis of measurement, but a valuation technique that may be used within historical cost-based or current-value models. This technique is used in the government reporting model, for example, to estimate the cost of retirement benefits, when determining the estimated total expenditure for closure and post-closure care of a solid waste landfill site, and when determining the "grant portion" of concessionary loans and portfolio investments.

.62 Government financial statements are prepared on the basis that recognized economic resources used up are measured in financial terms with no adjustments made for the effect of a change in the general purchasing power of the currency during the period. Although a government's performance in the management of its service potential 2 is generally a focus more appropriate to the nature and objectives of government, it cannot entirely be measured in financial terms.

.63 Financial statements are prepared on the assumption that the government is a going concern, meaning it will continue in operation, and will be able to realize assets and discharge liabilities and meet its statutory obligations in the normal course of operations for the foreseeable future.

Footnotes

1. Tangible capital assets are defined to include computer software.
2. Service potential embodies both the quality of service provided and the efficiency with which it is provided.

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SECTION PS 1100

financial statement objectives

SUPPLEMENT

This supplement sets out the previous wording of paragraphs that have been deleted as a consequence of approving ASSETS, Section PS 3210.

.22 **Economic resources** are scarce means that are useful for carrying out economic activities, such as consumption, production and exchange. Financial and non-financial resources comprise the economic resources of a government.

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SECTION PS 1100

financial statement objectives



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PURPOSE AND SCOPE

.01 This Section identifies and describes objectives of government financial statements that are generally acceptable to the users and preparers of the statements. These objectives provide the basis for determining standards of financial statement reporting and accounting principles that are consistent with one another and appropriate for government. Their goal is to improve government financial statements and enhance their comparability.

.02 "Financial statements" refers to the summary financial statements published by a government that report on the financial position and changes in financial position of the government reporting entity. Financial statements include the notes and schedules supporting the statements. "Government" refers to the elected and appointed policy-makers and administrators who together perform the executive function and are the preparers of financial statements.

.03 This Section does not discuss objectives of special purpose financial statements or other financial reports published by government.

ROLE OF OBJECTIVES IN STANDARD SETTING

.04 A conceptual framework for accounting consists of an interrelated and compatible system of objectives, standards or principles, and practices or procedures, all linked rationally to the needs of users (outlined in FINANCIAL STATEMENT CONCEPTS, Section PS 1000). Since financial statement objectives identify goals and purposes, the qualitative characteristics of financial information, and recognition, measurement, presentation and disclosure standards follow logically from them and provide guidelines for the development of compatible accounting practices.

.05 The objectives of financial statements define the nature of the information needed to meet the requirements of the users of the statements. Substantial agreement on the objectives by both the users and preparers of the financial statements is requisite to setting appropriate accounting and reporting standards. If standards were set without agreement on objectives, there would be no basis for preferring one standard over another or judging the effectiveness of alternative standards in fulfilling the purposes of the financial statements.

GOVERNMENT OPERATIONS

.06 Governments are inherently different from businesses. The unique characteristics of government have reporting implications as outlined in Appendix A.

.07 The objectives of financial reporting for governments and business are not the same. Specifically, the accounting standards for business do not adequately prescribe the recognition, measurement, presentation and disclosure of government financial information that is needed for accountability by governments and useful for decision making by the users of government financial statements.

.08 The goals of government are not the same as those of business. The primary goal of a business is profit and its resources are employed to that end. Investors put up capital in expectation of a return, and financial statements report the success or failure of the business in providing that

return. Results of operations are measured and reported in terms of profit or loss and it is added to or deducted from the owners' investment to measure financial position. Annual and accumulated earnings or losses are key measures of the performance of a business.

.09 Governments differ from business in both their objectives and financing. In general, governments provide public services and redistribute wealth for a variety of social and economic purposes. The delivery of a service does not, however, normally give rise to revenue, and the payment of taxes does not necessarily entitle a taxpayer to any particular public service or benefit. Because governments are granted the power to tax, their revenues are not substantially dependent upon voluntary contributions nor on the profitable sale of goods and services in the marketplace. Thus, except for commercial-type activities, the relationship between revenues and costs in any given period is not the same for government as it is for business.

.10 In any given period, a government may finance its operations from tax and other revenues or by borrowing or incurring other liabilities. The financial resources required are forecast and the government's financing plan is set out in the budget. Financial statements report the actual results of government operations and the extent to which revenues raised in the period were or were not sufficient to meet the expenses of that period. Users of the statements look to the operating surplus or deficit for the period, both on its own and in relation to the government's plan, in evaluating the government's fiscal management. Expenses, however, do not necessarily represent the total financial resources required. Governments, for example, also spend, lend and invest in addition to consuming economic resources in each accounting period. It is, therefore, also important to provide information about how a government financed its activities and met its cash requirements.

.11 Over the years, a government accumulates liabilities that must be settled and assets that provide resources for future operations. Information that reports the extent of the financial obligations that will have to be settled, or the extent of the assets that are available for future operations, is useful because it bears directly on future revenue requirements and on a government's ability to settle its obligations and finance its operations.

.12 The information needed to promote accountability and to aid understanding and assessments of government operations extends beyond reporting surpluses or deficits. For example, financial statements should provide information that describes the nature and purpose of government spending and the sources of its revenues and financing. They should also provide information that describes a government's non-financial resources that can be used in future operations and the cost of using those resources in service delivery. They should also provide information on investments and on potential obligations that may result from guarantees or indemnities.

OBJECTIVES OF GOVERNMENT FINANCIAL STATEMENTS

.13 The objectives of government financial statements that follow are based on the information needs of users, taking into account the limitations of financial statements as a reporting medium, the nature of government operations and legislative control.

Scope of government financial statements

.14 Governments carry out policies and deliver services through a variety of entities. Some are organizational and accounting entities (such as departments, special funds and accounts) that are integral to the overall government organization and through which the government directly performs its executive function. Others are separate corporate entities with their own management, which, under legislation, have been delegated financial powers and operational authority.

.15 To help users understand and assess the management of the public financial affairs and resources entrusted to governments, financial statements would account for the full nature and extent of the financial affairs and resources which a government controls. Financial statements would account for not only the organizational and accounting entities through which a government directly performs its function, but also the separate funds, agencies and enterprises which a government controls.

.16 Objective 1

Financial statements should provide an accounting of the full nature and extent of the financial affairs and resources which the government controls, including those related to the activities of its agencies and enterprises. [APRIL 2005]

.17 The presentation of information in the financial statements may need to vary in order to recognize the different nature and purpose of individual entities and their relationship to the government. However, the information reported in the financial statements, together with that in the notes and schedules integral to those statements, should provide a useful summary accounting of the full nature and extent of the financial activities authorized by the legislature and administered through government departments, special funds, agencies and enterprises.

.18 Government financial statements are not intended to replace the separate financial statements of individual departments, funds, agencies and enterprises. Those separate statements constitute important accountability reports by their respective managements. However, those statements alone do not provide the public and other users with an understandable overview of the full nature and extent of the financial resources and affairs which the government controls.

Reporting financial position

.19 Financial statement information is used to gain an understanding of, and assess the state of, a government's finances at a point in time. Such information facilitates assessments of the government's financial viability, future tax and revenue requirements, and ability to maintain and expand the level and quality of its services.

.20 Objective 2

Financial statements should present information to describe the government's financial position at the end of the accounting period. Such information should be useful in evaluating:

- (a) *the government's ability to finance its activities and to meet its liabilities and contractual obligations; and*
- (b) *the government's ability to provide future services. [APRIL 2005]*

.21 Governments provide public services and redistribute wealth for a variety of social and economic purposes. To meet those objectives, governments need information about the cost of services and the affordability of services. An understanding of the extent of the financial "lien"

the government has on its ability to provide future services as a result of past transactions and events is essential information. Governments also need to have an appreciation of the magnitude of the total economic resources they have on hand to deliver services. A government's net financial resources / net debt position, assessed in combination with the non-financial resources position of the government, provides a measure of the net recognized economic resources available to the government at the financial statement date to provide services in the future.

(paragraph PS 1100.22 deleted) [Former paragraph PS 1100.22 retained in Archived Pronouncements.]

.23 **Financial resources** include cash, claims to cash, investments and any other resources of the government that are not for consumption in the normal course of operations and are expected to contribute to net cash inflows (such as inventories for resale). A government's financial assets, as defined in FINANCIAL STATEMENT CONCEPTS, Section PS 1000, comprise the financial resources of a government.

.24 **Non-financial resources** include all items of a fixed or permanent nature (such as tangible capital property), claims to goods and services (such as prepaid items) and consumable goods (such as inventories of supplies). Non-financial resources also include intangibles, Crown lands and natural resources.

.25 Certain non-financial resources are, however, not given accounting recognition as assets in government financial statements. For example, all government intangibles, and all natural resources and Crown lands that have not been purchased by the government, are not given accounting recognition in government financial statements. A government's non-financial assets, as defined in FINANCIAL STATEMENT CONCEPTS, Section PS 1000, comprise the recognized non-financial resources of a government.

.26 Because the non-financial resources of government are different in nature from those held by a business, however, the financial position of a government has two dimensions:

- (a) the net financial resources or net debt of a government; and
- (b) the recognized non-financial resources of the government, which represent unexpired service potential available to be consumed by the government in the future.

.27 The term "net debt" is used to describe the first indicator of a government's financial position in this Section. The net assets of a government represent the net economic resources recognizable by the government. The two dimensions of the government's financial position are combined to calculate this second indicator of a government's financial position, called its accumulated surplus or deficit.

.28 Net debt is measured as the difference between a government's liabilities and financial assets. This difference bears directly on the government's future revenue requirements and on its ability to finance its activities and meet its liabilities and contractual obligations. Net debt provides a measure of the future revenues required to pay for past transactions and events. The extent of a government's net debt and the financial ability of the government to service that debt is an important test of the sustainability of that government. When a government's financial assets exceed its liabilities, this indicator of a government's financial position would be called "net financial assets" and it would provide a measure of the net financial assets on hand that can provide financial resources to finance future operations.

.29 A government's net debt is an important indicator of a government's financial position, highlighting the financial affordability of future government service provision. A net debt position represents a "lien" on the ability of the government to apply financial resources and future revenues to provide services. Non-financial assets are added to net debt to calculate the other indicator of a government's financial position — its accumulated surplus or deficit. Non-financial assets are "prepaid service potential". Reporting a government's recognized non-financial resources as part of its financial position provides information necessary for a more complete understanding of a government's debt position, financial position and future operating requirements.

.30 The nature of the majority of government non-financial assets is different from the nature of those held by a business. Capital assets are held by a business in order to generate future net cash inflows to provide a return to investors, as well as to finance operations, expansion and debt retirement. If the net realizable value of an asset of a business is greater than the present value of its expected future net cash inflows to the business, it would normally be sold. In contrast, for government, like not-for-profit organizations, recognition and valuation of capital assets are based on their service potential; for the most part, such assets do not generate future net cash inflows. In addition, they do not normally provide resources to discharge the liabilities of the government, unless they are sold and thus converted back into financial assets.

.31 The tangible capital assets and other non-financial assets of a government form part of its financial position because they provide resources that the government can employ in the future to accomplish its objectives. The government can use these assets to provide services. The services that the government can provide as a result of owning a capital asset are the future benefits embodied by the asset. Including such assets in the government's financial position provides a more complete picture of the economic resources available to and utilized by the government.

.32 A key distinction between the financial and non-financial assets of a government is the degree of choice in application associated with them. Financial assets can be used to discharge liabilities or provide services, while non-financial assets can normally be used only for service provision. Given that many users are more familiar with the nature of the elements reported in the financial statements of profit-oriented enterprises, it is crucial that the financial statements identify this fundamental characteristic of government non-financial assets.

.33 In addition, users expect financial statements to disclose the nature and term of liabilities and assets and of potential liabilities represented by contractual obligations and contingencies such as guarantees and indemnities.

Reporting changes in financial position

.34 Users look to government financial statements to provide a meaningful summary of the sources, allocation and consumption of the resources administered by the government in the period. They also need to understand the extent to which the expenses of the accounting period were met by the revenues recognized in the period.

.35 This information is useful in gaining an understanding of and assessing a government's resource requirements, the purposes for which resources were used and applied and the nature and extent of its revenue-raising activities. The statements also inform users about the extent to which resources will be required from future revenues to pay for programs and activities of the period, the cost of resources consumed in delivering goods and services in the period and how the government financed its activities in the period.

.36 Objective 3

Financial statements should present information to describe the changes in a government's financial position in the accounting period. Such information should be useful in evaluating:

- (a) *the sources, allocation and consumption of the government's recognized economic resources in the accounting period;*
- (b) *how the activities of the accounting period have affected the net debt of the government; and*
- (c) *how the government financed its activities in the accounting period and how it met its cash requirements.* [APRIL 2005]

Reporting government operations

.37 Financial statements should show how and where a government gets its revenues to provide information that is useful in: analyzing the impact of a government's revenue-raising activities on the economy; gaining an understanding of a government's finances by showing its revenue sources and their relative contributions; and evaluating the revenue-producing capacity of its investments.

.38 Financial statements should report the nature and purpose of a government's expenses in the period to show the allocation and consumption of resources. To account for all expenses by nature and purpose, a government could provide a variety of information. For example, financial statements could show expenses by function or major program to display the resources consumed by each type of government activity; by object of expense to disclose the nature of the resources consumed by a government; and by department or ministry to reflect its responsibility for costs.

.39 Expenses represent the cost of resources consumed in delivering government goods and services in the period. When used in conjunction with output and outcome information, cost information provides a basis for assessing the performance of government programs and activities and the government's use of the resources entrusted to it. By showing all government expenses by nature and purpose, the financial statements disclose the resources consumed by each type of government activity.

.40 Businesses exist to generate profits. Governments exist to provide services to their constituents. Accordingly, net income as measured by a business is not an appropriate measure of a government's service output. Outputs and outcomes of government programs are best measured using both financial and non-financial performance information. Such evaluations would include consideration of the cost / benefit of each program.

.41 Still, it is important to account for the extent to which revenues raised in the period were sufficient to meet the expenses of that period. This difference measures the net change in a government's liabilities and assets in the accounting period and is important in explaining the change in the government's financial position in the period.

.42 Government revenues are recognized when the transactions or events giving rise to the revenues occur, and expenses are recognized when incurred; thus, revenues and expenses are reflected in the financial statements in accordance with the timing of the effect of the related transaction or event on the economic resources of the government.

.43 One dimension of the relationship that exists between government revenues and expenses is the link between the revenue-raising capacity of the government and the estimated cost of government services in any one period that is assessed when governments budget. Government budgeting is an iterative process whereby a government considers both its revenue-raising capacity for the period in looking at what expenses it can budget for, as well as estimating the expenses that should be incurred in the period, and the revenues that would need to be raised to cover those costs, as well as any other needs, such as debt retirement.

.44 Another dimension of the relationship between revenues and expenses is that the net difference between them is a measure of the extent to which the net economic resources of the government have been maintained after the activities of the period have been taken into account. Regardless of whether the revenues were specifically raised to fund the costs they are netted against, this information is important because the extent of a government's net economic resources provides an indication of its ability to provide services in the future.

.45 Investors and creditors of profit-oriented enterprises are interested, for the purpose of making resource allocation decisions, in predicting the ability of the entity to earn income and generate cash flows in the future to meet its obligations and to generate a return on investment. The public, elected officials and other users of government financial statements are interested, for making resource allocation and other decisions, as well as for assessing government accountability, in the government's cost of service and how that cost was funded, and in predicting the ability of the government to meet its obligations and achieve its service delivery objectives.

.46 The financial statements summarize cost of service information at a functional level. The more detailed service costs that underlie this summary provide the government with the management information to meet objectives such as cost control, cost recovery, alternative service delivery, results-based management and performance measurement.

.47 Measuring the cost of services is relevant to taxpayers because this accounting provides information for evaluating government services. Measuring the cost of services, however, deals only with the cost side of a cost / benefit analysis and does not address the non-financial aspects of the effectiveness of services. Nevertheless, judgments as to the value of the service and the government's effectiveness in meeting program objectives cannot be made without cost data as a starting point.

Reporting the change in net debt

.48 In any given period, a government finances its expenditures by raising revenues, applying existing financial resources or incurring liabilities. Unlike expenses, which are the cost of goods and services consumed in the accounting period, **expenditures** are the cost of goods and services acquired by the government in the period. Expenditures include transfer payments due where no value is received directly in return.

.49 The information presented in a statement of change in net debt provides important accountability regarding the extent to which the expenditures of the government in the accounting period have been met by revenues recognized in the period.

.50 The statement of change in net debt needs to report the significant items that explain the difference between the surplus or deficit of the government for the accounting period as reported on the statement of operations and the change in net debt in the period. The statement can provide information useful for explaining why a government can have a surplus from operations, but still have an increase in its net debt. In this

way, the financial statements articulate and display the relationship between the change in recognized net economic resources and the change in net debt in the accounting period.

.51 For example, many significant items that explain the nature of the difference in the two measures result from the effects of the capitalization of non-financial assets. Some items are taken into account in calculating the (expense-based) operating surplus or deficit for the accounting period, but are excluded from the calculation of the (expenditure-based) change in net debt for the period. For example, the cost of consuming tangible capital assets (amortization) is reflected in an expense-based operating surplus or deficit for the period, while the cost of acquiring non-financial assets in the period is reflected in the change in net debt.

.52 A statement of change in net debt summarizes several key "change in position" messages:

- (a) the extent to which the costs of services provided in the period have been met by the revenues recognized in the period (the operating surplus or deficit for the period);
- (b) the extent of the capital expenditures in the period;
- (c) the extent to which the expenditures of the period have been met by the revenues recognized in the period (the change in net debt in the period);
- (d) on a summary basis, the extent to which the planned amount for each of the above noted items, and any other explanatory items, has been achieved in the period; and
- (e) the net remeasurement gains and losses in the accounting period.

Reporting cash flow

.53 In any given period, a government finances its activities and meets its obligations by revenue raising, by external borrowing and by using existing cash balances. Financial statements should show how a government financed its activities and met its cash requirements.

