

**Transition to the
Accrual Basis of Accounting:
Guidance for Governments
and Government Entities**

**International Federation of Accountants
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United States of America**

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The approved text of this Study is that published in the English language.

This Study includes discussion of International Public Sector Accounting Standards and Exposure Drafts issued as of January 2002.

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Acknowledgment

The Public Sector Committee is developing a set of International Public Sector Accounting Standards (IPSASs). The IPSASs in the initial core set are based on International Accounting Standards (IASs) published by the International Accounting Standards Committee (IASC). The International Accounting Standards Board (IASB) and the International Accounting Standards Committee Foundation (IASCF) were established in 2001 to replace the IASC. The IASs issued by the IASC remain in force until they are amended or withdrawn by the IASB.

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IFAC
PUBLIC
SECTOR
COMMITTEE

Transition to the
Accrual Basis of Accounting:
Guidance for Governments
and Government Entities

ISSUED BY THE
INTERNATIONAL
FEDERATION OF
ACCOUNTANTS



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FOREWORD

Many of the International Federation of Accountants Public Sector Committee's (PSC's) constituents, including some currently reporting on a cash basis, have expressed support for the application of the accrual basis of accounting to governmental financial reporting. This support is based on the view that accrual information includes, supplements and enhances the cash information currently provided and benefits both internal and external users. Many of these constituents also sought guidance from the PSC on the process of transition from the cash to the accrual basis. This Study has been prepared in response to that request. It identifies key issues to be addressed in the migration from the cash to the accrual basis of accounting. It also identifies alternate approaches that can be adopted in implementing the accrual basis of accounting in an efficient and effective manner in the public sector.

The PSC has made significant progress in developing a core set of International Public Sector Accounting Standards (IPSASs) to be applied when either the accrual or the cash basis of accounting is adopted. By the end of 2002, I anticipate that the PSC will have issued twenty IPSASs on the accrual basis of Accounting, and a comprehensive IPSAS on the cash basis of accounting. These IPSASs establish an authoritative set of independent international financial reporting standards for governments and others in the public sector organizations. Application of the IPSASs will support developments in public sector financial reporting directed at improving decision-making, financial management, and accountability. The PSC considers the IPSASs to be an integral element of reforms directed at promoting social and economic development.

The PSC believes governments and government entities will find the Study useful as they deal with the many and complex technical, systems and cultural issues necessary to implement an accrual system. The Study identifies key requirements of IPSASs. It also identifies other sources of useful guidance on issues not dealt with by IPSASs. However, readers should note this Study does not establish new or additional authoritative requirements and should not be considered a substitute for the IPSASs themselves. It is intended that this be a "living document" and be updated periodically as further IPSASs are issued, and additional implementation issues and experiences are identified.

Ian Mackintosh
Chairman
Public Sector Committee
International Federations of Accountants

April 2002

TRANSITION TO THE ACCRUAL BASIS OF ACCOUNTING: GUIDANCE FOR GOVERNMENTS AND GOVERNMENT ENTITIES

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PART I – INTRODUCTION

This Study is intended to assist governments and government entities wishing to migrate to the accrual basis of accounting in accordance with International Public Sector Accounting Standards (IPSASs). It may also assist governments and government entities wishing to report on a comprehensive cash basis of accounting, including the adoption of the major principles in any future IPSAS which is developed from Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*.

Part I of this Study addresses general issues associated with the transition to accrual accounting, including factors influencing the nature and speed of the transition, options in respect of the transition paths, and the management of the transition process. It also considers issues associated with the identification, design and delivery of training.

The main purpose of this Study is to help entities intending to move to the accrual basis of accounting and comply with the accrual-based IPSASs. The Study also includes discussion of certain topics not addressed by current IPSASs or Exposure Drafts. Where the Study discusses topics not addressed by current IPSASs or Exposure Drafts, the requirements of other authoritative accounting pronouncements such as International Accounting Standards (IASs) are used to illustrate the practical implementation issues associated with that topic. The IASs were prepared and published by the International Accounting Standards Committee (IASC). In 2001 the International Accounting Standards Board (IASB) was established to replace the IASC. The IASB has stated that the standards it will issue will be referred to as International Financial Reporting Standards (IFRSs). The first seventeen IPSASs are based on IASs to the extent appropriate for the public sector. The use of IFRSs, IASs or other standards to illustrate such topics does not necessarily reflect the views of the PSC on any issue. The Study is not an accounting manual, nor does it attempt to establish authoritative accounting practices or standards.

This Study should be considered a work in progress. It will be revised periodically to reflect developments in IPSASs and input received by the PSC on the experiences of readers in migrating to reporting on an accrual basis.

Transition to the Accrual Basis of Accounting

CHAPTER 1: INTRODUCTION

Key Points

- This Study will assist governments and government entities wishing to report on the accrual basis of accounting in accordance with the accrual-based International Public Sector Accounting Standards (IPSASs). It will also assist governments and government entities wishing to report on a comprehensive cash basis of accounting, including the adoption of the major principles in any future IPSAS which is developed from Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*.
- The Study includes discussion of topics covered by current accrual IPSASs, as well as certain topics not yet addressed by the Public Sector Committee (PSC).
- This Chapter summarizes some of the benefits associated with the adoption of accrual accounting by governments.
- The PSC is seeking input from readers regarding their experiences in moving to accrual-based accounting. Such input will influence subsequent editions of this Study.

Introduction

- 1.1 This Study was issued by the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC). IFAC is an organization of national professional accountancy organizations that represent accountants employed in public practice, business and industry, the public sector and education. The PSC focuses on the accounting, auditing and financial reporting needs of national, regional and local governments, related governmental entities, and the constituencies they serve. It addresses these needs by issuing and promoting benchmark guidance, conducting educational and research programs, and facilitating the exchange of information among accountants and those who work in the public sector.
- 1.2 The PSC has prepared this Study in order to assist governments and government entities wishing to report on the accrual basis of accounting in accordance with IPSASs. The PSC has identified a need for practical guidance and supporting information for governments and government entities making the transition to the accrual basis of accounting. This Study identifies the nature and scope of many of the tasks required during this process.
- 1.3 The guidance in this Study includes:
 - an overview of the wider context in which the transition to accrual accounting may occur;
 - a discussion of various transition paths that entities choosing an incremental implementation process may adopt;
 - identification of the main tasks associated with recognition of assets, liabilities, revenues and expenses, including issues associated with identification and measurement of those elements;

- some implications of adopting accrual-based IPSASs; and
- practical suggestions based on the experience of other entities and jurisdictions.

International Public Sector Accounting Standards

Accrual-Based Standards

- 1.4 The PSC is developing a set of IPSASs on financial reporting under the accrual basis of accounting for the public sector. The full text of Standards and Exposure Drafts currently on issue is available at <http://www.ifac.org>.
- 1.5 The main purpose of this Study is to help entities intending to move to the accrual basis of accounting and comply with the accrual-based IPSASs. The Study also includes discussion of certain topics not addressed by current IPSASs or Exposure Drafts. Where the Study discusses topics not addressed by current IPSASs or Exposure Drafts, the requirements of other authoritative accounting pronouncements such as International Accounting Standards (IASs) are used to illustrate the practical implementation issues associated with that topic. The IASs were prepared and published by the International Accounting Standards Committee (IASC). In 2001 the International Accounting Standards Board (IASB) was established to replace the IASC. The IASB has stated that the standards it will issue will be referred to as International Financial Reporting Standards (IFRSs). The first seventeen IPSASs are based on IASs to the extent appropriate for the public sector. The use of IFRSs, IASs or other standards to illustrate such topics does not necessarily reflect the views of the PSC on any issue. The Study is not an accounting manual, nor does it attempt to establish authoritative accounting practices or standards.
- 1.6 In the absence of an IPSAS, each entity is required to apply other appropriate authoritative pronouncements to guide the development of its accounting policies. The PSC acknowledges that generally accepted accounting practice in relation to certain topics varies between jurisdictions. International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements* explains that management will need to use its judgment in developing an accounting policy that provides the most useful information to users of the entity's financial statements. IPSAS 1 provides guidance for management in making this judgment.

Cash-Based Standard

- 1.7 The PSC has also issued Exposure Draft IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*. Although the focus of this Study is on the transition to the accrual basis, some parts of the Study may also assist readers who are seeking information which may be useful for complying with any IPSAS on the cash basis that is developed based on Exposure Draft IPSAS ED 9. Appendix 2 of this Chapter explains the relevance of specific Chapters of this Study for entities intending to comply with Exposure Draft IPSAS ED 9. In addition,

Appendix 2 of Chapter 4 illustrates the accounting policies that may be required in order for an entity to comply with Exposure Draft IPSAS ED 9¹.

Other Sources of Guidance

- 1.8 A complete list of the PSC's publications on accrual accounting in the public sector (IPSASs, Studies and Occasional Papers) is available on the IFAC web site (<http://www.ifac.org>). Many of these publications, including Study 11, Governmental Financial Reporting, are available electronically at no charge.
- 1.9 In relation to topics where no IPSAS has yet been developed, this Study uses IASs or other national accounting standards to illustrate the types of reporting requirements an entity may face. This does not imply a considered position of the PSC on those topics. It should be noted in relation to this that commentary in IPSAS 1 establishes a hierarchy of guidance. In the absence of an IPSAS on a particular issue, entities should initially refer to other IPSASs dealing with similar and related issues, other publications of IFAC, and pronouncements of other standard setting bodies (for example IASs) and accepted public or private sector practice, but only to the extent that they are consistent with the IPSASs.
- 1.10 Where possible, web site references to sources of information have been provided. A list of web sites containing information on aspects of financial reporting in various jurisdictions and entities is attached as Appendix 1 to this Chapter.

Structure of the Study

- 1.11 A wide range of transitional paths between the cash and accrual bases is possible. This Study is structured in a way that is intended to be useful to readers, whatever the transition path they are contemplating. The Study also acknowledges that the extent of information currently available on assets and liabilities and the reliability of that information will vary greatly between jurisdictions and individual entities. Readers are encouraged to use the Study as a tool to help them identify which steps in the transition their government or agency has already addressed/completed and the areas in which further work is required.
- 1.12 The Study has four main parts as follows:
 - Introduction: (Chapters 1 to 3) this part addresses general planning and project management issues;
 - General Financial Reporting Issues: (Chapters 4 and 5) this part deals with the selection, development and approval of accounting policies, and issues associated with the definition and identification of reporting entities;
 - Financial Elements: (Chapters 6 to 8) this part outlines the broad steps required for the identification, recognition, measurement and disclosure of assets, liabilities, revenues

¹ As more IPSASs are released, the implications of certain accounting issues for the cash basis of accounting will be considered and this may eventually lead to a revision of the IPSAS based on Exposure Draft IPSAS ED 9 (or the subsequent IPSAS) and the disclosures required under the cash basis of accounting.

and expenses. The broad approaches outlined in these Chapters could be adapted and applied to particular items; and

- Specific Topics: (Chapters 9 to 15) this part highlights implementation issues associated with two specific IPSASs, and provides guidance in relation to a selection of topics not addressed, or only partially addressed, by existing IPSASs.

1.13 This Study does not provide comprehensive coverage of all the issues on which readers may be seeking advice. This Study has been published in the interest of providing timely assistance to support the adoption of accrual accounting. Readers are invited to propose suggestions or provide material for inclusion in future editions of this Study. As noted below, future Occasional Papers outlining the experience of various jurisdictions may also be a useful resource.

Occasional Papers

1.14 The PSC is considering supporting this Study with a series of Occasional Papers documenting case studies from specific jurisdictions on their transition to the accrual basis of accounting. Occasional Papers published to date are:

- Occasional Paper 1 *Implementing Accrual Accounting in Government: The New Zealand Experience*;
- Occasional Paper 2 *Auditing Whole of Government Financial Statements: The New Zealand Experience*;
- Occasional Paper 3 *Perspectives on Accrual Accounting*; and
- Occasional Paper 4 *The Delegation of Public Services in France, An Original Method of Public Administration: Delegated Public Service*.
- Occasional papers on the Modernization of Government Accounting in France and Resource Accounting and Budgeting in the United Kingdom are currently being finalized for publication.

1.15 The PSC invites individual public sector entities or jurisdictions to use the Occasional Papers series to share their experiences in adopting accrual accounting. The PSC has developed an outline illustrating the possible structure and contents of future Occasional Papers (copies available from the PSC Secretariat).

1.16 It is envisaged that future Occasional Papers could explain the nature of a particular jurisdiction's transition to accrual accounting in the context of that jurisdiction's environment and any reforms relevant to financial management. A change to accrual accounting rarely occurs in isolation – often the introduction of accrual accounting will be merely a subset of a much larger reform project, and the nature of these wider reforms can often have an impact on the speed and style of transition to accrual accounting. Changes may occur within the context of a widespread decentralization of government functions and/or the development of an integrated financial management system (the integration of the basic financial functions and responsibilities within a single and coordinated system). The Occasional Papers may

include explanation of the background to the introduction of accrual accounting, the nature of accounting/management arrangements prior to the reforms, and changes to the legislative framework, accounting system and budgeting system within a jurisdiction. An explanation of the planned implementation strategy and reasons for selecting that strategy would be helpful to jurisdictions trying to determine their own implementation strategy. At a more detailed level, accounting policy issues and issues associated with the identification, recognition and measurement of particular assets, liabilities, revenues and expenses would be of interest. In addition, the Occasional Papers could include a description of whole-of-government reporting issues and an explanation of the role of internal and external auditors during the transition.

Benefits of Accrual Accounting

- 1.17 The PSC has commented extensively on the benefits of accrual accounting for governments and individual public sector entities in previous Studies (Studies 5, 6, 8, 9 10 and 11) and Occasional Papers (Papers 1 and 3). In order to provide some context for readers who are not familiar with the PSC's other publications, this section contains a summary of the benefits of reporting on the accrual basis.
- 1.18 The information contained in reports prepared on an accrual basis is useful both for accountability and decision-making. Financial reports prepared on an accrual basis allow users to:
- assess the accountability for all resources the entity controls and the deployment of those resources;
 - assess the performance, financial position and cash flows of the entity; and
 - make decisions about providing resources to, or doing business with, the entity.
- 1.19 At a more detailed level, reporting on an accrual basis:
- shows how a government financed its activities and met its cash requirements;
 - allows users to evaluate a government's ongoing ability to finance its activities and to meet its liabilities and commitments;
 - shows the financial position of a government and changes in financial position;
 - provides a government with the opportunity to demonstrate successful management of its resources; and
 - is useful in evaluating a government's performance in terms of its service costs, efficiency and accomplishments.

Financial Position

- 1.20 Accrual accounting provides information on an entity's overall financial position and current stock of assets and liabilities. Governments need this information to:
- make decisions about the feasibility of financing the services they wish to provide;

Transition to the Accrual Basis of Accounting

- demonstrate accountability to the public for their management of assets and liabilities recognized in the financial statements;
- plan for future funding requirements of asset maintenance and replacement;
- plan for the repayment of, or satisfaction of, existing liabilities; and
- manage their cash position and financing requirements.

1.21 Accrual accounting requires organizations to maintain complete records of assets and liabilities. It facilitates better management of assets, including better maintenance, more appropriate replacement policies, identification and disposal of surplus assets, and better management of risks such as loss due to theft or damage. The identification of assets and the recognition of depreciation helps managers to understand the impact of using fixed assets in the delivery of services, and encourages managers to consider alternative ways of managing costs and delivering services.

1.22 Accrual accounting provides a consistent framework for the identification of existing liabilities, and potential or contingent liabilities. The recognition of obligations meeting the definition of a liability and the criteria for recognition:

- compels governments to acknowledge and plan for the payment of all recognized liabilities, not just borrowings;
- provides information on the impact of existing liabilities on future resources;
- means that it is possible to allocate responsibility for the management of all liabilities; and
- provides necessary input for governments to assess whether they can continue to provide current services and the extent to which they can afford new programs and services.

1.23 Accrual accounting highlights the impact of financing decisions on net assets/equity and may lead governments to take a longer term view when making financing decisions than is generally possible when relying on cash or modified cash reports. Information on net assets/equity also means that governments may be held accountable for the financial impact of their decisions on both current and future net assets/equity. Changes in an entity's net assets/equity between two reporting dates reflect the increase or decrease in its wealth during the period, under the particular measurement principles adopted and disclosed in the financial statements. Under the accrual basis of accounting, the financial statements will include a Statement of Financial position which discloses information about assets and liabilities. Where assets and liabilities are not equal, a residual figure for net assets/equity will be reported. Where this figure is positive it can be interpreted as the net resources that may be applied for the provision of goods or services in the future, and therefore the community's investment in the reporting entity. Where the figure is negative it may be viewed as the amount of future taxation or other revenues which are already committed to paying off debt and other liabilities. Net assets/equity can comprise some or all of the following components:

- contributed capital;

- accumulated surpluses and deficits; and
- reserves (for example revaluation reserve; foreign currency translation reserve).

Financial Performance

- 1.24 Accrual accounting provides information on revenues and expenses, including the impact of transactions where cash has not yet been received or paid. Accurate information on revenues is essential for assessing the impact of taxation and other revenues on the government's fiscal position, and in assessing the need for borrowing in the long term. Information on revenues helps both users and governments themselves to assess whether current revenues are sufficient to cover the costs of current programs and services.
- 1.25 Governments need information about expenses in order to assess their revenue requirements, the sustainability of existing programs, and the likely cost of proposed activities and services. Accrual accounting provides governments with information on the full costs of their activities so that they can:
- consider the cost consequences of particular policy objectives and the cost of alternative mechanisms for meeting these objectives;
 - decide whether to fund the production of services within government sub-entities, or whether to purchase goods and services directly from non-government organizations;
 - decide whether user fees should cover the costs associated with a service; and
 - allocate responsibility for managing particular costs.
- 1.26 Accrual accounting can provide financial information on whether sub-entities are delivering specified services, and delivering them within agreed budgets. The same information, at a more detailed level, can also be used within sub-entities for the management of activity and program costs.
- 1.27 Accrual accounting allows an individual entity to:
- record the total costs, including depreciation of physical assets and amortization of intangible assets, of carrying out specific activities;
 - recognize all employee-related costs and to compare the cost of various types of employment or remuneration options;
 - assess the most efficient way of producing their goods and services and of managing the resources over which they have been delegated authority;
 - determine the appropriateness of cost-recovery policies; and
 - monitor actual costs against budgeted costs.

Cash Flows

- 1.28 Accrual accounting provides comprehensive information on current cash flows and certain projected cash flows, including the cash flows associated with debtors and creditors. It can therefore lead to better cash management and may assist in the preparation of more accurate cash budgets.

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Micallef, F., Sutcliffe, P., and Doughty, P., *Financial Reporting by Governments*, AARF Discussion Paper 12, 1994.

Sutcliffe, P., Micallef, F., and Parker, L.D., *Financial Reporting by Government Departments*, AARF Discussion Paper 16, 1991.

Appendix 1: Web Site References

Australia

Australian Accounting Standards Board

<http://www.aasb.com.au>

Australian National Audit Office

<http://www.anao.gov.au>

Australian State and Territory Governments (general entry point)

<http://www.gov.au>

Department of Finance and Administration: Accounting Centre for Excellence

<http://www.finance.gov.au/ace>

Department of Finance and Administration (Commonwealth Government of Australia)

<http://www.finance.gov.au>

Department of Treasury and Finance (Tasmania)

<http://www.tres.tas.gov.au/domino/dtf/dtf.nsf>

New South Wales Treasury: Office of Financial Management

<http://www.treasury.nsw.gov.au>

Canada

Government of Ontario

<http://www.gov.on.ca/MBS/english/index.html>

Auditor General of Canada and the Commissioner of the Environment and Sustainable Development

<http://www.oag-bvg.gc.ca>

Public Works and Government Services Canada

<http://www.pwgsc.gc.ca>

Treasury Board of Canada Secretariat

<http://www.tbs-sct.gc.ca>

Treasury Board of Canada Secretariat: Financial Information Strategy

<http://www.tbs-sct.gc.ca/fin/fis-sif>

Hong Kong

Government of the Hong Kong Special Administrative Region: Treasury

<http://www.info.gov.hk/tsy>

International

Asian Development Bank

<http://www.adb.org>

International Accounting Standards Board

<http://www.iasb.org.uk>

International Federation of Accountants

<http://www.ifac.org>

International Fund for Agricultural Development

<http://www.ifad.org>

International Monetary Fund

<http://www.imf.org>

International Organization of Supreme Audit Institutions

<http://www.intosai.org>

Organisation for Economic Co-operation and Development: Public Management and Governance

<http://www.oecd.org/puma>

The World Bank Group

<http://www.worldbank.org>

Mexico

Instituto Mexicano de Contadores Públicos, A.C.

<http://www.imcp.org.mx>

New Zealand

New Zealand Government Online

<http://www.govt.nz>

New Zealand Society of Local Government Managers

<http://www.solgm.org.nz>

Office of the Controller and Auditor-General of New Zealand

<http://www.oag.govt.nz>

The Treasury

<http://www.treasury.govt.nz>

South Africa

National Treasury

<http://www.finance.gov.za>

Office of the Auditor General

<http://www.agsa.co.za>

South African Reserve Bank

<http://www.resbank.co.za>

The South African Institute of Chartered Accountants

<http://www.saica.co.za>

The Institute for Public Finance and Auditing

<http://ipfa.pwv.gov.za>

Sweden

Ekonomistyrningsverket (Swedish National Financial Management Authority)

<http://www.esv.se>

Riksrevisionsverket (Swedish National Audit Office)

<http://www.rrv.se>

United Kingdom

HM Government: HM Treasury

<http://www.hm-treasury.gov.uk>

National Audit Office

<http://www.nao.gov.uk/>

Resource Accounting Manual: HM Treasury

<http://www.resource-accounting.gov.uk>

The Chartered Institute of Public Finance and Accountancy

<http://www.cipfa.org.uk>

Whole of Government Accounts Programme

<http://www.wga.gov.uk>

United States

Defense Finance and Accounting Service

<http://www.dfas.mil>

Governmental Accounting Standards Board

<http://www.gasb.org>

Financial Accounting Standards Board

<http://www.fasb.org>

Federal Accounting Standards Advisory Board

<http://www.fasab.gov>

The General Accounting Office

<http://www.gao.gov>

Appendix 2: Relevance of this Study for Cash-Based Reporting

This appendix summarizes the relevance of various Chapters of this Study for entities wanting to prepare comprehensive cash basis financial statements, including those intending to comply with any future IPSAS which is developed from the Exposure Draft IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*.

PART I – INTRODUCTION

Chapter 1	Introduction	General relevance.
Chapter 2	Managing the Process	General relevance – to the extent that accounting changes are planned.
Chapter 3	Skills Assessment and Training	The specification of competencies can occur within entities applying the cash basis. However, the guidance in the Chapter is not generally relevant unless significant changes in skills required are envisaged.

PART II – GENERAL FINANCIAL REPORTING ISSUES

Chapter 4	Accounting Policy Issues	The Chapter contains examples of accounting policies that may be required in order for an entity to prepare cash basis reports.
Chapter 5	Reporting Entity Issues	General relevance.

PART III – FINANCIAL ELEMENTS

Chapter 6	Assets	Not required for cash basis reporting. Relevant to the extent that an entity maintains records of certain assets and wishes to begin planning for the introduction of accrual accounting.
Chapter 7	Liabilities	Not required for cash basis reporting. Relevant to the extent that most entities operating under the cash basis of accounting maintain comprehensive records of debt and borrowings.
Chapter 8	Revenues and Expenses	Not required for cash basis reporting. Relevant to the extent that some entities recognize certain receivables and payables. The discussion on classification and disclosure of components of revenue is relevant.

PART IV – SPECIFIC TOPICS

Chapter 9	Cash	General relevance.
Chapter 10	Intangible Assets	Not required for cash basis reporting.
Chapter 11	Financial Instruments	Not required for cash basis reporting.
Chapter 12	Employee-Related Liabilities	Not required for cash basis reporting.
Chapter 13	Liabilities Arising from Social Policy Obligations	Not required for cash basis reporting.
Chapter 14	Non-Exchange Revenue	Not required for cash basis reporting.
Chapter 15	Foreign Currency	Not required for cash basis reporting. Exposure Draft IPSAS ED 9 contains proposals for the translation of cash flows and cash balances.

CHAPTER 2: MANAGING THE PROCESS

Key Points

This Chapter contains a discussion of:

- some of the factors that can influence the nature and speed of the transition to accrual accounting. It also outlines some transition options;
- the adoption of accrual accounting for both the individual entities that form the public sector, and the government as a whole;
- the role of the external auditor in any transition path;
- some of the impacts on budgeting, control and audit for countries contemplating membership of the European Union; and
- some of the generalizations that can be made regarding the potential impact of various systems of government and the current political environment on the transition process. The groupings considered for this purpose are developed countries, transitional economies and developing countries.

Introduction

- 2.1 This Chapter outlines some of the broader issues that can affect the speed and style of transition to the accrual basis. Although the focus of this guidance is the management of accounting change, the adoption of accrual accounting does not occur in isolation and the style of transition is affected by the context within which it occurs.
- 2.2 Factors that may influence the nature and speed of the transition to accrual accounting include:
 - the system of government and the political environment;
 - whether the reforms are focused solely on accounting change or whether they encompass other wider scale reforms;
 - whether the changes are being driven from the “top down”, or “bottom up”. For example, changes driven by the top level of government are usually mandatory for all entities within that government and may have fixed time frames. This Chapter discusses the adoption of accrual accounting for both the individual entities that form the public sector and the government as a whole (regardless of whether whole-of-government financial statements are prepared). However, many of the comments in this Chapter are equally relevant for individual entities planning for the transition to accrual accounting;
 - the current basis of accounting used by the entity, the capability of existing information systems, and the completeness and accuracy of existing information, particularly in relation to assets and liabilities;

- the basis of accounting to be used in the preparation of budget documents. Not only does a change in the budgeting and budget authorization process represent another component of the overall transition, but it will also have an impact on the information systems requirements;
- the level of political commitment to the adoption of accrual accounting; and
- the capacity and skills of the people and organizations responsible for implementing the changes.

2.3 This Chapter contains more detailed discussion of certain key factors and how they can influence the style of transition. It also outlines various transition options.

The Economy and the System of Government

2.4 Although each jurisdiction will have a number of distinguishing characteristics that influence the design of its transition path, it is possible to make some generalizations regarding the potential impact of various systems of government and the current political environment on the transition process. The subheadings used for the purpose of discussion within this document are:

- developed countries;
- transitional economies; and
- developing countries.

2.5 These sub-headings are used purely for the purpose of illustrating how certain factors can influence the selection of a transition path. They are not comprehensive and in some cases are not mutually exclusive. The types of transition paths discussed under each sub-heading are merely examples of transition paths that may be more likely to occur within jurisdictions that fit that classification.

Developed Countries

2.6 Restraints on resources and expertise are less problematic in developed economies than in developing or transitional economies. However, the political systems in place in developed economies can present barriers to reform of the financial reporting and management systems in place in those economies. Two common systems of government within developed countries are presidential systems and parliamentary systems.

2.7 In a presidential system, a single person is democratically elected as leader of the executive (the arm of government that performs the day-to-day management role) for a prescribed period of time. That person is not subject to removal by the legislature other than in exceptional circumstances. This separation of powers between the executive and the legislature means that the legislature provides an independent review of the merits of proposed legislation. Such independence is a strength of the presidential system. However, it can also lead to delays or blocks to the passage of legislation. Where proposed financial reforms require changes in legislation, detailed planning, including the development of a

communication strategy for the legislature, may be required to enhance the likelihood of the legislation being passed within a certain time frame. In addition, any proposals to require legislative review of budgets and financial statements under the revised financial system would need to take into account the internal processes of the legislature and the possible time required for such reviews to occur.

- 2.8 In a parliamentary system of government, the government is formed by the political party that is able to gain the most votes from the members of Parliament in a one-chamber parliament, or the governing chamber in a two-chamber parliament. The government does not necessarily control a majority of votes in the Parliament, and therefore cannot always guarantee that its legislation will be passed. There may be significant debate of issues within the Parliament, but a government that wishes to proceed with financial management reforms usually controls the executive and has sufficient numbers within Parliament to secure the passage of legislation. A key aspect of the early stages of transition within a parliamentary system is ensuring that there is sufficient political commitment by the governing party/parties to the reforms. Once this support has been obtained it is also important to focus on providing information to opposition parties to allow for informed debate of proposals and to “buy-in” support from key opposition members. Transition times can be significantly faster under a parliamentary system.
- 2.9 Parliamentary systems of government have also been associated with wide-scale financial management reforms. The potential scope of wide-scale financial management reforms and various approaches to such reforms are discussed in more detail later in this Chapter.
- 2.10 Regardless of whether a parliamentary or presidential system is in effect, some jurisdictions operate under systems where the legislation and regulations underpinning government budgeting and reporting are particularly detailed and are regarded as fundamental aspects of the constitution. This can have an impact on the transition in that it may be very difficult to bring about changes in existing legislation and regulations. In such cases, individual entities may be encouraged to adopt accrual accounting, while maintaining existing budgetary systems. Under this entity-by-entity approach, formal political approval of the changes may not be required, and less centralized management of the reforms occurs. However, each individual entity would still need to develop a set of accounting policies and may need guidance on the source and application of authoritative accounting standards. Where financial information from such entities is likely to be consolidated in the future, early specification of certain accounting policies by central entities may prevent problems at a later date.

Transitional Economies

- 2.11 Transitional economies are often undergoing rapid economic and institutional change and may regard financial management reform as a necessary step in the ongoing redevelopment of the public sector. To this extent, there may be political support for proposed changes. The political acceptance of change means that widespread reform (for example, major changes to the system of financial management, and the adoption of accrual accounting across all types of government entities) is more likely.

- 2.12 Transitional economies often have records of assets purchased. The existence of relatively complete asset records makes the identification and recognition of assets a much easier task. Asset accounting policies still have to be developed and applied (for example recognition thresholds need to be applied to existing asset records) but much less time and resources need to be devoted to asset identification and validation.

Developing Countries

- 2.13 The main constraints facing developing countries, in terms of changes to the basis of accounting used by government entities, are likely to be the existing capability of entities in terms of accounting systems and qualified staff, and the resources available within or outside government to develop that capability. Such resource restrictions mean that developing countries may be more inclined to consider step-by-step implementation paths.
- 2.14 There is some debate over the benefits of devolving management authority as part of financial reforms, particularly in the context of developing countries. This debate is not central to the adoption of accrual accounting and is therefore not addressed in this Study. However, where devolution of management authority occurs in conjunction with the adoption of accrual accounting, the management of the change process will be critical to the success of the reforms.
- 2.15 Developing countries may be reliant upon external assistance to implement reforms. Where a jurisdiction is reliant upon such assistance (for example, loans or donor aid) to help resource the transition to accrual accounting, the amount and types of assistance available may influence the transition path. For example, aid agencies may be willing to fund certain developments within a limited number of pilot entities or may offer assistance in the form of expert personnel. Some websites that include details of financial management assistance projects are listed in the Appendix to this Chapter.
- 2.16 Developing countries may be more inclined to use training strategies that focus on the development of in-house training and the use of entity staff to deliver training (referred to as the “train the trainers” approach). Although the “train the trainers” approach is an option for any jurisdiction, it is particularly useful where resources are limited or where a jurisdiction is bi-lingual or multi-lingual.

Transition Paths

- 2.17 Within jurisdictions, the style and speed of the transition may vary greatly. A wide range of approaches is possible. Possible approaches are discussed below – various combinations of these approaches are also possible.

Application of the Reforms to Types of Entities

- 2.18 The reforms may be applied to all public sector entities within a government, or they may be restricted to certain types of entities. For example, the implementation of accrual accounting may occur on a sector-by-sector basis. It may begin with autonomous and semi-autonomous

government entities which already have some responsibility for managing the resources under their control and which are outside the centralized accounting system. Obtaining political approval for changes in the basis of accounting for autonomous entities and subsequently implementing those changes is often easier because the change is less likely to have implications for the existing system of central budgeting and reporting. Alternatively, the changes may focus first on budget sector entities because such entities make up the core of government activities.

- 2.19 The transition to accrual accounting may be mandatory for certain types of entities, or it may be voluntary for some or all of them. The advantages of allowing entities to choose to adopt accrual accounting are that the individual entities are then motivated and committed to the reform process. However, voluntary transitions can cause difficulties in that the use of different bases of accounting by various entities within a government precludes the preparation of consolidated financial statements for the whole-of-government entity. The use of different bases of accounting by individual entities within a level of government may also involve different budgeting and monitoring regimes. Voluntary choice (also referred to as self-selection) is sometimes used when a small number of pilot entities are sought to trial the reforms. The use of pilot entities allows a government to gain experience in how to deal with the reforms and the problems likely to be encountered, and assists in developing a core of trained personnel.
- 2.20 It is possible to design different transition paths for different types or sizes of entities. For example, large entities may be delegated authority to design and oversee the development of their financial information systems, whereas smaller entities may be required to follow a centrally determined transition path, including the implementation of specific financial information systems. For example, many Government Business Enterprises (GBEs) will already use the accrual basis of accounting. The transition path for such GBEs would therefore focus on ensuring consistency of accounting policies and other consolidation issues.

Whole-of-Government Reporting

- 2.21 Where a government decides to implement whole-of-government reporting, there are a number of paths it can take. The first accrual whole-of-government reports can be required at the same time as the first accrual reports from individual entities. Alternatively, the production of such reports may be delayed for a period to allow more time to focus on the transition by individual entities, the boundaries of the reporting entity and other consolidation issues. Another option is to produce consolidated accrual reports for various sub-sectors of the whole-of-government reporting entity as an interim step, and then complete whole-of-government reports.

Step-by-Step Implementation

- 2.22 Accrual accounting requires the recognition of all assets and liabilities which meet the definition of assets and liabilities and satisfy the criteria for recognition of assets and liabilities. However, this does not preclude an entity from choosing to move to the full

accrual basis by recognizing assets and liabilities in stages. For example, it is possible to focus first on the recognition of short-term assets and liabilities such as debtors and creditors. Recognition of tangible assets would often occur next, although recognition of tangible assets may also occur in stages with those assets that are readily identified and measured being recognized first. The recognition of non-exchange (taxation) receivables and intangible assets may be deferred for a period in order to resolve issues associated with the measurement of these assets.

- 2.23 Similarly, the recognition of liabilities can occur in a step-by-step manner. Public debt is often recognized first because an entity usually has reasonably accurate records of existing borrowings. Pension and other long-term obligations may be recognized in stages.

Accrual Budgeting/Authorization

- 2.24 If accrual budgeting is being introduced as part of the reforms, the change in budgeting and authorization processes may occur at the same time as the initial change to accrual reporting. However, in a number of jurisdictions it has occurred at least one to two periods after the introduction of accrual reports. This delay is sometimes required to provide assurance to those responsible for authorization of budgets that the new financial systems can provide reliable information on which to base budget authorizations.

Reform Period

- 2.25 Usually, the resources available or the extent of political commitment will determine the period over which reforms occur. These periods can differ from jurisdiction to jurisdiction. Reform periods may be short (say, one to three years), medium (say, four to six years) or long (say over six years).
- 2.26 A short reform period may be appropriate where there is strong political support and a limited number of entities. Medium reform periods provide more time for the preparation of detailed implementation plans, the development of accounting policies and implementation and testing of new systems. They also provide a reasonably long time for the education of groups such as government employees and politicians regarding the changes. The benefits of a longer implementation period need to be balanced against the risks of “reform fatigue”. Reform fatigue occurs when those at the forefront of the changes in government entities lose the sense of urgency and enthusiasm needed to implement the reforms, particularly if no benefits emerge early in the process.
- 2.27 In selecting a time frame for the transition, a government may also establish target dates or stages (milestones) for the achievement of various aspects of the reforms. Entities may be required to meet certain criteria by certain dates in order to progress to the next stage of implementation. For example, entities may be required to have recognized major /all assets and liabilities and have operational information systems before they are permitted to implement cash management reforms.

2.28 Governments that have adopted accrual accounting have done so over varying time frames and in some cases, in a number of stages. For example, the United Kingdom produced its first resource (accrual) accounts for individual departments in 1999-00 and the first request for parliamentary approval of spending on a resource-base (accrual-base) for 2001-02. A staged approach for the preparation of consolidated financial statements for the whole of the public sector is planned. This process will include consolidation of unaudited central government accounts using information from the National Accounts for 2001-02, consolidation of central government accounts using generally accepted accounting principles for 2003-04 and whole-of-government accounts for 2005-06.

Transition and External Audit

2.29 Many jurisdictions require the preparation of audited financial statements by the government as a whole and/or by individual controlled entities. Depending upon the type of transition path chosen, a jurisdiction may need to explore some options for meeting audit requirements during the transition period. The acceptability of options will depend upon the legislative requirements in that jurisdiction. Options for dealing with audit requirements during the transition period include:

- continuing to prepare audited financial statements under the existing basis of accounting until the transition is complete. This would involve the preparation of parallel reports for a period of time;
- an audit report which states compliance with the stated basis of accounting. This option allows an entity to phase in the requirements of accounting standards over a period of time;
- preparing an unaudited and unpublished set of financial statements as a trial run (often in parallel with the production of a set of audited financial statements under the existing basis of accounting);
- publishing an unaudited set of financial statements as an interim step and for a limited number of reporting periods; and
- publishing an audited set of financial statements with some audit qualifications. A government may choose to give a public commitment to resolve these issues over a set period of time.

2.30 The nature of the relationship between the executive and the external/independent auditor will vary across jurisdictions. Although it is essential that auditors maintain their independence, there are many benefits to be obtained from establishing a cooperative working relationship with the auditor at the beginning of the transition process. This could include formally consulting the external auditor over proposed transition paths. An auditor would be unlikely to give an absolute assurance that a particular system or process would meet audit requirements. However, the auditor may be able to provide helpful advice regarding the criteria that would be used in assessing the system or process.

Implementation Plans

- 2.31 Having selected a transition path, an entity then needs to develop an implementation plan to enable it to achieve its goals. The Appendix to this Chapter contains the key headings for a generic implementation plan that indicates many of the issues that need to be considered.

Successful Transition

- 2.32 The transition to accrual accounting is a major project for most governments. Like any large-scale project, it requires careful planning and management. Transition is likely to be smoother and faster when the following features are present:
- a clear mandate;
 - political commitment;
 - the commitment of central entities and key officials;
 - adequate resources (human and financial);
 - an effective project management and coordination structure;
 - adequate technological capacity and information systems; and
 - the use of legislation to provide formal authority and signal commitment to the changes.

Mandate

- 2.33 A clear mandate from the appropriate level of the government stating what the reforms will encompass, the expected timing and the authority of various government bodies to initiate the changes required, is important. A clear mandate gives relevant officials and entities the power to initiate change and oversee the reforms.

Political Commitment

- 2.34 Political commitment from both the governing body, or those elected representatives who oversee the governing body, and the opposing party is generally required to secure initial approval for the proposed changes and to provide continuing support for the changes when obstacles or opposition are encountered. Changing the basis of accounting requires considerable resources. If political commitment is not established early in the process, inability to overcome problems later in the process may result in scarce resources being wasted.

Commitment of Central Entities and Key Officials

- 2.35 One reason the active support and leadership of top governmental officials and politicians is required is that changes to the basis of accounting, together with other financial management reforms such as the devolution of authority for resources, involve changes to the power structure. Key people who are prepared to publicly stand by the changes may also fulfill the role of “fixers” when things go wrong. Although such key people are essential, it is

necessary to guard against the risk of the project failing if a key person withdraws support or is no longer available. Financial reforms may also require a change in the culture of the public service. For example, an individual may be given more responsibility for financial management and be expected to understand and use new types of financial information. Such culture changes take time and effort. The “buy-in” of top officials can help this process.

Adequate Resources

- 2.36 A variety of skills are required to manage and maintain a change to the accrual basis of accounting. Identification of the types of skills required, and planning to ensure the availability of those skills is critical to the success of the transition. An entity will generally need:
- individuals with project management and change management skills;
 - individuals with an understanding of and experience in accounting policy issues and systems requirements;
 - key personnel who understand the interrelationships between the different elements of the reform process;
 - individuals with the ability to record data in an accrual accounting system and to extract and explain information from the system. This would normally involve both the recruitment of additional staff and some additional training for existing staff (Chapter 3 *Skills Assessment and Training* discusses these issues in more detail); and
 - adequate funding for additional resources required, including additional staffing, acquisition of specialist skills and the development and installation of financial information systems.

Project Management

- 2.37 Project management generally involves splitting the project into separate components that can then be managed by individuals with the appropriate skills and experience. A reform project should have:
- a documented framework/philosophy. The agreed approach needs to be documented to form a consistent base for the communication of the reforms, to assist staff to understand the reasons for the changes and the approach being taken, and to ensure that actual implementation is in accordance with these decisions;
 - a formal implementation plan. The nature of the implementation plan will vary depending upon the style and scale of the reforms. Examples of implementation plans (key headings only) for the adoption of accrual accounting are included in the Appendix to this Chapter;
 - a clear allocation of responsibility for each task and the respective roles and responsibilities of key entities and officials;

Transition to the Accrual Basis of Accounting

- project milestones together with procedures for monitoring the performance of entities and individuals against those milestones. Some jurisdictions (for example, the Philippines and Thailand) have developed “trigger points”, which are a series of documented criteria that entities must meet at certain stages of the project. These trigger points form the basis for deciding whether devolution of resources will occur, and the audit report on each stage highlights areas where risks exist and where remedial action may be necessary;
- an approval/sign-off process detailing who has authority for particular decisions;
- formal communication and coordination mechanisms to distribute information to and collect information from entities; and
- a budget. Initial costs need to be clearly identified and budgeted for. If individual entities associated with the transition are expected to manage changes within their existing budget or within a nominal additional budget, this needs to be clearly identified at the beginning of the project.

Technological Capacity and Information Systems

2.38 The adoption of accrual financial reporting in conjunction with other public sector reforms often involves changes to a wide range of information systems. Entities contemplating a transition to accrual accounting need to perform an assessment of all existing systems that link to the financial reporting system. For example, changes may be required to the following systems:

- revenue system;
- purchase acquisition system;
- travel system;
- grant and benefit systems;
- human resources and payroll systems;
- fixed assets system;
- property management system;
- inventory system;
- debt system;
- budget system; and
- non-financial systems.

2.39 The assessment of existing systems could include the following issues:

- What information is currently held within the systems?
- What additional information is required (including an assessment of the information required in order to comply with accrual-based IPSASs)?

- To what extent should centralized systems be decentralized (this will be dependent upon the policy framework underlying any wider reforms)?
- What is the current degree of integration of financial and other systems compared to the degree of integration desired?
- Should existing systems be replaced or adapted, and if systems are to be replaced, should the replacement be with an “off the shelf” system or a custom design system?

2.40 Where a government is planning to introduce a new financial management system, it may need to consider redesigning its existing record keeping systems in order to make sure that they support its financial management systems. Tools for assessing existing arrangements and systems are described in Barata, Cain and Routledge (2001). Such tools include the use of assessment worksheets which require the reviewer to assess matters such as whether the record keeping system restricts access to records by unauthorized staff and whether an auditor can easily trace transactions from originating documents, manual transaction registers, journals and ledgers, through to successive summarization.

Use of Legislation

2.41 The process of drafting legislation and consulting key groups on the proposed changes has a number of benefits. The use of legislation demonstrates the strength of the government’s commitment to the changes. The consultation process that usually accompanies legislative changes provides an opportunity to inform and educate other political parties and influential groups within government of the benefits of the changes. The drafting of legislative represents an additional step in the planning and development process. As such, it provides an opportunity to review the proposed changes to ensure they are comprehensive and consistent. As noted in paragraph 2.10, under the entity-by-entity approach, formal political approval of changes to the system of financial reporting and financial management may not be required.

Focusing Effort to Use Resources Wisely

2.42 Most entities planning a transition to accrual accounting have limited resources. It is therefore essential that the entities use those resources as efficiently and effectively as possible. Good project management, including clear identification of goals, responsibilities, timelines and dependencies, is an important aspect of using resources wisely.

2.43 In addition, the application of materiality can have a significant impact on aspects of the transition, particularly the speed of the transition. Information is material if its omission or misstatement could influence the decisions or assessments of users made on the basis of the financial statements. For example, a complete and accurate opening Statement of Financial Position is one of the first steps in implementing the accrual basis. Identifying and valuing all assets and liabilities can take considerable time. However, it is a fundamental step in the process and, if an entity is seeking an unqualified audit report, the opening balances must be supported by reliable records and appropriate valuations. In establishing the opening balances for the Statement of Financial Position, the concept of materiality can assist with

the identification of those assets and liabilities that will be subject to the highest level of external scrutiny. It is therefore appropriate to devote more time and resources in the initial stages to the identification and valuation of these assets and liabilities than others.

- 2.44 Less-material assets and liabilities still need to be identified and valued in a manner that is acceptable to the internal and external auditors. However, it may be possible to produce acceptable short-term information using approaches that require less time and resources than the approaches used for other assets and liabilities. Possible interim solutions which may be acceptable in some situations include:
- using an approximation of the final intended valuation method;
 - using samples to determine the reliability or accuracy of information rather than verifying the information held on each item; and
 - temporarily omitting specific categories of assets or liabilities from the balance sheet.
- 2.45 The concept of materiality can also be used to help structure the consolidation process and the amount of time and effort that goes into calculating the consolidation adjustments. If a particular category of inter-entity transactions is immaterial, the transactions would not need to be eliminated on consolidation. Similarly, if differences between accounting policies do not have a material impact, it will not be necessary to perform adjustments to align the accounting policies of entities within the consolidated financial statements.
- 2.46 Interim approaches such as those outlined above can help an entity make significant and observable progress in short time frames. However, an entity will need to consider whether such approaches will still allow it to meet its objectives, such as an unqualified audit opinion. The stewardship obligations of an entity may also mean that such approaches are inappropriate for some transactions and balances.

Accrual Budgeting

- 2.47 This Study focuses on the adoption of accrual financial reporting. However, a brief discussion of accrual budgeting is included in this Chapter because a growing number of jurisdictions are adopting accrual budgeting and authorization systems (OECD, 2000). An accrual budget would be supported by a full set of forecast financial statements including a projected Statement of Financial Position, Statement of Financial Performance and Cash Flow Statement. The full set of forecast financial statements, including the assumptions used in preparing those statements, may be subject to review by a legislative body. Formal budget appropriations or authorizations are consistent with, or linked to, the figures presented in the statements.
- 2.48 Accrual financial reporting can be implemented in conjunction with a cash-based or other budgeting/authorization system. Even where a jurisdiction plans to change its method of budgeting to an accrual basis, this change may be scheduled for one or two periods following the introduction of accrual accounting. This is usually to ensure the accuracy and reliability of the accrual data before changing the budgeting system. However, some jurisdictions that have operated under such dual systems have noted that this may hinder the acceptance of the

accrual-based accounting. The use of dual systems also requires extensive reconciliations between the two systems.

- 2.49 The success of accrual-based accounting is partly dependent upon the other incentives provided to managers. If managers are held accountable for managing cash-based budgets, then their focus (and the focus of politicians) may continue to be on cash resources, at the expense of the new accrual information.

Chart of Accounts

- 2.50 A chart of accounts is a systematic coding system for the classification and coding of transactions and events within the accounting system. It defines the organization of ledgers used within the accounting system. For example, the asset classifications available within the chart of accounts may allow assets to be classified by type, term (current or non-current), responsibility center, location, etc. The chart of accounts may also include codes for recording transactions against budgetary approvals.
- 2.51 Where a number of individual entities are required to provide information to a central entity for the preparation of consolidated financial statements or for other reporting purposes, it is usual to have a central chart of accounts. This central chart of accounts needs to:
- meet the needs of both individual and central entities;
 - provide a uniform coding structure for coding financial transactions; and
 - permit flexibility for individual entities to adapt it to their particular requirements.
- 2.52 The central chart of accounts needs to be developed early in the process to allow individual entities time to tailor it to their own needs. Individual entities need to incorporate the requirements of their chart of accounts when specifying the deliverables required from accounting software.

Other Governmental Reporting

- 2.53 It is also desirable to design financial reporting systems so that they can provide the data required for other forms of governmental reporting such as Government Finance Statistics (GFS). The revised GFS is on an accrual basis, but there are some differences between the systems that will require adjustments if the same data set is to be used for both sets of financial reporting.

The Impact of EU Accession on Budgeting, Control and Audit

- 2.54 Where a country is contemplating becoming a member of the European Union (EU), the impact of EU policies, rules and regulations on national budgeting, financial reporting and auditing systems needs to be considered. Preparation for EU membership (for example, additional staff training and the development of new information systems) can be successfully combined with more widespread financial reforms. One implication of EU membership is that generally more emphasis needs to be placed on internal control systems

and internal audit. The Organisation for Economic Co-operation and Development (OECD) has published a study that describes the experience of certain member states in integrating national and European Community budgetary procedures and requirements (OECD 1998a, OECD 1998b). The following quote from the OECD study illustrates the lessons learned in adapting the Swedish budgetary and financial control systems to meet the requirements of EU membership.

It is important that national preparations start early, well before accession. In the beginning, the most important steps are to:

- *launch training programs (language and technical skills);*
- *establish contacts with the Commission and Member States on the expert level; and*
- *assess the quality of present systems for budgeting and financial control in the light of the EC Treaty and Regulations.*

The quality of systems is often improved if EU funds can be handled in the same way as national funds. If the national system does not meet EC requirements in some respect, it may be worthwhile to consider changes also for the national resources. In some cases, however, it is inevitable to create specific functions or routines for the EU funds, both in policy-making and administration and control of EU revenues and expenditures.

The complexity of and resources needed for purely technical matters, such as creation of necessary electronic data processing (EDP) systems, must not be underestimated. Differences in powers between EU and national inspectors and auditors may be avoided.

Good co-ordination between the Ministry of Finance and the line ministries, as well as rapidity and timeliness, are crucial for the process to work smoothly and results to be achieved. This is equally important in budget-related matters, as well as financial control and anti-fraud measures. The Ministry of Finance should be given a leading role in the process to formulate the state's position on proposals and strategic decisions.

The set-up of systems for financial management, control and internal audit within the areas of agriculture, Structural Funds and customs should be given high priority and careful consideration. It is expected of all Member States to co-operate closely with the Commission's Financial Controller (DG XX).

The relationship between national and regional levels can be difficult if the division of responsibilities in the management and control process is not clarified at an early stage.

EC requirements change continuously in order to improve efficiency and strengthen the protection of the Communities' financial interests. This is an ongoing process which probably will never cease. All Members of the Union must therefore be prepared, and set up their systems accordingly, for further negotiations, tighter EC rules and further adjustments in their respective national systems¹.

¹ OECD 1998a, page 100

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Appendix: Generic Implementation Plan – Key Headings

Project Initiation

- Document project and obtain project approval
- Establish the steering committee
- Prepare detailed project plan(s)
- Establish project team
 - Project sponsor
 - Project manager
 - Project team (team leader/director and other staff)
- Identify required resources
- Obtain required resources

Detailed Scoping and Planning

- Document existing processes, procedures and legislative requirements (including existing accounting policies and systems)
- Identify proposed changes or areas of change (including proposed accounting policies and systems)
- Systems planning
 - Identify structure/ownership of proposed systems
 - Identify system requirements (existing and new systems)
 - Identify control requirements
 - Identify interfaces required
 - Develop the chart of accounts
 - Develop interfaces (if applicable)
- Reporting
 - Develop new reporting requirements
- Audit
 - Liaise with external auditor to assess impact of changes on audit process
 - Identify role of internal audit during the change process

Develop communications plan

Prepare training strategies (for example, project team, accrual accounting, and computer literacy)

Develop change management strategy

Implementation Phase

Initiate project management responsibilities and reporting structures

Implement new systems/system changes

Implement interfaces

Develop detailed accounting policies

Develop/amend supporting financial management policies and procedures

Implement roles and responsibilities

Deliver training

Obtain approval to switch to new systems

Implement other phased projects (for example, the recognition of specific categories of assets or liabilities may be phased)

Reporting

Develop improved external and internal reporting

Develop financial and non-financial performance measures

Review controls and procedures that support the integrity of financial and non-financial information

Examples of Implementation Plans

- Plan to implement accrual accounting within a jurisdiction previously using modified accrual accounting: Financial Information Strategy (FIS) in the Canadian Federal Government Implementation Strategy Guide, January 1999
<http://www.tbs-sct.gc.ca>
- Plan to prepare annual financial statements: ANAO Better Practice Guide, Financial Statements Preparation, 1996
<http://www.anao.gov.au>
- Plan to implement GASB Statement 34 within a State Government: The State of Michigan GASB Statement 34 Implementation Plan Overview July 2000
- Plan to integrate financial systems: Defense Finance and Accounting Service (DFAS) Systems Integration and Implementation Plan, October 2000
<http://www.dfas.mil>

Web Sites with Details of Financial Management Assistance Projects

- <http://www.adb.org/Publications>
- <http://www.usaid.gov.au>
- <http://www.sagric.com.au>

CHAPTER 3: SKILLS ASSESSMENT AND TRAINING

Key Points

- To reap the full benefits of the transition to accrual accounting, it is important that all personnel involved understand the reasons for the change, are capable of implementing the changes in their own entity, can operate the resultant new systems and procedures and understand the information produced.
- Entities need to assess the impact of the changes on the competencies required in relevant positions, and develop a strategy which includes, but is not confined to, training for upgrading skills.
- Options for addressing gaps in competency include recruitment, consultants, development of external courses and training for existing staff.