.54 The amount of cash flows arising from operating activities is a key measure of the extent to which the operations of the government have generated sufficient cash flows to maintain the programs and services of the government, invest in new capital assets, repay loans, and make new investments without recourse to external sources of financing. Cash flows from operating activities are primarily derived from the principal revenue-raising activities of the government. Therefore, they generally result from the transactions and other events that enter into the determination of the results of the accounting period.

.55 Some transactions, such as the sale of a capital asset, may give rise to an accounting gain or loss, which is included in the determination of results for the accounting period. The cash flows relating to such transactions are, however, cash flows from capital activities.

.56 Unlike the cash flow statement of a business, a government cash flow statement reports cash flow related to capital acquisitions as being used in or from capital activities because unlike the capital assets of a business, there are no future cash inflows associated with many government assets, only future service potential. So, there is no "return on investment" associated with these capital "investments" as there is for a business. Investing is a term that can only be applied to government financial assets because of the nature of government non-financial assets.

Legislative control and government financial accountability

.57 Legislative control over finances is essential to responsible government. While it is the sole prerogative of the government to propose plans for spending and financing of government activities, all costs, spending, revenue raising, investing and borrowing must be sanctioned by legislation. Legislation may provide direct authority to government to provide services at specified costs, to spend, to raise revenue, to invest and to borrow, or it may delegate powers that provide similar authority to government agencies or enterprises.

.58 Because it provides financial authority and powers, the legislature or council has the right and responsibility to hold the government accountable for the management of financial affairs and the use of resources. Legislators and councillors seek assurance that financing and operations were carried out in accordance with the authorities and powers granted. They, along with investors and the public, are also interested in assessing the government's performance in the management of financial affairs. Government financial statements should provide information that is useful in providing such assurance and in making such assessments.

.59 Users need information that helps them assess the government's results in the management of its resources and financial affairs. Financial information that makes it possible to identify variances, to compute trends and to analyze operations is useful in fulfilling this need. A comparison of the actual results with those originally forecast by the fiscal plan (the budget and main estimates of expenses or expenditures) and with those of prior periods is necessary to identify significant variances. To facilitate meaningful comparisons, planned and prior period results need to be reported on a basis and for a scope consistent with that used to report the actual results of the current period. In addition, financial statements must provide information necessary to establish trends in spending, revenues, investing and borrowing, cost of operations and in key relationships such as debt or debt-servicing costs to revenue.

.60 Users look to financial statement information as a principal means of determining whether the public resources entrusted to the government were administered in accordance with legislative authorities. For example, legislative authorities for spending usually specify the purpose of the spending and set some limits either in amount or by way of other conditions. Financial statements must provide information at an appropriate level of aggregation to show that activities were within the limits established by the appropriate legislative authorities. For example, the financial statements of a government should provide information to highlight when its revenue, expense, expenditure, borrowing and investing activities were not carried out within the amounts authorized by the legislature. Such summary information would be capable of being supported by supplementary information reported by government on a more detailed basis.

.61 Objective 4

Financial statements should demonstrate the accountability of a government for the resources, obligations and financial affairs for which it is responsible by providing information useful in:

- (a) *evaluating the financial results of the government's management of its resources, obligations and financial affairs in the accounting period; and*
- (b) *assessing whether resources were administered by the government in accordance with the limits established by the appropriate legislative authorities.* [APRIL 2005]

.62 The financial statements provide a measure of a government's performance in the achievement of its objectives. The financial statements also show the cumulative effect of past budgetary decisions on the financial position and results of government operations. Important accountability information about the budget decisions of the current period is provided when financial statements include a comparison of the government's actual and planned financial results of its management of its resources, obligations and financial affairs in the period.

.63 Unlike the continuity and relatively focused direction provided by a company's board of directors, the organizational objectives of a government tend to be very broad, are continuously redefined in each budget, and are often completely revamped whenever there is a change of government. The budget plays a dominant role in portraying public policy. It establishes estimates of revenues and expenses / expenditures. The budget includes financing requirements for both operating and capital spending. It is used to set tax rates and determine borrowing requirements. A government's budget is a critical element in the accountability cycle and the standard against which subsequent performance is judged. Governments are thus held publicly accountable for the choices they have made, for their programs, the cost of services, and the financial position of their jurisdiction.

.64 Two comparisons of actual and budgeted results, on the statement of operations and the statement of change in net debt respectively, provide the key accountability information integral to evaluating the government's performance in achieving its operational and spending plans:

- (a) a comparison of the actual and planned financial results of the government's management of its recognized economic resources, obligations and financial affairs; and
- (b) a more focused comparison of the government's actual and planned financial results in the management of its financial resources, obligations and financial affairs.

.65 The incremental accountability provided by including budget figures on the statement of change in net debt can be attributed to the provision of information about actual and budgeted spending on non-financial assets, to the display of the actual and budgeted extent to which expenditures of the period were met by revenues recognized in the period, and to the inclusion of actual and budgeted opening and closing net debt numbers.

.66 If a government's budget or appropriations are prepared on a different basis or for a different scope than its financial statements, the government needs to provide a link with the financial statements so that the legislature or council understands how the government's results for the period compare to the results it planned and the amounts authorized to accomplish those plans. In either circumstance, or when neither the budgeted scope nor basis is consistent with that used for reporting actual results, the financial statements will need to provide a reconciliation of the planned information included in the financial statements with that originally budgeted.

APPENDIX A

UNIQUE CHARACTERISTICS OF GOVERNMENT

#	Unique characteristics	Explanation	Reporting implications
1	Government's goal is to provide services and redistribute resources, not make a profit.	Government accountability is primarily for the level, quality and cost of services provided. Some governments redistribute resources through grants, concessionary loans and other transfers, in accordance with government objectives. In fact, most resource redistribution involves service provision by one level of government or another, except for welfare and other monetary assistance programs. The ability of a government to afford existing services and meet the need for new services is also key information.	Net cost of services and affordability of services should be reported. The net economic resources (net assets) available to use in providing future services should be reported.
2	Most government tangible capital assets are different in nature than those held by a business.	Most government tangible capital assets represent service capability, rather than future cash inflows to the government. They, and other non-financial assets, therefore represent the portion of the government's financial position that is unexpired service potential. The distinction between financial and non-financial assets of a government is the degree of choice in application associated with them. Financial assets can be used to discharge liabilities or provide services, while non-financial	Financial assets and non-financial assets should be reported separately on the statement of financial position. The net financial resources / net debt of the government and the net economic resources (accumulated surplus / [deficit]) measures should both be reported on the statement of financial position as they represent different

		assets are normally used only for service provision, unless they are sold and thus converted back into financial assets.	perspectives of the government's financial position.
3	Government capital spending may not focus on maximizing financial return because government objectives are broader.	A business is interested in what acquired capital will produce — the end product and the related net cash inflows. For government, the end product might not always be financial. Sometimes it is the process of building the capital that achieves a government objective (for example, providing employment or regional development).	Capital spending and its effect on net debt must be highlighted in the financial statements.
4	The principal source of revenue for governments is taxation.	The payment of taxes is obligatory — not part of an exchange transaction nor a voluntary contribution or investment. The bulk of government revenues do not arise from the direct sale of goods and services.	Ability to tax = ability to spend. So net debt needs to be reported because it represents the government's future revenue requirements based on past transactions and events (such as spending) to be met from future taxes and is an indication, therefore, of the affordability of additional spending.
5	Senior governments hold assets acquired in right of the Crown.	For many governments, the value and use of these items far outweigh the value and use of recognized assets. A business does not have access to these types of assets unless they are paid for.	Practical issues regarding the measurement and valuation of these assets prevent their financial statement recognition; however, disclosure of the existence of these assets is key to understanding the government's total economic resources.
6	Governments operate in a non-competitive environment. 1a	No competitive market for most government outputs means that there is no independent indication of their value. And many of the services provided by government are unlikely to be provided by anyone else, such as welfare and defence. The benefits of government services cannot be measured solely by a bottom line that shows net revenues or expenses.	Net cost of services and affordability of services are the financial measures required, but these are not enough to show the efficiency and effectiveness of government services. Performance measurement information is needed, too. There is no one measure of government performance. Non-financial performance measures are also needed.
7	A government's budget portrays public policy, establishes estimates of revenue, expense, expenditure and financing requirements and is an important part of the government accountability cycle.	The budget includes financing requirements for operating and capital spending. It sets tax rates and decides borrowing requirements. A comparison of actual-to-budget amounts demonstrates public accountability for government finances.	Actual-to-budget comparisons should be provided in the financial statements.
8	Some governments have debt capacities unparalleled by most other organizations in Canada.	Some governments' only limits on their borrowing are the ability of their tax base to bear the debt burden and the financial community's assessment of that ability. Businesses are normally reined in sooner than governments. The federal government can control the money supply and has access to international agreements that no other organizations have recourse to. Both factors are taken into account in any assessment of its ability to service its debt load. High debt levels affect the	Debt and net debt are crucial to highlight in government financial statements.

flexibility of all levels of government in providing programs and services, especially in times of economic downturns.

9 Governments are held to a higher standard of accountability than a business or a not-for-profit organization.

A broader public accountability must be demonstrated in government financial statements because the nature of a democratically elected government requires a degree of transparency in financial reporting that most private sector reports do not offer. The level of understanding of government finances held by most financial statement users demands this greater transparency. Governments are accountable to taxpayers on many levels, in contrast to the more limited accountability a company has for return on investment to a limited group of investors.

The nature of taxpayers as contributors to government finances requires that they be given simple yet robust information about what has been done with their money — that is, complete information about the government's financial position and results is needed and each financial statement should convey clear, key messages about government finances.

Footnotes

1a. Some government business enterprises (as defined in GOVERNMENT REPORTING ENTITY, Section PS 1300) operate in competitive environments. For the purposes of their own financial statements, government business enterprises follow the standards in the CPA Canada Handbook – Accounting for profit-oriented enterprises.

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SECTION PS 1150

generally accepted accounting principles

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PURPOSE AND SCOPE	
.01 This Section:	
(a) establishes standards for financial reporting in accordance with generally accepted accounting principles;	
(b) describes what constitutes generally accepted accounting principles, and their sources; and	
(c) provides guidance on sources to consult when selecting accounting policies and determining appropriate disclosures, when a matter is not dealt with explicitly in the primary sources of generally accepted accounting principles.	
.02 This Section applies to all governments. It also applies to those organizations that consider the CPA Canada Public Sector Accounting Handbook (CPA Canada PSA Handbook) to be the most appropriate to their objectives and circumstances. An entity applying this Section is referred to as a "public sector reporting entity".	
DEFINITIONS	
.03 The following definitions have been adopted for the purposes of this Section:	
(a) Accounting policies encompass the specific principles, and the methods used in their application, that are selected by a public sector reporting entity in preparing financial statements.	
(b) Generally accepted accounting principles (GAAP) encompass broad principles and conventions of general application, as well as rules and procedures that determine accepted accounting practices at a particular time.	
(c) Primary sources of GAAP are, in descending order of authority:	
(i) standards in Sections PS 1201-PS 3510;	
(ii) Public Sector Guidelines; and	
(iii) appendices and illustrative material of those pronouncements described in (i)-(ii) above.	
SOURCES OF GAAP	
.04 A public sector reporting entity should apply every primary source of GAAP that deals with the accounting and reporting in financial statements of transactions or events encountered by the public sector reporting entity. [APRIL 2005]	
.05 When the primary sources of GAAP do not deal with the accounting and reporting in financial statements of transactions or events encountered by the public sector reporting entity, or additional guidance is needed to apply a primary source to specific circumstances, the selection of an appropriate accounting policy requires the exercise of professional judgment. In these circumstances, a public sector reporting entity should adopt accounting policies and disclosures that are consistent with:	
(a) the primary sources of GAAP; and	
(b) the application of the concepts described in FINANCIAL STATEMENT CONCEPTS, Section PS 1000. [APRIL 2005 *]	
.06 The primary sources of GAAP provide the financial statement accounting and reporting requirements, as well as explanations and guidance for most transactions and events encountered by a public sector reporting entity. Management is required to be knowledgeable about the primary sources of GAAP. As well, management is required to be aware of changes to the primary sources, because what constitutes GAAP at a particular time changes and adapts to reflect economic and social conditions.	

.07 No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise. As a result, matters may arise that are not specifically addressed in the primary sources of GAAP. It is necessary to refer to other sources when the primary sources do not deal with the accounting and reporting in financial statements of transactions or events that a public sector reporting entity encounters, or when additional guidance is needed to apply a primary source to specific circumstances.

.08 A public sector reporting entity consults sources other than primary sources of GAAP to assist in selecting accounting policies and disclosures only when these sources comply with paragraph PS 1150.05. The public sector reporting entity evaluates sources in selecting the appropriate accounting policies and disclosures based on all of the following criteria:

- (a) The specificity of the source — A source that deals with the specific circumstances is likely to be more relevant than one from which the public sector reporting entity must analogize.
- (b) The authority of the issuer or author — A source issued by an accounting standard setter in its own jurisdiction is likely to be more relevant than a source issued by others in the same jurisdiction.
- (c) The continued relevance of the source — The passage of time may diminish the relevance of certain sources.
- (d) The development process for the source — A source developed after extensive consultation and debate is likely to be more relevant than a source developed without such discipline.

.09 The selection of appropriate accounting policies and disclosures requires the exercise of professional judgment. In exercising professional judgment, a public sector reporting entity takes into account the primary sources of GAAP, as well as the concepts described in paragraph PS 1150.05(b). The public sector reporting entity would not analogize to a primary source of GAAP if the source used states that it applies only to the particular circumstances described therein.

.10 A public sector reporting entity considers all sources of GAAP that it consults in the context of the concepts described in paragraph PS 1150.05(b), which describes the concepts underlying the development and use of accounting principles in financial statements. A public sector reporting entity adopts accounting policies that are consistent with these concepts. The Public Sector Accounting Board (the Board) considers a source to be consistent with the concepts in paragraph PS 1150.05(b) when the guidance in that source is compatible with the qualitative characteristics of financial information, the elements of financial statements, and the recognition and measurement criteria in paragraph PS 1150.05(b).

.11 In selecting appropriate accounting policies and disclosures, interpretations of a source do not constitute evidence that the criteria in paragraph PS 1150.05 have been met if it is likely that most parties, exercising professional judgment, would reject them as not resulting in a fair presentation in accordance with GAAP.

.12 When the concepts described in paragraph PS 1150.05(b) conflict with a primary source of GAAP, the requirements of the primary source of GAAP prevail. The Board is guided by the concepts described in paragraph PS 1150.05(b) in the development of future pronouncements and in its review of existing pronouncements. Therefore, the number of cases of conflicts between the concepts described in paragraph PS 1150.05(b) and primary sources of GAAP will diminish over time.

.13 A public sector reporting entity may be required to prepare financial statements in accordance with regulatory, legislative or contractual requirements. When these requirements are within the range of acceptable choices allowed by this Section, the basis of accounting can be described as being in accordance with GAAP. At times, conflict between GAAP and regulatory, legislative or contractual requirements may exist. In such cases, users of financial statements need to know that the statements are not prepared in accordance with GAAP. Therefore, if the basis of accounting used to prepare such financial statements conflicts with the requirements of this Section, that basis cannot be described as being in accordance with GAAP.

Primary sources of GAAP

.14 In CPA Canada PSA Handbook Sections, italicized and non-italicized paragraphs have equal authority. Italicized paragraphs generally state the main principles, while non-italicized paragraphs generally explain the principles or their application to a particular situation. In addition, non-italicized paragraphs may include guidance for practices that are encouraged or desirable, but not required. To be in accordance with GAAP, a public sector reporting entity needs to comply with the non-italicized paragraphs as well as the principles. When there appear to be different ways of interpreting the non-italicized paragraphs, the public sector reporting entity selects the treatment that is most consistent with the principles.

.15 Public Sector Guidelines set out the Board's interpretations of existing Handbook Sections, or its opinions on other issues of concern with respect to matters of financial accounting policies and disclosures for which the process of issuing exposure drafts and eventual Handbook Sections does not apply or cannot be undertaken on a timely basis.

.16 Appendices are an integral part of the primary sources of GAAP. Illustrative material included in Appendices indicates how the accounting policies and disclosures specified in a document might be applied in particular situations or summarizes aspects of the underlying document. Illustrative material includes an introductory statement specifying that it is illustrative only.

.17 The Board issues Statements of Recommended Practice (SORPs) with respect to matters of reporting in the public sector. The objective of SORPs is to enhance decision making and accountability by improving the understandability of reports issued in the public sector. SORPs do not form part of generally accepted accounting principles.

Other sources

.18 Paragraphs PS 1150.19-.24 identify some of the other sources that a public sector reporting entity might consult to assist in selecting accounting policies and disclosures that comply with paragraph PS 1150.05.

.19 Pronouncements issued by other bodies authorized to issue accounting standards may be useful sources to consult. For example, accounting pronouncements published with the authority of the Canadian Accounting Standards Board (AcSB), International Accounting Standards Board (IASB), US Federal Accounting Standards Advisory Board (FASAB), US Governmental Accounting Standards Board (GASB), or International Public Sector Accounting Standards Board (IPSASB) are often important sources to consult on matters not covered by primary sources of GAAP or for assistance in applying a primary source of GAAP to specific circumstances.

.20 When a public sector reporting entity chooses to consult a source described in paragraph PS 1150.19, it applies professional judgment and evaluates the source in the context of the relative manner in which the standard setter requires its pronouncements to be applied, as well as in the context of the related pronouncement. When an accounting standard setter does not have a conceptual framework that is similar to the concepts referred to in paragraph PS 1150.05(b), the public sector reporting entity needs to ensure that the selected source is consistent with those concepts.

.21 In exercising professional judgment, a public sector reporting entity might wish to consult exposure drafts and other documents approved by the Board for public comment when no primary source of GAAP applies to the particular situation. The requirements of any existing accounting pronouncement that would be affected by the proposals in draft material remain in force until the effective date of the superseding material. Since the proposals in draft material are subject to revision, public sector reporting entities need to consider the consequences of any changes that may be made to the proposals as they are finalized. A document at a more advanced stage of the consultation process supersedes earlier versions.