Introduction

- 3.1 This Chapter discusses issues associated with the identification, design and delivery of training, under the following headings:
- Identification of Target Groups
 - Identification of Training Needs
 - Training Strategies
 - Delivery of Training
 - Evaluation and Assessment
 - Cross-Training
 - Ongoing Training
 - Lessons Learned
- 3.2 The successful adoption of accrual accounting (in part or in full) and the associated systems changes cannot occur without appropriately trained personnel. In addition, training on the benefits of accrual accounting and general awareness of the reforms and expected benefits is crucial – people need to be convinced of the benefits or they will not see the purpose of the reforms. Such training needs to occur at all levels of government and needs to be at least partially driven and “owned” by individual entities. The development of an effective training strategy, and delivery of appropriate training in accordance with that strategy is an essential element of transition risk management. The development of training strategies and the implementation of training programs should therefore be identified as project milestones.
- 3.3 In common with any major reform or systems change, in order to reap the full benefits of the change, it is important that personnel:

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- understand the reasons for the changes, the reform design, the implementation approach and reform implications (training is one way of implementing a communications strategy);
- understand the practicalities of implementing the reforms in their own entity and are able to implement the changes;
- are able to operate systems and procedures following implementation (at both a centralized and decentralized level); and
- are able to use the information generated by new systems.

3.4 In addition to changes in the specific skills required, the implementation of changes to financial management systems may also require cultural or “mind-shift” changes. For example, senior public officials may be expected to assume much greater responsibility for the financial management of an entity. It is important that both the technical and the cultural aspects of change are addressed in the development of communications and training strategies.

Identification of Target Groups

- 3.5 The identification of target groups and the development of training strategies for each target group mean that training can be customized to the needs of specific groups. The number of target groups identified will depend upon the size of the organization and the resources available. When resources are limited, broader target groups and more generalized training may be necessary.
- 3.6 Although the nature and composition of target groups will vary across entities, the following examples may assist entities to identify appropriate target groups.

Examples of Target Groups Within a Central Government:

- Politicians and Legislative Users
- Public Oversight Bodies
- Central Entities (for example Audit, Personnel)
- Budget/Finance Analysts in Finance Entities
- Heads of Departments/Entities
- Senior Managers
- Operational Managers
- Finance Managers
- Finance Staff
- General Staff
- Media

Examples of Target Groups Within an Individual Entity¹:

- Reform Implementation Team
- Senior Management
- Program Managers
- Administration Support to Program Managers
- Senior Finance Managers
- Finance Officers
- Internal Auditors
- System Operators
- Asset Managers (for example, Inventory and Property Managers)
- Functional Support Groups (for example, Purchasing Staff)

3.7 The purpose of training target groups may vary. For example:

- education of key leaders of the government regarding the role, purpose and objectives of the reform will reinforce political support; and
- management and other staff need to understand their roles and responsibilities within the context of the reforms, their responsibilities within their sub-systems, and the relationships between the various sub-systems.

Identification of Training Needs

3.8 “Needs” assessment involves identifying discrepancies between existing capacities and the capacities desired following the reforms, and determining the relative priority of discrepancies.

3.9 The first stage in the identification of training needs is to look at the impact of the reforms on the type of skills, knowledge and behavior (referred to collectively as competencies) required for various types of positions. Many reforms include decentralization of functions and this can have a major impact on the competencies required.

3.10 Competencies are most useful when they are expressed in terms of outputs and behavior. Competencies may be expressed in levels (for example level 1 could be used to denote core skills and level 2 could be used to denote advanced skills), but such levels will not necessarily link directly to particular grades within the public sector remuneration system. A mix of competencies, experience and responsibility usually determines grades and pay of individuals and positions. Although the development of a competence framework may take some time, the existence of a generic framework for certain public sector positions allows

¹ Some of these target groups may also be applicable at the whole-of-government level.

individual entities to more easily develop their own competence framework and makes it easier to identify training needs.

3.11 Useful references for the development of competencies include:

- *Financial and Accountancy Competences Framework: Report by Working Group* (HM Treasury, 2000). This document includes examples of generic competencies for various financial and accounting positions within the public sector, and explains how those competencies link to relevant national qualifications.
- *Principles and Practices in Managing Financial Records: A Reference Model and Assessment Tool* (Barata, Cain and Routledge, 2001). This document provides a skills matrix for assessing the skills and knowledge required at different levels for managing financial records.
- *Competence-Based Approaches to the Preparation and Work of the Professional Accountant* (IFAC, 2001). This paper explores the topic of accountant competency, providing an analysis of approaches used by various accountancy institutes around the world. The discussion paper seeks to define “competence” and “capabilities”, provides guidance to accountancy membership bodies on their role in developing competencies and capabilities, and assesses various methods. The framework within the paper draws together an outcomes approach (accountants performing roles and tasks in the workplace to a defined standard) and an inputs approach (knowledge, skills and abilities).

3.12 Once the skills required under the new system have been identified, these requirements can be compared with the skills and experience available. It may be helpful to differentiate between those skills that are commonly required in the private sector and those that relate exclusively to the public sector. This would be of use if wide-scale recruitment from the private sector were likely.

3.13 When an entity moves from cash accounting to accrual accounting, it experiences changes in the types of knowledge required, and in the way in which the organization is managed and operates. Under cash accounting, it is common for many accounting and management functions to be centrally managed and for individual entities to have limited authority over assets and other resources. In this type of environment, accounting skills are not in high demand and as a consequence there may be a severe shortage of personnel with the accounting qualifications required to implement accrual accounting.

3.14 However, training will need to focus on more than accounting skills. In the public service, training generally has two different components:

- a technical component that reflects the knowledge and skills to be mastered; and
- an environmental or organizational component that reflects the values, policies and practices of the public service.

3.15 In other words, it is not sufficient for personnel to master the technical aspects of accrual accounting and information management. They must understand the reasons for its implementation, as well as the rules, the policies and the new norms of the government. The

adoption of accrual accounting is also usually accompanied by devolution of financial management responsibilities to program managers. They cannot take initiative, be critical, or feel accountable if they do not understand the foundation for the changes.

- 3.16 Once the gaps between the skills and experience currently available and those required to implement and operate the new systems have been identified, the next step is to consider alternative ways of meeting those training needs and, where appropriate, to develop training strategies.

Training Strategies

- 3.17 Options for addressing the gap between the capabilities of existing staff and the capabilities required include:
- the recruitment of qualified accountants from outside the public service;
 - use of consultants/contractors;
 - the development of public sector accounting and management courses in conjunction with universities and other training organizations (or the education of university lecturers in government reforms so that they can incorporate these reforms within existing courses); and
 - the provision of training to existing staff through:
 - seminars and workshops provided by professional accounting bodies;
 - formal courses offered by academic and other training institutions (such training may be available as part of a formal study leave program);
 - courses developed and offered by government training facilities (these courses may also be made available to individual entities who wish to customize the materials);
 - internal seminars, workshops and conferences by individual entities; and
 - seminars and workshops by external audit entities.
- 3.18 The resources available will determine the appropriateness of various training strategies. For example, limited resources may mean that training takes place over a longer time frame and that existing staff are used to develop and deliver training programs. The types of systems and software chosen will also impact on training strategies. For example, if “off-the shelf” software solutions or “industry standard” approaches are used, it is likely that either the manufacturer or other private providers will already have developed training material to support the product or approach.
- 3.19 Although this Chapter focuses on issues associated with training existing staff, it also includes a brief discussion of recruitment from the private sector and the use of consultants and contractors.

Recruitment from the Private Sector

- 3.20 An entity's ability to recruit qualified staff from outside the public sector will depend upon the state of the labor market at that time and the ability of the public sector to meet private sector remuneration and other terms and conditions of employment.
- 3.21 It will also depend upon whether individuals with private sector experience perceive that they have the appropriate skills and experience to transfer to the public sector environment. Mobility of individuals between the private and public sectors is enhanced when financial reporting and underlying systems requirements are similar in both sectors. There will usually be some differences in financial reporting between the two sectors. However, governments can choose a style of reform that minimizes these differences and increases the likelihood of people, systems and training resources transferring between sectors.

Consultants and Contractors

- 3.22 In the short term, the use of consultants and contractors may be an efficient way to meet immediate resource needs or to obtain specialized assistance. Some factors to consider in obtaining maximum benefit from consultants include:
- the early identification of skilled personnel to work alongside consultants;
 - the use of a formal agreement to transfer knowledge to permanent staff;
 - the development of teams and mechanisms so that this knowledge transfer can occur; and
 - the use of guidelines and monitoring procedures to ensure sustainability in the knowledge transfer.
- 3.23 Where there is a shortage of consultants in a particular field, the cost of using consultants may be very high relative to the cost of training existing staff. However, even in such cases, there can still be benefits in using a limited number of experienced consultants together with internal staff. For example, the use of experienced systems consultants can reduce the risk of inappropriate configurations and subsequent re-work.

Development of University (and Other) Courses

- 3.24 The development of customized public sector courses to be offered by academic or other training institutions requires a significant investment in time and other resources. However, where the number of staff requiring training warrants the development of customized courses, the following benefits can occur:
- increased relevance of training for participants;
 - knowledge learned may be directly applied – the learner is not required to assess the extent to which the course material is applicable to the public sector environment;
 - following the initial investment in time, little effort is required by the government; and

- the course is a long-term resource which can be developed and refined to keep pace with further public sector changes.

3.25 The courses developed in conjunction with academic or training institutions may be general or very specific. For example, a general course such as a Stage I course in government accounting could be developed. This type of course would then be available to existing government employees and the wider student population, thus increasing awareness of government accounting among potential future employees. More specific courses consisting of a number of modules may be developed for targeted groups of employees. For example, a program could consist of a mixture of core modules and a number of optional modules.

Training

3.26 Possible training topics include:

- overview of reforms;
- general awareness of the reforms and anticipated benefits;
- general principles of accrual accounting;
- code of ethics/code of conduct;
- corporate governance;
- accrual accounting:
 - government accounting standards and policies;
 - preparation of financial statements;
 - meeting internal and external audit requirements;
 - chart of accounts; and
 - accounting for assets;
- asset management; and
- systems training.

3.27 Centrally developed material can be provided to individual entities so that the effort required for customization is minimized. Central entities may also choose to provide details of qualified instructors for various aspects of training. However, individual entities are often responsible for identifying their own training needs and deciding how to meet those needs. For example, where a number of entities are implementing the same financial systems, a central entity or group of entities may organize customized courses and workshops specific to that financial system. However, each entity would normally be responsible for determining the extent of its involvement in such training and in selecting the individuals who are to participate.

Delivery of Training

- 3.28 Entities have a number of training decisions to make, including:
- training topics and content;
 - in-house or external provider (or some mix, such as “train the trainers”);
 - method(s) of delivery; and
 - the timing of training.
- 3.29 Methods of delivery could include:
- traditional instructor-led classroom training;
 - multi-media computer-based courses (instructor-led or self-paced); and
 - workshops.
- 3.30 The choice of training will need to take into account cost, time constraints and the ability of staff to be released from work for training.
- 3.31 The technique of “train the trainers”, whereby an entity trains its own staff to act as trainers for other staff is increasingly being viewed as a lower cost way of disseminating externally developed material. Benefits of the “train the trainer” approach include:
- lower cost than using consultants;
 - the training material is understood at an in-depth level by a wider number of entity staff;
 - staff may be more receptive to being trained by colleagues;
 - where more than one language is used within a jurisdiction this approach makes it easier to provide bi-lingual or multi-lingual training; and
 - the trainers become expert resources for the entity and are useful long after the entity has converted to accrual accounting.
- 3.32 However, the “train the trainers” approach carries some risk. Possible problems with this approach include:
- staff selected to be trainers because they have certain technical competence may not be comfortable in a training role;
 - trainers may not deliver the message as well as experienced external trainers; and
 - trainers may deliver inaccurate messages.
- 3.33 Where the “train the trainers” approach is used, the commitment of trainers can be increased by ensuring that they are convinced of the importance of the changes and the need for the training.

- 3.34 The timing of training is important. If it is too early in the transition process, staff may forget what they learned and need refresher courses. Although general training may commence up to a year prior to implementation, some training (for example, systems training) will be best delivered just prior to implementation. Topics such as using the financial information generated by the new systems may be required both before and after implementation.

Evaluation and Assessment

- 3.35 A post-audit review of training can be used to evaluate the effectiveness of the training and assess the need for further training.
- 3.36 One indicator of the extent to which additional training is required is the amount of assistance that external auditors have provided in order to obtain unqualified financial statements or to minimize the extent of qualifications. Although there will often be confidentiality considerations, entities may be willing to allow an independent reviewer access to their audit files.

Cross-Training

- 3.37 In developing training strategies for various groups of staff, an entity may wish to consider cross training certain groups of staff, for example, accounts payable and purchasing staff. Cross training refers to the practice of training staff in two or more areas. Cross training means that staff are more aware of the links between various activities and can work in other areas to ease high workloads or staff shortages.

Ongoing Training

- 3.38 Although an initial burst of training is required to support the introduction of accrual accounting, an entity will usually have an ongoing need to provide financial management training to its staff. A summary of the new system and the financial management responsibilities of various staff need to be built in to induction programs for new staff and regular refresher courses for other staff.
- 3.39 Following the introduction of accrual accounting, an entity will need to develop policies and procedures to support the operation of systems and the management of financial risks. Policy manuals and guidelines are a form of training that assist employees in carrying out their duties and assist with on-the-job training.

Lessons Learned

- 3.40 A study prepared on behalf of the Treasury Board of Canada (Hickling Corporation, 1997) identified some key “lessons learned” from government organizations that have already converted to accrual accounting systems. These lessons learned included the following.
- It is almost impossible to overestimate the amount of training required.

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- Anticipate staff turnover during implementation, since this increases the burden on training and could delay project implementation.
- Training is best when using actual data because it is more meaningful to personnel being trained.
- Try an integrated training approach which allows participants from different work areas to discuss what they do and how they interface¹.

¹ (Hickling Corporation 1997)

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United States General Accounting Office (GAO), *Human Capital A Self-Assessment Checklist for Agency Leaders*, Version 1, GAO/OGC-00-14G
<http://www.gao.gov>

PART II – GENERAL FINANCIAL REPORTING ISSUES

Part II of this Study explains the role of International Public Sector Accounting Standards in establishing accounting policies, and outlines the steps required to develop and approve accounting policies. It also applies the guidance in International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* to illustrate the types of issues that need to be addressed in identifying controlled entities for the purpose of preparing consolidated financial statements.

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CHAPTER 4: ACCOUNTING POLICY ISSUES

Key Points

- International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements* defines accounting policies.
- International Public Sector Accounting Standards (IPSASs) specify the required accounting treatment for certain transactions and events. In the absence of an IPSAS an entity needs to develop policies based on other authoritative guidance.
- The development of accounting policies includes identifying those bodies and individuals with the authority to develop and approve policies for various reporting entities, and establishing an appropriate process for the development and approval of such policies.
- Consultation on proposed accounting policies is a useful quality check and assists with communication.

Introduction

- 4.1 This Chapter describes some of the key steps involved in developing and approving a set of accounting policies. An early focus on accounting policies is appropriate, as accounting policies can impact on the subsequent requirements of information systems, training strategies and communication strategies. For example, if an entity decides to revalue certain classes of property, plant and equipment to fair value, it will need to develop procedures for obtaining fair values on a regular basis and ensure that the accounting information system is designed to accept revaluations.

Definition

- 4.2 Accounting policies are defined in IPSAS 1 as the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements. Accounting policies clarify the application of the requirements in relevant accounting standards to individual transactions and balances. IPSAS 1 contains guidance on the selection of accounting policies, and requires the disclosure of significant accounting policies in the notes to the financial statements. International Public Sector Accounting Standard IPSAS 3 *Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies* specifies the accounting treatment for changes in accounting policies.
- 4.3 A number of IPSASs contain guidance on how to account for specific transactions and events. Where an IPSAS is adopted by an entity, a summary of the accounting treatment required by the IPSAS represents the accounting policy for that transaction or event. Some IPSASs allow entities to select from alternative accounting treatments. Where there is currently no IPSAS on a topic, an entity will need to develop policies based on other authoritative guidance.

- 4.4 A summary of all significant accounting policies is included in external (published) financial statements. This summary is often referred to as the “Statement of Accounting Policies”. IPSAS 1, paragraph 130, states, “In deciding whether a specific accounting policy should be disclosed, management considers whether disclosure would assist users in understanding the way in which transactions and events are reflected in the reported performance and financial position.” IPSAS 1 also gives examples of accounting policies that an entity might consider presenting. Appendices 1 and 2 to this Chapter include a more extensive list of topics for which an entity may need to develop an accounting policy or prepare a disclosure statement.
- 4.5 The summarized accounting policies presented in the external (published) financial statements focus on significant accounting policies. In contrast to these “external” policies, an entity’s “internal” policies may include a more detailed description of the accounting treatment adopted in respect of every type of transaction or event. The detailed internal policies would generally be prepared first, with the external policies being derived from these detailed policies. In the case of revenue items, the more detailed policies may describe the classification of each type of revenue, the point at which that revenue item is to be recognized, and the method of calculating amounts receivable. Such detailed accounting policies may be referred to as an “Accounting Policy Manual”. The United Kingdom *Resource Accounting Manual* (HM Treasury, 2001) is an example of such an accounting policy manual.
- 4.6 The initial accounting policies developed by an entity may also need to include an explanation of the valuation method(s) used to obtain opening balances for certain assets and liabilities. Further discussion of possible approaches to establishing opening balances of assets is found in Chapter 6.

Accounting Policies and Other Policies

- 4.7 Accounting policies are a subset of financial management policies. Entities making the transition to accrual accounting will need to establish a new set of accounting policies and review existing financial management policies in areas such as debt management, cash management, asset management and financial authorities/delegations. For example, asset management guidelines may state who is responsible for the custody and maintenance of an asset, what steps they are required to take to safeguard the asset, and who is responsible for reporting loss or damage to the asset. Following the introduction of accrual accounting, asset management policies may also state who has the authority to enter or amend data in the financial systems.

The Development of Accounting Policies

- 4.8 The development and approval of accounting policies includes both process tasks and technical specification of policies. The tasks identified in this section have been written from the perspective of a government intending to produce whole-of-government financial statements which are consistent with IPSASs. Many of the tasks are also relevant for individual reporting entities within a government. In the case of an individual reporting

entity, one of the first steps would be to establish the extent of the entity's authority to develop its own accounting policies.

4.9 The development of accounting policies includes the following steps:

- Identify who has the authority to approve the policies. Where consolidated financial statements will be prepared, it is desirable to have consistent accounting policies across the reporting entity. In the absence of consistent accounting policies, adjustments are required at the time of consolidation. For this reason, a central body commonly retains the right to determine significant accounting policies. However, this does not preclude individual entities from being given the authority to develop more detailed accounting policies or policies for transactions and balances that are specific to their entity.
- Identify those responsible for developing and reviewing the policies prior to final approval. Appropriate representatives may include the chief financial accountant, internal auditors, financial officers, and external auditors from a range of entities (in terms of both size and functions).
- Establish time frames for development, consultation and approval.
- Decide whether legislative backing for the accounting standards is desired, and if so, initiate legislative changes.
- Identify authoritative accounting standards. Where there is no IPSAS on a particular topic, identify other sources of authoritative guidance. Where there are no authoritative accounting standards applicable to the public sector within a jurisdiction, it will be necessary to identify and/or develop a procedure for the development and approval of such accounting standards. IPSAS 1 explains that management will need to use its judgment in developing an accounting policy that provides the most useful information to users of the entity's financial statements. IPSAS 1 provides guidance for management in making this judgment.
- Develop a full set of accounting policies for internal use, as follows.
 - Identify the transactions and balances for which accounting policies will be required (both the controlling entity and the consolidated entity if relevant).
 - Determine the style of guidance that will be required in the policies. Minimal guidance is appropriate when employees are familiar with accrual accounting and the accounting standards being applied. Detailed guidance could include a summary of the key requirements of an accounting standard and examples of the application of that standard to particular transactions and balances of the entity.
 - Review existing accounting policies. Ensure that existing practices are documented so that the financial impact of changes in policies can be assessed. Check whether any of the existing accounting policies will be appropriate under the new basis of accounting.
 - Apply relevant accounting standards and other sources of authoritative guidance.

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- Prepare new policies in consultation with relevant individuals and groups (including employees with responsibility for managing transactions and balances).
 - Review and approve policies internally.
 - Identify the information system requirements of the accounting policies (and the implications of this for existing systems).
 - Prepare a statement of significant accounting policies for disclosure in general purpose external (published) financial statements.
 - Consult with affected groups as part of due process and as part of the communications strategy. Consultation with the following groups may be appropriate:
 - auditors;
 - heads of government entities;
 - finance staff from individual entities within the wider reporting entity;
 - the local accounting profession;
 - elected or appointed representatives including legislative committees; and
 - academics.
 - Develop guidance on the application of policies.
 - Determine the expected impact of the policies on reported results and position and develop an education and communications strategy to manage expectations around the first set of published statements.
- 4.10 The following two suggestions may help this aspect of the transition to be completed in a timely fashion:
- Use existing accounting standards such as IPSASs and other standards to the maximum extent possible. Not only does this save time and require fewer resources, it also allows more energy to be directed to the resolution of complex issues and implementation issues.
 - Attempt to minimize expectations regarding local development of accounting standards and policies. The development of new approaches and reporting frameworks can be extremely time consuming. Stress the benefits of conforming with independently established accounting standards.

Accounting Policies and the Transition to Accrual Accounting

- 4.11 As part of the transition to reporting on the accrual basis, an entity needs to:
- consider the impact of its transition path on its reported accounting policies;
 - determine the point at which it intends to assert full compliance with IPSASs;
 - decide whether to take advantage of any of the transitional provisions in IPSASs; and

- decide how to deal with adjustments to opening balances and comparative information at the first application of IPSASs.

Transition Path

- 4.12 An entity may decide to defer the application of the accrual basis to the recognition of certain transactions or balances for a set period of time. If it does so, it needs to decide how to:
- communicate this process to readers of financial statements so that they can make best use of the reported information; and
 - present changes in amounts reported due to changes in accounting policies.

Compliance with IPSASs

- 4.13 IPSAS 1, paragraph 26, states that “An entity whose financial statements comply with International Public Sector Accounting Standards should disclose that fact. Financial statements should not be described as complying with International Public Sector Accounting Standards unless they comply with all the requirements of each applicable International Public Sector Accounting Standard.” An entity therefore needs to decide at what point it intends to assert full compliance with IPSASs and the impact of this date upon the timing of the various tasks outlined in this Study.

First-Time Application of IPSASs

- 4.14 Entities may choose to adopt IPSASs at a time suitable for them. This will vary between jurisdictions depending upon the approach taken to adoption of accrual accounting and the time frame adopted. An entity can claim full compliance with accrual-based IPSASs only when it has complied with the requirements of all IPSASs on issue.
- 4.15 Some IPSASs contain transitional provisions which provide temporary relief from certain requirements in the IPSASs. For example, International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* provides temporary relief from the requirement to eliminate in full balances and transactions between entities within the economic entity. The transitional provisions are available for the amount of time stated in the IPSAS (in the case of IPSAS 6 the transitional provision is available for three years), commencing on the date of first application. Where an entity decides to use a transitional provision, this use would need to be acknowledged in the accounting policies. The entity would also need to make sure that it develops a plan of action to enable full compliance with the IPSAS within the required time frame.
- 4.16 There may be other issues which arise on first-time application of IPSASs which are not dealt with by IPSASs currently on issue. For example, how should an entity deal with any changes in reported figures, such as accumulated balances and comparative amounts, caused by the first-time application of IPSASs? Entities will need to develop their own policies in relation to such issues. Other authoritative pronouncements may be helpful in identifying and dealing with such issues. For example, the International Financial Reporting Interpretations

Committee (IFRIC) of the International Accounting Standards Board (IASB) Interpretation SIC 8 *First Time Application of IASs as the Primary Basis of Accounting* (IASB, August 1998) provides guidance on the treatment of adjustments to accumulated surpluses/deficits arising from the first-time application of International Accounting Standards¹.

Relevance to the Cash Basis of Accounting

- 4.17 An entity wanting to report on a comprehensive cash basis of accounting, including the adoption of the major principles in any future IPSAS based on Exposure Draft ED 9 *Financial Reporting Under the Cash Basis of Accounting*, would disclose the accounting policies used in the preparation of its financial statement(s).

¹ At the time of writing, the International Accounting Standards Board (IASB) was considering the development of a standard on first-time adoption which would replace SIC-8. Details of the proposals under consideration are available on the IASB web site.

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Appendix 1: Examples of Issues Requiring Accounting Policies: The Accrual Basis¹

This Appendix illustrates topics on which accounting policies or disclosure statements regarding assumptions used in the preparation of the financial statements may be required. The list of policies shown is not necessarily comprehensive. The specific policies may be based on IPSASs or, in the absence of a relevant IPSAS, on other authoritative sources of guidance adopted by the entity. The types of policies required will vary depending upon the type of entity; for example, a national government may require a number of policies on various types of non-exchange revenue. By contrast, an individual public sector entity within that government may have only one form of non-exchange revenue. Application of the accounting policies specified in IPSASs will deal with a number of the accounting policy issues identified in this Appendix. Accounting policies would need to be subject to periodic review in order to ensure that they are consistent with authoritative accounting standards and generally accepted accounting practice over time.

GENERAL

Entities to whom the policies apply

Reporting Entity

Consolidation of Controlled Entities

Combination of Associates

Joint Ventures

Reporting Period

Accrual Basis Used

Going Concern Assumption

Measurement Basis

Application of Materiality

Explanation of Changes in Accounting Policies

ASSETS

Definition and Recognition of Assets

Classifications to be used within the financial statements

Cash and Cash Equivalents

¹ Note: Some policies will be applicable at the whole-of-government level only. These policies are indicative only. Each entity would develop a policy for each relevant transaction and balance.

Accounts Receivable and Accrued Revenue (by type)
Bad and Doubtful Debts
Inventories (by type)
Prepayments
Investments (by type)
Investment Property
Property, Plant and Equipment (by type)
Leased Assets/Sale and Leaseback Transactions
Information Technology Assets (Hardware and Software)
Intangible Assets
Biological Assets
Heritage Assets

LIABILITIES

Definition and Recognition of Liabilities
Classifications to be used within the financial statements
Accounts Payable and Accrued Expenses (by type including transfers/grants payable)
Finance Lease Liabilities
Provisions for Employee Entitlements
Other Provisions
Pension Liability
Borrowings
Bonds/Stock
Unearned Revenue
Currency Issued
Social Policy Obligations (by type)

REVENUE

Definition and Recognition of Revenues
Classifications to be used within the financial statements
Application of classification system to all revenues

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Recognition of Investment Revenue (by type, for example interest and dividend/distribution revenue)

Recognition of Revenue from the Provision of Goods and Services (by type, examples listed)

Output revenue (under a purchaser/provider model)

User charges (exchange only)

Trading revenue

Certain government grants

Property rental

Recognition of Types of Non-Exchange Revenue (by type, examples listed)

Taxes

Levies

Fines

Certain government grants

Donations

Other Revenue

Surplus or Loss on Construction Contracts

Operating Lease Revenue

Finance Lease Revenue

EXPENSES

Definition and Recognition of Expenses

Classifications to be used within the financial statements

Application of classification system to all expenses

Employee Expenses (including contributions to superannuation schemes)

Supplies and Consumables

Depreciation

Amortization of Intangible Assets

Transfer Payments/Grants and Donations (by type)

Interest and Financing

Income Tax/Income Tax Equivalents (where appropriate)

EQUITY/NET WORTH

Composition of Equity/Net Worth
Contributed Capital
Accumulated Surplus and Deficit
Asset Revaluation Reserve
Foreign Currency Reserve

OTHER POLICIES

General Presentation and Disclosure
Extraordinary Items
Fundamental Errors
Gains and Losses on Disposal of Non-Current Assets
Assets and Liabilities Transferred
Commitments
Contingent Liabilities
Contingent Assets
Events After the Reporting Date
Cost Accounting Policies
Comparatives
Related Party Disclosures
Foreign Currency
Accounting for Hyperinflation
Administered/Entity Transactions
Budget Reporting
Non-Financial Reporting

Appendix 2: Examples of Issues Requiring Accounting Policies: The Cash Basis

This Appendix illustrates topics on which accounting policies or disclosure statements may be required under the cash basis of accounting. Appropriate accounting policies for many of these topics are specified in Exposure Draft IPSAS ED 9¹.

GENERAL ACCOUNTING POLICIES

- Entities to whom the policies apply
- Basis of Accounting Policies
- Reporting Entity
 - Consolidation of Controlled Entities
 - Joint Ventures
- Reporting Period
- Cash Basis
- Going Concern Assumption
- Application of Materiality
- Explanation of Changes in Accounting Policies

RECEIPTS

- Definition and Recognition of Receipts²
- Classification of Receipts
 - Whole-of-Government level
 - Individual entity level

PAYMENTS

- Definition and Recognition of Payments
- Classification of Payments
 - Whole-of-Government level

¹ As more IPSASs are released, the implications of certain accounting issues for the cash basis of accounting will be considered and this may eventually lead to a revision of the IPSAS based on Exposure Draft IPSAS ED 9 and the disclosures required under the cash basis of accounting.

² Because, under the cash basis of accounting, receipts and payments are recognized when cash is received or paid, there is generally little need for further policies in relation to the recognition of various receipts and payments.

Individual entity level

CASH

Definition of Cash

Cash and Cash Equivalents

OTHER POLICIES

General Presentation and Disclosure

Extraordinary Items

Fundamental Errors (if applicable)

Additional Asset and Liability Disclosures (if applicable)

Commitments (if applicable)

Contingent Liabilities (if applicable)

Contingent Assets (if applicable)

Cost Accounting Policies (if applicable)

Comparatives

Foreign Currency

Accounting for Hyperinflation (if applicable)

Budget Reporting

Non-Financial Reporting

Transition to the Accrual Basis of Accounting

CHAPTER 5: REPORTING ENTITY ISSUES

Key Points

- This Chapter applies the guidance in International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* to illustrate the types of issues that need to be addressed in identifying entities that should prepare financial statements, and in identifying controlled entities that should be included in the consolidated financial statements.
- At the time of writing, International Public Sector Accounting Standards (IPSASs) dealing with the determination of the boundaries of the reporting entity and the preparation of consolidated financial statements are:
 - IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities*; and
 - IPSAS 8 *Financial Reporting of Interests in Joint Ventures*.

Introduction

- 5.1 This Chapter looks at the question of how to decide which individual entities and groups entities should prepare general purpose financial reports as reporting entities. In the case of groups of entities, it discusses which sub-entities should be included in the group reporting entity. For example, which entities should be included in the financial report prepared for a whole-of-government reporting entity, a department, a state or a province?
- 5.2 A reporting entity is any entity that prepares general purpose financial reports for external users dependent on information in those financial reports. A reporting entity may therefore be an individual entity such as a department, ministry or other government entity, or it may be an entity group such as the whole-of-government. The term “economic entity” is used to refer to a reporting entity which comprises a number of individual entities. Therefore the whole-of-government reporting entity is an economic entity. However, a department, ministry or other government entity may also control other entities and therefore be a group reporting entity. Existing reporting entities within a jurisdiction may be specified in legislation or they may have developed over time without any legislative or theoretical underpinning.
- 5.3 The Public Sector Committee (PSC) has not currently developed any authoritative guidance on the definition of an individual reporting entity, although the PSC has previously discussed this issue in Study 8, *The Government Financial Reporting Entity* (IFAC, July 1996). The PSC has addressed the issue of identifying group reporting entities in IPSAS 6. Study 8 explains that individual reporting entities may be defined by reference to the existence of users who are dependent on general purpose financial reports for information for accountability and/or decision-making purposes, and who do not have the authority to demand special purpose reports. In respect of most entities, it will be readily apparent whether there are users who are dependent on financial reports for accountability and

decision making purposes. In respect of other entities, it will be necessary to consider factors such as:

- the separation of management from those with an economic interest in the entity; and
- whether users are likely to depend on financial reports for information for accountability and/or decision-making purposes.

5.4 Consideration of factors such as the economic or political importance/influence of an entity and its financial characteristics (the extent of its resources and obligations) may also be relevant in determining whether it is likely that there are users dependent on an entity's financial report.

5.5 Most IPSASs apply equally to the financial statements of an individual entity and to consolidated financial statements for an economic entity, such as whole-of-government financial statements. IPSAS 6 applies to consolidated financial statements. This Chapter outlines the key requirements in IPSAS 6 and identifies a number of steps that are required in order to apply IPSAS 6. IPSAS 8 includes requirements for reporting of joint ventures such as jointly controlled operations, jointly controlled assets and jointly controlled entities. IPSAS 8 is discussed in paragraphs 5.15 and 5.17.

Boundaries of the Reporting Entity

The Concept of Control

5.6 IPSAS 6 adopts the concept of control to determine the boundaries of the reporting entity. Under this approach the government financial reporting entity includes all those entities and transactions which the government controls. That is, it includes all resources controlled by, and all obligations of, the reporting entity regardless of the administrative or legal entities created to manage those resources and obligations. IPSAS 6 defines control within a public sector context and provides guidance on determining whether control exists. It defines control as “the power to govern the financial and operating policies of another entity so as to benefit from its activities.” Both the power aspect and the benefit aspect are required to be present for control to exist. For example, if an entity had the power to appoint or remove a majority of the members of the governing body of another entity and the power to dissolve the other entity and obtain a significant level of the residual economic benefits, it would control the other entity in accordance with IPSAS 6.

5.7 IPSAS 6 requires that controlling entities prepare consolidated financial statements incorporating all controlled entities. However, in some limited circumstances IPSAS 6 allows an entity not to prepare consolidated financial statements and requires an entity to omit certain controlled entities from the consolidation. Entities are required to be omitted from the consolidation when control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its subsequent disposal in the near future, or when the entity operates under severe external long-term restrictions which prevent the controlling entity from benefiting from its activities.

Consolidated Financial Statements

- 5.8 The consolidated financial statements of each reporting entity will include all revenues, expenses, assets and liabilities of the reporting entity meeting the respective definition and recognition criteria. They will not include revenues, expenses, assets and liabilities that are not controlled by the reporting entity. Examples of items not controlled by the reporting entity may include assets held in trust for others and assets managed in an agency capacity on behalf of another entity.

Implementation: Determining the Boundaries of the Reporting Entity

- 5.9 Determining the boundaries of the reporting entity involves a review of existing reporting entities and identification of controlled entities. In this context the following steps are necessary:
- Identify and document the existing reporting entity/entities and the legislative requirements or decisions that have created the reporting entity/entities.
 - Consider whether all entities that are currently required to report are in fact entities in respect of which it is reasonable to expect the production and publication¹ of general purpose financial statements. As discussed in the introduction to this Chapter, the test for this is generally whether there are external users dependent upon these financial reports for information for accountability and/or decision-making purposes. In many jurisdictions this will include the whole-of-government entity and each individual department or government entity. However, the appropriate decision on whether individual government entities should be separate reporting entities may vary between jurisdictions.
 - Consider whether there are other entities that should produce and publish general purpose financial statements.
 - Identify potential controlled entities. Examples of entities which it may be appropriate to review for evidence of a control relationship include entities receiving regular or substantial amounts of government funding, entities established by legislation (such as regulatory bodies), committees or groups established under the oversight of a government department or entity, and entities to which the government has provided financial assistance or guarantees to prevent financial collapse. Although it is suggested that such entities should be reviewed, many will not be controlled entities. However, it is prudent to consider all such entities at this point.
 - Apply the control criteria in IPSAS 6 to all potential controlled entities to determine whether they are controlled entities or jointly controlled entities (note that clarification of the legal status of some entities may be required during this process).
 - Identify both the overall (consolidated/group) reporting entity and all individual reporting entities within that entity. As part of this process it is necessary to determine whether there is a need to prepare financial statements for the ultimate controlling entity

¹ The term “publication” as used here includes “public access” in any form.

as an individual reporting entity. For example, should a national government preparing consolidated financial statements also report separately on transactions and balances which belong to the government itself, as opposed to any of its controlled entities? In the private sector the controlling entity is referred to as the “parent” and may be a separate reporting entity in its own right. However, in the public sector, despite the fact that some transactions relate to the controlling entity only, this does not necessarily mean that the controlling entity is a separate reporting entity. It is necessary to consider any legal reporting requirements and also whether there is a body of users dependent upon such information who are unable to demand financial information to meet their specific information needs.

- Review existing legal reporting requirements to see if they need to be aligned with the proposed reporting entities (determined using IPSAS 6).

5.10 The following examples illustrate the way in which two jurisdictions approached the issue of which entities should form part of the whole-of-government reporting entity. Some of these examples occurred prior to the issuance of IPSAS 6 and may not be entirely consistent with IPSAS 6. IPSAS 6 contains detailed guidance on the types of tests which should be applied to determine whether an entity is a controlled entity.

Determining the Whole-of-Government Reporting Entity

Example 1

Tests used in one jurisdiction to determine which entities outside central government should form part of the whole-of-government reporting entity were:

- Did the government own a majority of the voting shares?
- Did the government have the power to dismiss a majority of the members of the governing body, or where no such body existed, have the power to dismiss the chief executive, and replace the governing body or the chief executive with a governing body or chief executive which was primarily responsible to the government?
- Did the government have the right to more than 50% of the entity’s net assets on disestablishment?
- Had the Parliament deemed the entities to be owned by the government?

Example 2

In one jurisdiction the government was deemed to control an entity where that other entity was accountable to the government and the government had a residual financial interest in the net assets of that entity.

Determining the Whole-of-Government Reporting Entity (continued)

Example 3

A jurisdiction used the criteria in its private sector accounting standard to develop tests to determine the boundary for the whole-of-government reporting entity. The tests were also adopted in the determination of the central government sector for statistical reporting. No significant differences were found between the classification of entities using the new tests and the existing statistical classification because both are based on the concept of control. Examples of the tests applied included:

- The Crown is a quasi-member of the undertaking and the Crown, the Monarch or Ministers (on behalf of the Government) have the right to appoint or remove directors holding a majority of the voting rights at meetings of the board on all, or substantially all matters.
- The Crown has the right to exercise dominant influence over the undertaking by virtue of provisions contained in the undertaking's memorandum or articles, an Act of Parliament or through the activities of the body being substantially restricted by specific legislation or by virtue of a control contract.
- The Crown is a quasi-member of the undertaking and Ministers control a majority of the voting rights in the undertaking.
- The Crown has a participating interest in the undertaking and it actually exercises dominant influence over the undertaking, or it and the undertaking are managed on a unified basis.

Consolidation

- 5.11 Consolidation is the process of presenting the financial statements of all entities that make up the reporting entity as if they were the financial statements of a single entity. It involves adding together all items on a line-by-line basis and eliminating any transactions or balances between members of the reporting entity.
- 5.12 In order to consolidate the financial statements of various entities it is necessary to:
- have a system for collecting financial statements of all the entities within the reporting entity. Some of the entities will be autonomous entities with their own accounting policies and systems. Regardless of the manner in which they recognize and classify transactions and balances in their own financial statements, these entities will need to conform to the standard policies and classifications when providing financial information for consolidation. Information for consolidation purposes may be provided in a variety of ways. Where the various entities use a centralized accounting system or a common reporting system it may be obtained directly, or the information may be summarized on a spreadsheet which is then entered into a consolidation package;

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- ensure that the accounting policies used by the individual entities within the reporting entity are consistent to the extent practicable. If they are not consistent it will be necessary to make adjustments at the time of consolidation to align the policies (for example, where a sub-entity accounts in accordance with a standard that is relevant for its activities but that is not relevant to the controlling entity accounts). Some differences between policies for immaterial items may be acceptable but this will need to be considered in the context of other factors affecting materiality. IPSAS 6, paragraph 45, requires that “Consolidated financial statements should be prepared using uniform accounting policies for like transactions and other events in similar circumstances. If it is not practicable to use uniform accounting policies (other than the bases of accounting) in preparing the consolidated financial statements, that fact should be disclosed together with the proportions of the items in the consolidated financial statements to which the different accounting policies have been applied”;
- collect information on the nature and amount of inter-entity transactions and balances. Inter-entity transactions and balances are eliminated on consolidation. Where entities within the wider economic entity regularly transact with each other it may be appropriate to establish additional codes for inter-entity transactions so that such transactions can be recorded directly within the accounting system. Consideration of materiality is also appropriate in determining the level of effort which goes into identifying inter-entity transactions and balances. The view of external auditors on the desirability of various methods of identifying inter-entity transactions can assist at this point. Entities preparing group financial statements under the cash basis may already have identified a number of inter-entity transactions;
- select the method of performing the consolidation. Where a new accounting system is being established, or where an existing accounting system is being substantially overhauled, it is generally possible to incorporate a consolidation component. Alternatively it may be possible to use or adapt a standard consolidation software package. Where there are a relatively small number of entities it may be possible to use a spreadsheet to perform the consolidation. It is also necessary to decide whether the consolidation is going to be done as one exercise or whether there will be a series of sub-consolidations within the group. For example, individual government entities may consolidate the financial statements of all their controlled entities and then all the government entities may be consolidated; and
- capture information required to meet the disclosure requirements in various IPSASs, including the disclosure of amounts owed to other entities within the economic entity. The process used in one jurisdiction is explained below.

Example of Consolidation Process Adopted in One Jurisdiction

In the preparation of the consolidated financial statements for the whole-of-government in one jurisdiction, controlled entities are required to provide information by completing an information pack (a return). Returns are provided through the Internet and using data encryption devices to the entity with responsibility for compilation of consolidated financial statements. Returns are consolidated in a Microsoft database. The information packs have a number of validation rules to ensure that basic checks on the entry of financial information are satisfied before being consolidated. Entities can link these information packs to their general ledgers, which allows their information packs to be automated off their internal reporting processes. Once an entity has the process running smoothly it takes around three hours to complete an information pack.

Entities are required to have internal procedures to ensure that the information provided in the returns is accurate and complete. Information submitted for consolidation must be checked for accuracy and completeness before it is signed-off. The information provided for use in the consolidated financial statements must agree with and be reconciled to the entity's financial management information system and audited financial statements.

Disclosures Required

5.13 International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements* and IPSAS 6 require a number of disclosures to be made regarding the nature of the reporting entity. The disclosures required include:

- the name of the reporting entity;
- whether the financial statements cover the individual entity or the economic entity (with the economic entity being a group of entities comprising the controlling entity and any controlled entities);
- a list of significant controlled entities and the proportion of ownership interest;
- the reasons for not consolidating any controlled entity;
- the name of any controlled entity in which the controlling entity holds an ownership interest and/or voting rights of 50%, together with an explanation of how control exists;
- the name of any entity in which an ownership interest of more than 50% is held but which is not a controlled entity, together with an explanation of why control does not exist;
- the effect of the acquisition and disposal of controlled entities on the financial position at the reporting date, the results for the reporting period and the corresponding amounts for the preceding period; and
- in the controlling entity's separate financial statements, a description of the method used to account for controlled entities.

National Accounts

- 5.14 Whole-of-government financial reports may be restricted to one level of government or may include more than one level of government depending upon the way in which levels of government have been established and are operated within a particular jurisdiction. By contrast, statistical systems such as Government Finance Statistics and the System of National Accounts (or regional equivalents) adopt a standard approach to the definition of the government sector. An entity may wish to consider providing, as additional information, an explanation of any differences in the whole-of-government reporting entity in financial statements prepared for financial reporting purposes and the government sector in statistical reports.

Joint Ventures and Joint Control

- 5.15 In some circumstances, an entity may have joint control, rather than individual or full control, over another entity. IPSAS 8, paragraph 5, defines a joint venture as “a binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control” and joint control as “the agreed sharing of control over an activity by a binding arrangement”.
- 5.16 The steps outlined in this Chapter for the identification of controlled entities may also be applied to the identification of jointly controlled entities. In order to determine the appropriate accounting treatment for a joint venture, an entity will also need to classify the joint ventures as jointly controlled operations, jointly controlled assets or jointly controlled entities. IPSAS 8 establishes the accounting treatment for jointly controlled operations, jointly controlled assets and jointly controlled entities in a venturer’s separate financial statements and a venturer’s consolidated financial statements.
- 5.17 IPSAS 8 allows either the proportionate consolidation method or the equity method of accounting for jointly controlled entities to be adopted in the consolidated financial statements of the venturer. The discussion in this Chapter of implementation issues associated with consolidation is also relevant to the proportionate consolidation of jointly controlled entities. In some cases a government may have significant influence over an entity but not control or jointly control that entity. IPSAS 7 *Accounting for Investments in Associates* includes requirements for accounting for these arrangements.

Relevance to the Cash Basis of Accounting

- 5.18 For those preparing consolidated cash basis reports, the determination of the reporting entity and the preparation of a consolidated primary financial statement involve the same process as for the accrual basis. The consolidation requirements for the cash basis of accounting will be addressed in the future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*.

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Appendix: Accounting Policies

This Appendix illustrates the accounting policies which are to be used to determine the reporting entity. The policies are the internal accounting policies developed by a central entity for application in the preparation of whole-of-government financial statements for a hypothetical national government. They could also be used by individual government entities that control other entities. In some jurisdictions, the entities required to prepare financial statements for external users will be defined in legislation. In such cases, if the reporting entity wishes to assert compliance with IPSAS 6, it will need to assess whether the legal reporting entity is consistent with the application of IPSAS 6.

Reporting Entity

The financial statements are to disclose the entities controlled or jointly controlled by the entity and forming part of the consolidated financial statements.

Consolidation of Controlled Entities

The consolidated financial statements are to include all controlled entities required to be included by International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities*. If a controlled entity is acquired and held exclusively with a view to its disposal in the near future, it should be excluded from consolidation and accounted for as an investment.

Controlled entities are to be consolidated using the purchase method of combination in accordance with IPSAS 6. All material transactions and balances between sub-entities are to be eliminated on combination.

Uniform accounting policies are to be applied in the preparation of consolidated financial statements.

The entity will ensure that details of material transactions (and any resulting balances) between the reporting entity and any other reporting entities within the whole-of-government reporting entity are recorded.

Combination of Associates

Entities over which the reporting entity has significant influence are to be accounted for as associates using the equity method of accounting in accordance with International Public Sector Accounting Standard IPSAS 7 *Accounting for Investments in Associates*.

If an investment is acquired and held exclusively with a view to its disposal in the near future, it is to be accounted for under the cost method in accordance with IPSAS 7.

Joint Ventures

The reporting entity's interest in joint ventures (jointly controlled operations, jointly controlled assets and jointly controlled entities) is to be recognized and accounted for in accordance with International Public Sector Accounting Standard IPSAS 8 *Financial Reporting of Interests in Joint Ventures*.

PART III – FINANCIAL ELEMENTS

Part III of this Study outlines the main types of assets, liabilities, revenues and expenses that occur in public sector entities. It identifies International Public Sector Accounting Standards (IPSASs) dealing with the definition, recognition, measurement and disclosure of these items. The Study outlines the requirements of key IPSASs (or, in the absence of an IPSAS, other sources of authoritative guidance) and the types of implementation tasks associated with recognizing these items and complying with IPSASs or other accounting standards.

The Chapters in this Part of the Study focus on selected assets, liabilities, revenues and expenses. For example, Chapter 6 focuses on issues associated with the recognition of property, plant and equipment. The implementation tasks and issues that are illustrated in these Chapters may also be able to be applied more generally to other assets, liabilities, revenues and expenses.

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CHAPTER 6: ASSETS

Key Points

- At the time of writing, International Public Sector Accounting Standards (IPSASs) dealing with the definition, recognition, measurement or disclosure of assets are:
 - International Public Sector Accounting Standard IPSAS 2 *Cash Flow*;
 - International Public Sector Accounting Standard IPSAS 5 *Borrowing Costs*;
 - International Public Sector Accounting Standard IPSAS 11 *Construction Contract*;
 - International Public Sector Accounting Standard IPSAS 12 *Inventories*;
 - International Public Sector Accounting Standard IPSAS 13 *Leases*;
 - International Public Sector Accounting Standard IPSAS 15 *Financial Instruments: Disclosure and Presentation*;
 - International Public Sector Accounting Standard IPSAS 16 *Investment Property*; and
 - International Public Sector Accounting Standard IPSAS 17 *Property, Plant and Equipment*.
- Asset topics for which IPSASs are currently not developed include:
 - receivables associated with non-exchange revenue (discussed in Chapter 14);
 - measurement of financial instruments (discussed in Chapter 11);
 - intangible assets (discussed in Chapter 10);
 - impairment of assets; and
 - biological assets.
- This Chapter considers issues associated with the initial and ongoing recognition of inventories, construction contracts, receivables, and property, plant and equipment.
- Although the main focus of this Chapter is on the identification, recognition and measurement of assets for financial reporting purposes, one of the key reasons that entities adopt accrual accounting is in order to obtain better information on assets for management purposes. An entity could choose to maintain only that data required for financial reporting purposes, but it would then be missing out on one of the main benefits of adopting accrual accounting. This Chapter therefore contains a brief description of some of the policies and procedures and system requirements for good asset management.

Introduction

- 6.1 International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements*, paragraph 6 defines assets as “resources controlled by an entity as a result of past events and from which future economic benefits or service potential are expected to flow to

the entity”. Assets are recognized for financial reporting purposes when they meet all elements of this definition, when it is probable that future economic benefits or service potential will flow to the entity, and when the asset has a cost or value that can be measured reliably.

6.2 Examples of assets held by governments and government entities include:

- financial assets:
 - cash and cash equivalents;
 - revenues receivable;
 - loans and advances to other governments;
 - other loans and advances;
 - investments; and
 - derivatives;
- physical assets:
 - inventories;
 - heritage assets and property, plant and equipment, including infrastructure assets and defense or military assets;
 - investment properties; and
 - natural resources; and
- intangible assets

6.3 This Chapter discusses the tasks and issues associated with the initial identification, recognition and measurement of assets, and the systems and procedures required to support the ongoing preparation of accrual financial statements. It considers issues associated with inventories, receivables and property, plant and equipment. Issues associated with cash and intangible assets are covered in Chapters 9 and 10 respectively.

6.4 Much of the Chapter is devoted to consideration of property, plant and equipment. Reasons for this emphasis on property, plant and equipment include:

- the fact that most entities have some property, plant and equipment;
- the relative significance of property, plant and equipment as a proportion of an entity’s total assets; and
- that many of the issues covered in relation to property, plant and equipment are also relevant to other non-current assets.

General Asset Issues

- 6.5 In order to prepare an implementation plan for the recognition of assets, an entity needs to have some idea of the scope of the tasks involved and the likely amount of resources that these tasks will take. The amount of work required to recognize assets depends on the extent to which an entity already has information available on those assets. General steps in the recognition of assets include:
- compilation of an asset register for all types of assets held by the entity;
 - determination of the categories of assets that will be used in the chart of accounts and the financial statements;
 - preparation of accounting policies for each category;
 - assessment of the accuracy and completeness of existing information on each category;
 - compilation of accurate opening balances for each category (identification, application of definition of asset, and measurement); and
 - establishment of systems to support the ongoing requirements of accrual accounting.
- 6.6 These steps are discussed in more detail in paragraphs 6.36 to 6.62 in relation to property, plant and equipment. Depending upon the basis of accounting previously used by an entity and the nature of supplementary information held, the amount of work required may vary considerably between entities and jurisdictions.