.22 CPA Canada research reports and studies may also be consulted to the extent that they comply with paragraph PS 1150.05. In addition, organizations other than the Board may issue guidance indicating how primary sources of GAAP may be applied in particular circumstances. Since the guidance in these sources has not received Board approval, the views of the Board may differ. Therefore, caution needs to be exercised in using these sources.

.23 Accounting textbooks, journals, studies and articles that take the Canadian public sector environment into account are consulted in preference to those that do not.

.24 Sometimes, a practice has been established that does not result from written material. The relevance of such a practice is demonstrated by its compliance with paragraph PS 1150.05 and not by its general use.

TRANSITIONAL PROVISIONS

.25 This Section applies to fiscal years beginning on or after April 1, 2005.

.26 For local governments that are currently required by legislation or regulation to prepare their financial statements in accordance with a basis of accounting other than GAAP, this Section applies to fiscal years beginning on or after April 1, 2006.

Footnotes

* Editorial change — February 2007.

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SECTION PS 3060

government partnerships



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PURPOSE AND SCOPE

.01 This Section defines a government partnership and establishes standards on how to account for and report a government's interest in government partnerships in government financial statements, 1 regardless of the structures and forms under which the government partnership activities take place. This Section does not deal with accounting by the government partnership itself.

.02 The standards are intended to apply to governments.

.03 This Section applies in situations where economic activities meet the definitions and criteria outlined in paragraph PS 3060.06 and paragraphs PS 3060.11-.28, even though such activities may not be referred to as government partnerships. However, this Section does not apply in situations where economic activities do not meet the definitions and criteria set out in those paragraphs even though they may sometimes be referred to as government partnerships. Accounting for such activities should be governed by their substance.

.04 For the purposes of this Section, an economic activity is not restricted to activities that generate a financial return, but extends to activities for the production and delivery of non-market goods and services that provide benefits to the community, such as law and order. That is, the partners may be motivated by factors other than the generation of financial return, such as the improvement of the welfare of their citizens.

.05 This Section does not apply to arrangements that are in and of themselves:

- (a) Executory contracts such as leases and sale-leaseback transactions.
- (b) Purchase / sale transactions such as outsourcing of services, management contracts and privatization. For guidance on how to account for revenues and expenses related to purchase / sale transactions, refer to FINANCIAL STATEMENT PRESENTATION, Section PS 1201.
- (c) Transfers such as shared-cost arrangements and government programs. For guidance on how to account for government transfers, refer to GOVERNMENT TRANSFERS, Section PS 3410.
- (d) Loans. For guidance on how to account for loans, refer to LOANS RECEIVABLE, Section PS 3050.
- (e) Loan guarantees. For guidance on how to account for loan guarantees, refer to LOAN GUARANTEES, Section PS 3310.

DEFINITIONS

.06 The following definitions have been adopted for the purposes of this Section:

A **government partnership** is not a government organization but is a contractual arrangement 2 between the government and a party or parties outside of the government reporting entity 3 that has all of the following characteristics:

- (a) the partners co-operate toward achieving significant clearly defined common goals;
- (b) the partners make a financial investment in the government partnership;
- (c) the partners share control of decisions related to the financial and operating policies of the government partnership on an ongoing basis; and
- (d) the partners share, on an equitable basis, the significant risks and benefits associated with the operations of the government partnership.

The contractual arrangement establishes that the parties have shared control over the government partnership, regardless of the difference in their ownership interest. Nevertheless, overall, there must be an equitable relationship between the financial investment of the government in the government partnership, the extent of control it is able to exercise over the activities of the government partnership, and the risks and benefits that accrue to the government from the government partnership. Government partnerships may be structured as operations under shared control, assets under shared control or organizations under shared control. [Former paragraph PS 3060.06 retained in Archived Pronouncements.]

.07 A **government business partnership** is a government partnership that has all of the following characteristics:

- (a) it is a separate legal entity with the power to contract in its own name and that can sue and be sued;
- (b) it has been delegated the financial and operational authority to carry on a business;
- (c) it sells goods and services to individuals and organizations other than the partners as its principal activity; and
- (d) it can, in the normal course of its operations, maintain its operations and meet its liabilities from revenues received from sources other than the partners.

.08 A **partner** is a party to a government partnership.

.09 **Proportionate consolidation** 4 is a basis of accounting for a government's interest in government partnerships, other than government business partnerships, whereby a government's pro rata share of each of the assets, liabilities, revenues and expenses that are subject to shared control, is combined on a line-by-line basis with similar items in the government's financial statements. ADDITIONAL AREAS OF CONSOLIDATION, paragraph PS 2510.06, provides details for applying the proportionate consolidation method.

.10 **Modified equity** is a basis of accounting for a government's interest in government business partnerships whereby the equity method of accounting is modified only to the extent that the government business partnership's accounting principles are not adjusted to conform with those of the government.

ELEMENTS THAT DEFINE A GOVERNMENT PARTNERSHIP

Contractual arrangement

.11 A distinctive characteristic common to all government partnerships is that two or more partners are bound by a contractual arrangement which establishes that the partners have shared control over the government partnership. This characteristic of shared control distinguishes a government's interest in a government partnership from investments in other activities in which the government may exercise control (see GOVERNMENT REPORTING ENTITY, Section PS 1300, BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500, ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510, and PORTFOLIO INVESTMENTS, Section PS 3041).

.12 Activities conducted with no formal contractual arrangement, but which meet the definition of a government partnership set out in paragraph PS 3060.06, are in substance government partnerships for the purposes of this Section.

.13 The contractual arrangement establishes shared control over the government partnership. Such a requirement ensures that no single partner is in a position to control the activities of the government partnership unilaterally. The arrangement identifies those decisions in areas essential to the goals of the government partnership that require the consent of all the partners and those decisions which may require the consent of a specified majority of partners.

.14 The contractual arrangement may be evidenced in a number of ways, for example, by a contract between the partners or minutes of discussions between the partners. In some cases, the arrangement is incorporated in the enabling legislation, articles or other by-laws of the government partnership. Whatever its form, the contractual arrangement is usually in writing and deals with such matters as:

- (a) the activity, duration and reporting obligations of the government partnership;
- (b) the appointment of the board of directors or equivalent governing body of the government partnership and the voting rights of the partners;
- (c) the financial investments by the partners; and
- (d) the sharing by the partners of the output, revenues, expenses or surpluses or deficits of the government partnership.

.15 In some cases, the contractual arrangement may designate a partner, or an outside party or parties, as the manager or operator of the government partnership. The manager does not control the government partnership, nor does the manager exercise shared control with the partners solely by virtue of his or her management role. Rather, the manager acts within the financial and operating policies that the partners have prescribed.

.16 A government may incorporate regulations in any contractual arrangement it enters into (e.g., level of service, level of maintenance of an asset that may be returned to it at the end of a set term). Governments regulate a variety of activities with which they have no ongoing operational involvement. As such, regulations in and of themselves do not constitute shared control.

Significant clearly defined common goals

.17 Common goals are those that all partners share. For example, a number of communities may join together to build and operate a landfill site or a recreational facility. The significant common goals of the communities involve service provision and sharing the costs and revenues associated with the operations of the facility, and so, the arrangement would qualify as a government partnership.

.18 On the other hand, a community may hire an individual or organization to operate a recreational facility for a fee. The significant goals of the government are to provide a service and cost savings, while the significant goal of the management organization is to earn revenues from the contract to manage the facility. While the significant goals of each party are mutually beneficial, they are not common to both parties to the contract, and so, the arrangement does not qualify as a government partnership.

Financial investment

.19 A financial investment may be in the form of assets and/or assuming responsibility for ongoing operating costs. The investment of financial assets and tangible capital assets in the government partnership would be accounted for in accordance with paragraphs PS 3060.41-.54. The value assigned to the responsibility for ongoing operating costs would be that determined in the contractual arrangement for the government partnership.

Shared control

.20 Shared control of a government partnership means that the partners make decisions related to the financial and operating activities of the government partnership on an ongoing basis based on the terms of the contractual arrangement; none of the partners is in a position to exercise unilateral control over the government partnership. When there is shared control, partners have an active ongoing interest or relationship in the arrangement other than as passive investors or as parties to a purchase / sale transaction. Shared control would exist, for example, when a joint board is established to oversee the provision of police or fire protection services for a number of local governments.

Shared risks and benefits

.21 In a government partnership, each partner is exposed to a share of the combined risks and shares in the benefits related to the common goals of the government partnership. In a government partnership, there must be an equitable sharing among the partners of the significant risks and benefits. For example, the government partners may operate a landfill site to provide a service to their constituents on a shared cost basis. The partners would generally share the operating and environmental risks, as well as the revenues associated with operating the landfill site.

.22 Risks and benefits would not be considered to be equitably shared in an arrangement where the government retains the full risk of owning an asset while allowing another party to receive the benefit of earning revenue from user fees derived from that asset. Risks and benefits would not be equitably shared when, for example, a government owned a highway that it allowed a private sector organization to operate and earn revenues from, based on the agreement and any necessary legislation.

FORMS AND STRUCTURES OF GOVERNMENT PARTNERSHIPS

Operations under shared control

.23 The operations of some government partnerships may involve the use of the assets and other resources of the partners, rather than the establishment of an organization or a financial structure that is separate from the partners themselves. In these circumstances, each partner may use its own assets for the purposes of the activities of the government partnership. The assets remain under the ownership and control of each partner. Each partner also incurs its own expenses and liabilities and raises its own financing, which represent its own obligations. The arrangement may provide a means by which the revenue from the sale of goods or services by the government partnership and any expenses incurred in common are shared among the partners.

.24 An example of operations under shared control is when two or more partners combine their resources and expertise for use in the operation of a landfill site. One partner may provide the land, others the equipment and others cash.

.25 In other cases, the activities of the government partnership may be carried out by the employees of one of the partners alongside the partner's similar activities. For example, provision of social services through a government partnership may involve one of the government partners being responsible for the staffing and administration of the program while all partners contribute ongoing funding.

Assets under shared control

.26 Some government partnerships involve the shared control, and often the shared ownership, by the partners of one or more assets invested in, or acquired for and dedicated to the purposes of, the government partnership. Assets under shared control are used to obtain benefits for the partners. Such a government partnership does not involve the establishment of a corporation or other organization, or a financial entity that is separate from the partners themselves. For example, several local governments may form a government partnership to acquire fire protection equipment to provide service to their constituents.

Organizations under shared control

.27 An organization under shared control is a type of government partnership which involves the establishment of a separate organization (e.g., a corporation) in which each partner has an interest. The organization operates similarly to other organizations, except that a contractual arrangement between the partners establishes shared control over the economic activities of the organization.

.28 In an organization under shared control, each partner usually contributes cash or other resources to the government partnership. The organization owns the assets of the government partnership and incurs liabilities and expenses. It may enter into contracts in its own name and raise financing for the purposes of the activities of the government partnership. For example, several local governments may operate a transit organization to provide transit services to their constituents.

ACCOUNTING FOR THE GOVERNMENT'S INTEREST

Government partnerships other than government business partnerships

.29 *Government financial statements should recognize the government's interest in government partnerships, except for government business partnerships, using the proportionate consolidation method.* [OCT. 1999]

.30 Governments may enter into government partnerships that are similar to governmental units 5 except for the extent of government control — the government shares control of the government partnership with its partners, while it controls the governmental unit. Governmental units are government organizations that carry out government activities that are integral to a government's operations in directly performing its executive function and are consolidated in the government's financial statements under GOVERNMENT REPORTING ENTITY, Section PS 1300. Government partnerships that carry out similar activities to governmental units would be accounted for using proportionate consolidation.

.31 Proportionate consolidation of such government partnerships provides financial statement users with the same sort of information about the financial position and results of operations of the government as would be available if the government managed the resources and operations through a governmental unit. Proportionate consolidation also reflects the level of activities (e.g., costs and revenues) on the government's statement of operations, the financial resources available, and the risks to which the government is exposed for such activities.

Government business partnerships

.32 *Government business partnerships should be accounted for by the modified equity method applied using the government's share of the government business partnership.* [OCT. 1999]

.33 Governments may enter into government business partnerships that are similar to government business enterprises 6 except for the extent of government control. Such government partnerships may also carry out similar activities to government business enterprises. A government business partnership differs from other government partnerships in its relationship to the government, and its objectives and operations. A government business partnership represents a financial asset of the government and given its autonomy, business-oriented objectives, and financial self-sufficiency, 7 equity accounting is appropriate. Consistent with GOVERNMENT REPORTING ENTITY, Section PS 1300, for government business enterprises, the modified equity method is the most suitable form of equity accounting for government business partnerships.

.34 Accounting for government business partnerships by the modified equity method avoids commingling the budget and actual results of government business partnerships on a line-by-line basis with those of government activities having different objectives. It also avoids including the government's share of the gross debt of government business partnerships with the gross debt of other government organizations, as the government business partnerships are expected to repay that debt from their own revenues.

.35 The modified equity method supplemented with disclosure of condensed financial information gives financial statement users an informative accounting of the full nature and extent of the financial affairs and resources of those government business partnerships. It provides a measure of the impact that government business partnerships may have on a government's ability to discharge its liabilities or to provide financial resources for future operations.

Change in circumstances

.36 A change in circumstances over the life of a government partnership could affect either the valuation of the government's interest in the government partnership or in some cases, whether the arrangement would continue to be treated as a government partnership.

.37 In some cases, impairments in value of an asset invested in a government partnership or recognition of a contingent liability would require a write-down in the value of the government's reported interest in the government partnership.

.38 In other cases, the sharing of control, risks and benefits may change to such an extent as to cause an arrangement to no longer meet the definition of a government partnership. In such cases, the government's interest would be accounted for in accordance with GOVERNMENT REPORTING ENTITY, Section PS 1300, or other relevant Public Sector Accounting Standards or Guidelines. 8

.39 The circumstances affecting a government business partnership may also change so that it no longer meets the definition of a government business partnership. Failure to meet any of the four elements of the government business partnership definition in paragraph PS 3060.07, would require such a change in status of the government business partnership.

.40 The alteration of an accounting treatment necessitated by events or transactions that reflect a difference in substance from those previously occurring is not considered to be a change in accounting policy or change in classification as described in ACCOUNTING CHANGES, Section PS 2120. Therefore, the change in accounting treatment would not be applied retroactively. Nevertheless, the change in accounting treatment, the underlying reasons for the change and the financial effect of the change would be disclosed.

ACCOUNTING FOR INVESTMENTS OF ASSETS

.41 *When a government invests assets in a government partnership and receives in exchange an interest in the government partnership, any loss 9 that occurs should be recognized at the time of the initial investment in the statement of operations. [OCT. 1999]*

.42 The existence of such a loss would usually provide evidence of a decline that is other than temporary, in the carrying value of the relevant assets retained by the government. It is also necessary for the government investing the assets to recognize the decline in value of the portion of the assets retained.

.43 *When a government invests assets in a government partnership and receives in exchange an interest in the government partnership, any gain 10 that occurs should be reported in the financial statements of the government as a deferred gain at the time of the initial investment only to the extent of the interests of the other non-related partners. [OCT. 1999]*

.44 The amount of the deferred gain is equal to the other partners' proportionate share of the difference between the fair value and net carrying amount of the asset.

.45 *When a government partnership other than a government business partnership is dissolved, any deferred gain related to the assets invested by the government should be recognized as revenue. [OCT. 1999]*

.46 For government partnerships other than government business partnerships, the deferred gain would not be amortized. It would only be realized at the time the government partnership is dissolved and the assets are distributed to the partners.

.47 *For government business partnerships, any deferred gain related to the assets invested by the government should be amortized to net operating results in a rational and systematic manner over the life of the invested assets. If the invested assets are non-depreciable, the deferred gain should be amortized to net operating results on a basis appropriate to the expected revenue or service to be obtained from their use by the government business partnership. When the invested assets are disposed of by the government business partnership to an independent third party, any unamortized portion of the deferred gain should be recognized as revenue. [OCT. 1999]*

.48 When the government invests assets in a government business partnership, the deferred gain would be amortized. As an asset is consumed over time by a government business partnership using it to generate cash inflows, deferred gains arising from the government's investment of assets in the government business partnership would become realized. Realization would occur because, by definition, government business partnerships are self-sustaining from revenues received from outside of the government business partnership. Deferred gains related to government business

partnerships would also become realized when a government business partnership sells an asset invested by the government to an independent third party or when the government business partnership is dissolved.

Reporting tangible capital assets

.49 When tangible capital assets are invested in a government partnership other than a government business partnership, the government should report those assets as follows:

- (a) the other non-related partners' share of assets invested by the government would be treated as disposals by the government; and
- (b) the government's share of assets invested by the other non-related partners would be treated as purchases by the government in accordance with the relevant standards in *FINANCIAL STATEMENT PRESENTATION*, Section PS 1201, and *TANGIBLE CAPITAL ASSETS*, Section PS 3150. [OCT. 1999 *]

.50 Under *FINANCIAL STATEMENT PRESENTATION*, Section PS 1201, a government reports tangible capital assets as assets on the statement of financial position. *TANGIBLE CAPITAL ASSETS*, Section PS 3150, describes the accounting for the tangible capital assets of a government.

.51 The tangible capital assets of a government business partnership would be reflected in the government's financial statements in its one-line investment account (the "equity pickup"). The financial statements of a government business partnership would be prepared on the same basis as a private sector business. Under the modified equity method, the accounting policies of the government business partnership are not modified before determining the amount of the government's interest in the government business partnership. As a result, the government would not report the tangible capital assets of a government business partnership as described in paragraph PS 3060.49 and paragraphs PS 3060.53-.54.

(paragraph PS 3060.52 deleted)

Investments of tangible capital assets by the reporting government

.53 When a government invests an asset in a government partnership other than a government business partnership, the government would report the other non-related partners' proportionate share of an asset invested by the government as a disposal. In particular:

- (a) Governments would account for the other partners' share of the net carrying amount of the asset as a disposal.
- (b) Governments would recognize the net carrying amount in the statement of financial position, and would calculate deferred gains and losses based on the fair value less the net carrying amount of the assets.