Inventories

- 6.7 This section highlights some issues that need to be addressed as part of the planning for the identification and measurement of inventories, and explains the application of IPSAS 12 *Inventories*. IPSAS 12 defines inventories as assets:
- in the form of materials or supplies to be consumed in the production process;
 - in the form of materials or supplies to be consumed or distributed in the rendering of services;
 - held for sale or distribution in the ordinary course of operations; or
 - in the process of production for sale or distribution.
- 6.8 Within the public sector, inventories are often held for use in service delivery or the production and sale of goods. Examples of inventories include:
- ammunition;
 - consumable stores;
 - maintenance materials;
 - spare parts for plant and equipment other than those dealt with under IPSAS 17;
 - strategic stockpiles (for example, energy reserves);

- stocks of unissued currency;
- postal service supplies held for sale (for example, stamps);
- work in progress, including:
 - educational/training course materials; and
 - client services (for example, auditing services) where those services are sold at arm's length prices; and
- land/property held for sale.

6.9 For the purpose of external reporting, entities can choose to classify inventories by type or by stage of completion (for example, raw materials, work in progress and finished goods). IPSAS 1 encourages the classification of assets (including inventories) as either current/non-current or in broad order of their liquidity. A distinction between inventories held for sale or not intended for sale may also be made.

6.10 Therefore, two of the first tasks in relation to inventories are to identify all inventories that meet the definition in IPSAS 12 and to decide what categories of inventories will be used within internal systems and in the external financial statements.

Inventories – Recognition

6.11 Tasks associated with the recognition of inventories include:

- the establishment of recognition thresholds;
- identification of the point at which title to various types of inventories passes to the entity; and
- the establishment of systems and procedures to track costs associated with inventories in order to recognize inventory on hand at the end of the period.

6.12 Goods or services purchased by the entity are usually recognized when title to the goods has passed to the entity or the services have been rendered, and there is a legal obligation to pay for the goods or services. The recognition of goods in transit will depend upon the terms of the agreement under which the inventories were purchased.

6.13 The recognition of consumable items (for example, stationery) as inventories will depend upon the materiality of the items (both in terms of purchases and the amounts on hand at period end). Inventory items that fall below the established threshold level for the recognition of inventories (both individually and collectively) would be expensed on acquisition.

6.14 Recognition of work in progress is outlined in the Appendix to this Chapter. Systems for tracking costs and stocktaking procedures are discussed below.

Inventories – Systems

- 6.15 In order to meet the objectives of inventory control, an entity needs to establish systems for ordering, storing, using or selling inventories and accounting for these activities. The objectives of inventory management are to ensure that inventories are:
- adequate to meet the needs of ongoing activities without disruption;
 - managed to reduce funds tied up in inventories and storage costs; and
 - subject to a good system of internal controls to minimize loss through damage, deterioration, unauthorized use or theft.
- 6.16 In developing an accounting system for inventories, an entity will need to decide whether to operate a perpetual or periodic system. Under a perpetual system, inventory records are updated each time goods are received, used or sold. Under a periodic system, information on the levels of goods held is obtained by way of periodic stocktakes. Where an entity is tracking the cost of particular processes or activities, the accounting system will also need to record the area or activity to which inventory is to be charged. Where inventories are significant, computer-based inventory management systems, purchasing systems and accounts payable systems may be required. Inventory management systems need to be linked with, or regularly reconciled to, the general ledger.

Inventories – Stocktaking

- 6.17 Stocktakes are required to provide sufficient evidence of the existence and condition of inventories. The great majority (by value) of inventories should be covered by an annual stocktake at period end. External auditors will need to review stocktaking procedures to ensure that they can rely on the information collected, and will generally want to witness some stocktaking procedures. The entity should document all discrepancies identified and any action taken such as write-offs and/or amendments to inventory records. A regular review of such discrepancies and the action taken may assist the entity in continually improving its inventory management procedures.

Inventories – Assignment of Cost

- 6.18 IPSAS 12 allows cost to be assigned to inventories sold, or removed from inventories for use, by one or more of the following methods:
- specific identification (for items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects); or
 - first-in first-out (FIFO) or weighted average cost.
- 6.19 Although IPSAS 12 allows some choice of method for the assignment of cost, it requires that an entity should use the same cost formula for all inventories having similar nature and use to the entity.

Inventories – Obsolescence and Damage

- 6.20 IPSAS 12 requires inventories to be carried at the lower of cost or net realizable value. This means that regular (at least annual) checks for damage and obsolescence are required. Where items are written down to net realizable value, it is necessary to keep a record of the information on which the assessment of net realizable value has been based.

Biological Assets

- 6.21 There is currently no IPSAS that deals with biological assets. Agricultural products are specifically excluded from the scope of IPSAS 12 and natural increases in agricultural products are excluded from the scope of International Public Sector Accounting Standard IPSAS 9 *Revenue from Exchange Transactions*. In the absence of an IPSAS, one source of authoritative guidance is International Accounting Standard IAS 41, *Agriculture* (IASB, December 2000). The Public Sector Committee (PSC) has not yet addressed the application of this Standard to public sector entities.
- 6.22 IAS 41 prescribes the accounting treatment, financial statement presentation and disclosures related to agricultural activity. It does not deal with processing of agricultural produce after harvest – IPSAS 12 should be applied to such inventories. IAS 41 does not establish any new principles for land related to agricultural activity. Instead, IPSAS 17 or IPSAS 16 *Investment Property* would be applied as appropriate.

Bullion

- 6.23 Gold and silver bullion may be held for speculative purposes or because an entity is responsible for the production and storage of bullion. When it is held for speculative purposes, or where the quantity exceeds that which is required for the ongoing production of coins, it may be valued in the same way as marketable securities. Where an entity is responsible for the production of bullion it is treated as inventory.

Construction Contracts

- 6.24 Where an entity holds assets as inventories for sale, distribution or use as defined in IPSAS 12, it will account for work-in-progress of these assets in accordance with IPSAS 12. However, in some cases an entity such as a works and services department may enter a contract to construct an asset for another entity. Where work in progress relates to a construction contract as defined in IPSAS 11 *Construction Contracts*, the work in progress should be accounted for in accordance with IPSAS 11. The cost of construction work in progress includes:
- costs that relate directly to the specific contract;
 - costs that are attributable to contract activity in general and can be allocated to the contract on a systematic and rational basis; and
 - such other costs as are specifically chargeable to the customer under the terms of the contract.

- 6.25 IPSAS 11 requires contract revenue and contract costs to be recognized as revenue and expenses by reference to the percentage of completion of the contract where this can be reliably estimated. The gross amount due from customers for contract work is recognized as an asset and the gross amount due to customers for contract work is recognized as a liability.

Receivables

- 6.26 Receivables consist of amounts owed to the entity by others, including other government entities and the public. Types of receivables include:
- interest receivable;
 - amounts due in relation to goods and services provided to others;
 - amounts due in relation to fines and penalties levied by the entity;
 - amounts due from another government entity or a different level of government in relation to non-reciprocal transfers to the entity; and
 - taxation receivables.
- 6.27 Prepayments are not receivables – however, unless they are material they are often presented together with receivables. At the end of the reporting period the entity may have paid for some services in advance of receiving or using the services (for example, rent may be paid one month in advance). In checking for the existence of prepayments, entities would need to review the terms and conditions of its agreements with suppliers.
- 6.28 This Chapter provides a brief discussion of some implementation issues associated with the initial recognition of receivables and the ongoing identification and review of receivables. The recognition points for related revenues are discussed in Chapters 8 and 14.

Receivables – Opening Balances

- 6.29 Determination of opening balances of accrued revenues and accounts receivable involves a thorough examination of all recorded amounts receivable. The entity needs to:
- compile an aggregate list of all recorded amounts receivable (the same process can be applied to short-term loans and advances and amounts receivable in relation to unpaid user fees and charges);
 - check that the amount recorded is correct and is not in dispute;
 - check that the item is legally enforceable. If it is not legally enforceable this may reduce the likelihood of collecting the amount owed;
 - assess the likelihood of recovering the amount owed – check that contact details for the individual or entity are correct and assess whether the individual or entity has sufficient funds to pay the amount owed;
 - in the case of amounts in dispute or where the individual or entity is experiencing financial difficulties or cannot easily be traced, the entity needs to consider whether it is

worth the cost of taking legal or other action to recover the amount owed. In some cases the entity may decide that it is not politically acceptable to recover an amount – this is sometimes the case with extremely old debts; and

- where a write-off, write-down or waiver is proposed, the entity needs to carry out any procedures required before such action, document the recommended action, record details of any approval obtained and update the financial records.

6.30 The entire process needs to be thoroughly documented to enable opening balances to be established and to provide an audit trail.

Receivables – Write-offs and Waivers

6.31 An entity needs to develop or review its policy and procedures on write-offs of receivables and waivers of amounts receivable, including:

- the circumstances in which they may occur;
- who has the authority to recommend the write-off or waiver;
- who has the authority to authorize the write-off or waiver;
- the type of proof or documentation required to support the recommendation;
- the documentation required to record the action; and
- any disclosure required (for example, there may be legislative disclosure requirements).

6.32 The type of proof or documentation required to support a recommendation for a write-off of a debt could include:

- debtor's name and details;
- details as to why the entity may need to write-off the debt; and
- due date for payment and number of days overdue.

6.33 The policy and procedures may need to set out the process to be followed for the initial review of balances, which may occur at a central level, and the ongoing review of balances, which should occur each year. Recorded amounts of balances owed can be significantly more than amounts likely to be collected. This is often the case where memorandum records of amounts owed have been recorded under a cash accounting system but there has been no regular review of amounts for collectability. Writing-off large amounts can be a politically sensitive issue. In order to help this process go smoothly it is helpful to obtain early approval for these policies and procedures. It is also helpful to ensure that elected and appointed representatives understand the process and the likely impact of the process.

6.34 Write-offs can occur in the following situations:

- an error in the original amount recorded;
- proven insolvency of the debtor;

- untraceable debtor;
- a change in government policy or a government directive; and
- administrative write-offs of small amounts. For example, amounts under a certain monetary threshold may not warrant further action.

6.35 Although an entity may have decided that an amount is not collectible and may have written it off in the financial statements, the entity has not forgone any legal rights to recover the amount. An entity may maintain memorandum records of amounts written-off that it intends to continue trying to collect.

Property, Plant and Equipment

6.36 The following topics in relation to property, plant and equipment are discussed below:

- the definition and recognition of property, plant and equipment;
- a list of steps in the initial recognition of property, plant and equipment;
- recognition thresholds for property, plant and equipment;
- identification of classes of property, plant and equipment;
- depreciation and useful life issues;
- asset management practices;
- asset registers and information systems requirements;
- valuation issues;
- financial statement issues;
- implementation issues and transitional provisions; and
- lessons learned.

Property, Plant and Equipment – Definition and Recognition

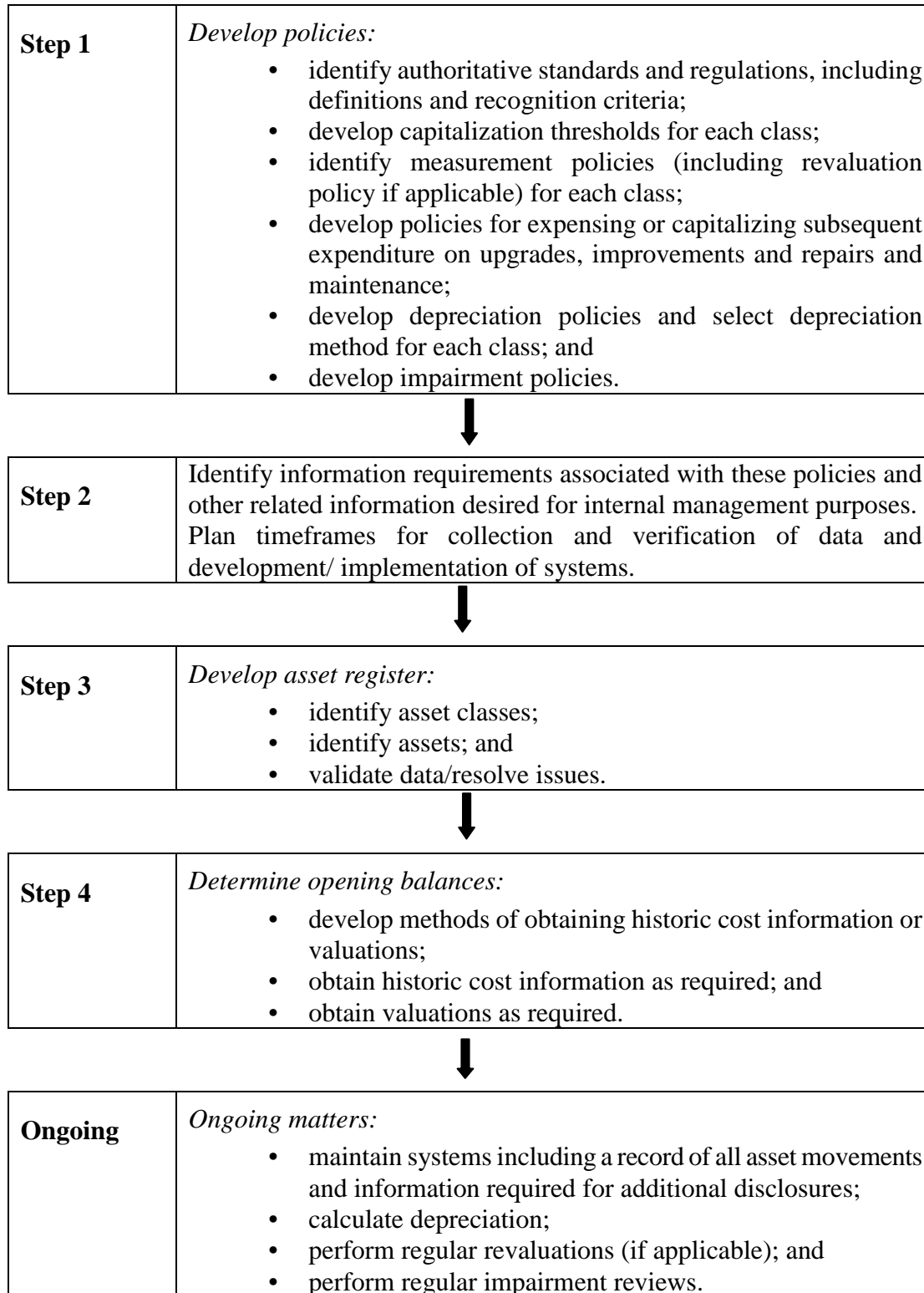
6.37 IPSAS 17, paragraph 12, defines property, plant and equipment as “tangible assets that: (a) are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one reporting period.” An item of property, plant and equipment will be recognized on the face of the financial statements as an asset when it is probable that benefits embodied in the asset will be realized and that the asset has a cost or other value that can be reliably measured. Before an item is recognized as property, plant and equipment for financial reporting purposes it must satisfy the definition of an asset and the definition of property, plant and equipment.

6.38 Items of property, plant and equipment meeting the definition but not the recognition criteria cannot be recognized within the financial statement totals. However, such items may meet the definition of contingent assets. A contingent asset is “a possible asset that arises from

past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity” (Exposure Draft of International Public Sector Accounting Standard IPSAS ED 21 *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 18). A contingent asset is disclosed where an inflow of economic benefits or service potential is probable.

- 6.39 The first step in the identification and recognition of property, plant and equipment is the preparation of an implementation plan. The implementation plan for initial recognition of assets and the development of systems to support ongoing accrual accounting for those assets may be a subset of the main implementation plan or a separate plan. The plan needs to identify:
- all the required tasks including development of policies, identification and valuation of assets and development of asset management policies and procedures;
 - the person/position responsible for each task;
 - the person/position responsible for management of this aspect of the plan;
 - project milestones and deadlines;
 - dependent items within the asset recognition plan and between asset recognition and other parts of the wider project; and
 - process and timeframe for resolution of issues.
- 6.40 The tasks likely to flow on from the implementation plan are set out in the diagram below. The steps outlined in this diagram can be applied to most types of non-current assets. Although the steps are shown sequentially, some of the steps could, and may need to, occur concurrently.

Figure 6.1 Recognition of Property, Plant and Equipment



- 6.41 Further discussion of some of the key steps outlined in the above diagram follows.
- 6.42 Step 3, the development of an asset register, will also involve a review of current systems and asset management practices. An entity will need to:
- decide whether to retain/modify existing asset records/systems or develop new systems;
 - decide whether an asset register is to be integrated with the general ledger;
 - design and implement systems;
 - decide which managers within the entity have responsibility for asset management; and
 - review/develop asset management practices.
- 6.43 The development of the asset register also involves:
- complete identification of all potential assets;
 - collection of data;
 - application of definitions of assets and property, plant and equipment;
 - application of recognition criteria;
 - application of capitalization thresholds;
 - verification of ownership where necessary;
 - identification of restrictions/covenants over ownership;
 - identification of asset classes and components;
 - assessment useful lives; and
 - validation of data (ongoing).
- 6.44 Step 4, the determination of opening balances, includes the collation of historic cost data and the valuation of any assets if they are to be measured at other than historic cost, as required by valuation policies. Collation of historic cost data includes the identification of all costs to make an asset operational and the estimation of historic cost where such actual historic cost is not available. The valuation of assets includes:
- deciding whether to value all assets or whether to use a sampling approach;
 - the identification of appropriate valuers for each class of asset;
 - the preparation of instructions for valuers;
 - the collection of information required by valuers; and
 - a management review of valuations.
- 6.45 The identification of opening balances for property, plant and equipment is merely the first step in the process of preparing accrual-based financial statements. Other steps are the:

- identification of closing balances
- identification of all movements during the period;
- calculation of depreciation;
- identification of audit issues and the development of plans to resolve these issues;
- development and testing of interfaces between the asset register and general ledger; and
- identification and collection of other asset information required to be disclosed in the financial statements.

Property, Plant and Equipment – Recognition Thresholds

Capitalization/Reporting Threshold

- 6.46 Each entity needs to determine the value above which assets are capitalized and reported in the financial statements. Assets below the relevant threshold are expensed in the period of purchase and those above the threshold are recognized as assets in the Statement of Financial Position. The use of capitalization thresholds reduces the cost of gathering data because it decreases the total number of fixed assets that have to be recorded and tracked. This saving to the entity must be considered in relation to the significance of the data to users of the financial statements. One method sometimes used by entities to set an initial capitalization threshold (sometimes referred to as the *de minimis* level) is to require that a certain percentage (for example, at least 95%) of estimated total assets by value are reported in the financial statements. This method requires that the entity is able to make a reasonable estimate of total assets. Different thresholds will be appropriate for different entities – although, for consolidation purposes the controlling entity will establish a level above which assets must be capitalized. Different thresholds may be established for different classes of assets.
- 6.47 Despite the use of capitalization thresholds for most classes of assets, an entity may still report all of a particular type of asset if it considers that this is appropriate. For example, an entity may choose to record and report all land, regardless of whether its recorded value is below the capitalization threshold.

Capitalization of Assets Below the Reporting Threshold

- 6.48 Some assets may have a lower value, per unit, than the capitalization threshold. However, such assets may be material as a group. In this case, the assets are generally recorded as a single group asset, with one combined value. Examples where the recognition of assets as a single group may be appropriate include:
- computer networks;
 - furniture and fittings;

- certain types of equipment; and
- professional libraries.

6.49 Despite the fact that such items may be recorded as a single asset in the financial systems, an entity is still able to monitor or control the use and maintenance of these assets via a subsidiary system. For example, each personal computer may be recorded as an element of the computer network.

Recording Threshold

6.50 An entity may choose to record certain items that fall below the capitalization/reporting threshold. In accordance with the capitalization policy, these items would be expensed when purchased. However, a description of the items and their location may be recorded. For example, these items may be bar-coded and recorded in a separate asset register. This type of recording is appropriate for items such as video recorders, scanners, fax machines, mobile telephones and certain tools. These items are sometimes referred to as “portable” items. Regular checks of such items, as part of the annual stocktake, can assist in better management of the items and reduce the risk of theft.

Capitalizing Upgrades and Improvements

6.51 In accordance with IPSAS 17, subsequent disbursements on property, plant and equipment are only recognized as an addition to an asset when the disbursement improves the condition of the asset, measured over its total life, beyond its most recently assessed standard of performance. A monetary (or other) threshold may also be applied to upgrades and improvements (note: this threshold does not have to be the same as the one used for the initial capitalization of the relevant asset). For example, an entity may decide to recognize any modification or enhancement that increases capacity or efficiency by more than 10%.

6.52 Any assets or components of assets which are replaced as part of an upgrade or improvement program need to be removed from the asset register and any other relevant records. Any residual carrying value for such assets or components would need to be written-off at that point.

6.53 The entity may need to develop guidelines and examples (and provide training) for managers with asset responsibility, illustrating the types of transactions that would normally be capitalized or expensed.

6.54 The following two diagrams summarize the application of capitalization thresholds to asset purchases and to spending subsequent to purchase.

Figure 6.2 Recording Threshold

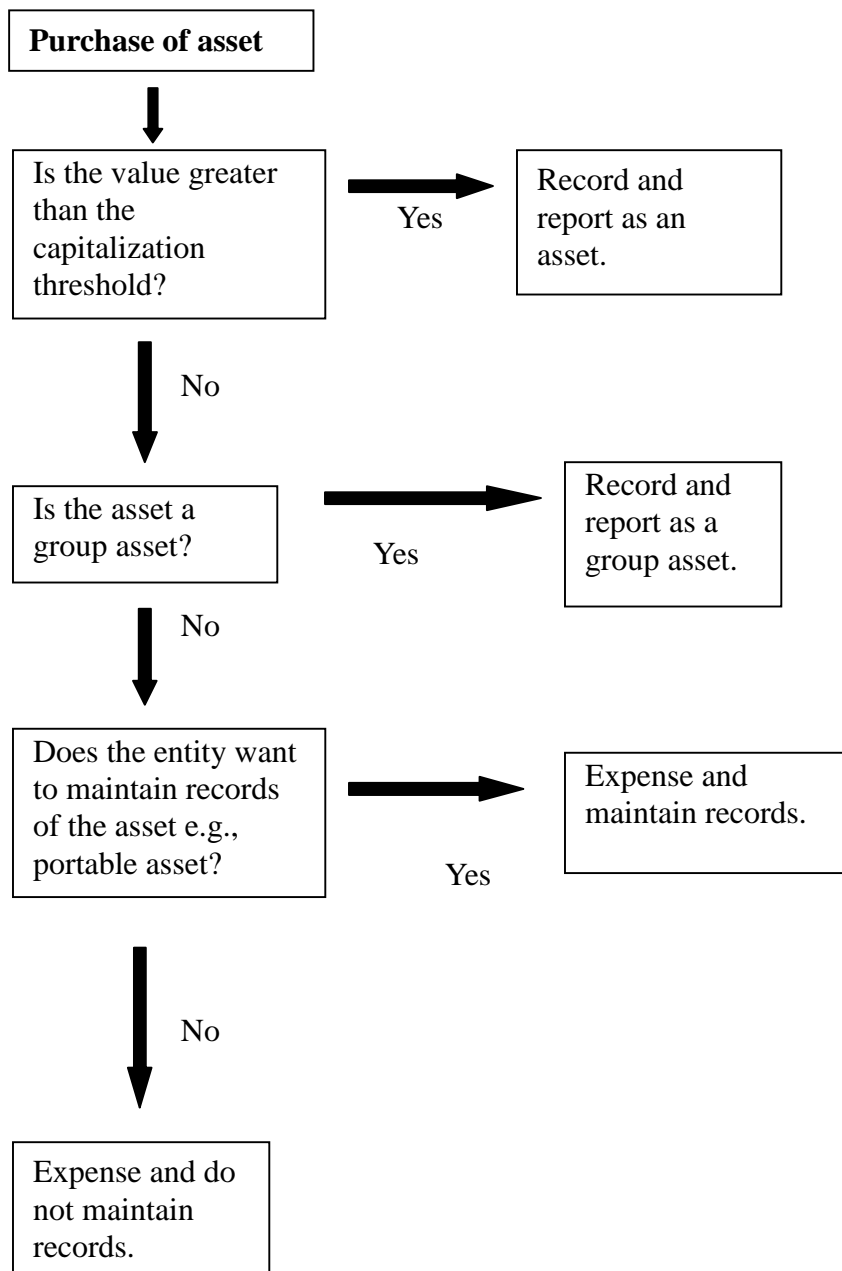
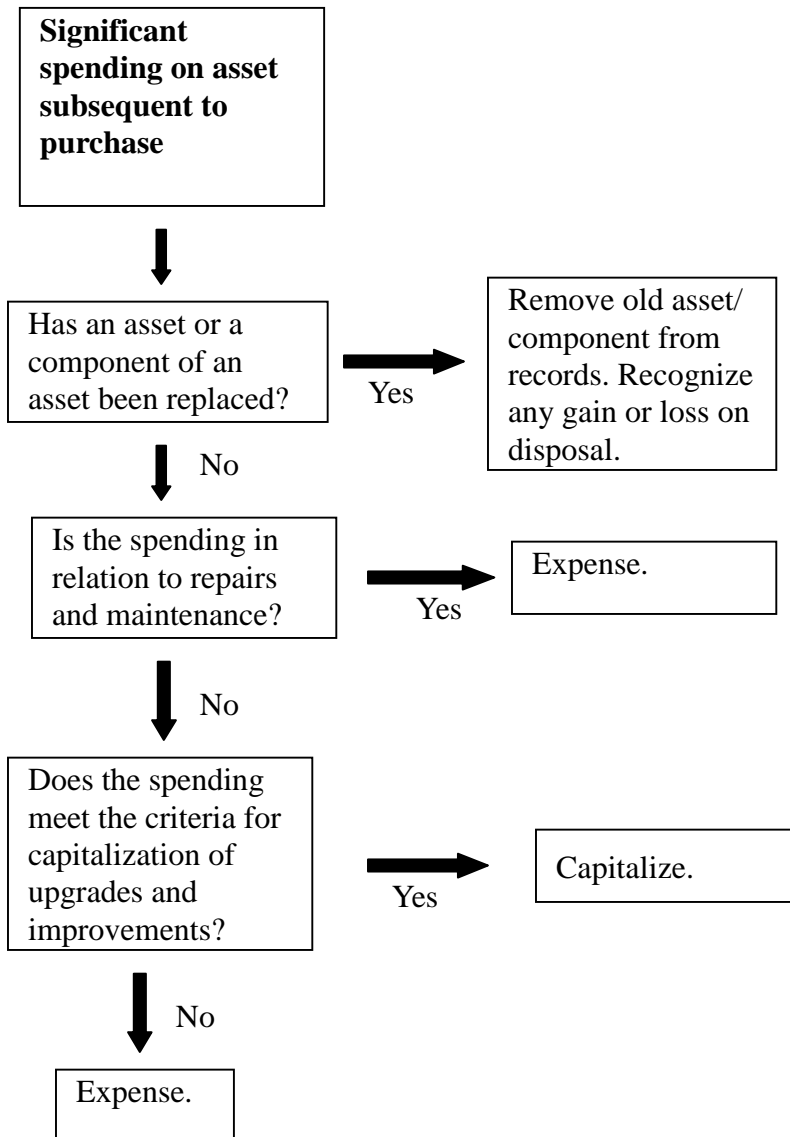


Figure 6.3 Capitalizing Upgrades and Improvements



Borrowing Costs

6.55 In accordance with International Public Sector Accounting Standard IPSAS 5 *Borrowing Costs*, borrowing costs that are incurred either can be recognized as an expense (benchmark treatment) or, where they have been incurred on a qualifying asset, can be capitalized (allowed alternative treatment). Qualifying assets are considered to be assets that because of their nature take a long period to get ready for their intended use or sale, for example, office buildings, hospitals and roads.

6.56 When the allowed alternative treatment is adopted by an entity, it should be applied consistently to all borrowing costs that are directly attributable to the acquisition, construction or production of all qualifying assets.

Property, Plant and Equipment – Identifying Asset Classes and Components

- 6.57 The following list from IPSAS 17 is a useful starting point in the identification of classes of property, plant and equipment:
- land;
 - operational buildings;
 - roads;
 - machinery;
 - electricity transmission networks;
 - ships;
 - aircraft;
 - specialist military equipment;
 - motor vehicles;
 - furniture and fixtures;
 - office equipment; and
 - oil rigs.
- 6.58 This list is not comprehensive. Other common assets for public sector entities include sewer systems, water and power supply systems, communication networks. In addition, an entity may decide to recognize the following as separate classes of assets:
- surplus assets;
 - obsolete items; and
 - assets acquired by way of finance lease.
- 6.59 IPSAS 17 does not require that an entity recognize heritage assets. However, an entity may choose to recognize heritage assets. Some jurisdictions distinguish between operational (for example, historic buildings used as office accommodation) and non-operational heritage assets (for example non functional bridges and buildings that have only historical significance). The specific classes of property, plant and equipment will vary between entities, depending upon the type of assets held and the materiality of particular types of assets. Each class of assets may also have sub-classes.
- 6.60 Some assets have a number of components. For example, the components of a water system may include the:
- pipes;
 - reservoirs;
 - pumping station; and

- service connections.
- 6.61 An entity needs to decide whether it is appropriate to recognize the components as separate assets or collectively as part of the larger asset. Components are accounted for as separate assets when they have useful lives that are different from those of the items of property, plant and equipment to which they relate. Provided the recognition criteria in IPSAS 17 are satisfied, replacement or renewal of a component is accounted for as the acquisition of a separate asset and the replaced asset is written-off. The recognition of components will be influenced by factors such as:
- the recognition threshold;
 - materiality (for example, whether the separate recognition of a component will have a material impact on depreciation);
 - whether the component performs a separate function; and
 - whether the component's useful life differs from that of other components.
- 6.62 As part of accounting for network or system assets an entity may need to:
- construct an asset management database;
 - identify appropriate components of the system or network;
 - ascertain the age and condition of the components;
 - assess the remaining useful life of existing asset components;
 - identify features of the component, for example type of surface or method of construction for a road;
 - identify the level of use that particular parts of the system or network are subject to;
 - establish a method for distinguishing between maintenance and upgrades or improvements for that component;
 - determine the valuation of assets for inclusion in the financial records;
 - calculate the amount of decline in service potential (depreciation) for the financial period;
 - plan for a cycle of inspection to check accuracy of records against actual conditions; and
 - link the underlying data to asset management plans, and link asset management plan information to the financial records and financial statements (that is, reconcile to general ledger information).

Property, Plant and Equipment – Assessment of Useful Lives

- 6.63 The useful life of an asset will vary depending upon the purpose for which the asset is used, the level of use, the nature and amount of maintenance and the climatic conditions. For example, the useful life of buildings is often shorter in tropical areas, due to the impact of

high humidity, than in temperate climates. Relevant sources of information for determining asset lives include:

- discussions with the people responsible for the use and maintenance of assets;
- the useful lives of similar assets used by other entities and jurisdictions (the useful lives of major classes of assets are disclosed in annual reports);
- past records of asset acquisition and disposal; and
- the useful lives implicit in the depreciation rates approved by taxation authorities for income determination. Although these figures are established for the purpose of determining taxable income for private sector business activities, they may nonetheless provide a useful starting point or point of comparison. However, useful lives approved by taxation authorities may be consistently lower than actual useful lives.

6.64 The following considerations may be helpful in deciding how much time and effort to spend assessing the useful lives of assets:

- Initial assessments of useful lives could be used for a set period and then reviewed.
- To what extent will the uncertainty regarding the useful life of an asset impact on depreciation expense and, if relevant, a charge for the use of capital?

6.65 Useful lives need to be reviewed periodically. For example, the existence of a large number of completely written-down assets still in use by an entity would indicate that the estimates of useful life are too short.

Property, Plant and Equipment – Asset Management Practices

6.66 A key factor in the development of asset management policies and procedures is “who will be responsible for the condition, use and performance of assets?” For example, some classes of assets may be centrally managed and individual operational managers may require little information about those assets. In other cases, responsibility for assets may be devolved to operational managers. In this case, each person with responsibility for asset management needs to know exactly what the responsibility entails and who has the authority to make changes to the accounting records.

6.67 Ideally, an entity will have asset policies and procedures that cover all aspects of asset management, including:

- general accounting procedures (refer below for examples);
- planning (for example, the development of policies on the provision of operational facilities and other staff amenities such as canteens and gyms);
- acquisition;
- operation (refer below for examples); and
- disposal.

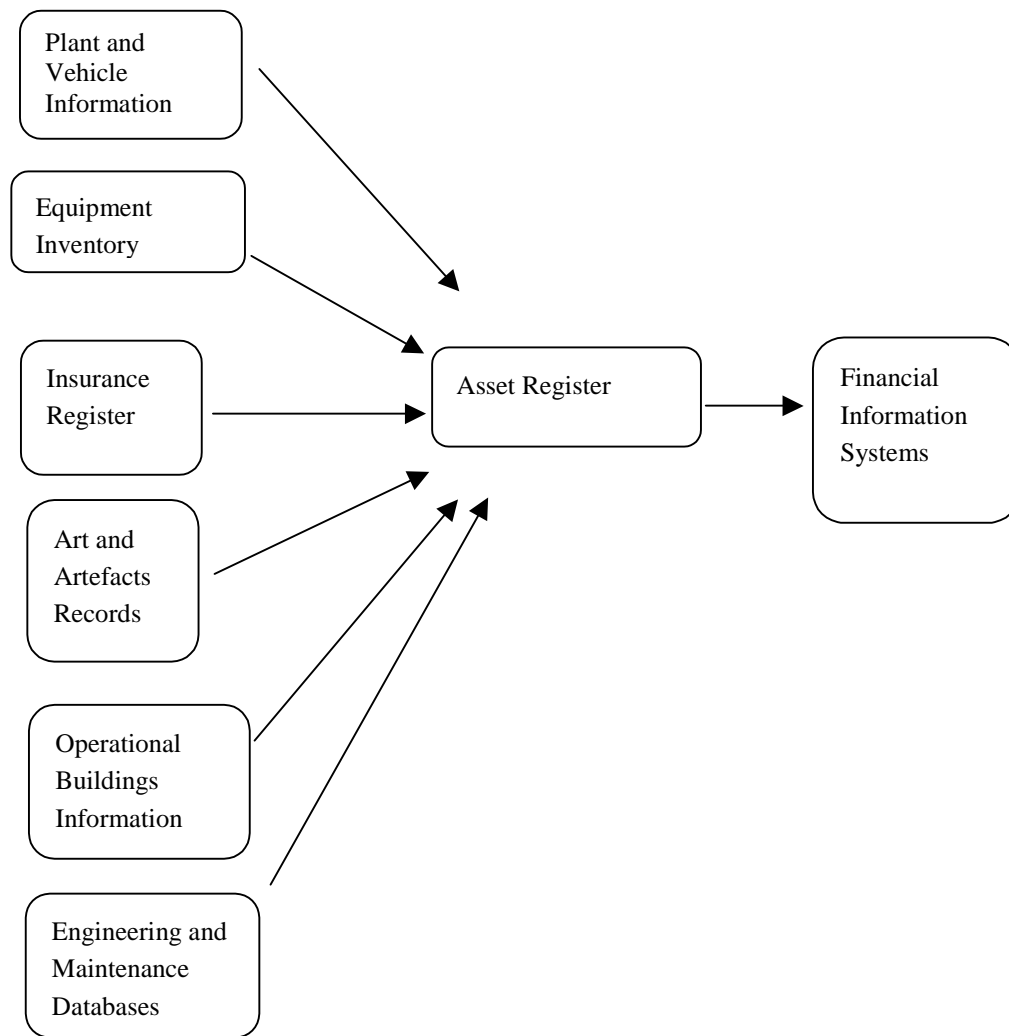
- 6.68 General accounting procedures for property, plant and equipment include:
- recording assets in fixed asset registers with an identifiable audit trail (for example a bar-coded sticker on each asset and unique reference numbers);
 - regular reconciliation of the asset register to general ledger balances;
 - annual management checks for existence, continuing use, remaining life, obsolescence;
 - annual reviews for impairment;
 - regular reviews of useful lives;
 - proper purchasing procedures to ensure that all additions are identified and recorded; and
 - proper sales or write-off procedures to ensure all disposals are managed and recorded.
- 6.69 Operating procedures for assets could include:
- establishing performance indicators (for example, levels of under-used space);
 - developing operation and maintenance plans (including cost maintenance priorities highlighting essential and urgent work);
 - procedures for monitoring the condition and use of assets;
 - developing maintenance plans;
 - tracking assets that are off-site, for example, transfers, loans and off-site repairs; and
 - safeguarding and protection of assets.
- 6.70 Not all of these policies and procedures need to be in place at the beginning of the transition to accrual accounting. Some of them will evolve as managers become more familiar with the impact of assets on financial reporting, and asset management issues. However, these policies and procedures have an impact on the type of asset management systems that are required and in particular, the structure and content of the asset register (refer next section). It is therefore helpful if they are considered (even if not developed) at an early stage of the transition.
- 6.71 The type of operating policies required also depends upon the extent of an entity's responsibility for asset management. Where procurement, maintenance and disposal functions are centrally managed, an entity will be responsible for following the procedures established by central entities rather than developing its own procedures.
- 6.72 In order to comply with IPSAS 17, adequate asset management plans or other appropriate information systems are necessary to reliably estimate the decline in service potential (depreciation), and to ensure reliable reporting of the carrying value of those assets.
- 6.73 In the absence of an asset management plan the following problems can occur:
- poor use of assets;

- failure to rationalize surplus assets;
- significant variation in running costs between locations;
- inadequate management information;
- deteriorating physical condition of stock; and/or
- continuing maintenance of uneconomic assets.

Property, Plant and Equipment – Asset Registers

- 6.74 An asset register is a complete and accurate list of assets owned by an entity that is regularly updated and validated. It records the opening and closing balances of classes of property, plant and equipment and is used to support the reported figures in the financial statements. The compilation of an asset register for property, plant and equipment is one of the major steps in the adoption of the accrual basis. It is a critical part of an asset management information system and will normally contain information beyond that required for financial reporting.
- 6.75 The size and complexity of an asset register will depend on:
- the number and type of assets held by the organization; and
 - the volume of purchases, transfers and disposals.
- 6.76 In its simplest form an asset register may be a manual document or a spreadsheet. Alternatively, it can be a computerized system that interfaces directly with the general ledger (most computerized accounting systems have this facility). However, an asset register does not have to be a single computerized system or document. It can be a series of sub-systems with linkages and a common directory. The design of an asset register will to a large extent be influenced by the content of existing asset management systems and databases.
- 6.77 The following diagram illustrates how a number of systems can link to form an asset register.

Figure 6.4 Asset Register



6.78 Key issues in the design and development of an asset register are:

- what information does it need to contain; and
- should it be integrated with the general ledger/other systems?

6.79 For each asset, an effective asset register needs to contain the following details (where applicable):

- name of asset;
- physical description;
- serial number;
- date of acquisition (purchase, creation, donation, forfeiture);
- location;

- person/position responsible for custody and maintenance of asset;
- due date for replacement;
- expected useful life:
 - original life;
 - expired life; and
 - remaining life;
- date asset life last reviewed;
- any evidence of impairment;
- historic cost or valuation (initially if known and subsequently as valuations are completed);
- depreciation method and rate (once determined);
- book value; and
- date of disposal.

6.80 An asset register could also contain (or be linked to) other relevant information such as insurance details and planned maintenance. Features of a good asset register include:

- asset data is updated as transactions and events occur;
- the data is regularly reconciled with acquisition data, any subsidiary systems and the general ledger;
- the data is readily available to asset managers, at the level of detail they require, preferably “on-line”; and
- the data is structured to allow different classifications of assets to be distinguished.

6.81 Possible sources of data for asset registers include:

- existing asset lists and systems (details of vehicles and computer equipment are often available);
- insurance lists;
- lists of properties where the entity pays property taxes, electricity, water or other utilities; and
- information on land and buildings held by government entities responsible for cleaning or maintenance.

6.82 These records can often be the starting point for the compilation of an asset register. These sources of data may be used as the primary data or used to reconcile information held on assets within different systems. It is essential, however, that at some point these records are checked for accuracy and completeness. Such records will not generally have been an

integral part of the accounting system, and they may have been updated periodically rather than as transactions occurred.

- 6.83 In compiling the initial list of assets, it is often helpful to reconcile information in various systems with each other and with financial records. Where the information in a fixed asset register is drawn from a number of different systems, it is essential that the underlying records for all items are reliable. In order to be able to rely on the information in existing systems, details of additions and disposals must have been correctly recorded in preceding years. Errors identified in existing systems need to be resolved and corrected. If the accuracy and completeness of existing systems is in doubt, complete or partial stocktakes will be required. Poorly performed stocktakes do not provide reliable information. It is important to get this step right, or, in order to get reliable information and a clean audit opinion, it will need to be done again.
- 6.84 Once accrual accounting has been adopted, stocktakes need to be performed regularly. Cyclical coverage of assets can vary between types of assets depending upon their risk profiles and degree of physical security. Not all stocktakes need to be performed manually. It is possible to purchase or design software that performs automated stocktakes of information technology equipment attached to a local area or other network. The following illustrates how a department developed stocktaking instructions which were clear and thoroughly explained to those involved.

Illustration Clarifying and Communicating Stocktaking Instructions

Department A had established a computerized asset register. However, the data in the asset register was not very accurate and resulted in an audit qualification. To resolve the problem the department conducted a complete stocktake of all fixed assets and re-entered all the asset data. In order to ensure that the stocktake resulted in the collection of complete and accurate data, the department created teams of experienced staff, led by an accountant. The stocktake instructions were re-drafted so that they were clearly understood by all people participating in the stocktake. As part of the process, the department made a video showing people how to perform the stocktake. The video showed all types of equipment held by the department, described the name and function of each piece of equipment and showed the location of the serial number.

- 6.85 Ownership of assets, especially land, needs to be checked and resolved. Items that may need special attention include:
- land requisitioned for a particular purpose but never returned to the original owners;
 - forfeited assets (which may or may not belong to the entity); and
 - donated assets and assets held in trust (which may include assets owned by the entity but required to be used for a particular purpose).
- 6.86 Where there are problems with the accuracy of data (for example, quantity, location, age), or ownership cannot be immediately resolved, options include:

- loading the data into the asset register (together with information on the issues to be resolved) and clearly flagging the issue; and
 - noting the discrepancies and referring the issue to more specialized staff (for example, legal advisers) for resolution.
- 6.87 At the stage that the entity begins to collect information for the asset register, the software and systems to be used to account for fixed assets may not have been selected or designed. Ideally, information would be collected in a form compatible with the software. Even in the absence of such decisions, it is still possible to compile the basic data required for the asset register. At some point, asset register information may need to be transferred from one format to another. The benefits of making early progress on the asset register need to be compared to the likely time and cost of transferring information into a different system.
- 6.88 An asset register may be compiled in stages. The first stage may consist of compiling a list of all property, plant and equipment controlled by the reporting entity. This information can be collected prior to the finalization of accounting policies, as valuation and measurement issues can be resolved at the second stage. In addition, where information on particular classes of assets is difficult to obtain or determining control will be difficult, the collection of information on such assets can be treated as a separate exercise. Alternatively, identification and valuation can proceed on a class-by-class basis.

Integration of Asset Registers with the General Ledger

- 6.89 Asset registers may be separate systems or they may be integrated with the general ledger and other systems. If they are separate, then information from the asset register needs to be periodically transferred (using a manual or computerized interface) into the general ledger for the preparation of the financial statements. If the asset register is integrated with the general ledger, then the opening and closing balance information can automatically flow through into the general ledger, and automatic journal entries for depreciation can be created.
- 6.90 Integration of the asset register with other systems has clear advantages. For example, integration of the asset register with the purchasing, capital planning, preventative maintenance, accounts payable (to capture acquisitions) and general ledger systems:
- minimizes manual intervention;
 - reduces the possibility of corruption of data, or error;
 - reduces the number of reconciliations required;
 - prevents duplicate data entry and processing; and
 - allows journals for depreciation and asset revaluations to be automatically generated.
- 6.91 An asset register may also be integrated with the human resource management information system. This allows the tracking of employee possession of attractive and portable items.
- 6.92 However, during the initial stages of implementation, an entity may be constrained by the nature of existing systems and the time and cost to re-design or replace these systems.

Manual or computer interfaces between existing systems and the general ledger will therefore be required. Such interfaces are a potential source of errors, not least the possibility that not all data on assets may be transferred. In order to avoid problems arising from interfaces, careful design, training and testing are required.

Validation of Asset Registers

- 6.93 Validation of asset registers involves conducting checks to show that the information in the register is complete and accurate as at a certain date. Compilation of a register can take one to two years, and during that time assets will have been acquired, enhanced and disposed of. Validation of figures to be used for opening balances is therefore required. Lists of additions, enhancements, and disposals should be generated and centrally reviewed for reasonableness. Validation is also required on an ongoing basis.
- 6.94 In most cases, there will be some asset movements (additions, enhancements and disposals) between the original valuation and loading of information into the asset register and the reporting date.
- 6.95 Methods of validating figures to be used for opening balances include:
- for land and buildings – documenting the source of information and procedures followed to establish the completeness of the records; and
 - for other fixed assets – circulating information held on the asset register to employees responsible for physical custody of assets asking for confirmation of the accuracy and completeness of the records.
- 6.96 Good validation procedures include:
- assigning responsibility for validation of information on each class of assets to one person/position;
 - ensuring that physical existence checks are conducted by staff independent of those responsible for custody of the assets;
 - requiring written confirmation of any amendments;
 - requiring written statements confirming the accuracy of asset register information (subject to any amendments provided);
 - retaining records of any adjustments made to the asset register following receipt of proposed amendments; and
 - keeping records of which parts of the register have been validated and the dates on which the data was validated.
- 6.97 If it is not possible to conduct all verifications at the reporting date, it would be prudent to confirm the acceptability of a phased program of verification with the external auditor.

- 6.98 Due to time constraints, an entity may initially omit some immaterial categories of assets from the asset register. Subsequently, these assets will need to be identified (by component), valued, entered into the asset register and recognized in the financial statements. The subsequent recognition of such assets will generally lead to both an increase in assets and net assets/equity.

Asset Registers – Summary

- 6.99 The following key points will be useful for entities developing an asset register:
- If preparing for converting to accrual accounting, start collecting basic information on assets immediately, even if this information is simply collected on a spreadsheet.
 - Make sure stocktake instructions are clear and thoroughly explained to those conducting the stocktake.
 - Start small – it is better to create a simple but workable asset register which has the minimum data required for all assets than to attempt and never finish a more complex register.
 - Communicate with users to make sure registers are usable and used.
 - Provide training for users of the asset management systems and asset register – a slow take up by users requires follow up action.
 - Allow sufficient time for researching proof of ownership, including reconciling historical documents of ownership to more recent records – this task can be very time consuming.
 - Establish a process for dealing with assets where ownership is disputed or cannot be resolved prior to reporting date.
 - Remember to develop systems to track items (such as major components/spare parts) that are owned by the entity but are held by contractors for the repair, overhaul or modification of assets.
 - Properties identified for disposal must be checked to ensure that they are valued in accordance with the policy on valuation of properties for disposal.
 - Do not spend more to obtain information than the information is worth.

Property, Plant and Equipment – Valuing Assets

- 6.100 IPSAS 17 deals with both the initial measurement of property, plant and equipment and measurement subsequent to recognition. Valuations may be required at the time of initial recognition where the item's cost cannot be determined reliably, or is not relevant. IPSAS 17 requires the item to be valued at cost as at the date it is acquired. Where an asset is acquired at no or nominal cost, its cost is its fair value. Fair value is defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction” (IPSAS 17, paragraph 12). The relevant method will depend upon the circumstances. For example, different valuation methods are usually applied to

items that will continue to be used and items that have been identified as surplus or otherwise intended for disposal. Valuation methods that may be relevant in assessing fair value include:

- open market value;
- market-based value; and
- depreciated replacement cost.

6.101 The International Valuation Standards Committee issues internationally accepted valuation standards. These standards seek compatibility with International Financial Reporting Standards (IFRSs) (formerly International Accounting Standards (IASs)) and include references to relevant IFRSs.

6.102 Steps in valuing assets include:

- develop valuation policies, including the valuation method, for each class of asset;
- decide whether assets within those classes are to be valued;
- prepare instructions for valuers;
- collate information required by valuers;
- select valuers; and
- perform management review of valuations.

Valuation Policies

6.103 The following example of an accounting policy illustrates the use of valuations in the determination of opening balances.

Example: Accounting Policy – Initial Recognition of Property, Plant and Equipment

Items purchased or acquired before [date] or whose cost cannot be determined or is not reliable, are to be recorded at depreciated replacement cost (adjusted to take into account any major differences between the actual asset and the replacement asset). That is, the depreciated replacement cost is to be based on the estimated present cost of constructing the existing component of the asset by the same or (similar method) of construction.

6.104 In some cases, the original cost of the item may be available but significant development work may have been carried out since that date. For example, aircraft may have significant capitalized development costs. If original contract details for this work are not available, valuations of parts and estimations of development costs can be used to determine opening balances.

Full Population or Sample

- 6.105 It is possible to use stratified sampling when establishing the value of assets. This method was used in New Zealand for the valuation of archived material.

Instructions for Valuers

- 6.106 Valuers require detailed instructions as to the valuation policies and specific details of assets to be valued. An example of the considerations which should be taken into account when compiling detailed instructions for valuers is contained in the United Kingdom National Audit Office's *Resource Accounts: Preparing for Audit* (United Kingdom National Audit Office, November 1997). In particular, it is important to be aware that the effectiveness of a valuation exercise will be largely dependent upon the quality of the instructions.
- 6.107 Suggestions for developing instructions for valuers include:
- requiring valuers to establish the completeness of the list of assets at a given site;
 - requiring valuers to provide a value and an estimated useful life for each asset;
 - using a relatively low capitalization threshold for valuations and applying this threshold to gross values (as opposed to net values). The threshold used in the asset register can be higher than this, but sufficient data is required to make an informed judgment;
 - being explicit about whether valuations are to include or exclude relevant taxes or duties; and
 - stating which set of professional valuation guidelines is applicable.

Information Required by Valuers

- 6.108 The data required by valuers for land is likely to include:
- area;
 - ownership and title;
 - planning consents and agreements;
 - restrictive covenants, easements and rights of way;
 - use(s); and
 - access.
- 6.109 The data required by valuers for buildings is likely to include:
- type of building, roof and heating system;
 - year of construction;
 - gross external area;
 - net internal area;

- number of stories;
- estimated replacement cost for insurance purposes;
- condition surveys; and
- maintenance records and expenditure.

Selection of Valuers

- 6.110 Qualified external valuers are generally used to obtain reliable and independent valuations. However, the cost of obtaining valuations may mean that internal staff may be used to value some assets. The use of internal staff may be more appropriate where computer-based models, price indices and catalogues are being used to obtain approximations of historic cost or current value. Where internal staff are used to perform valuations, it is important that the valuations are in full accordance with the best practice followed by firms of professional valuers and that sound audit trails (including references to price indices and catalogues used) are established.

Management Review of Valuations

- 6.111 Management is still responsible for the accuracy of valuations, even when performed by external valuers. Before valuations are entered into asset registers, management therefore needs to review them for completeness and reasonableness. Management should document that this review has occurred, any issues identified and subsequent action taken. Some of the problems that can arise include:
- assets not owned by the entity being included in the entity's records;
 - assets owned by the entity not being included; and
 - assets identified as being held for disposal being valued on a continuing use basis.
- 6.112 Reconciliation between management records, the asset register and valuations is a useful check to ensure that all assets owned have been valued and that all assets valued are indeed owned. Evidence of such reconciliations is important audit evidence.
- 6.113 After the valuation data has been inserted in the asset register, only those transactions that took place after the valuation date should be reflected in the asset register. Subsequent valuations should be reviewed for consistency. Copies of valuation reports form supporting documentation for opening balances.

Examples of Approximations

- 6.114 Where historic cost is the valuation method adopted, but such information is not available for each asset, valuations are normally required to determine opening balances. The transitional provisions of IPSAS 17 allow entities to recognize property, plant and equipment at cost or fair value at the date of its acquisition. Some jurisdictions have adopted such methods of

estimating historic cost, for example, one jurisdiction has developed a computer-based model that will provide an estimate of historic cost for real property and infrastructure assets.