Investments of tangible capital assets by the other partners

.54 When a non-related partner invests a tangible capital asset in a government partnership other than a government business partnership, the government would report its proportionate share of that tangible capital asset as a purchase. In particular, governments would treat that amount as an increase in the tangible capital assets reported in the statement of financial position.

PRESENTATION AND DISCLOSURE

.55 Government financial statements should disclose, in notes or schedules:

- (a) a description of the nature and purpose of government partnerships;
- (b) a listing of government partnerships, including the government's share, separately identifying those that are accounted for using the proportionate consolidation method and those that are accounted for by the modified equity method; and
- (c) condensed supplementary financial information relative to government partnerships. Such financial information should be provided separately for those government partnerships accounted for using proportionate consolidation and those accounted for using modified equity, on:
 - (i) the financial position and results of operations, including:
 - total assets and liabilities segregated by main classification;
 - net assets or liabilities, separately displaying accumulated other comprehensive income;
 - total revenues and expenses; and
 - net operating results for the period, separately displaying other comprehensive income;
 - (ii) the nature and amount of any adjustments to net assets or net operating results, as shown in the financial statements of the government partnerships, to arrive at the amount included in the government's statement of financial position or statement of operations; and
 - (iii) transactions and balances with organizations included in the government reporting entity. [OCT. 2006]

.56 *The government should disclose its share of any contingencies and contractual obligations of government partnerships and those contingencies that exist when the government is contingently liable for the liabilities of other parties to those government partnerships. [OCT. 1999 *]*

.57 *Deferred gains arising from the government's investment of assets in the government partnership should be reported with liabilities in the government's statement of financial position. [OCT. 1999]*

.58 Users of government financial statements need an appreciation of the magnitude of financial activities conducted by government partnerships and the effect of their operations on the government. This information would usually be presented on a combined basis.

.59 Separate disclosure of the government's share of any contingencies and contractual obligations of government partnerships would include, as appropriate:

- (a) the government's share of any contingencies and contractual obligations of the government partnership;
and
- (b) the government's responsibility, if any, for the other partners' share of the contingencies of the government partnership.

If the government guarantees more than its proportionate share of a government partnership's liabilities, such a guarantee would be disclosed.

.60 The level of detail disclosed by governments should reflect the highly aggregated nature of financial statements. In deciding the level of detail to disclose, governments should consider the usefulness of the information to the reader in assessing the nature of, and the costs associated with, government partnerships.

APPENDIX A



Footnotes

1. The term "financial statements" refers to the summary financial statements published by a government that report on the financial position and changes in financial position of the government reporting entity.
2. A chart showing the various types of government contractual arrangements, including government partnerships, is included as Appendix A.
3. In arrangements where government employees jointly manage an employee benefit program (e.g., a pension plan) with the government, the employees are not considered to be parties outside of the financial reporting entity for the purposes of applying the definition of a government partnership.
4. Detailed guidance on the application of proportionate consolidation is set out in ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510.
5. Governmental units are defined in BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500.
6. GOVERNMENT REPORTING ENTITY, paragraph PS 1300.28, defines a government business enterprise.
7. GOVERNMENT REPORTING ENTITY, paragraph PS 1300.31, identifies factors for determining the financial self-sufficiency of a government business enterprise. Those factors would be considered when assessing the financial self-sufficiency of a government business partnership.
8. BASIC PRINCIPLES OF CONSOLIDATION, Section PS 2500, ADDITIONAL AREAS OF CONSOLIDATION, Section PS 2510, PORTFOLIO INVESTMENTS, Section PS 3041, and FINANCIAL INSTRUMENTS, Section PS 3450, may also provide relevant guidance in some cases where the arrangement no longer meets the definition of a government partnership.
9. A loss occurs when the fair value of the asset invested is less than its net carrying amount in the government's financial statements.
10. A gain occurs when the fair value of the asset invested is greater than its net carrying amount in the government's financial statements.

* Editorial change — January 2003, February 2007 and June 2011.

* Editorial change — September 2004.

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SECTION PS 3210

assets



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PURPOSE AND SCOPE

- .01 This Section:
- (a) provides guidance for applying the definition of assets set out in FINANCIAL STATEMENT CONCEPTS, Section PS 1000, and establishes general disclosure standards for assets; but
 - (b) does not include standards for recognition and disclosure of specific types of assets, which are dealt with in other Handbook Sections.
- .02 It may be useful to read this Section in conjunction with CONTINGENT ASSETS, Section PS 3320, and CONTRACTUAL RIGHTS, Section PS 3380.

ASSETS

- .03 **Assets** are economic resources controlled by a public sector entity as a result of past transactions or events and from which future economic benefits are expected to be obtained.
- .04 Assets have three essential characteristics:
- (a) They embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows.
 - (b) The public sector entity can control the economic resource and access to the future economic benefits.
 - (c) The transaction or event giving rise to the public sector entity's control has already occurred.
- .05 Economic resources are not assets unless they meet the three characteristics of assets.

Economic resources

- .06 Economic resources embody value because they enable an entity to meet its objectives, such as the provision of public goods and services, redistribution of wealth, generation of cash inflows or reduction of cash outflows.
- .07 To embody value as an economic resource, there must also be some restriction on its availability. For example, the air we breathe generally cannot be an economic resource unless access to it is restricted.
- .08 Economic resources can arise from, but are not limited to, the following:
- (a) contracts or agreements (for example, accounts receivable and leases);
 - (b) another government's legislation (for example, transfers receivable);
 - (c) government's own legislation (for example, taxes, fines and penalties);
 - (d) voluntary contributions (for example, donations); or
 - (e) construction and development (for example, roads).
- .09 Economic resources can be:
- (a) financial in nature (for example, cash, accounts receivable and investments); or

(b) non-financial in nature (for example, tangible capital property, prepaid items and inventories of supplies).

.10 Without an economic resource, future economic benefits cannot be obtained. For example, a fire truck (the economic resource) needs to exist before it can provide fire suppression services (the future economic benefits).

Future economic benefits

.11 The essence of assets are their future economic benefits. Assets embody future economic benefits that allow public sector entities to achieve their objectives. The future economic benefits embodied in assets involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows or to reduce cash outflows.

.12 Often the public is the beneficiary of the goods and services provided by a public sector entity. For example, assets such as fire trucks are used to provide fire suppression services to the public. Hospital buildings and medical equipment are used to provide health care services. Parks, schools and libraries provide recreational, educational and research opportunities to the public. Water treatment plants provide goods, such as potable water. Such assets benefit public sector entities as they assist in achieving the entity's primary objective of providing public goods and services. This benefit is different from the benefit that the public receives.

.13 The future economic benefits embodied in an asset may also be in the form of generating future cash inflows. Cash inflows benefit the public sector entity because cash can be used to purchase or to provide goods and services, redistribute wealth or settle liabilities. Benefits in the form of cash inflows relate to resources, such as loans receivable, inventory for resale and portfolio investments. Also, some public sector resources generate cash inflows because they have user fees associated with them.

.14 The future economic benefits may also take the form of a capacity to reduce cash outflows. For example, this may be the case when betterment of a tangible capital asset reduces the cost of providing goods and services.

.15 There is a close association between incurring a cost and the generation of an asset. However, not all costs result in a future economic benefit. For example, costs incurred to maintain the current service capacity of an asset do not provide a future economic benefit. Also, a public sector entity may obtain an asset without incurring costs. For example, items that have been donated to the public sector entity may provide that entity with future economic benefits and, hence, satisfy the definition of assets.

Control

.16 A public sector entity controls the economic resource and access to the future economic benefits when it:

- (a) can benefit from the economic resource through its capacity to provide goods and services, to provide future cash inflows or to reduce cash outflows;
- (b) can deny or regulate access to those benefits by others; and
- (c) is exposed to the risks associated with the economic resource.

.17 An entity that controls an economic resource has the ability to benefit from the economic resource. For example, a recipient of a transfer benefits from the transfer as it can use the transfer to provide goods or services.

.18 An entity that controls an economic resource has the ability to deny or regulate access to the future economic benefits associated with the economic resource by others. For example, an entity controlling a bus has the ability to deny or regulate access to the related transportation services.

.19 An entity that controls an economic resource is exposed to the risks associated with the economic resource. For example, the entity may hold an investment, the value of which may decline and result in a loss.

.20 Some economic resources are subject to certain external restrictions that specify the purpose(s) for which resources are to be used. For example, there may be external restrictions imposed on the public sector entity's own assets, as is the case with some sinking fund investments. Such restrictions on the use of an economic resource do not negate the public sector entity's control of the economic resource.

.21 Although control may be seen as applying to an asset as a whole, the concept can also be applied to individual rights related to the asset. For example, a single leased asset embodies different economic benefits. It may give the lessee the right to use the property and the lessor the right to receive rents and any residual value. Thus, both parties may have assets corresponding to their respective rights.

.22 Control of an economic resource and of access to the future economic benefits are essential characteristics of an asset, whereas possession or ownership is not. For example, a public sector entity may control the economic resource and access to the future economic benefits through a capital lease arrangement yet not own the economic resource.

.23 A public sector entity's ability to regulate an economic resource does not, in and of itself, constitute control of an asset. A public sector entity may establish the regulatory environment in an industry or sector within which organizations operate and impose conditions or sanctions on their operations. For example, a pollution control authority may have the ability to close down the operations of entities that are not complying with environmental regulations. However, this power does not constitute control because the pollution control authority's interest extends only to the regulatory use of the economic resources and does not include the ability to control access to the future economic benefits.

.24 A public sector entity may act as trustee when it administers trusts on behalf of the beneficiaries specified in the agreement or statute. As trustee, the public sector entity merely administers the assets, following the terms and conditions set out in the agreement. It does not control the asset because it does not have access to the future economic benefits. Those benefits flow to the beneficiaries.

Past transactions and events

.25 It is the occurrence of a past transaction or event on or before the financial statement date that distinguishes a present economic resource controlled by a public sector entity from an economic resource that may be controlled by a public sector entity in the future.

.26 The past transaction or event that gives rise to control of an economic resource resulting from exchange agreements or contracts usually occurs at the point of exchange. This arises when substantially all the benefits and risks of ownership have been transferred to the public sector entity and normally coincides with the disbursement of funds, exchange of other assets or assumption of liabilities.

.27 Meeting the eligibility criteria under an authorized transfer often determines the past transaction or event giving rise to control of an economic resource in non-exchange contracts or agreements. Shared cost agreements (reimbursement arrangements) are an example where the control of an economic resource arises when the recipient incurs eligible expenditures.

.28 The existence of a law, by-law or policy in relation to a particular program is not a past transaction or event that gives rise to control of an economic resource. Control does not exist until the underlying event occurs.

.29 The past transaction or event giving rise to control of an economic resource must have occurred by the financial statement date. Legislation having retroactive application cannot create a past transaction or event. Any economic resources related to that legislation would be accounted for in the current and relevant future periods, not in the period of the effective date of the legislation.

DISCLOSURE

.30 An economic resource may meet the definition of an asset. However;

- (a) it is not capable of being recognized in the financial statements because an appropriate basis of measurement and a reasonable estimate of the amount involved cannot be made; or
- (b) other Handbook Sections prohibit its recognition.

.31 For unrecognized assets, disclosing the major categories of assets provides information about the economic resources available to the public sector entity. The major categories of assets would be determined by type of asset, such as Crown land.

.32 *Information about the major categories of assets that are not recognized should be disclosed in the notes. When an asset is not recognized because a reasonable estimate of the amount involved cannot be made, the reason(s) for this should be disclosed. [APRIL 2017]*

TRANSITIONAL PROVISIONS

.33 This Section applies to fiscal years beginning on or after April 1, 2017. Earlier adoption is permitted.

APPENDIX A

DECISION TREE — ECONOMIC RESOURCES

The following decision tree has been prepared to illustrate the accounting treatment specified in this Section. The decision tree is illustrative only and matters of principle relating to particular situations should be decided in the context of the Section.



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SECTION PS 3250 retirement benefits



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PURPOSE AND SCOPE

.001 This Section establishes standards on how to account for and report obligations for employee retirement benefits in government financial statements. Other employee future benefits are specifically dealt with in POST-EMPLOYMENT BENEFITS, COMPENSATED ABSENCES AND TERMINATION BENEFITS, Section PS 3255.

.002 In this Section, terms that appear in **bold type** are defined in the glossary of terms.

.003 Obligations for **retirement benefits** result from a promise by a government to provide these benefits to employees because of retirement in return for their services. Pensions and other retirement benefits, such as extended health care and life insurance benefits, are a form of compensation offered for services rendered and accrue over the years employees render those services. The fundamental accounting task is to determine the amount of the obligation for retirement benefits to attribute to each period of employee service. Determining such amounts involves not only accounting for past transactions and events; it also requires forecasts of future events, such as inflation, investment returns, medical costs and employee turnover and mortality.

.004 If employees and/or retirees are covered by more than one **retirement benefit plan**, then a government needs to determine its obligation separately for each plan.

.005 The standards in this Section are based on the accounting framework recommended in FINANCIAL STATEMENT OBJECTIVES, Section PS 1100, and FINANCIAL STATEMENT PRESENTATION, Section PS 1201. That framework emphasizes the need to account for all liabilities incurred by a government to help legislators, taxpayers, investors and other users of **financial statements** assess: a government's future cash requirements from taxes and other revenues; its ability to meet financial obligations, both short-term and long-term; and its ability to maintain current services and finance new programs. Such assessments are essential when making financial decisions in government and when evaluating those decisions.

.006 Accounting for all of the retirement benefits incurred by governments is particularly important because many of those governments have accumulated significant liabilities. Many governments have chosen not to set aside funds to meet retirement benefit payments when they become due. Where those liabilities have not been recorded, financial statements do not adequately provide all of the information needed by users to help them assess a government's financial position and results of operations. It is important that financial statements account for a government's liabilities for all retirement benefits to show clearly the extent to which these obligations are to be paid from cash to be raised from future tax and other revenue sources.

.007 The basis for determining obligations for retirement benefits set out in this Section is also appropriate for determining a government's contractual obligations arising from guarantees or commitments to employee retirement benefit plans of other public sector organizations that are not part of the government reporting entity. Such obligations exist, for example, when a provincial government agrees to guarantee defined retirement benefits for employees of local school boards, agrees to guarantee a minimum rate of return on retirement benefit fund assets, or agrees to provide a significant portion of the funds required by a plan sponsor. A careful reading and evaluation of such agreements is necessary to determine the substance of the obligation and whether a **liability, contractual obligation or contingency** exists that would be reported in a government's financial statements.

The objectives of funding and accounting

.008 Determining whether a retirement benefit plan should be funded and the amount to be funded each period is a financial management matter. The funding objective is to determine an acceptable policy for financing the estimated ultimate cost of a benefit plan. An **actuarial valuation for funding purposes** is performed to calculate the contributions required to secure the benefits promised.

.009 The accounting objective is to measure and report the obligation for employee retirement benefits and to attribute the costs of those benefits to the periods in which the related services are rendered. To meet that objective, a method is needed to determine the amount of the obligation for retirement benefits outstanding, which represents the liability at the financial statement date, and the value of the benefits employees earned during the period, which represents the expense of that period. Accordingly, it is necessary to develop accounting estimates of liabilities for retirement benefits and expenses using an **actuarial cost method and actuarial assumptions** that ensure essential information required for fair presentation of financial condition and results of operations can be reported in government financial statements.

.010 Because the objectives of determining the most appropriate funding policy are not necessarily the same as those of determining the most appropriate accounting method, the liability for accounting purposes may not be the same as the amount due but not yet funded at the financial statement date according to the funding plan. In addition, the retirement benefit expense of the period for accounting purposes may not be the same as the contribution computed in the period for funding purposes.

Defined benefit and defined contribution plans

.011 Two types of benefit plans are addressed in this Section — **defined benefit plans** and **defined contribution plans**. A defined benefit plan is one that specifies either the benefits to be received by employees after retirement or the method for determining those benefits. Generally, the amount and value of the benefits to be paid depend on a number of factors and events. These include how long the employee and any survivors live, how many years of service the employee renders, and the employee's compensation and retirement age. When a government provides benefits under a defined benefit plan, it is at risk with respect to the amount of the benefit that each employee will receive (actuarial risk) and with respect to the investment returns on any assets set aside to pay for the cost of these benefits (investment risk).

.012 When a government provides benefits under a defined contribution plan, it does not assume the actuarial and investment risks inherent in a defined benefit plan. A defined contribution plan (or money purchase plan) is one in which a government's contributions in respect of services rendered by employees are specified. The government is required by the plan to make a specific fixed contribution each period. If that contribution is made, no additional government contributions are required now or in the future for the related service. The employees are at risk. This is generally because the amount of the benefit that will be payable to an employee is dependent upon the funds accumulated for each employee's account and the investment earnings on the accumulated funds.

.013 Because benefit plans are often complex, careful analysis and professional judgment are needed to determine whether the substance of a particular plan makes it a defined benefit or a defined contribution plan.

.014 In some circumstances, a benefit plan may include both defined benefit and defined contribution promises. The plan, for example, may guarantee a basic defined retirement benefit and state that additional benefits, such as inflation protection, will be provided on a defined contribution basis. In such circumstances, a government would determine its obligation for the defined benefit component of the plan as a defined benefit plan and the defined contribution component of the plan as a defined contribution plan. Once the type(s) of promise is identified, the accounting and reporting principles in this Section would be followed accordingly.

DEFINED BENEFIT PENSION PLANS

Liability and expense

.015 Obligations for retirement benefits result from a promise by a government to provide retirement benefits to employees because of retirement in return for their services. The obligations arise as employees render services. Therefore, as employees render services, the value of the retirement benefits attributed to those services would be recorded as a liability and expense as are other forms of current compensation.

.016 *The statement of financial position should report the retirement benefit liability and the statement of operations should report the expenses for retirement benefits on the basis of the value of the benefits attributed to employee service to the financial statement date.* [SEPT. 2001]

.017 The components of the **retirement benefit liability** are:

- (a) **accrued benefit obligation** including the effects of plan amendments, settlements and curtailments;
- (b) **plan assets**, if any; and
- (c) unamortized **actuarial gains and losses**.

.018 The cost of retirement benefits promised during the period is comprised of the **retirement benefits expense**, and the **retirement benefits interest expense**.