- 6.115 Where valuations are used to establish opening balances of assets, depreciated replacement cost of an asset may be established by reference to the buying price of a similar asset in an active and liquid market. Depreciated replacement cost may be approximated by using historic cost updated by price indices (and depreciated to reflect remaining useful life), or by using prices in current catalogues.
- 6.116 Another method of reducing the time and effort required in obtaining opening balances is to extrapolate values obtained from external valuers to assets not included in the valuation exercise. It would be prudent to obtain the views of the external auditors on the use of this method beforehand.

Property, Plant and Equipment – Financial Statement Issues – External Audits

- 6.117 This section considers how an entity can ensure that it is well prepared for an external audit. The main objective of this Study is to provide practical guidance to entities intending to report on an accrual basis, and intending to adopt IPSASs as part of that process. Many of the entities using this guidance will also have the objective of preparing external financial statements that receive an unqualified audit opinion. In order to help entities reap the benefits of the work they have put into the transition, this section discusses a selection of audit issues associated with property, plant and equipment. Although the focus is on property, plant and equipment, some of the discussion is also applicable to other areas. This section is not comprehensive. It is intended to provide examples of the types of planning and preparation that may be required to attain the goal of an unqualified audit opinion.
- 6.118 There are a number of steps that management and staff can take to help the audit go smoothly and to minimize the risk of a disclaimer or a qualified audit report. They include:
- understanding the auditor’s objectives;
 - maintaining audit trails;
 - having supporting information and schedules ready; and
 - being aware of common audit issues and taking steps to avoid their occurrence.
- 6.119 An auditor is interested in assessing whether the entity’s systems, controls, validations and management reviews provide assurance regarding the following general audit objectives:
- completeness – there are no unrecorded assets, events or other undisclosed items relating to assets;
 - existence – the asset exists at a given date;
 - rights and obligations – the asset properly pertains to the entity at a given date;
 - valuation – the asset is recorded at an appropriate carrying value; and

- presentation and disclosure – an item is disclosed, classified and described in accordance with the applicable accounting standards/regulations.

6.120 An audit trail consists of a positive set of links for each transaction or balance from source to account, and back. It is the ability to track from the financial statements back through the prime accounting records to the underlying transactions and events (and back again) so that management and the auditor may substantiate the individual account figures. Audit trails include the use of control totals and trail data when obtaining information from other computerized systems, and the use of documentation to support all decisions and assumptions. Examples of audit trails and system controls can be found in auditing textbooks and in-house system manuals. See for example United States Defense Finance and Accounting Service (1998).

6.121 Supporting schedules required for the preparation and audit of the financial statements include:

- a copy of the asset register by asset category;
- a reconciliation of opening and closing balances of each class of asset;
- a copy of the stocktake procedures and the stocktake report;
- a reconciliation of the stocktake report to the asset register;
- a list of write-offs/write-downs;
- a schedule of spending subsequent to purchase showing which spending has been capitalized in accordance with the policy on capitalization;
- a schedule of any revenue or expense to be recognized in the statement resulting from the sale of assets; and
- valuation reports, where applicable, including the basis, date and name and qualifications of the valuer.

6.122 An entity can expect an auditor to verify:

- selected opening balances:
 - historic costs or other appropriate cost base; and
 - useful life and amortization policy;
- selected acquisitions, disposals, repairs and maintenance expenses, write-downs and write-offs during the period; and
- the depreciation or amortization charge for selected assets.

6.123 In addition, the auditor will require a discussion of the methodology used, by asset class, to identify and value opening balances, and will be checking that regular reconciliations between the asset register and general ledger are performed.

Opening Balances

- 6.124 Evidence to support opening balances of assets can be provided by way of the following documents and procedures:
- a reconciliation of the initial asset register totals to valuation reports;
 - copies of confirmations from asset holders that asset registers are accurate and complete;
 - a record of adjustments made to the asset register following review by asset holders;
 - lists of fixed asset additions, enhancements and disposals, with documentation of validation procedures performed on them; and
 - reasonableness checks on depreciation and revaluation (to include comparisons with any prior period figures available).
- 6.125 Opening balances need to:
- be recognized and valued according to the chosen accounting policies;
 - be accurately entered into the accounting system;
 - be consistent with any figures brought forward from the cash-based accounts, for example, suspense accounts;
 - have clearly identifiable, documented sources;
 - have evidence of management review for ownership, accuracy and completeness; and
 - have evidence of physical verification, where appropriate.

Financial Statement Disclosures

- 6.126 An entity will need to ensure that its financial systems and records can provide the information required in order to meet the disclosure requirements of accounting standards, to monitor and assess potential financial risks associated with assets (for example, environmental clean up costs) and to provide data for voluntary disclosures.
- 6.127 Examples of disclosures required by accounting standards include:
- any class of property, plant and equipment not recognized under the transitional provisions in IPSAS 17;
 - the existence and amounts of restrictions on title for property, plant and equipment pledged as securities for liabilities (IPSAS 1);
 - the amount of disbursements on property, plant and equipment in the course of construction (IPSAS 11); and
 - the amount of commitments for the acquisition of property, plant and equipment (IPSAS 1).
- 6.128 Additional asset disclosures could include:

Transition to the Accrual Basis of Accounting

- any properties where dangerous/toxic substances are associated with the land or the buildings (refer to Chapter 7 for a discussion of contaminated land and landfill sites); and
- any rights or obligations that attach to ownership or occupation and will transfer with the properties.

6.129 In addition to those disclosures required by accounting standards, an entity may choose to disclose:

- physical descriptions of certain assets (for example state highways, national forests, recognized and unrecognized mineral deposits); and
- descriptions of heritage assets.

Problems Identified During Audit

6.130 Issues that have been identified by auditors, across a range of jurisdictions, include:

- physical stocktakes not being performed according to instructions (including breach of internal control by using staff with responsibility for assets to perform the stocktakes);
- deficiencies in stocktake procedures and unresolved discrepancies;
- items that form part of a larger asset (for example, a building) being recorded as single assets rather than as a series of components. This can lead to the age and condition of components being misstated as the components may have been upgraded or replaced since initial recognition of the assets;
- poor implementation of bar coding and scanning;
- stickers used for recording asset register references on assets such as furniture and equipment being incorrect or not visible;
- policies, procedures, and training not being in place to ensure the sustainability of the asset register (or components of it);
- assets being recorded at incorrect locations;
- depreciation rates and useful lives not reviewed regularly (leading to large numbers of assets fully depreciated despite having future value);
- acquisitions and disposals not recorded in a timely manner in asset registers or not processed in the general ledger;
- missing disposal documentation;
- lack of documentation to support the figures in the asset register;
- figures presented for audit not subjected to any prior management review;
- incomplete data on dates of acquisition (required for depreciation calculations);
- asset registers not regularly reconciled to subsidiary records; and
- asset registers not regularly reconciled to the general ledger.

- 6.131 This list shows that, although difficulties in valuation may be perceived as the major audit issue, poor implementation of stocktakes, incomplete documentation and a lack of regular reconciliations are just as likely to lead to an audit qualification.

Property, Plant and Equipment – Transitional Provisions

- 6.132 IPSAS 17 recognizes that due to the amount of work involved in identifying and obtaining the cost or valuation of all categories of property, plant and equipment, some entities may wish to recognize categories of assets progressively. It therefore provides a temporary provision for an entity to recognize some, but not all classes of property, plant and equipment. The provision is available for a maximum of five years from the date of adoption of accrual accounting in accordance with IPSASs. In addition, IPSAS 17 does not require entities to recognize heritage assets, nor does it require entities to apply the normal measurement requirements if entities elect to recognize heritage assets.

Property, Plant and Equipment – Lessons Learned

- 6.133 General lessons learned regarding the recognition of assets include the following:
- Start early – sufficient lead – time is critical.
 - Obtain support from all concerned.
 - Work very closely with auditors.
 - Be prepared to make some mistakes.
 - Be pragmatic.
 - The process is evolutionary.
 - Phased recognition of classes of assets has both advantages and disadvantages.
 - Integrated systems avoid a number of audit issues arising from interfaces.
 - Ensure there is a good audit trail including documentation for estimates and assumptions.

Relevance to the Cash Basis of Accounting

- 6.134 The issues identified in this Chapter are relevant for entities intending to comply with any future IPSAS based on IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* if they wish to provide additional note disclosure on the nature and amount of various categories of assets. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the primary financial statements.

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Appendix: Accounting Policies

This Appendix illustrates examples of accounting policies for inventories, receivables, bad debts and write-offs, and property, plant and equipment. These policies are examples of policies that might be developed by a central entity for application by all individual entities forming part of a whole-of-government reporting entity. The policies are consistent with the requirements of IPSAS 12 and IPSAS 17. However, it is possible that other policies that are consistent with these standards could also be developed. The policy for property, plant and equipment does not take advantage of any of the transitional provisions in IPSAS 17. The main choice available to entities under IPSAS 17 is whether to measure assets at depreciated historic cost or at fair value. The policy illustrated uses initial cost, with subsequent revaluations to fair value for certain assets.

Inventory – Measurement, Cost Assignment

In accordance with International Public Sector Accounting Standard IPSAS 12 *Inventories*, inventories are to be measured at the lower of cost and net realizable value (NRV) on an item-by-item or group basis¹. Inventories held for distribution at no charge, or for a nominal charge, are to be measured at the lower of cost and current replacement cost.

When inventories are sold or consumed, the carrying amount of those inventories is to be recognized as an expense in the period in which the related revenue is recognized.

The amount of any write-down of inventories to NRV (due to obsolescence, damage, or other reasons) and all losses of inventories are to be recognized as an expense in the period the write-down or loss occurs.

Costs are to be assigned to inventories using specific identification or FIFO as appropriate.

Inventory – Work in Progress

Work in progress is to be measured at the lower of cost and NRV.

Where work in progress of an entity relates to the provision of non-capital items or services, work in progress is to be determined on the basis of costs to date based on the stage of completion. Accurate records of work in progress will therefore require an auditable costing system to track costs, including records of labor input, overhead absorption rates and additional direct costs.

Receivables

Receivables relating to goods and services are to be recognized at the time goods or services are provided, in accordance with the policies on revenue recognition. The raising of an invoice, assessment or any other obligation to pay usually evidences the recognition of an account receivable. Amounts invoiced to clients where the entity has not yet provided the goods or services, are to be recognized as both accounts receivable and unearned revenue. All accounts receivable are to be recorded at the amounts expected to be ultimately collected.

¹ IPSAS 12 does not deal with work in progress of services which are to be distributed for no or nominal consideration directly in return from the recipients. The entity is not expected to have any such services. However, if such services do occur, the costs of producing the service are to be expensed as they occur.

Receivables relating to non-exchange revenues are to be recognized in accordance with the policy on recognition of the relevant non-exchange revenue.

Interest receivable is to be recognized in accordance with the policy on recognition of interest revenue.

Bad and Doubtful Debts

All bad debts are to be written-off and an adequate provision is to be made for doubtful debts.

Bad debts are to be written-off as soon as the entity becomes aware that the amount is unlikely to be collected in full. Where the bad debt was previously provided for as a doubtful debt, the bad debt is to be written-off against the provision. Where the bad debt was not previously provided for, the bad debt is to be expensed.

If, at any time, the debt is recovered, the write-off is to be reversed.

Property, Plant and Equipment – Recognition

Items of property, plant and equipment that meet the recognition criteria for assets and have a value greater than [*each entity to select an appropriate amount having regard to materiality*] are capitalized and depreciated in accordance with International Public Sector Accounting Standard IPSAS 17 *Property, Plant and Equipment*.

Property, Plant and Equipment – Cost

Items of property, plant and equipment are initially to be recorded at cost.

On initial application of IPSAS 17, assets not previously recognized are to be recognized either at cost where cost is considered to be relevant, or in other cases at their fair value as at the date of first recognition.

The cost of an item of property, plant and equipment includes:

- the purchase price (including relevant taxes and duties, less trade discounts and rebates); and
- the directly attributable costs of bringing the asset to working condition for its intended use (including the cost of site preparation, initial delivery and handling costs, installation costs, professional fees such as for architects and engineers, and the estimated cost of dismantling the asset and restoring the site if required).

Self-constructed plant and equipment is accounted for in accordance with IPSAS 17 as follows:

- the cost of materials, labor and other inputs used during the construction process is obtained from transactions with parties external to the entity;
- the cost of abnormal amounts of wasted material, labor or other resources is not included in the cost of the asset; and

- administration and other general overhead costs are not included unless they can be directly attributed to the construction of the asset or bringing it to its working condition.

Property, Plant and Equipment – Following Acquisition

Following acquisition, property, plant and equipment is accounted for in accordance with IPSAS 17 as follows:

- recorded at cost (less any accumulated depreciation and any accumulated impairment loss) or revalued amount (fair value at date of revaluation less any subsequent accumulated depreciation and any accumulated impairment loss);
- reviewed regularly for evidence of impairment;
- subsequent expenditure is capitalized only when it is probable that future economic benefits or service potential over the total life of the asset (in excess of the most recently assessed standard of performance of the existing asset), will flow to the entity. All other subsequent disbursements are recognized as expenses in the period in which they are incurred; and
- gains or losses arising from the retirement or disposal of an item are accounted for as gains and losses on disposal of non-current assets.

Property, Plant and Equipment – Revaluation

Land, buildings, leasehold improvements and infrastructure are to be revalued every five years except where more frequent valuations are necessary to comply with IPSAS 17. Other assets are not to be revalued.

Revaluations are to be accounted for in accordance with IPSAS 17 as follows:

- entire classes of assets are to be revalued;
- revaluations are to be made with sufficient regularity that the carrying amount does not differ from that which would be determined using fair value at the reporting date;
- valuations are to be undertaken by registered valuers [*reporting entities will list registered valuers as appropriate for each class*];
- where no market value exists, value is to be assessed in relation to other similar assets or depreciated replacement cost;
- any accumulated depreciation in respect of the class of assets is first credited to the assets to which it relates;
- a revaluation increase for a class of assets is directly credited to an asset revaluation reserve (except that a revaluation increase is recognized as revenue to the extent that it reverses a revaluation decrease of the same class of assets previously recognized as an expense);
- a revaluation decrease for a class of assets is recognized as an expense (although a decrease should be charged directly against any related revaluation surplus to the extent

that the decrease does not exceed the amount held in the revaluation surplus in respect of that same class of assets); and

- revaluation increases and decreases relating to individual assets *within a class* of property, plant and equipment are offset against one another within that class (but are not offset in respect of assets in different classes).

The initial recognition of an item of property, plant and equipment at its fair value, in the absence of a determinable or reliable cost, does not constitute a revaluation.

Property, Plant and Equipment – Infrastructure Assets

Each component of an infrastructure asset with a materially different useful life from other components is accounted for as a separate asset and depreciated over its useful life.

Where the initial cost of construction is not known, a proxy such as depreciated replacement cost is to be used.

In common with other classes of property, plant and equipment, infrastructure assets are revalued in accordance with IPSAS 17.

Property, Plant and Equipment – Leased Assets

Assets acquired under finance leases are accounted for in accordance with International Public Sector Accounting Standard IPSAS 13 *Leases*. They are recognized as assets. The associated lease obligations are recognized as liabilities. Leased assets are depreciated in the same manner as other similar assets owned by the entity.

The assets (and liabilities) are recognized at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments.

Assets leased by way of an operating lease are accounted for in accordance with IPSAS 13.

Property, Plant and Equipment – Heritage Assets

Heritage assets are not required to be recognized under the provisions of IPSAS 17. Where an entity does recognize heritage assets it is not required to apply the measurement requirements of IPSAS 17. However, where an entity recognizes and measures heritage assets, it is required to make disclosures in accordance with IPSAS 17.

CHAPTER 7: LIABILITIES

Key Points

- At the time of writing, International Public Sector Accounting Standards IPSASs (and Exposure Drafts) dealing with the recognition, measurement or disclosure of liabilities are:
 - International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements*;
 - International Public Sector Accounting Standard IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* (the reporting of liabilities denominated in foreign currencies);
 - International Public Sector Accounting Standard IPSAS 9 *Revenue from Exchange Transactions* (accounting for unearned revenue);
 - International Public Sector Accounting Standard IPSAS 13 *Leases* (liabilities associated with leased assets);
 - International Public Sector Accounting Standard IPSAS 15 *Financial Instruments: Disclosure and Presentation* (financial instruments); and
 - Exposure Draft International Public Sector Accounting Standard IPSAS ED 21 *Provisions, Contingent Liabilities and Contingent Assets Arising From Exchange Transactions* (liabilities of uncertain timing and amount, potential liabilities and liabilities not meeting the criteria for recognition).
- Liability topics for which IPSASs are currently not developed include:
 - recognition and measurement of financial instruments (discussed in Chapter 11);
 - payables associated with non-exchange revenue (discussed in Chapter 14);
 - provisions and contingent liabilities arising from non-exchange transactions (discussed in Chapter 14);
 - employee benefit liabilities (discussed in Chapter 12); and
 - social policy obligations arising from non-exchange transactions (discussed in Chapter 13).
- This Chapter discusses implementation issues associated with the adoption of accrual accounting for accounts payable and accrued expenses, debt, accrued interest, currency issued and environmental liabilities. (Illustrative accounting policies that might be adopted for certain classes of liabilities are included as an Appendix to the Chapters of this Study that deal with specific types of liabilities.)
- The nature of existing systems and the assessment of the completeness and accuracy of information within those systems will affect the amount of work required to determine opening balances and establish systems that support reporting on an accrual basis.

Introduction

- 7.1 IPSAS 1, paragraph 6, defines liabilities as “present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.” Liabilities are recognized for financial reporting purposes when the definition of a liability and the recognition criteria for liabilities (probability and measurability) are satisfied.
- 7.2 IPSAS 1 has implications for the classification of liabilities. It requires the disclosure of:
- taxes and transfers payable;
 - payables under exchange transactions;
 - provisions;
 - non-current liabilities; and
 - further sub-classification of line items presented on the face of the financial statements.
- 7.3 The liability classifications required by an entity will depend on the types of liabilities that the entity incurs. In some cases, central organizations or the controlling entity may assume responsibility for certain liabilities. A national government is likely to have the following types of liabilities:
- accounts payable arising from the purchases of goods and services;
 - accrued interest payable;
 - accrued salaries and wages;
 - accrued vested vacation pay or other accrued compensated absences;
 - employee pension obligations and other accrued employee benefits, including any accrued termination benefits;
 - amounts payable under guarantees and indemnities (where sufficient evidence is available to indicate that it is more likely than not that the amounts will be payable);
 - liabilities relating to unearned revenues;
 - transfer payments payable;
 - lease obligations related to finance leases;
 - bank loans and other short-term borrowings;
 - long-term debt (both to the private sector and to other government entities);
 - environmental liabilities; and
 - obligations under accident compensation schemes.
- 7.4 At a whole-of-government level, debt and borrowings and unfunded pension liabilities are likely to be the most significant non-current liabilities. Within individual public sector

entities, employee-related liabilities and provisions may be the most significant non-current liabilities.

- 7.5 The amount of work required to recognize liabilities depends on the extent to which an entity already has information available on those liabilities. General steps in the recognition of liabilities include:
- compiling a list of all types of liabilities incurred by the entity;
 - determining the categories of liabilities that will be used in the chart of accounts and the financial statements;
 - preparing accounting policies for each category;
 - assessing the accuracy and completeness of existing information on each category;
 - compiling accurate opening balances for each category (identification, application of the definition of a liability, and measurement); and
 - establishing systems to support the ongoing requirements of accrual accounting.
- 7.6 This Chapter discusses implementation issues associated with the adoption of accrual accounting for:
- accounts payable and accrued expenses;
 - debt and accrued interest;
 - currency issued; and
 - environmental liabilities.
- 7.7 Liabilities are also discussed in other Chapters as follows:
- accruals for employee-related expenses, including salary and wages, vacation leave and pension obligations (Chapter 12 *Employee-Related Liabilities*); and
 - transfers payable and other social policy obligations (Chapter 13 *Liabilities Arising from Social Policy Obligations*).
- 7.8 In common with the International Accounting Standards (IASs) on which they are based, IPSASs do not specifically address issues associated with Islamic financial services that do not fit with the notions in IPSAS 15 *Financial Instruments: Presentation and Disclosure*. For example, while IPSAS 15 may apply to a range of contracts or components of contracts that arise within Islamic law, its requirements regarding disclosure of interest will not be relevant. The Accounting and Auditing Organization for Islamic Financial Institutions prepares accounting standards for Islamic financial institutions. These standards are regarded as complementing IASs in areas where IASs are insufficient to meet the Islamic Law requirements to which Islamic financial institutions adhere in their business transactions.

Accounts Payable and Accrued Expenses

- 7.9 Accounts payable (also referred to as creditors) consist of amounts owed by the entity to others, including other government entities and the public. Types of accounts payables include:
- those which occur when goods and services have been purchased on credit, and an invoice has been received (or the amount is payable under the terms of an ongoing contract or agreement) but not paid as at the end of the period such as the purchase of office equipment;
 - amounts due to individuals in relation to non-exchange transfers such as welfare benefits; and
 - amounts due to other government entities or different levels of government in relation to non-exchange transfers such as grants.
- 7.10 Accrued expenses arise when goods and services have been purchased on credit from other parties during the period, and an invoice has not been received as at the end of the period or the amount is not yet due to be paid under the terms of a contract or agreement. Accrued expenses often have separate codes in the chart of accounts, but for purposes of disclosure in the financial statements they are often aggregated with accounts payable.
- 7.11 Determination of opening balances of accounts payable and accrued expenses involves a thorough examination of all ongoing expenses. The entity needs to:
- compile a list of all recorded amounts payable;
 - check that the amounts recorded for specific transactions are correct;
 - check that the recorded amounts are complete – this may involve seeking confirmation from regular suppliers; and
 - review all expenses to see if there are likely to be accrued expenses at period end.
- 7.12 The process followed needs to be documented to enable opening balances to be established and to provide an audit trail.

Debt and Accrued Interest

- 7.13 This section outlines key issues in accounting for debt and debt servicing costs on an accrual basis. Some of the issues discussed in this section are not directly linked to the adoption of accrual accounting. However, the adoption of accrual accounting is often linked to a review of debt management policies and procedures and other changes designed to improve the management of public debt.
- 7.14 Debt is a form of liability that represents money borrowed from individuals, banks or other institutions. The terms used to describe debt securities and other forms of borrowing vary across jurisdictions. Some of the terms used are shown in the table below.

Interest bearing/non-interest bearing	Indicates whether the security bears interest.
Marketable/non-marketable securities	Indicates whether the securities may be traded in financial markets or whether the holder has to keep the security until maturity.
Bills	Short-term obligations. Depending upon the jurisdiction the term may be up to one year or up to 90 days.
Notes	Medium-term obligations. Depending upon the jurisdiction the term may be between one year and ten years. In some jurisdictions notes may be used to describe securities with a term of less than one year.
Bonds/debentures	Long-term obligations. Depending upon the jurisdiction, the term may be more than 10 years. In some jurisdictions bonds/debentures may be any security over one year. They give the holder the unconditional right to a fixed or contractually determined variable money income in the form of coupon payments and/or a stated fixed sum on a specified date or dates when the security is redeemed.
Loans and advances	These may include loans and advances from other levels of government, other governments, multi-lateral and bi-lateral agencies and bank loans.

- 7.15 Bonds or debentures may have regular interest or coupon payments, they may be “zero-coupon” or they may have an inflation-adjusted premium payable on maturity. They may be issued at a premium or a discount.

Information Available Prior to the Transition

- 7.16 The amount of work required to recognize debt and debt servicing costs on an accrual basis will depend on an entity’s existing basis of accounting used for financial reporting and existing systems. For example, governments reporting on the modified accrual basis may already account for debt and interest expense in accordance with the accrual basis. Governments reporting on the cash basis will not recognize debt as a liability, but they normally have some system to record debt transactions and manage debt. The nature and reliability of these systems can vary immensely. Types or aspects of systems which may be used to record and manage debt transactions and balances include:
- manual records. These may include details of the initial debt, scheduled repayments, the current balance outstanding, dates interest is due, currencies, terms and conditions. Manual records may suffice where debt consists solely of loans and advances and there are a limited number of such obligations;
 - spreadsheets incorporating the details listed in the above bullet point. The spreadsheets may also perform interest calculations and be used to generate cash flow budgets;

Transition to the Accrual Basis of Accounting

- the general ledger of an accounting system. This may be used to record some debt transactions (refer also the section on systems below);
- specific software developed to maintain and forecast debt service requirements under the cash basis. These packages may link to other software applications that assist jurisdictions to monitor the sustainability of their debt (for example, the World Bank's Debt Sustainability Model). Such systems may or may not have the capability to integrate borrowing and investments to obtain consolidated cash flows; and
- treasury and cash management systems that can be used to manage both the debt and all the cash flows of a government. Such systems may also be able to generate the accounting entries required under cash accounting or accrual accounting (both modified historic cost and mark-to-market). Governments using such systems could be managing their debt portfolio on a mark-to-market basis while reporting on a cash basis.

7.17 Entities therefore need to identify:

- the requirements associated with reporting on the accrual basis;
- the information available from and the capabilities of their existing systems;
- the differences between what is required and what is available; and
- possible solutions, which may involve modifying existing systems or developing new systems.

7.18 The adoption of accrual accounting has a number of implications for the calculation of debt servicing costs, including the following:

- the calculation of interest expense (including accrued interest) becomes more complex. For example, the accrued interest on bonds is generally calculated on a yield-to-maturity basis.
- the discount is usually amortized over the term of the instrument and is recognized as an additional debt servicing expense. By contrast, under cash accounting the discount on issue of debt securities may be excluded from debt servicing costs and shown as a below the line adjustment to the recorded level of gross debt, or recognized in the accounts on the day of issue.
- premiums payable on redemption of index-linked bonds are recognized as a debt servicing expense over the life of the instrument. Under the cash basis, such premiums are not generally treated as debt servicing costs.
- the date of issue of debt has a much greater impact on the calculation of interest. This has implications for preparing and monitoring accrual budgets.
- where a government has foreign currency debt, the gains and losses arising as a result of currency movements on that debt will impact directly upon the Statement of Financial Performance. A risky portfolio will lead to increased volatility in the Statement of Financial Performance.