.019 The components of the retirement benefits expense are:

- (a) **current period benefit cost**;
- (b) cost of plan amendments incurred during the period;
- (c) net actuarial gains or losses recognized in the determination of the cost of a plan amendment in accordance with paragraphs PS 3250.068 and PS 3250.071;
- (d) gains and losses arising from plan settlements and curtailments incurred during the period;
- (e) amortization of actuarial gains and losses;
- (f) the amount recognized as a result of a temporary deviation from the plan, determined in accordance with paragraph PS 3250.073;
- (g) the change in a valuation allowance against the carrying amount of an **accrued benefit asset**, determined in accordance with paragraph PS 3250.050; less
- (h) employee contributions made during the period.

.020 The retirement benefits interest expense is the net of:

- (a) the interest cost on the accrued benefit obligation determined by applying the discount rate determined at the beginning of the period in accordance with paragraph PS 3250.044 to the average value of the accrued benefit obligation for the period; and
- (b) the expected return on plan assets for a defined benefit plan, determined by applying the assumed rate of return on plan assets to the average market-related value of assets for the period.

.021 The retirement benefits expense and the retirement benefits interest expense would be disclosed separately in the notes to the financial statements. A separate disclosure is needed to ensure that the amount reported as the retirement benefit expense is not affected by the purely financial decision of a government to fund or not fund the plan.

Actuarial cost methods

.022 Accounting for retirement benefits on the basis of employee services reflects the fact that there is no obligation for an employee when hired and that an obligation for retirement benefits exists as the employee renders service. The accounting task is to determine how to attribute the cost of the total retirement benefits promised to each period of employee service.

.023 For defined benefit plans, there are two main groups of actuarial cost methods. They are **level cost methods** and **accrued benefit methods**. Under the level cost methods, retirement benefit expenses are computed in such a manner as to produce a total current period benefit cost that remains constant, either in absolute dollars or as a percentage of salary, throughout an employee's service life. However, level cost methods are not recommended for accounting purposes because they do not reflect the cost of benefits earned by employees to the financial statement date.

.024 Under the accrued benefit methods, a distinct unit of retirement benefit is associated with each year of employee service rendered to the financial statement date. The actuarial present value of that unit of benefit is computed separately for the period during which it accrued. These methods are recommended because they reflect more directly the cost of retirement benefits earned by employees to the financial statement date.

.025 *An accrued benefit method should be used to attribute the cost of retirement benefits to the periods of employee service.* [SEPT. 2001]

.026 For certain **flat benefit retirement plans**, benefits vary only with periods of service rendered. For those plans, future salary and wage changes do not enter into the determination of the cost of retirement benefits earned to the financial statement date. For other defined benefit plans, such as **final pay retirement plans**, future salary and wage changes need to be incorporated into the cost of retirement benefits earned to the financial statement date because the benefit promise is based on future salary and wage levels. To estimate those levels, forecasts are needed of future inflation rates and of future salary increases. Similarly, for retirement medical plans, forecasts are needed of medical inflation rates.

.027 Accounting for the effect of future salary and wage changes ensures consistency when determining the present value of the cost of the retirement benefits earned to the financial statement date, i.e., the accrued benefit obligation. Because the discount rate used to determine that obligation includes an inflation component, for consistency the amount of the retirement benefits to be discounted must also include an inflation component. If only the discount rate used to determine the obligation includes an inflation component, then the accrued benefit obligation and expense would be understated significantly.

.028 One accrued benefit method that incorporates the effect of future salary and wage changes and attributes the value of retirement benefits to the years of employee service is the **projected benefit method prorated on services**. Under this method, generally an equal portion of the total estimated benefit, with salary projection for final pay plans and projection of medical inflation for retirement medical plans, is attributed to each year of service. The actuarial present value of the accrued retirement benefits is derived after the benefits are attributed to the years of service up to the financial statement date.

.029 *The projected benefit method prorated on services should be used to attribute the cost of retirement benefits to the periods of employee service.* [SEPT. 2001]

.030 When a retirement plan provides benefits that accrue in a non-uniform manner, the projected benefit method prorated on services may need to be adjusted to reflect the manner in which retirement benefits are earned by employees. For example, a pension plan formula may state that the pension benefit accrues at one percent of salary for the first 15 years and at two percent of salary for the final 20 years. In this circumstance, the prorating of the total estimated benefit to each accounting period would be adjusted to reflect the rates at which pension benefits are earned in that 35-year period.

.031 In some retirement plans, benefits promised in a contractual agreement or in legislation include inflation protection for current and future retirees and for former employees who have **vested** retirement benefits. For those plans, it is necessary to incorporate the impact of inflation protection in the determination of the cost of retirement benefits earned to the financial statement date.

.032 In other retirement plans, regular benefit increases for inflation protection may be provided even when such protection is not promised in a contractual agreement or in legislation. For those plans, careful analysis and professional judgment are needed to determine the substance of a government's obligation. If a regular pattern of benefit increases can be established over a reasonable period, it may be appropriate to incorporate the cost of such inflation protection in the cost of retirement benefits earned to the financial statement date and reported as an accrued benefit obligation.

Asset valuation

.033 The periodic valuation of plan assets is important because, to determine its retirement benefit liability and expense, a government needs to value the assets set aside for the purpose of meeting benefit payments.

.034 Most government plans require contributions from the employees as well as from the sponsoring government. Some governments place those contributions in a separate fund, which invests them in marketable assets. Those contributions and earnings are used to meet benefit payments to current and future retirees.

.035 When determining a government's retirement benefit liability and expense, plan assets would be valued at market-related values. Under this method, plan assets are recorded at market value or they are adjusted to market value over a period not to exceed five years. Values adjusted to market closely approximate current economic value in a manner that can minimize short-term fluctuations. Market-related values would be used because they are objective and verifiable. Once a basis of valuation is chosen it would be applied consistently.

.036 For some assets, such as real estate investments or non-marketable securities, market values are not readily available. For such assets, a method that approximates market can be used. For example, independent appraisals could be obtained, market values of similar properties could be reviewed, or future expected cash flows discounted at a market rate could be determined.

.037 *For a defined benefit plan, plan assets should be valued at market-related values.* [SEPT. 2001]

.038 In some cases governments issue non-marketable securities to their benefit funds on the condition that those securities are held in the fund to maturity. Market-related values for these assets may not be readily determinable. In such cases, non-marketable securities can be valued at cost.

Measurement date

.039 For a defined benefit plan, the plan assets and the accrued benefit obligation would usually be measured at the date of the financial statements. As a practical matter, an earlier date may be used provided the government adopts this practice consistently from year to year and as long as no significant change relevant to the valuation of the plan occurs between the valuation date and the financial statement date.

Actuarial assumptions

.040 Accounting for retirement benefit obligations of defined benefit plans requires forecasts of future events, such as inflation rates, investment returns, interest rates, wage and salary increases, medical inflation and employee turnover and mortality. Such forecasts form the basis of actuarial assumptions.

.041 Each key actuarial assumption would be based on the government's best estimate of those future events that have an effect on the accrued benefit obligation. The assumptions would take into account the expected long-term experience of the plan and the short-term forecast. Such an approach ensures that the reported accrued benefit obligation and expense recognize the long-term nature of retirement benefit promises as well as the experience of the plan expected in the short term. Assumptions about the long-term future, however, are not to be unduly influenced by the experience expected in the short term. At each actuarial valuation, assumptions need to be reassessed; they would be revised if expectations about the future change. All assumptions are based on the presumption that the plan will continue in effect in the absence of evidence to the contrary.

.042 *Actuarial assumptions should be based on the government's best estimates of expected long-term experience and short-term forecasts.* [SEPT. 2001]

.043 One commonly used approach that meets this standard is the use of streamed rate assumptions. Under the streamed rate approach, the short-term forecast of fund asset earnings, for example, would reflect the rates of return that assets currently held in the fund will earn until their maturity. As those assets mature, assumptions about their expected earnings on reinvestment would move to the expected long-term rate. Similarly, there would be streamed rate assumptions for salary increases.

.044 The actuarial assumptions underlying the valuation of the retirement benefit liability and expense would be internally consistent. For example, when a government determines its discount rates by reference to its plan asset earnings, the assumptions used to determine the short-term forecast incorporated in the discount rates would be consistent with the short-term forecast of rates of return on assets currently held in the fund. When a government determines its discount rates by reference to its cost of borrowing, the assumptions used to determine the short-term forecast incorporated in the discount rates would be consistent with the specific rates of interest and the periods committed to by the government on the amounts borrowed.

.045 *Actuarial assumptions should be internally consistent.* [SEPT. 2001]

.046 Internally consistent assumptions about future inflation rates are particularly important because of the significant impact those rates have on the reported accrued benefit obligation and related expenses. The same assumptions about future inflation need to be used when forecasting future rates of return on fund assets, future costs of borrowing and future salary and wage increases, and when determining the appropriate discount rates. In addition, methods of developing actuarial assumptions need to be consistent over time.

.047 Measurement of the cost of future medical benefits requires assumptions about the level and frequency of future claims and the cost of meeting those claims. The level and frequency of claims are particularly sensitive to the age of employees (and their beneficiaries) and may be sensitive to other factors, such as gender and geographical location. A government estimates future medical costs on the basis of historical data about its own experience, supplemented when necessary by historical data from other entities, insurance enterprises, medical providers or other sources. Historical data is adjusted to reflect any differences in demographic mix of the population or when there is reliable evidence that historical trends will not continue.

.048 Certain medical claims may be covered by governmental programs under existing law or by other providers of health care benefits. Benefit coverage by governmental programs is assumed to continue as provided by the present law and by other providers pursuant to their present plans.

.049 When making assumptions about future events, a government would obtain expert assistance from internal or external sources. One source of expert assistance is the **actuary** carrying out the actuarial computations. Periodic assessments are needed to ensure that the assumptions continue to be relevant.

Limit on the carrying amount of an accrued benefit asset

.050 *An accrued benefit asset should be presented on a government's statement of financial position net of any valuation allowance. When a defined benefit plan gives rise to an accrued benefit asset, a government should recognize a valuation allowance for any excess of the adjusted benefit asset over the expected future benefit. A change in valuation allowance should be recognized in the statement of operations for the period in which the change occurs.* [SEPT. 2001]

.051 A government with a defined benefit plan may have an accrued benefit asset for accounting purposes. An accrued benefit asset arises when the government's total contributions to the plan, including interest earned thereon, are greater than the retirement benefit expense recognized since the start of the plan. Contributions reflect the funding objectives of the plan. The benefit expense reflects the accounting objectives and may differ for a number of reasons, including the fact that actuarial gains and losses are deferred and amortized in future periods.

.052 A government may benefit from an accrued benefit asset either by withdrawing surplus assets or by taking a contribution holiday or receiving a refund of contributions. The accrued benefit asset may become impaired when there is a plan surplus for accounting purposes that the government is not entitled to benefit from fully. For example, there may be a regulatory moratorium on pension surplus withdrawals or uncertainties as to a government's legal right to use a plan's accounting surplus.

.053 To determine the extent to which an accrued benefit asset may be impaired, the government first determines the **adjusted benefit asset**. The adjusted benefit asset is the accrued benefit asset less net unamortized actuarial losses (determined on a basis using market value of assets).

.054 The adjusted benefit asset is then compared to the **expected future benefit**. When the expected future benefit exceeds the adjusted benefit asset, the accrued benefit asset is not impaired and, accordingly, no valuation allowance is required. The chart included as Appendix A to this Section is intended to set out the relationship between the various defined terms.

.055 The objective of the standard in paragraph PS 3250.050 is to limit a government's accrued benefit asset to the amount it can realize in the future. The expected future benefit is a calculated amount representing the benefit a government expects to realize from a plan surplus. An expected future benefit includes any withdrawable surplus or reduction in future contributions.

.056 A government determines its expected future benefit as the sum of:

- (a) the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
- (b) the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

.057 A government's expected future accruals for service for the current number of active employees are determined on a basis consistent with that used to determine its accrued benefit obligation. These expected future accruals for service, less required employee contributions and minimum contributions the government is required to make regardless of any surplus, are then discounted back to the current period to determine the present value. The interest rate used to calculate this present value is the expected rate of return on plan assets used to determine the benefit expense in the period.

.058 When administration expenses are paid by the plan and included in the normal cost calculation, a best estimate of the future administration expense is included in the expected future accruals for service. When administration expenses are paid by the plan and not included in the normal cost calculation, the rate of return on plan assets is adjusted to reflect the deduction of the administrative expenses.

.059 A key factor in determining a government's expected future benefit from a defined benefit plan with a plan surplus for accounting purposes is the ability of the government to withdraw assets from the plan. The expected future benefit includes amounts to which a government has a legally enforceable right of withdrawal. It excludes any withdrawable plan surplus a government is currently required, or intends, to allocate to employees. A government may not anticipate obtaining a legally enforceable right to withdraw a portion of a plan surplus to which it is not currently entitled, whether on the basis of precedent or otherwise. Accordingly, when withdrawal of plan surplus requires the approval of employees or an appropriate regulatory authority or a court of law, a government excludes any amount subject to this restriction from its expected future benefit until such approval has been obtained. A change in the allocation of surplus between a government and its employees is incorporated into the calculation of the expected future benefit only when it has been agreed to and, when required, approved by the appropriate regulatory authorities.

Actuarial gains and losses

.060 The periodic actuarial valuation of a government's obligation for retirement benefits will usually determine that adjustments are required due to experience different from that assumed or to changes in actuarial assumptions. Adjustments are needed when the actual experience of the benefit plan is different than that expected. Adjustments due to changes in actuarial assumptions are needed when a government believes revised assumptions are necessary to reflect a relatively permanent change in expected experience or to reflect new information. Adjustments are inevitable because the actuarial valuation requires ongoing forecasts of uncertain future events.

.061 Actuarial gains and losses would be amortized over a reasonable future period because of their tentative nature and because further adjustments will likely be required in the future. A reasonable future period is the **expected average remaining service life of the related employee group**. Amortization may commence in the period following the determination of the adjustment. Actuarial gains and losses would be determined on a market value basis or a basis adjusted to market value, consistent with paragraph PS 3250.035.

.062 *Except in the circumstances in paragraph PS 3250.068, PS 3250.071 and PS 3250.078, actuarial gains and losses should be amortized to the liability or asset and the related expense in a systematic and rational manner over the expected average remaining service life of the related employee group. [SEPT. 2001]*

Prior period service costs arising from plan amendments

.063 A plan amendment occurs when a benefit plan is changed or initiated. In such circumstances, retroactive credit may be given to employees for services rendered previously and, as a result, **prior period service costs** are incurred. For example, if the benefit formula is changed from one percent to two percent of final pay per year of service, the extra one percent may be credited to employees for years of service prior to the change.

.064 Plan amendments include the inception of a new plan that grants retroactive credit for past service, an increase in benefits related to past service for active employees, or an increase in benefits for former employees already retired.

.065 The cost of plan amendments related to prior period employee services would be accounted for as an expense in the period of the plan amendment. This method is recommended because it ensures that, when a government provides retroactive credit to employees for past services, legislators, taxpayers and investors are provided a full accounting of the cost of that decision in the period the decision is made. Such an accounting ensures that the effect of that decision, as it relates to the cost of prior period services, is recognized as an expense in the period a liability is incurred. It also provides information needed to

assess the extent to which future revenues are required by a government to pay for past transactions because all retirement benefit liabilities are accounted for in the financial statements.

.066 *The cost of plan amendments related to prior period employee services should be accounted for in the period of the plan amendment.* [SEPT. 2001]

.067 While all plan amendments related to prior period employee services are accounted for in the period of the plan amendment, the existence of the plan amendment may affect the recognition of actuarial gains, as described in paragraph PS 3250.068.

.068 *In the period of a plan amendment related to prior period employee services that results in an increase in the accrued benefit obligation, if net unamortized actuarial gains exist, these should be recognized immediately, to a maximum of the prior period service cost, and offset against the prior period service cost in the statement of operations, with separate disclosure in the notes.* [SEPT. 2001]

.069 When a government makes a plan amendment related to prior period employee services and has net unamortized actuarial gains, it would recognize these net unamortized actuarial gains immediately in the statement of operations, to a maximum of the prior period service cost. Recognition would be applied first to the oldest net unamortized actuarial gains within a plan. These actuarial gains would be deducted from the prior period service cost in the statement of operations. The notes to the financial statements would disclose this information.

.070 A plan amendment may decrease, rather than increase, a government's accrued benefit obligation. A decrease in the accrued benefit obligation would be accounted for immediately in the period of the plan amendment. The existence of the plan amendment may affect the recognition of actuarial losses as described in paragraph PS 3250.071.

.071 *In the period of a plan amendment related to prior period employee services that results in a decrease in the accrued benefit obligation, if net unamortized actuarial losses exist, these should be recognized immediately, to a maximum of the decrease in the accrued benefit obligation. The net amount would be recognized in the statement of operations, with separate disclosure in the notes.* [SEPT. 2001]

.072 In the period of a plan amendment that decreases the accrued benefit obligation any net unamortized actuarial losses would be recognized immediately to a maximum of the decrease in the accrued benefit obligation. Recognition would be applied first to the oldest unamortized net actuarial losses within a plan.

Temporary deviation from the benefit plan

.073 A government may decide to deviate temporarily from the provisions of a benefit plan to increase or decrease the government's share of the benefit costs incurred in the current period or past periods. For example, a government may grant an employee contribution holiday as a temporary deviation from the normal terms of the benefit plan. A government would look to the substance of the temporary deviation to determine the most appropriate accounting.

Plan settlements and curtailments

.074 A **plan settlement** and a partial plan settlement consist of the discharge, in whole or in part, of a government's obligation existing under a retirement benefit plan. They are irrevocable events by which a government or a plan is relieved of the primary obligation to pay all or some of the benefits promised and is relieved of significant risks in relation to the obligation or the assets used to make settlement. When a full plan settlement occurs, a future actuarial valuation is not required because the government no longer has an obligation related to that plan. Because the cost of discharging the obligation may differ from the related liability recognized previously, a gain or loss may arise.

.075 A **plan curtailment** is an event that reduces significantly the expected years of future service of present employees or eliminates, for a significant number of employees, the accrual of defined benefits for some or all of their future services. Plan curtailments include termination of a significant number of employees earlier than expected which may involve eliminating a government organization or program; they also include suspension of a plan so that a significant number of employees do not earn additional defined benefits for future services. When a plan curtailment occurs, future actuarial valuations are required because, even though the government's future obligations have been reduced, the government continues to have an obligation related to that plan.

.076 Generally, the act of settling or curtailing a retirement plan will result in a gain or loss because the actual cost of the settlement or curtailment will differ from the obligation recorded previously. Gains and losses determined upon a plan settlement or curtailment would be accounted for in the statement of operations in the period of the settlement or curtailment. This approach is recommended for plan settlements because the amount of the liability is known, it relates to services previously provided and it has been settled. Similarly, if a government settles only a part of a retirement plan obligation, the related gains and losses would be recognized immediately. This approach is also recommended for plan curtailments because the retirement benefit obligation is known with greater certainty, it relates to past employee services and the employees might no longer work for the government. For plan curtailments, the portion of the total gains and losses that would be accounted for would relate to the employees affected by the curtailment.

.077 In some circumstances, there will be unamortized actuarial gains and losses incurred prior to the plan settlement or curtailment. The net unamortized balances related to the obligation settled or to the employees affected by the curtailment would be recognized in the period of settlement or curtailment, and is included as part of the gain or loss arising on settlement or curtailment.

.078 *Gains and losses determined upon a plan settlement or curtailment should be accounted for in the period of the settlement or curtailment.* [SEPT. 2001]

Joint defined benefit plans

.079 Governments may participate jointly in defined benefit plans where the government shares the risks and rewards jointly with plan participants, represented by a sponsor or sponsors. **Joint defined benefit plans** are governed by a formal agreement between the sponsors, which establishes that the sponsors have shared control over the plan. A governing board is generally appointed by the joint sponsors with equal representation and a mutually agreed-upon chair.

.080 A government would consider the characteristics of the plan to determine whether it meets the definition of a joint defined benefit plan. In a joint defined benefit plan, funding contributions are shared mutually between the government and the plan members. The sponsors have control over decisions related to the administration of the plan and the level of benefits and contributions on an ongoing basis based on the terms of the contractual agreement. The sponsors share, on an equitable basis, the significant risks associated with the benefit plan. Risk would not be considered to be equitably shared in an arrangement where the government and the joint sponsors fund the plan equally but where the government retains the full risk of the accrued benefit obligation. If the government retains the residual risks it is unlikely that the plan meets the definition of a joint defined benefit plan.

.081 *When a government participates in a joint defined benefit plan, the government's risk is limited to its portion of the plan. The government should account for its portion of the plan in accordance with the standards for defined benefit plans.* [SEPT. 2001]

.082 A government may convert an existing defined benefit plan for which it is the sole sponsor to a joint defined benefit plan where the risks and benefits are shared. When converting to a joint plan, a government would consider whether there are any special accounting issues that arise, including whether the predecessor plan has been settled or partially settled and/or curtailed or partially curtailed. In assessing such issues a government would have regard to its specific circumstances and the terms of the joint defined benefit plan.

Disclosure

.083 The notes and schedules integral to the financial statements would disclose the methods and judgments applied in accounting for accrued benefit obligations and expenses. Full disclosure is particularly important for retirement obligations because the measurements depend heavily upon judgments rather than objective evidence.

.084 *Financial statements should disclose:*

- (a) *a general description of retirement benefit plans, benefit formulae and funding policy, including a description of significant changes to retirement benefit plans during the period;*
- (b) *the accrued benefit obligation at the end of the period, as determined by the actuarial valuation;*
- (c) *the market value of plan assets at the beginning and the end of the period and, if different, the market-related value of plan assets at the beginning and the end of the period;*
- (d) *the amount of retirement benefit liability or accrued benefit asset at the end of the period, indicating separately the amount of any valuation allowance determined in accordance with paragraph PS 3250.050.*
- (e) *unamortized actuarial gains and losses and the periods of amortization;*
- (f) *current period benefit cost;*
- (g) *cost of plan amendments incurred during the period;*
- (h) *net actuarial gains or losses recognized in the determination of the cost of plan amendments in accordance with paragraphs PS 3250.068 and PS 3250.071;*
- (i) *other gains and losses on accrued benefit obligations arising during the period;*
- (j) *other gains and losses on plan assets arising during the period;*
- (k) *gains and losses arising from plan settlements and curtailments incurred during the period;*
- (l) *amortization of actuarial gains and losses reflected in the current year expense;*
- (m) *the amount recognized as a result of a temporary deviation from the plan, determined in accordance with paragraph PS 3250.073;*
- (n) *the change in a valuation allowance determined in accordance with paragraph PS 3250.050;*
- (o) *the amount of contributions by employees during the period;*
- (p) *the components of the retirement benefits interest expense for the period;*
- (q) *the amount of contributions by the government during the period;*
- (r) *the amount of benefits paid during the period;*
- (s) *the expected return and actual return on plan assets during the period;*
- (t) *assumptions about long-term inflation rates, expected rate of return on plan assets, assumed health care cost trends, rate of compensation increase (for pay-related plans) and discount rate; and*
- (u) *the date of the most recent actuarial valuation performed for accounting purposes.* [SEPT. 2001]

.085 Some of this disclosure information may be presented in reconciliations of the beginning and ending balances of the accrued benefit obligation and plan assets for the period, taking into account any unamortized actuarial gains or losses existing at the financial statement date.

.086 A reconciliation of the beginning and ending balances of the accrued benefit obligation would include the items disclosed in accordance with paragraph PS 3250.084(b), (i), (k) and (o)-(r). A reconciliation of the beginning and ending balance of plan assets for the period would include the items disclosed in accordance with paragraph PS 3250.084(c), (f)-(g), (j)-(k), (m), (o)-(p) and (r).

.087 *A government should provide these disclosures separately for plans that provide pension benefits and plans that provide retirement benefits other than pensions.* [SEPT. 2001]

.088 *A government that has aggregated disclosures for its defined benefit pension plans, or for its other defined benefit retirement plans, should provide the disclosures separately for the aggregate of plans with accrued benefit obligations in excess of plan assets.* [SEPT. 2001]

.089 The level of detail disclosed by governments would reflect the highly aggregated nature of financial statements. In deciding the level of detail to disclose, governments would consider the usefulness of the information to the reader in assessing the nature of, and the costs associated with, a government's retirement benefit plans. The level of disclosure would also consider the sensitivity of the information in relation to the government's financial position.

.090 The description of the significant benefit plans and benefit formulae might include the plan surplus or deficit at the end of the period, demographic information about the participants and whether the benefit obligation includes the cost of inflation protection. The description of the funding policy might include the major types of plan assets and the basis of their valuation. The extent to which the fund holds securities of the sponsoring government would normally be disclosed.

.091 Governments are encouraged to provide additional disclosures about the significant actuarial assumptions underlying the reported amount of a government's accrued benefit obligation when the disclosures will enhance the financial statement users' understanding of that amount.

.092 A government may also choose to disclose a forecast of the cash required to pay its retirement benefit obligations in the short term, the medium term and the long term. If provided, such a forecast would include the amounts required in the next five years, and thereafter.

.093 *For joint defined benefit plans, in addition to the disclosures required in paragraphs PS 3250.084 government financial statements should disclose:*

- (a) *the significant accounting policies for joint plans;*
- (b) *a description of the unique nature and terms of any joint plans;*
- (c) *the government's share of the risks and benefits under the plans; and*
- (d) *the total financial status of any joint plans.* [SEPT. 2001]

.094 Users of government financial statements need an appreciation of the magnitude of the retirement benefit plans that governments jointly sponsor and the government's responsibility under the terms of any joint plans.

DEFINED CONTRIBUTION PLANS

.095 When a government establishes a defined contribution plan, it does not assume the actuarial and investment risks inherent in a defined benefit plan. The government typically agrees to contribute a certain amount in each period for services rendered by the employees and has no responsibility to make any further contributions. It is the employees who are at risk. This is generally because the amount of the benefit that will be payable to them is entirely dependent upon the amount of funds accumulated for each employee's account and the economic conditions prevailing at the retirement date (see paragraphs PS 3250.011-.014 for a further discussion of defined contribution plans).

Liability and expense

.096 For the most part, defined contribution plans do not present particular accounting problems. If the formula calls for government contributions on a regular predetermined basis and if those contributions have been made, then the expense recorded in the statement of operations is simply the required contribution of the accounting period. If the contributions have not been made as required, the retirement benefit expenses would include interest accrued during the period on any outstanding amounts payable to the fund. The liability for retirement benefits recorded in the statement of financial position would be the difference between the amount the government was required to contribute and the amount that was contributed to the financial statement date, including accumulated interest on any outstanding amounts payable to the fund at the financial statement date.

.097 *For defined contribution plans:*

- (a) *the liability for retirement benefits should be the difference between the amount a government was required to contribute and the amount that was contributed by the financial statement date including accumulated interest on any outstanding amounts payable to the fund at the financial statement date;*
- (b) *the retirement benefit liability should be accounted for in the statement of financial position;*
- (c) *the expense for retirement benefits should be the amount of required contributions provided for employees' services rendered in the period. Interest accrued during the period on any outstanding amounts payable to the fund should be accounted for as a retirement benefit interest expense; and*

(d) the retirement benefit expense and the retirement benefit interest expense should be accounted for in the statement of operations. [SEPT. 2001]

.098 When a defined contribution plan is amended, a government may agree to make contributions in respect of past service. The cost of current and expected future years' contributions related to a past service plan amendment is recognized immediately in the period the decision is made to amend the plan.

.099 *For a defined contribution plan, the cost of current and expected future years' contributions related to a past service plan amendment should be accounted for in the period of the plan amendment. [SEPT. 2001]*

Disclosure

.100 *For defined contribution plans, financial statements should disclose:*

(a) a general description of benefit plans, contribution formulae and funding policy;

(b) the expense recognized for the period; and

(c) a description of significant changes to benefit plans during the period. [SEPT. 2001]

.101 The description of the significant retirement benefit plans and contribution formulae might include demographic information about the participants.

.102 The description of the funding policy might also include: the employee and government contributions during the accounting period; the major types of plan assets, the total amounts and the basis of their valuation; and the extent to which the fund holds securities of the sponsoring government.

.103 The description of significant changes to the plan or to the financing of the plan might also include which employee group(s) is affected and a description of the impact of such changes on current and future retirement benefit liabilities and related expenses.

.104 The level of detail disclosed by governments would reflect the highly aggregated nature of financial statements. In deciding the level of detail to disclose, governments would consider the usefulness of the information to the reader in assessing the nature of, and the costs associated with, a government's retirement benefit plans. The level of disclosure would also consider the sensitivity of the information in relation to the government's financial position.

MULTIEMPLOYER AND MULTIPLE-EMPLOYER BENEFIT PLANS

Multiemployer plans

.105 A **multiemployer plan** is a defined benefit plan to which two or more governments or government organizations contribute, usually pursuant to legislation or one or more collective bargaining agreements. The main distinguishing characteristic of a multiemployer plan is that the contributions by one participating entity are not segregated in a separate account or restricted to provide benefits only to employees of the entity and thus may be used to provide benefits to employees of all participating entities.

.106 The federal and most provincial governments sponsor defined benefit plans in which many public sector organizations participate. Many local governments participate in such multiemployer plans. When benefits are provided to employees through a multiemployer plan, the amount for which an individual government is obligated under the plan may not be quantified. Generally, a contribution rate is established for each period to ensure that the plan assets are adequate to cover the plan's future benefit payments.

.107 When a government sponsors a defined benefit multiemployer retirement benefit plan, it has the responsibility to ensure that the defined benefits promised to employees are met. In that circumstance the sponsoring government is at risk for future experience gains or losses and would account for its related obligation for the entire multiemployer plan as a defined benefit plan.

.108 *When a government sponsors a defined benefit multiemployer retirement plan, the government should follow the standards for defined benefit plans in accounting for its obligation for the plan. [SEPT. 2001]*

.109 Although a multiemployer plan may have the characteristics of a defined benefit plan, sufficient information to follow the standards for defined benefit plans is normally not available for each participating employer other than the sponsoring government. For this reason, a multiemployer plan is accounted for by each participating government following the standards for defined contribution plans.

.110 *When benefits are provided to employees through a multiemployer retirement benefit plan, each entity participating in the plan, other than the sponsoring government, should follow the standards for defined contribution plans. [SEPT. 2001]*

.111 *The government should disclose any available information about any surplus or deficit in a multiemployer plan, the basis used to determine the surplus or deficit and the implications, if any, for the government. [SEPT. 2001]*

Multiple-employer plans

.112 A **multiple-employer plan** is a defined benefit plan maintained by more than one entity that is not a multiemployer plan. In contrast to multiemployer plans, a multiple-employer plan maintains separate accounts for each entity so that contributions provide benefits only for employees of the contributing entity. In addition, multiple-employer plans are intended to allow participating entities, commonly in the same industry, to pool their plan assets for investment purposes and to reduce the cost of plan administration. Multiple-employer plans may have features that allow participating entities to have different benefit formulae, with the entity's contributions to the plan based on the benefit formula selected by the entity.

.113 When benefits are provided to employees through a defined benefit multiple-employer plan, each government in the plan follows the standards on defined benefit plans and bases its accounting for plan assets on its proportionate interest in the assets of the multiple-employer plan.

.114 *When benefits are provided to employees through a defined benefit multiple-employer retirement plan, each entity in the plan should follow the standards for defined benefit plans.* [SEPT. 2001]

TRANSITIONAL PROVISIONS

.115 When implementing this Section, governments may have an initial unrecorded liability.

.116 The initial unrecorded liability would be accounted for as a change in accounting policy applied retroactively. This method is recommended because it ensures that all liabilities incurred to the financial statement date are accounted for in the statement of financial position. Such an accounting is needed to help users of financial statements assess the impact those liabilities may have on:

- (a) a government's future cash requirements from revenues and other sources;
- (b) a government's ability to meet its financial obligations, both short-term and long-term; and
- (c) a government's ability to maintain the level and quality of its services and to finance new programs.

.117 *This Section should be accounted for as a change in accounting policy applied retroactively.* [SEPT. 2001]

TIMING OF ACTUARIAL VALUATIONS

.118 Most governments do not have full actuarial valuations performed annually because of the magnitude of the information gathering and processing required. **Actuarial valuations for accounting purposes** would generally be done once every three years because of the financial importance of retirement benefit obligations. They would be done as close to the related financial statement date as is practical. In the years between valuations, an extrapolation would be used to compute the expected accrued benefit obligation and related expenses. Each year the government reviews matters such as changes to the plan, the actuarial assumptions, occurrence of settlements and curtailments, changes to the employee group and the rate of return on plan assets, and determines whether such matters necessitate any adjustments to the extrapolations. When the effect of any change is significant, a new valuation may be necessary.

.119 In the period a government implements this Section, it would need to assess whether a new actuarial valuation of its retirement benefit obligations is needed. A new valuation would be needed, for example, if the prior one is not current or is not prepared in accordance with this Section.

GLOSSARY

An **accrued benefit asset** is the amount of any asset recognized on a government's statement of financial position in respect of employee retirement benefits before deducting any valuation allowance that may be required. It is the sum of the government's accumulated cash contributions less the sum of the current and prior years' benefit expenses (before any change in the valuation allowance).

An **accrued benefit obligation** is the value of retirement benefits attributed to services rendered by employees and former employees to the financial statement date.

Actuarial assumptions are made as to the occurrence of a future event that will affect retirement benefit costs and obligations. They include assumptions about such matters as mortality, withdrawal, disability and retirement and about changes in compensation, interest on obligations and investment earnings.

Actuarial cost methods are used to determine the cost of providing retirement benefits and to allocate that cost to specific time periods. The two main families of actuarial valuation methods are:

Accrued benefit methods (also known as unit credit or single premium actuarial cost methods) — Under these methods a distinct unit of retirement benefit is associated with each year of credited service and the actuarial present value of that unit of benefit is separately computed for the period during which it is presumed to have accrued. Salary projection, when appropriate, is required.

Projected benefit method prorated on services — Under this accrued benefit method, generally an equal portion of the total estimated benefit (i.e., with salary projection, when appropriate) is attributed to each year of service. The actuarial present value of the accrued retirement benefits is derived after the benefits are attributed to the years of service up to the date of determination.

Level cost methods — Under these methods the retirement benefit cost assigned to any period is either the same dollar amount or the same percentage of compensation as any other period, and is a portion of the cost of the total prospective benefits of an employee group, either in absolute dollars or as a percentage of salary. (Entry age, attained age and aggregate actuarial cost methods are included in this family of methods.)

Actuarial gains and losses are changes in the value of the accrued benefit obligation and the plan assets resulting from:

- (a) experience different from that assumed; or
- (b) changes in an actuarial assumption.

An **actuarial valuation for accounting purposes** is an assessment of the financial status of a benefit plan. It consists of the valuation of assets held by the plan and calculation of the actuarial present value of benefits to be paid under the plan. The

valuation provides the information needed to determine the retirement benefit liability and related expenses in accordance with this Section.

An **actuarial valuation for funding purposes** is an assessment of the financial status of a benefit plan. It consists of the valuation of assets held to discharge the benefit liability and calculation of the actuarial present value of benefits to be paid under the plan. The valuation results in a calculation of the required future contributions and a determination of any gains or losses since the last valuation.

An **actuary** is a Fellow of the Canadian Institute of Actuaries.

An **adjusted benefit asset** is an accrued benefit asset less the amount, if any, by which the aggregate of any unamortized actuarial losses exceeds the aggregate of any unamortized actuarial gains.

A **contingency** is the result of an existing condition or situation involving uncertainty that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

Contractual obligations are obligations of a government to others that will become liabilities when the terms of those contracts or agreements are met.

The **current period benefit cost** is the actuarial present value of benefits attributed to services rendered by employees in the period.

A **defined benefit plan** specifies either the benefits to be received by employees after retirement or the method for determining those benefits. The most commonly used defined benefit plans are:

Final pay plan — Bases benefits on an employee's length of service and compensation over a specified number of years (usually the years of an employee's highest earnings).

Flat benefit plan — Provides a specified benefit for each year of service rendered; the benefit earned in each period is usually fixed and determinable under the terms of the plan and the amount of benefits to be received varies only with the years of service rendered.

A **defined contribution plan** is one in which the employer's contributions are fixed, usually as a percentage of compensation, and allocated to specific individuals. The retirement benefit for each employee is the amount that can be provided at retirement based on the accumulated contributions made on that individual's behalf and investment earnings on those contributions.

The **expected average remaining service life (EARSRL) of the related employee group** is the total number of years of future services expected to be rendered by that group divided by the number of employees in the group. The calculation of expected future services considers population decrements based on the actuarial assumptions but is not weighted by benefits or compensation.

The **expected future benefit** is a calculated amount representing the benefit a government expects to realize from a plan surplus. An expected future benefit includes any withdrawable surplus or reduction in future contributions. A government determines its expected future benefit as the sum of:

- (a) the present value of its expected future accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the government is required to make regardless of any surplus; and
- (b) the amount of the plan surplus that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

Financial statements are summary financial statements published by a government that report on the financial position and changes in financial position of the government reporting entity. Such statements present aggregated information and serve as a means by which a government demonstrates its accountability for the financial affairs and resources entrusted to it.

A **joint defined benefit plan** is a contractual arrangement between the government and another sponsor or sponsors representing plan participants that has all of the following characteristics:

- (a) the sponsors co-operate toward achieving the significant clearly defined common goal of providing retirement benefits in exchange for services rendered by the employees;
- (b) funding contributions are shared mutually between the government and the plan members, represented by the non-government sponsor;
- (c) the sponsors share control of decisions related to the administration of the retirement benefit plan and to the level of benefits and contributions on an ongoing basis; and
- (d) the significant risks associated with the retirement benefit plan are shared on an equitable basis between the government and the plan members, represented by the non-government sponsor.

The contractual arrangement establishes that the sponsors have shared control over the retirement benefit plan, and ensures that neither party is in a position to control the plan unilaterally. Nevertheless, overall, there must be an equitable relationship between the funding by the government of the retirement benefit plan, the extent of control it is able to exercise over the plan and the risks and benefits that accrue to the government from the plan.

Liabilities are present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits.

A **multiemployer plan** is a defined benefit plan to which two or more governments or government organizations contribute, usually pursuant to legislation or one or more collective bargaining agreements. The main distinguishing characteristic of a multiemployer plan is that the contributions by one participating entity are not segregated in a separate account or restricted to provide benefits only to employees of the entity and, thus may be used to provide benefits to employees of all participating entities.

A **multiple-employer plan** is a defined benefit plan maintained by more than one entity that is not a multiemployer plan. In contrast to multiemployer plans, a multiple-employer plan maintains separate accounts for each entity so that contributions provide benefits only for employees of the contributing entity. In addition, multiple-employer plans are intended to allow participating entities, commonly in the same industry, to pool their plan assets for investment purposes and to reduce the cost of plan administration. Multiple-employer plans may have features that allow participating entities to have different benefit formulae, with the entity's contributions to the plan based on the benefit formula selected by the entity.

A **plan asset** is an asset segregated and restricted in a trust or other legal entity separate from the reporting government to provide for retirement benefits under the following conditions:

- (a) the assets in the separate entity are to be used only to settle the related accrued benefit obligation, are not available to the government's own creditors, and either cannot be returned to the government or can be returned to the government only if the remaining assets of the trust are sufficient to meet the plan's obligations; and
- (b) to the extent that sufficient assets are in the separate entity, the government will have no obligation to pay the related retirement benefits directly.

For purposes of this Section, plan assets do not include amounts held by the government and not yet paid into the trust or other legal entity.

A **plan curtailment** occurs when the expected years of future service to be rendered by the existing employee group are reduced significantly or when benefits will not be earned by employees for some or all future periods.

A **plan settlement** occurs when an employer legally discharges the obligation for accrued retirement benefits either by transferring assets directly to plan participants in exchange for their rights to retirement benefits or by purchasing annuity contracts in which a third party unconditionally undertakes to pay all accrued retirement benefits.

A **prior period service cost** is the increase in the accrued benefit obligation associated with past service benefit improvements.

The **retirement benefit expense** is the cost of the retirement benefits promised during the period in exchange for services rendered during the period.

The **retirement benefit interest expense** is the cost of financing an unfunded retirement benefit obligation during the period.

The **retirement benefit liability** is the amount of any liability recognized on a government's statement of financial position in respect of retirement benefits. It is the sum of the current and prior years' benefits expenses less the government's accumulated cash contributions.

A **retirement benefit plan** is any arrangement (contractual or otherwise) by which a program is established to provide retirement income and other benefits to employees and/or retirees.

Retirement benefits are benefits expected to be provided after retirement to employees and their beneficiaries. These benefits include pension income, health care benefits, life insurance, and other miscellaneous benefits provided to employees after retirement.

Vesting is the recognition of the employees' rights to receive retirement benefits that are no longer conditional on the employees remaining in the service of the employer.

APPENDIX A

Limit on accrued benefit asset



The carrying amount on the statement of financial position would be the accrued benefit asset of \$30 less the valuation allowance of \$7 for an amount of \$23.

APPENDIX B

ILLUSTRATIVE EXAMPLES

The following examples have been prepared by CPA Canada staff to illustrate how the standards in Section PS 3250 might be implemented.

The examples are illustrative only and matters of principle relating to particular situations should be decided in the context of the Section. They are not intended to indicate preferred formats nor to prescribe standardized note disclosure, as variations in format and wording will be necessary to meet the requirements of differing circumstances.

For ease of presentation, selections are made from accounting alternatives permitted by the Section.

Example 1 — Defined benefit pension plan, assuming a separate pension fund is maintained

Example 2 — Defined benefit plan for retirement benefits other than pensions, assuming a separate fund is not maintained

Example 1 — Defined benefit pension plan, assuming a separate pension fund is maintained

The government sponsors contributory defined benefit pension plans for substantially all of its employees and for members of its Legislature. There are three main plans — the Public Service Plan, the Provincial Judges' Plan and the Elected Representatives' Plan. The Public Service and the Provincial Judges' plans provide for pensions equal to 1.5 percent of the average of the five highest years' salary for each year of service to a maximum of 35 years. The Elected Representatives' Plan provides for pensions equal to four percent of the average of five years' session indemnities for each year of service to a maximum of 15 years. The plans do not provide inflation protection. The average age of the 45,000 active employees is 42. There are 5,000 former employees who are entitled to deferred pension benefits and 11,000 retirees now receiving benefits.

Each year employees contribute seven percent of their salary to a separate pension fund and the government contributes an equal amount. While the government and employees are required to contribute equal amounts into the pension fund, the government retains the full risk of the accrued benefit obligation. The pension fund invests monies from the contributions in securities of organizations external to the government reporting entity as well as investing in some non-marketable bonds of the government.

At the beginning of fiscal year 20X1, an actuarial valuation of the government's employee pension obligations was done for accounting purposes using the projected benefit method prorated on services. The liability for pensions recorded in the statement of financial position was \$400 million. For purposes of this example it is assumed that there were no unamortized actuarial gains or losses at that time.

Key actuarial assumptions used in the valuation were based on the government's best estimates. Those assumptions involve forecasts of expected future inflation rates, investment returns, wage and salary increases, and employee turnover and mortality. A second actuarial valuation for accounting purposes was performed at the end of fiscal year 20X3. During the second valuation, the actuarial assumptions included in the first one were reviewed and no changes were considered necessary.

During fiscal 20X4, a plan amendment was made to the Public Service Plan increasing the benefits from 1.5 percent to two percent of the average of the five highest years' salary for each year of service to a maximum of 35 years. The plan amendment was effective March 31, 20X4 and relates to both future and past services. The government is responsible for funding the pension liability of \$25 million related to past services over the next 12 years. The increase in current period benefit costs due to rendering of service for fiscal 20X5 was \$1.5 million.

	<u>April 1, 20X0</u>	<u>March 31, 20X3</u>
Accrued benefit obligation	\$1.5 billion	\$2.2 billion
Pension fund asset	<u>\$1.1 billion</u>	\$1.8 billion
Pension liability recorded in the statement of financial position	\$.4 billion	\$.4 billion
	=====	=====
Expected average remaining service life of related employee groups (EARS�)		12 years
Plan amendment March 31, 20X4		\$25,000
Expected current period benefit cost:		
20X1	\$200 million	
20X2	\$220 million	
20X3	\$240 million	
20X4		\$240 million
20X5		\$250 million
20X5 related to plan amendment		\$1.5 million
20X6		\$260 million

Expected rates of return	8%
Expected salary escalations	5%
Expected inflation rates	3%

The following amounts related to other pension experience incurred throughout the period:

(\$ millions)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Employee funding contributions	110	115	120	126
Government funding contributions:				
— related to current service	110	115	120	126
Benefit payments to retirees	105	109	115	119

Exhibit I — Interest during the year on the average pension liability outstanding during the year

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Interest on expected average accrued benefit obligation:				
Accrued benefit obligation — opening balance (a)	1,500,000	1,718,800	1,971,744	2,200,000
Add: Current period benefit cost (b)	100,000	110,000	120,000	120,000
Deduct: Benefit payments (b)	<u>(52,500)</u>	<u>(54,500)</u>	<u>(57,500)</u>	<u>(59,500)</u>
Average accrued benefit obligation	1,547,500	1,774,300	2,034,244	2,260,500
	=====	=====	=====	=====
Interest at 8% on average accrued benefit obligation	123,800	141,944	162,740	180,840

Expected earnings on average pension fund assets:

Pension fund assets — opening balance (a)	1,100,000	1,417,600	1,598,048	1,800,000
Add: Employee and government funding contributions (b)	110,000	115,000	120,000	126,000
Deduct: Benefit payments (b)	<u>(52,500)</u>	<u>(54,500)</u>	<u>(57,500)</u>	<u>(59,500)</u>
Average pension fund assets	1,157,500	1,478,100	1,660,548	1,866,500
	=====	=====	=====	=====
Expected earnings on average pension fund assets at 8%	92,600	118,248	132,844	149,320
Total interest during the period on the average pension liability outstanding during the period (c)	31,200	23,696	29,896	31,520

(a) In the period of an actuarial valuation, the opening balance of the accrued benefit obligation is the actuarially determined amounts (opening balances 20X1 and 20X4). In the periods between valuations (20X2 and 20X3), the opening balance is equal to the expected closing balance for the previous year as determined in Exhibit II. The opening balance of pension fund assets is the actual amount reported in the financial records of the fund.

(b) Accrued, or assumed to take place, evenly throughout the year, therefore interest is accrued on one-half of the total.

(c) Interest during the year on average pension liability outstanding during the year = 8% of [(average accrued benefit obligation) – (average pension fund assets)].

Exhibit II — Expected closing balance of accrued benefit obligation

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Accrued benefit obligation — opening balance	1,500,000	1,718,800	1,971,744	2,200,000
Add: Current period benefit cost	200,000	220,000	240,000	240,000
Increase due to plan amendment	—	—	—	25,000
Interest accrued (Exhibit I)	123,800	141,944	162,740	180,840
Deduct: Benefit payments	<u>(105,000)</u>	<u>(109,000)</u>	<u>(115,000)</u>	<u>(119,000)</u>
Expected closing balance	1,718,800	1,971,744	2,259,484	2,526,840
	=====	=====	=====	=====

Exhibit III — Expected closing balance of pension fund assets

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Pension fund assets — opening balance (actual)	1,100,000	1,417,600	1,598,048	1,800,000
Add: Employee and government funding and contributions	220,000	230,000	240,000	252,000
Expected earnings (Exhibit I)	92,600	118,248	132,844	149,320
Deduct: Benefit payments	<u>(105,000)</u>	<u>(109,000)</u>	<u>(115,000)</u>	<u>(119,000)</u>
Expected closing balance	1,307,600	1,656,848	1,855,892	2,082,320
	=====	=====	=====	=====

Exhibit IV — Amortization of actuarial gains / losses on accrued benefit obligation (a)

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Expected closing balance of accrued benefit obligation at March 31 (Exhibit II)	N/A	N/A	2,259,484	N/A
Actual accrued benefit obligation (per the March 31, 20X3 actuarial valuation)			<u>2,200,000</u>	
Actuarial gain			<u>59,484</u>	
EARSL			12 years	
Annual amortization over EARSL			4,957	

(a) A straight-line method is used to amortize actuarial gains and losses over the expected average remaining service life of the related employee groups. Amortization commences in the year following the effective date of the related actuarial valuation.

Exhibit V — Amortization of actuarial gains / losses on pension fund asset earnings

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Expected closing balance of pension fund assets at March 31 (Exhibit III)	1,307,600	1,656,848	1,855,892	2,082,320
Actual pension fund assets	<u>1,417,600</u>	<u>1,598,048</u>	<u>1,800,000</u>	<u>2,142,320</u>
Actuarial gain (loss)	110,000	(58,800)	(55,892)	60,000
	=====	=====	=====	=====
EARSL	12 years	12 years	12 years	12 years
Annual amortization over EARSL	9,167	(4,900)	(4,658)	5,000

Exhibit VI — Unamortized actuarial gains and losses

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Unamortized actuarial gains and losses — opening balance	—	110,000	42,033	41,358
Actuarial gains (losses) due to:				
— accrued benefit obligation (Exhibit IV)	—	—	59,484	—
— earnings on pension fund assets (Exhibit V)	110,000	(58,800)	(55,892)	60,000
Amortization recorded during the year:				
— accrued benefit obligation (Exhibit IV)	—	—	—	(4,957)
— earnings on pension fund assets (Exhibit V)	—	(9,167)	(4,267)	391
— recognition of net unamortized actuarial gains as an offset to prior period service cost (a)	<u>—</u>	<u>—</u>	<u>—</u>	<u>(25,000)</u>
Unamortized actuarial gains and losses — closing balance	110,000	42,033	41,358	71,792
	=====	=====	=====	=====

(a) When the cost of a plan amendment that improves a benefit related to prior service is offset against net actuarial gains, the cost is offset first against the oldest gains. Additionally, it is only offset against gains in the Public Service Plan.

Exhibit VII — Liability recorded in the statement of financial position

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Accrued benefit obligation — closing balance (a) (Exhibit II)	1,718,800	1,971,744	2,200,000	2,526,840
Deduct: Pension fund assets — closing balance (Exhibit III)	(1,417,600)	(1,598,048)	(1,800,000)	(2,142,320)
Unamortized actuarial gains / losses (Exhibit VI)	<u>110,000</u>	<u>42,033</u>	<u>41,358</u>	<u>71,792</u>
Pension liability	411,200	415,729	441,358	456,312
	=====	=====	=====	=====

(a) In the period of an actuarial valuation, this is the actuarially determined amount (closing balance 20X3). In the periods between valuations, this is an expected closing balance.

Exhibit VIII — Expenses recorded in the statement of operations

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Pension expense:				
Current period benefit cost	200,000	220,000	240,000	240,000
Prior period cost of plan amendment incurred during the year	—	—	—	25,000
Recognition of unamortized net actuarial gains	—	—	—	(25,000)
Amortization of actuarial gains / losses (Exhibit VI)	<u>—</u>	<u>(9,167)</u>	<u>(4,267)</u>	<u>(4,566)</u>
	200,000	210,833	235,733	235,434
Less: Employee contributions	<u>(110,000)</u>	<u>(115,000)</u>	<u>(120,000)</u>	<u>(126,000)</u>
Pension expense	<u>90,000</u>	<u>95,833</u>	<u>115,733</u>	<u>109,434</u>

Pension interest expense:

Interest during year on the average pension liability outstanding during the year (Exhibit I)	<u>31,200</u>	<u>23,696</u>	<u>29,896</u>	<u>31,520</u>
Total pension-related expenses	121,200	119,529	145,629	140,954
	=====	=====	=====	=====

Exhibit IX — Non-cash items recorded in the statement of cash flow

(\$ thousands)	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>
Pension liability:				
— beginning of year (Exhibit VII)	400,000	411,200	415,729	441,358
— end of year (Exhibit VII)	<u>411,200</u>	<u>415,729</u>	<u>441,358</u>	<u>456,312</u>
Increase in pension liability	11,200	4,529	25,629	14,954
	=====	=====	=====	=====

Financial statement disclosure**Illustrative Note to the Financial Statements**

The government sponsors contributory defined benefit pension plans for substantially all of its employees and for members of its Legislature. There are three main plans — the Public Service Plan, the Provincial Judges' Plan and the Elected Representatives' Plan. The plans provide pensions based on length of service and final average earnings. They do not provide for inflation protection. The average age of the 45,000 active employees covered by the plans is 42. There are 5,000 former employees who are entitled to deferred pension benefits. At present, the plans provide benefits for 11,000 retirees; benefit payments were \$119 million in 20X4 and \$115 million in 20X3.

Employees make contributions equal to seven percent of their salary and the government contributes an equal amount. In 20X4, total contributions for current year's service were \$252 million (20X3 — \$240 million). Total benefit payments to retirees during the year were \$119 million (20X3 — \$115 million). A separate pension fund is maintained. Pension fund assets are invested primarily in marketable investments of organizations external to the government reporting entity, with some invested in non-marketable bonds of the government. The pension liability at March 31 includes the following components:

(\$ thousands)	<u>20X4</u>	<u>20X3</u>
Accrued benefit obligation	2,526,840	2,200,000
Pension fund assets:		
Marketable securities	(1,942,320)	(1,610,000)
Government bonds	<u>(200,000)</u>	<u>(190,000)</u>
	384,520	400,000
Unamortized actuarial gains / losses	<u>71,792</u>	<u>41,358</u>
Pension liability	456,312	441,358
	=====	=====

Actuarial valuations for accounting purposes are performed triennially using the projected benefit method prorated on services. The most recent actuarial report was prepared at March 31, 20X3. The accrued benefit obligation shown for 20X4 is based on an extrapolation of that 20X3 valuation. There is a net unamortized actuarial gain to be amortized on a straight-line basis over the expected average remaining service life of the related employee groups (12 years).

The actuarial valuation was based on a number of assumptions about future events, such as inflation rates, interest rates, wage and salary increases and employee turnover and mortality. The assumptions used reflect the government's best estimates. The expected inflation rate is three percent. The discount rate used to determine the accrued benefit obligation is eight percent.

Pension fund assets are valued at market values. The expected rate of return on plan assets is eight percent. The actual return on plan assets was 8.6 percent. Plan assets include government bonds valued at an estimated market value of \$200 million (20X3 — \$190 million).

The total expenses related to pensions include the following components:

(\$ thousands)	<u>20X4</u>	<u>20X3</u>
Current period benefit cost	240,000	240,000
Prior period cost of plan amendment	25,000	—
Recognition of net unamortized actuarial gains	(25,000)	—
Amortization of actuarial gains / losses	<u>(4,566)</u>	<u>(4,267)</u>
	235,434	235,733
Less: Employee contributions	<u>(126,000)</u>	<u>(120,000)</u>
Pension expense	<u>109,434</u>	<u>115,733</u>
Interest cost on the average accrued benefit obligation	180,840	162,740
Expected return on average pension plan assets	<u>(149,320)</u>	<u>(132,844)</u>
Pension interest expense	<u>31,520</u>	<u>29,896</u>
Total expenses related to pensions	140,954	145,629
	=====	=====

The pension expense is included in the statement of operations as a component of program expenses. The pension interest expense is included in the public debt interest expense.

On March 31, 20X4, a plan amendment was made to the Public Service Plan increasing the rate at which pension benefits accrue. The amendment relates to both future and past service. The benefit accrual of \$25 million is based on an actuarial valuation of the increase in the accrued benefit obligation due to past service. The government intends to fund this amount over a 12-year period (\$1 million in 20X4).

Statement of Financial Position (excerpts)

As at March 31 (\$ thousands)	<u>20X4</u>	<u>20X3</u>
Liabilities		
Accounts payable	x	x
Accrued liabilities	x	x
Borrowings		
Treasury bills	x	x
From other governments	x	x
Bonds payable to pension fund (note)	200,000	190,000
Other	x	x
Pension liability (note)	<u>456,312</u>	<u>441,358</u>
Total liabilities	<u>x</u>	<u>x</u>
Excess of liabilities over financial assets	x	x
	=====	=====

Statement of Operations (excerpts)

For the year ended March 31 (\$ thousands)	<u>20X4</u>	<u>20X3</u>
Expenses		
Health (includes pension expense)	x	x
Education ...etc.	x	x

Public debt interest (includes pension interest expense)

_____ x
x
=====

_____ x
x
=====

Example 2 — Other retirement benefits plan

The government provides certain retiree health and life insurance benefits to its employees. The plan is unfunded and requires no contribution from employees.

In 20X3 the government adopted accrual accounting for the benefit plan. Prior to that date the government recognized benefit expenses equal to its payments for the actual costs incurred by the retirees and no liability for retirement benefits other than pensions was recorded in the statement of financial position.

At the beginning of fiscal year 20X3, an actuarial valuation of the government's obligations for retirement benefits other than pensions was done for accounting purposes using the projected benefit method prorated on services. Key actuarial assumptions used in the valuation were based on the government's best estimates. Those assumptions involve forecasts of expected future inflation rates, cost of long-term debt, employee mortality and medical costs. A second actuarial valuation for accounting purposes was performed at the end of fiscal year 20X5. During the second valuation, the actuarial assumptions included in the first one were reviewed and no changes were considered necessary.

(\$ thousands)

April 1, 20X2

March 31, 20X5

Accrued benefit obligation

100,000

150,000

Expected average remaining service life of related employee groups (EARS�)

12 years

Plan amendment September 30, 20X5

10,000

Expected current period benefit cost:

20X3

3,500

20X4

3,800

20X5

4,000

20X6

4,000

20X6 related to plan amendment

500

20X7

5,200

20X8

5,400

Expected cost of long-term debt

8%

Expected salary escalations

5.5%

Expected medical inflation rates

10%

Expected inflation rates

5.5%

Benefit payments to retirees

20X3

2,500

20X4	2,800
20X5	2,900
20X6	3,100

Exhibit I — Interest during the year on the average liability for retirement benefits other than pensions outstanding during the year

(\$ thousands)	<u>20X3</u>	<u>20X4</u>	<u>20X5</u>	<u>20X6</u>
Interest on expected average accrued benefit obligation:				
Accrued benefit obligation — opening balance (a)	100,000	109,040	118,803	150,000
Add: Current period benefit cost (b)	1,750	1,900	2,000	2,125
Increase in accrued benefit obligation due to plan amendment (c)	—	—	—	5,000
Deduct: Benefit payments (b)	<u>(1,250)</u>	<u>(1,400)</u>	<u>(1,450)</u>	<u>(1,550)</u>
Average accrued benefit obligation	100,500	109,540	119,353	155,575
	=====	=====	=====	=====
Interest at 8% on average accrued benefit obligation (d)	8,040	8,763	9,548	12,446

(a) In the period of an actuarial valuation, the opening balance of the accrued benefit obligation is the actuarially determined amounts (opening balances 20X3 and 20X6). In the periods between valuations (20X4 and 20X5), the opening balance is equal to the expected closing balance for the previous year.

(b) Accrued, or assumed to take place, evenly throughout the year, therefore interest is accrued on one-half of the total.

(c) Since the plan amendment was effective mid-year, interest is earned for one-half of the year on the increase in accrued benefit obligation due to past service = $\frac{1}{2}$ (10,000). Similarly, interest is earned on the increase in the current period benefit cost following the plan amendment. The average current period benefit cost in 20X6 is, therefore, = $\frac{1}{2}$ (4,000) + $\frac{1}{4}$ (500).

(d) Interest during the year on average liability outstanding during the year = 8% of average accrued benefit obligation.

Exhibit II — Expected closing balance of accrued benefit obligation

(\$ thousands)	<u>20X3</u>	<u>20X4</u>	<u>20X5</u>	<u>20X6</u>
Accrued benefit obligation — opening balance	100,000	109,040	118,803	150,000
Add: Current period benefit cost	3,500	3,800	4,000	4,500
Increase due to plan amendment	—	—	—	10,000
Interest accrued (Exhibit I)	8,040	8,763	9,548	12,446
Deduct: Benefit payments	<u>(2,500)</u>	<u>(2,800)</u>	<u>(2,900)</u>	<u>(3,100)</u>
Expected closing balance	109,040	118,803	129,451	173,846
	=====	=====	=====	=====

Exhibit III — Amortization of actuarial gains / losses on accrued benefit obligation (a)

(\$ thousands)	<u>20X3</u>	<u>20X4</u>	<u>20X5</u>	<u>20X6</u>
Expected closing balance of accrued benefit obligation at March 31 (Exhibit II)	N/A	N/A	129,451	N/A
Actual accrued benefit obligation (per the March 31, 20X5 actuarial valuation)			<u>150,000</u>	
Actuarial gain (loss)			(20,549)	

EARSL

12 years

Annual amortization over EARSL

(1,712)

(a) A straight-line method is used to amortize actuarial gains and losses over the expected average remaining service life of the related employee groups. Amortization commences in the year following the effective date of the related actuarial valuation.

Exhibit IV — Unamortized actuarial gains and losses

(\$ thousands)	<u>20X3</u>	<u>20X4</u>	<u>20X5</u>	<u>20X6</u>
Unamortized actuarial gains and losses — opening balance	N/A	N/A	—	(20,549)
Actuarial gains (losses) due to:				
— accrued benefit obligation (Exhibit III)			(20,549)	—
Amortization recorded during the year:				
— accrued benefit obligation (Exhibit III)			—	1,712
— recognition of net unamortized actuarial gains as an offset to prior period service cost			—	—
			(20,549)	(18,837)

Exhibit V — Liability for retirement benefits recorded in the statement of financial position

(\$ thousands)	<u>20X3</u>	<u>20X4</u>	<u>20X5</u>	<u>20X6</u>
Accrued benefit obligation — closing balance (a) (Exhibit II)	109,040	118,803	150,000	173,846
Unamortized actuarial gains / losses (Exhibit IV)	—	—	(20,549)	(18,837)
Liability for retirement benefits	109,040	118,803	129,451	155,009

(a) In the period of an actuarial valuation, this is the actuarially determined amount (closing balance 20X5). In the periods between valuations, this is an expected closing balance.

Exhibit VI — Expenses recorded in the statement of operations

(\$ thousands)	<u>20X3</u>	<u>20X4</u>	<u>20X5</u>	<u>20X6</u>
Retirement benefit expense:				
Current period benefit cost	3,500	3,800	4,000	4,500
Prior period cost of plan amendment incurred during the year	—	—	—	10,000
Recognition of unamortized net actuarial gains	—	—	—	—
Amortization of actuarial gains / losses (Exhibit III)	x	x	x	1,712
Retirement benefit expense	3,500	3,800	4,000	16,212
Retirement benefit interest expense (Exhibit I)	<u>8,040</u>	<u>8,763</u>	<u>9,548</u>	<u>12,446</u>
Total expenses related to retirement benefits	11,540	12,563	13,548	28,658

Financial statement disclosure

Illustrative Note to the Financial Statements

The government sponsors a defined benefit plan for retirement benefits other than pensions for substantially all of its employees. The plan provides extended health and dental as well as life insurance to employees.

Total benefit payments to retirees during the year were \$3.1 million (20X5 — \$2.9 million). The plan is unfunded and requires no contribution from employees. The retirement benefit liability at March 31 includes the following components:

(\$ thousands)	<u>20X6</u>	<u>20X5</u>
Accrued benefit obligation	173,846	150,000
Unamortized actuarial gains / losses	<u>(18,837)</u>	<u>(20,459)</u>
Retirement benefit liability	155,009	129,451
	=====	=====

Actuarial valuations for accounting purposes are performed triennially using the projected benefit method prorated on services. The most recent actuarial report was prepared at March 31, 20X5. The accrued benefit obligation shown for 20X6 is based on an extrapolation of that 20X5 valuation. There is a net unamortized actuarial loss to be amortized on a straight-line basis over the expected average remaining service life of the related employee groups (12 years).

The actuarial valuation was based on a number of assumptions about future events, such as inflation rates, interest rates, medical inflation rates, wage and salary increases, and employee turnover and mortality. The assumptions used reflect the government's best estimates. The expected inflation rate is 5.5 percent. The discount rate used to determine the accrued benefit obligation is eight percent.

The total expenses related to retirement benefits other than pensions include the following components:

(\$ thousands)	<u>20X6</u>	<u>20X5</u>
Current period benefit cost	4,500	4,000
Prior period cost of plan amendment	10,000	—
Amortization of actuarial gains / losses	<u>1,712</u>	<u>—</u>
Retirement benefit expense	16,212	4,000
Retirement benefit interest expense	<u>12,446</u>	<u>9,548</u>
Total expenses related to retirement benefits	28,658	13,548
	=====	=====

The retirement benefit expense is included in the statement of operations as a component of program expenses. The retirement benefit interest expense is included in the public debt interest expense.

On September 30, 20X5, a plan amendment was made to the plan increasing the rate at which retirement benefits accrue. The amendment relates to both future and past service. The benefit accrual of \$10 million is based on an actuarial valuation of the increase in the accrued benefit obligation due to past service.

Statement of Financial Position (excerpts)

As at March 31 (\$ thousands)	<u>20X6</u>	<u>20X5</u>
Liabilities		
Accounts payable	x	x
Accrued liabilities	x	x
Borrowings		
Treasury bills	x	x
From other governments	x	x
Other	x	x
Retirement benefit liability (note)	<u>155,009</u>	<u>129,451</u>
Total liabilities	<u>x</u>	<u>x</u>
Excess of liabilities over financial assets (a)	x	x

(a) The opening balance of the excess of liabilities over financial assets in 20X3 has been restated to reflect a change in accounting policy for employee retirement benefit obligations applied retroactively. The effect of this restatement is as follows:

(\$ thousands)

Excess of liabilities over financial assets — beginning of year:

As previously reported	x
Adjustments due to change in accounting policy applied retroactively	<u>100,000</u>
As restated	x

Excess of expenses over revenues during the year	<u>x</u>
--	----------

Excess of liabilities over financial assets — end of year	x
---	---

Statement of Operations (excerpts)

For the year ended March 31 (\$ thousands)	<u>20X6</u>	<u>20X5</u>
--	-------------	-------------

Expenses

Health	(includes retirement benefit expense)	x	x
Education ...etc.		x	x
Public debt interest (includes retirement benefit interest expense)		<u>x</u>	<u>x</u>
		x	x
		<u>=====</u>	<u>=====</u>

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SECTION PS 3320

contingent assets



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PURPOSE AND SCOPE

.01 This Section:

- (a) defines and establishes disclosure standards on contingent assets; but
- (b) does not include disclosure standards for specific types of contingent assets.

.02 It may be useful to read this Section in conjunction with ASSETS, Section PS 3210, and CONTRACTUAL RIGHTS, Section PS 3380.

DEFINITION

.03 **Contingent assets** are possible assets arising from existing conditions or situations involving uncertainty. That uncertainty will ultimately be resolved when one or more future events not wholly within the public sector entity's control occurs or fails to occur. Resolution of the uncertainty will confirm the existence or non-existence of an asset.

CHARACTERISTICS OF CONTINGENT ASSETS

.04 Contingent assets are distinct from assets because they are characterized by the uncertainty related to the existence of an asset at the financial statement date.

.05 Contingent assets usually arise from unplanned or unexpected events that lead to an existing condition or situation the outcome of which is uncertain. The outcome or resolution of the condition or situation after the financial statement date will confirm whether an asset exists.

.06 Contingent assets have two basic characteristics:

- (a) An existing condition or situation that is unresolved at the financial statement date.
- (b) An expected future event that will resolve the uncertainty as to whether an asset exists.

.07 The mere fact that an estimate of an amount is involved (measurement uncertainty) does not, in and of itself, constitute the type of uncertainty that characterizes a contingent asset. For example, even though there may be measurement uncertainty related to income tax receivable, there is nothing uncertain about the fact that this asset exists. Any uncertainty is related solely to the amount thereof.

Existing condition or situation

.08 For a contingent asset to be present, there usually is an unplanned or unexpected event leading to an existing condition or situation where the evidence indicates that a public sector entity may have an asset. For example, a public sector entity may have incurred an unexpected loss and there is sufficient evidence for potential recovery. The potential for recovery constitutes the existing condition or situation giving rise to a possible asset. It is a possible asset because of the uncertainty around recovery and it is only a future event that will confirm whether an asset exists.

.09 Passing legislation that has retroactive application after the financial statement date cannot create an existing condition or situation at the financial statement date. Further, elected or public sector entity officials may announce public sector entity intentions in a period following the financial statement date but before the completion of the

financial statements. If a condition or situation did not exist at the date of the financial statements, there is no contingent asset. However, there may be a subsequent event.

Confirming future event

.10 For a contingent asset to exist, there must also be an expected confirming future event that will resolve the uncertainty. The expected confirming future event provides additional information as to whether a public sector entity had an asset at the financial statement date. The confirming future event does not create an asset – it only proves or disproves its existence at the financial statement date.

.11 The future confirming event cannot be wholly within the control of the public sector entity. For example, when a public sector entity is involved in a lawsuit, the future confirming event (the resolution of the lawsuit) is not within the control of that public sector entity.

EXISTENCE OF UNCERTAINTY

.12 The determination of whether an asset exists at the financial statement date depends on an assessment of the probability of a future event occurring, or not occurring, confirming that an asset existed at the financial statement date. This probability can be expressed by the following:

- (a) likely — the probability of the occurrence (or non-occurrence) of the future event(s) is high;
- (b) unlikely — the probability of the occurrence (or non-occurrence) of the future event(s) is slight; and
- (c) not determinable — the probability of the occurrence (or non-occurrence) of the future event(s) cannot be determined.

.13 Assessing the likelihood of the future confirming event occurring and estimating its financial effects are matters for judgment by those responsible for preparing the financial statements. In identifying contingent assets and determining their amount, consideration would be given to all information available prior to completion of the financial statements, supplemented by experience in similar transactions and, in some cases, reports from independent experts.

DISCLOSURE

.14 In assessing the public sector entity's financial position and results, it is important to understand its contingent assets. As a minimum, knowledge of the existence, nature and extent of contingent assets is warranted because they indicate the economic resources that may be available to the public sector entity. The relevance of such information to the decision-making process arguably outweighs the inherent uncertainty.

.15 Disclosure of the nature of contingent assets includes a description of the circumstances giving rise to the uncertainty and information about the anticipated resolution of the uncertainty.

.16 When a reasonable estimate can be made, disclosure of the extent of a contingent asset includes the public sector entity's best estimate and a range of possible amounts, unless it would have an adverse effect on the outcome. A financial statement user may not find disclosure of a broad range of amounts, which may extend from the minimum possible amount to the maximum possible amount, as useful as a narrower range that comprises what is reasonable.

.17 When an estimate of the amount has been made, the basis for that estimate would be disclosed. It may also be useful to disclose the significant assumptions underlying the contingent asset that are subject to change and the impact that a change would have on the estimate. Disclosure of the extent could also be accomplished by disclosing the minimum likely amount of the contingent asset, accompanied by an explanation of the significant factors that could affect the resolution of the contingent asset and the prospects that any contingent asset will be more than the minimum likely amount.

.18 The level of disclosure also considers the sensitivity of the information.

.19 *The existence of a contingent asset at the date of the financial statements should be disclosed in notes to the financial statements when the occurrence of the confirming future event is likely. [APRIL 2017]*

.20 *The following information should be disclosed in notes or schedules relative to a contingent asset:*

- (a) *the nature;*
- (b) *the extent, except in those cases where the extent cannot be measured or disclosure of the extent would have an adverse effect on the outcome;*
- (c) *the reason(s) for any non-disclosure of the extent; and*
- (d) *when an estimate of the amount has been made, the basis for that estimate. [APRIL 2017]*

TRANSITIONAL PROVISIONS

.21 This Section applies to fiscal years beginning on or after April 1, 2017. Earlier adoption is permitted.

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