- 7.19 Entities adopting accrual accounting need to assess the completeness and accuracy of existing information. The purpose of the evaluation is to determine whether existing information is sufficiently accurate to provide information on opening balances. In addition, the evaluation should provide an indication of the extent to which systems operating under the existing basis of accounting correctly record transactions and events during the period. As a starting point, the accuracy and completeness of the following will need to be assessed:
- amount borrowed (including premium or discount on issue), repaid and still outstanding;
 - dates for repayment of principal or redemption of instruments;
 - interest rates and dates/coupon rates and dates;
 - the existence of index-adjusted instruments and the likely impact of such changes on the final amount to be repaid; and
 - the currency in which debt is repayable.
- 7.20 This step is more important where manual systems or a number of systems have been used to record information, particularly where controlled entities have the authority to borrow. A review of existing systems and the specification of functionality requirements for future systems (as discussed below) is also required.

Review of Systems

- 7.21 In preparing for the adoption of accrual accounting, entities using the cash basis should review all existing systems to determine the extent to which existing systems can be adapted to meet the needs of accrual accounting. If this is not possible, new systems will be required. Entities using the cash basis may have, or be considering purchasing, an entity management system with some of the standard accounting modules such as purchasing, order entry, payables, receivables, payroll and general ledger. Such systems may also offer a “treasury” module. If such modules meet all the functionality requirements, they have the advantages of fully integrated systems. However, to the extent that they do not provide this functionality (for example risk management) or capture all the relevant transaction flows, interfaces with other systems would need to be developed.
- 7.22 The other alternative is to purchase a separate treasury/debt management system. Most treasury/debt management systems can generate accounting entries and then use an interface to incorporate those entries into the general ledger.
- 7.23 The costs and balances (assets and liabilities) associated with running the debt management activity itself may be recorded in a separate system.

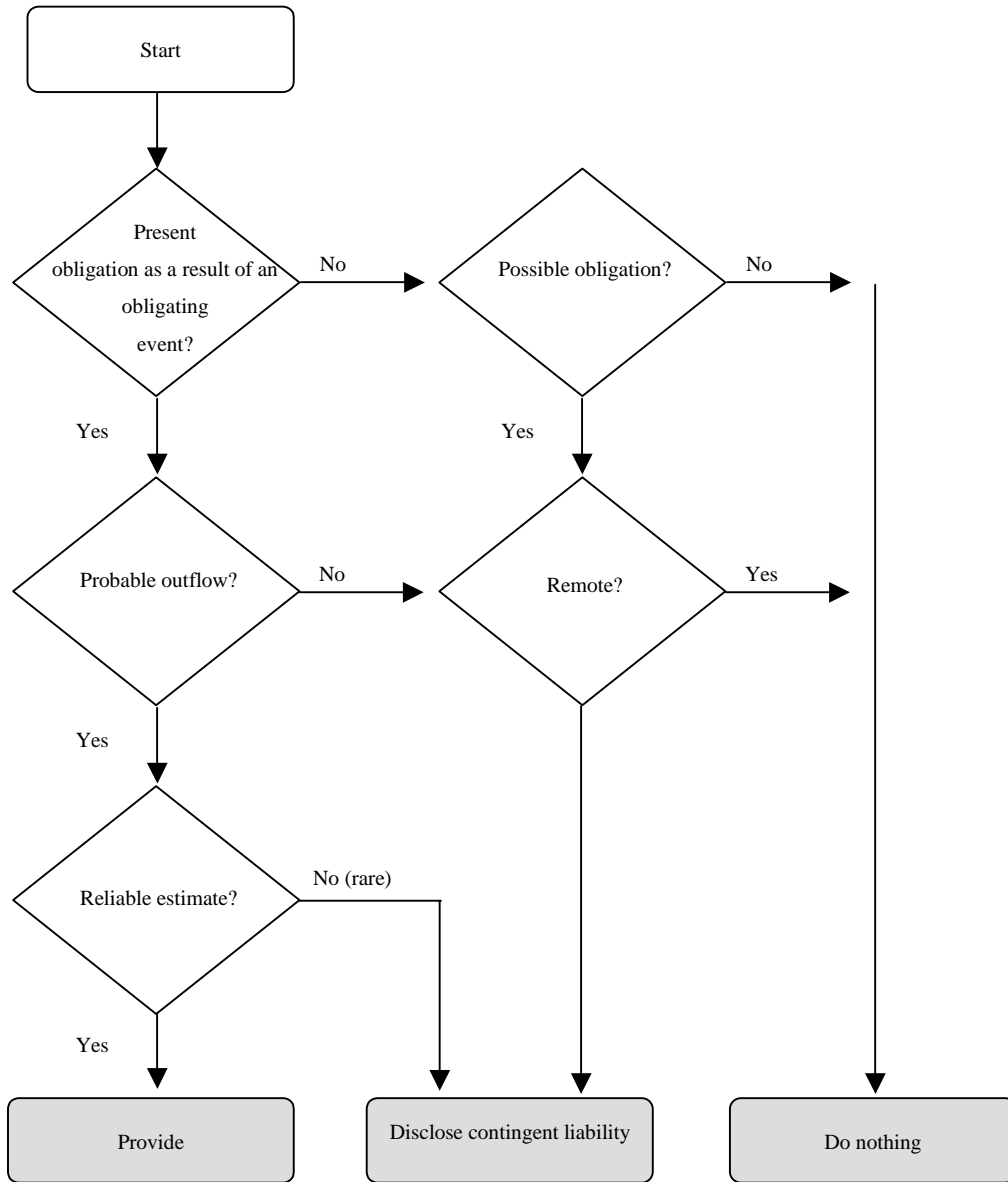
Development of Accounting Policies for Debt and Borrowings

- 7.24 Before debt is recognized as a liability it must:
- meet the definition of a liability;
 - be probable that an outflow of benefits will be required; and

- be capable of reliable measurement.

7.25 Items not meeting these criteria may meet the definition of a contingent liability. Contingent liabilities are defined in Exposure Draft IPSAS ED 21. Contingent liabilities are not recognized. Details of contingent liabilities are disclosed in the notes to the financial statements. In accordance with Exposure Draft IPSAS ED 21, paragraph 38, “If it becomes probable that an outflow of future economic benefits or service potential will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).”

Figure 7.1 Decision Tree – Recognition of Provisions



- 7.26 The decision tree in Figure 7.1 summarizes the main recognition requirements of the standards for provisions and contingent liabilities that fall within the scope of Exposure Draft IPSAS ED 21. The decision tree does not form part of the standards and should be read in the context of the full text of the standards. In some cases, it is not clear whether there is a present obligation. In these cases, Exposure Draft IPSAS ED 21 explains that a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the reporting date. The decision tree indicates that if an outflow is not probable then disclosure of a contingent liability is required unless the probability of an outflow is remote, in which case the entity neither recognizes a provision nor discloses a contingent liability.
- 7.27 IPSAS 15 contains requirements regarding the disclosure and presentation of financial instruments (discussed further in Chapter 11). However, there is no specific IPSAS dealing with the recognition and measurement of debt. In the absence of an IPSAS, entities will need to identify authoritative sources of guidance. International Accounting Standard IAS 39, *Financial Instruments: Recognition and Measurement* is one possible source of such guidance.
- 7.28 IAS 39 is likely to be updated and may be replaced by a more comprehensive standard at some time in the future. As discussed later in Chapter 11, a group of international and national standard setters has prepared a *Draft Standard* outlining proposals for a more comprehensive standard (Financial Instruments Joint Working Group, December 2000).
- 7.29 The major issue regarding domestic currency liabilities is whether they should be measured at face value (cost less principal repayments and amortization) or fair value (market values). The Joint Working Group *Draft Standard*, referred to in paragraph 7.28 above, proposes measurement of virtually all financial instruments at fair values.
- 7.30 If international and national standard setters adopt the proposals in the Joint Working Group *Draft Standard* the proposals could have a significant impact on the accounting policies used for external financial reporting of financial instruments, including debt. However, as mark-to-market information is commonly used to manage debt portfolios, the implications for debt management systems may be far less (many entities currently recognize debt on a cost basis and disclose fair values as additional information). Although at the time of writing, these proposals are still at a consultation stage, when considering the functionality requirements for debt management systems it would be prudent to allow for the generation of accounting entries on a mark-to-market basis.

Premiums and Discounts on Issue

- 7.31 Discounts/premiums arising on the issue of a debt instrument are generally treated as an increase/decrease in the cost of borrowing. Discounts and premiums are recognized in the Statement of Financial Position on issue (government securities are measured at their nominal value adjusted for the unamortized portion of the premium or discount on issue). Unamortized premiums are added to the reported amount and unamortized discounts are subtracted from the reported amount.

- 7.32 Discounts/premiums are generally amortized over the period of the instrument on a yield-to-maturity basis (for floating rate debt instruments the amortization may be over the first interest period).

Accrued Interest

- 7.33 For the purpose of financial reporting under the accrual basis, interest is calculated as it is incurred. This includes interest which is due and payable, as well as the amount of interest which would be payable if interest were required to be settled at the reporting date. A brief summary of the relevant method of calculation is provided below.

Interest on deposits, loans	Multiply the relevant rate of interest by the principal outstanding for the reporting period.
Interest on bills and similar short-term instruments	The difference between the face value and the price paid at the time of issue (i.e. the discount) measures the interest payable over the life of the bill. Interest is measured on a yield-to-maturity basis.
Interest on bonds and debentures	<p>For ordinary bonds interest expense is the accrued portion of the coupon payment due.</p> <p>For zero-coupon bonds interest expense is the difference between the redemption price and the issue price. Interest is calculated on a yield-to-maturity basis.</p> <p>For index-linked bonds the change in the value of the principal outstanding between the beginning and the end of a particular reporting period due to the movement in the relevant index is treated as interest accruing in that period, in addition to any interest due.</p>

- 7.34 Entities reviewing their accounting policies and systems as part of the move to accrual accounting may also wish to review the method of compiling data for statistical systems such as the System of National Accounts (SNA) and the European System of Accounts (ESA). There has been some debate regarding the method of calculating interest within statistical systems. Details of this debate, including the various options (the debtor approach, the acquisition approach and the creditor approach) and some responses by various countries, are outlined in *Accrual Recording of Interest: Is There a Case for Revising the 1993 SNA?* (IMF, 1999).

Derivatives

- 7.35 Financial derivatives used by debt managers include interest rate swaps and cross-currency swaps. Interest rate swaps allow debt managers to adjust the debt portfolio's exposure to interest rates; for example, by synthetically converting a fixed rate obligation into a floating

rate one. Similarly, a cross-currency swap can be used to synthetically change the currency exposure of a debt obligation. Accounting for derivatives is discussed in Chapter 11 *Financial Instruments*.

Traded Debt

- 7.36 Where debt instruments are traded, they are frequently recorded at fair (market) value. Entities with traded debt may need to identify the portfolio of debt instruments that are traded to enable the correct accounting policy to be applied.

Currency Issued

- 7.37 While no IPSAS addresses this issue, “currency issued” is often recorded. The revenue received from issuing currency may be referred to as “seigniorage”. Where the central bank, often called a “reserve” or “federal” bank, forms part of the reporting entity, currency issued may be recorded as a liability, although this varies across jurisdictions. The rationale for this treatment is that it is similar to banks recording deposits as liabilities.
- 7.38 Entities adopting accrual accounting will therefore need to:
- determine whether the central bank forms part of the consolidated reporting entity;
 - decide whether to recognize a liability for issued currency and, if this approach is adopted, obtain accurate information regarding the opening balance of issued currency;
 - decide whether interest earned on the proceeds of currency will be separately classified; and
 - ensure that the chart of accounts includes relevant codes.

Environmental Liabilities

- 7.39 This section addresses accounting issues associated with certain types of environmental obligations. Depending upon the nature of the obligation and the legislative environment within which a jurisdiction operates, these obligations may meet the definition of a provision. Guidance on accounting for provisions (other than those arising from social policy obligations) is found in Exposure Draft IPSAS ED 21. Environmental risks or obligations include:
- landfills;
 - other contaminated sites; and
 - other obligations.
- 7.40 Under accrual accounting all environmental obligations that meet the definition and recognition criteria for liabilities should be recognized. This involves:
- identification of the nature of any possible obligation or risk;

- identification by the entity of possible obligations and the source of those obligations; and
- identification of possible/probable future cash flows and the factors influencing the size and timing of those cash flows. For example, clean up costs will be influenced by the possible types of action to address a problem (removal, containment or redemption) and the current technology available.

7.41 Determination of the obligating event can be a difficult issue for some environmental obligations. Obligations may be legal or constructive. Legal obligations can be evidenced by legislative requirements and legally enforceable contracts. A constructive obligation is defined in Exposure Draft IPSAS ED 21, paragraph 18, 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.*

7.42 In the absence of a legal obligation, an entity needs to try and determine whether there is sufficient evidence to indicate the existence of a constructive obligation.

Landfills

7.43 Entities may have a constructive or legal obligation under statute to avoid, remedy, or mitigate the environmental effects of landfills. There may be requirements regarding standards for the day-to-day operation of landfills, requirements for closure and post-closure care. Post-closure care can require monitoring the site for up to 30 years after closure, the costs of which can be significant.

7.44 Recognition of landfill obligations would involve measuring the liability based on the expenditure required to settle the obligation at reporting date (taking into account the time value of money).

7.45 An entity will need to maintain data on landfills in order to assess the likely timing and amount of future obligations. Relevant data includes:

- adequate identification to permit the site to be located;
- a description of the landfill closure and post-closure care requirements;
- the basis of recognition and measurement of the liability;
- the reported liability for closure and post-closure care at the reporting date, the estimated total cost of closure and post-closure care, and the amount remaining to be recognized;
- the remaining capacity of the site and the estimated remaining landfill life in years;
- the estimated length of time needed for post-closure care; and
- costs incurred to date, by year.

Other Contaminated Sites

- 7.46 Entities may be responsible for managing contaminated sites. Contamination may be caused by the following:
- asbestos remediation;
 - old gasworks sites;
 - meat processing sites;
 - timber treatment plants;
 - quarries;
 - sawmills;
 - garbage disposal sites (other than landfills);
 - pesticide and poison storage sites;
 - effluent treatment and disposal; and
 - fuel storage and retail sites.
- 7.47 Depending upon the nature of the obligation to clean up and manage a contaminated site, the actual or probable costs may be accounted for as a liability or a contingent liability.

Other Environmental Obligations

- 7.48 Other types of possible environmental obligations include stormwater drainage and treatment, sewage treatment, contaminated water supply, erosion protection, and coastal hazards. Each of these issues needs to be researched to determine whether it is appropriate to:
- recognize the costs when incurred;
 - recognize a liability; or
 - disclose a contingent liability.

Register of Contaminated Sites

- 7.49 An entity will need to maintain a record of contaminated land in order to manage the sites and to assure auditors that it is monitoring any liabilities (actual and potential) arising from such contamination. This information (often referred to as a register) is an important tool in managing the clean-up of sites.
- 7.50 Information that may be required in relation to land that is contaminated or has associated liabilities includes:
- adequate identification to permit the site to be located;
 - description of contamination or suspected contamination;

- action plan for site restoration or monitoring;
- estimated cost for further monitoring or restoration (including dates of estimates and assumptions underlying the estimates);
- classification as liability or contingent liability (and assumptions or facts supporting the classification); and
- costs incurred to date, by year.

Debt Management Objectives

- 7.51 Although the adoption of accrual accounting is not required in order to initiate a review of debt management objectives and practices, it is often a catalyst for such a review. The establishment or review of debt management objectives is appropriate prior to the introduction of accrual accounting as it may have implications for systems and accounting policies. For example, the debt management objectives may mean that the debt portfolio is to be managed on a mark-to-market basis. If the debt is to be formally reported on a modified historic cost basis, the systems chosen should be able to cope with both bases of accounting.
- 7.52 Debt management objectives are influenced by a government's public policy framework (that is, the government's monetary, fiscal and exchange rate policies) and the government's risk management framework. Examples of risks associated with debt portfolios include market risk, funding risk, credit risk, liquidity risk, portfolio concentration risk and operational risk. Debt management objectives and the risk management framework may have implications for the most appropriate organizational structure and systems.
- 7.53 The main objective of public debt management is to ensure that the government's financing needs and its payment obligations are met at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk. Other examples of objectives include developing a domestic debt market and maintaining certain percentages of foreign currency debt in specified currencies.
- 7.54 In order to assist countries in their efforts to reduce financial vulnerability, the International Monetary Fund and the World Bank, in cooperation with national debt managers, have developed a set of guidelines on public debt management. *The Guidelines for Public Debt Management* (IMF and World Bank, 2001) are designed to assist policy makers in considering reforms to strengthen the quality of their public debt management and reduce their country's vulnerability to international financial shocks. They seek to identify areas in which there is broad agreement on what generally constitutes sound practices in public debt management. They focus on principles applicable to a wide range of countries at different stages of development and with various institutional structures of national debt management. The Guidelines should assist policy advisers and decision-makers involved in designing debt management reforms. They include discussion of risk management frameworks.

Review of Organizational Structure and Internal Controls

- 7.55 Although a review of organizational structure and internal controls is not strictly required in order to adopt accrual accounting, both of these factors can have an impact on the efficiency of operations, the reliability of information produced and the potential for fraud. On a broad level the entity must determine who has responsibility for the management and reporting of all types of liabilities. The issues associated with management of internal operations are outlined in the following extract from *The Guidelines for Public Debt Management* (IMF and World Bank, 2001, page, 17).

33. Risks of government losses from inadequate operational controls should be managed according to sound business practices, including well-articulated responsibilities for staff, and clear monitoring and control policies and reporting arrangements. Operational risk, due to inadequate controls and policy breaches, can entail large losses to the government and tarnish the reputation of debt managers. Sound risk monitoring and control practices are essential to reduce operational risk.

34. Operational responsibility for debt management is generally separated into front and back offices with distinct functions and accountabilities, and separate reporting lines. The front office is typically responsible for executing transactions in financial markets, including the management of auctions and other forms of borrowing, and all other funding operations. It is important to ensure that the individual executing a market transaction and the one responsible for entering the transaction into the accounting system are different people. The back office handles the settlement of transactions and the maintenance of the financial records. In a number of cases, a separate middle or risk management office has also been established to undertake risk analysis and monitor and report on portfolio-related risks, and to assess the performance of debt managers against any strategic benchmarks. This separation helps to promote the independence of those setting and monitoring the risk management framework and assessing performance from those responsible for executing market transactions. Where debt management services are provided by the central bank (e.g., registry and auction services) on behalf of the government's debt managers, the responsibilities and accountabilities of each party and agreement on service standards can be formalized through an agency agreement between the central bank and the government debt managers.

Relevance for the Cash Basis of Accounting

- 7.56 The issues identified in this Chapter are relevant for entities intending to comply with the requirements of any future IPSAS based on International Public Sector Accounting Standard Exposure Draft IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* only if they wish to provide additional disclosure on the nature and amount of various categories of liabilities. Although an entity may provide additional disclosures within the financial statements or as supplementary information, non-cash amounts cannot be included in the amounts shown on the face of the primary financial statement. Although borrowings are not recognized as liabilities under the cash basis, separate schedules of borrowings and details of securities over assets are often disclosed. Any cash inflow from borrowings will also appear as cash receipts in the primary financial statement.
- 7.57 Although the use of cash accounting does not preclude the use of additional records and systems, entities using the cash basis may not have developed systems that provide the full range of information useful for debt management purposes. For example, an entity may have manual records showing the currency of specific borrowings but may not have readily accessible data on the currency exposure associated with its debt. A preliminary assessment

Transition to the Accrual Basis of Accounting

of some of the exposures an entity wishes to manage may assist an entity in determining the importance of certain functions within the debt management system.

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CHAPTER 8: REVENUES AND EXPENSES

Key Points

- At the time of writing, International Public Sector Accounting Standards (IPSASs) and Exposure Drafts dealing with the recognition, measurement and presentation of revenue and expenses are:
 - International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements* (presentation and disclosure);
 - International Public Sector Accounting Standard IPSAS 5 *Borrowing Costs* (the expensing or capitalization of borrowing costs);
 - International Public Sector Accounting Standard IPSAS 9 *Revenue from Exchange Transactions* (including revenue from the rendering of services, the sale of goods, interest, royalties, dividends and their equivalents, and exchanges of goods);
 - International Public Sector Accounting Standard IPSAS 11 *Construction Contracts* (revenue from construction contracts);
 - International Public Sector Accounting Standard IPSAS 12 *Inventories* (the initial recognition of purchases as inventories or expenses and the subsequent expensing of inventories used);
 - International Public Sector Accounting Standard IPSAS 13 *Leases* (revenue and expenses of lessors and lessees);
 - International Public Sector Accounting Standard IPSAS 16 *Investment Property* (investment properties); and
 - International Public Sector Accounting Standard IPSAS 17 *Property, Plant and Equipment* (depreciation of property, plant and equipment).
- Revenue and expense topics for which IPSASs are currently not developed include:
- non-exchange revenue (discussed in Chapter 14);
- employee expenses (discussed in Chapter 12);
- expenses arising from social policy obligations (liabilities arising from social policy obligations are discussed in Chapter 13);
- the measurement of revenues and expenses arising from gains and losses on financial instruments (discussed in Chapter 11); and
- amortization of intangible assets (discussed in Chapter 10).

Introduction

- 8.1 IPSAS 1, paragraph 6, defines revenue as “the gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.” IPSAS 1, paragraph 6, defines expenses as “decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrence of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.” Revenue and expenses are recognized for financial reporting purposes when all elements of the definitions and the recognition criteria (probability and measurability) for revenue and expenses are satisfied.
- 8.2 Common types of revenue for national governments include:
- Non-exchange revenues:
 - direct and indirect taxes;
 - duties;
 - fees and fines; and
 - other non-reciprocal transfers;
 - Exchange revenues:
 - sales of goods or services;
 - dividends;
 - interest; and
 - net gains arising from the sale of assets; and
 - Other gains.
- 8.3 Common types of expenses for national governments include:
- personnel (employee-related) expenses;
 - cost of goods sold/services provided;
 - physical asset use (depreciation and loss of service potential);
 - rental and leasing costs;
 - maintenance;
 - interest;
 - expenses relating to financial assets;
 - transfers (including grants and donations) to other governments, organizations and individuals; and

- other losses:
 - changes in market value; and
 - foreign exchange losses.
- 8.4 The amount of work required to recognize revenues and expenses on an accrual basis depends on the extent to which an entity already has information available on those assets. General steps in the recognition of revenues and expenses include the:
- compiling a list of all types of revenues and expense relevant to the entity;
 - determining the categories of revenues and expense to be used in the chart of accounts and the financial statements;
 - preparing accounting policies for each category of revenue and expense;
 - assessing the accuracy and completeness of existing information on each category;
 - establishing systems to support the recognition of revenue and expense items or developing interim measures to provide reasonable estimates of revenue and expense items. The establishment of systems may be evolutionary. An entity may gradually adapt its recording systems to improve the accuracy and reliability of information concerning revenue and expense items.
- 8.5 Topics covered in this Chapter include:
- classification of revenues and expenses;
 - development of accounting policies;
 - recognition point for revenues and expenses;
 - purchasing and payment systems;
 - allocation/costing systems; and
 - internal controls.
- 8.6 The Appendix to this Chapter includes examples of accounting policies for a range of revenue and expense items.
- 8.7 Related topics covered in other Chapters include:
- depreciation of property, plant and equipment (Chapter 6);
 - impairment of assets (Chapter 6);
 - accounts receivable and accrued revenue (Chapter 6);
 - amortization of intangible assets (Chapter 10);
 - interest cost (Chapter 11);
 - employee-related expenses (Chapter 12);

- expenses associated with social policy obligations (Chapter 13); and
- revenue from non-exchange transactions, including taxation revenue, grants and donations (Chapter 14).

8.8 Accrual accounting requires the recognition of revenue when it is earned and expenses when they are incurred, rather than when the associated cash or consideration is received or paid. This leads to the recognition of accounts receivable (debtors), accounts payable (creditors) and accrued revenue and expenses. The recognition of these assets and liabilities has been briefly discussed in Chapters 6 and 7. Assets associated with the recognition of taxation receivable and accrued taxation revenue are discussed in Chapter 14.

Classification

- 8.9 Each entity needs to develop a classification system for revenues and expenses for use in the chart of accounts, the face of the financial statements, the notes to the financial statements and internal reports. The chart of accounts is often developed by a central entity, although individual entities may have flexibility to add items.
- 8.10 Useful sources of information in establishing revenue and expense classifications include:
- the disclosures required by IPSASs and any other authoritative accounting standards;
 - existing classification systems used under the current basis of accounting;
 - the classifications required for statistical reporting (for example, refer International Monetary Fund, December 2000); and
 - the classifications required by any external agency or legislative body.
- 8.11 Where an entity has been using a basis of accounting other than the accrual basis, it will need to ensure that the classification system is extended to take account of accrued revenue and expenses.
- 8.12 Classifications specifically required in order to meet the requirements of IPSASs include:
- within the consolidated reporting entity there will need to be provision for identification of revenues and expenses by each government entity and by each program, area of activity or other component required by legislation or government directive;
 - revenues and expenses controlled by the entity need to be identified separately from revenues and expenses controlled by the government as a whole or by another entity. This split is required in order to satisfy the definitions of revenue and expense (IPSAS 1);
 - significant categories of revenue (IPSAS 1), including separate identification of revenue arising from:
 - the rendering of services;
 - the sale of goods;

- interest, royalties and dividends or their equivalents; and
- exchanges of goods (IPSAS 9);
- separate identification of exchange and non-exchange revenue and the associated receivables (IPSAS 1);
- separate identification of expenses by the nature of the expense (input type) or by function (IPSAS 1). Operating costs applicable to revenues, recognized as expenses during the period are to be classified by nature (IPSAS 12);
- separate identification of:
 - depreciation or amortization expense;
 - salaries and employee benefits; and
 - finance costs (IPSAS 1);
- separate identification of borrowing costs so that they may be reviewed to see whether they meet the conditions for capitalization to qualifying assets (IPSAS 5);
- the amount of revenue recognized in relation to inventories sold, exchanged or distributed during the period (IPSAS 12);
- the carrying amount of inventories sold, exchanged or distributed during the period, or operating costs (raw materials, consumables, labor costs, other operating costs and the net change in inventories) applicable to revenue (IPSAS 12); and
- separate identification of write-downs or losses associated with inventories occurring during the period and any reversals of write-downs during the period (IPSAS 12).

Accounting Policies

8.13 An entity will require policies on:

- classification of inflows as revenue of the entity or revenue of another entity such as the government as a whole;
- recognition and measurement of each type of exchange revenue (for example, sale/distribution of goods and services, interest, gains and losses on investment properties);
- the treatment of various types of appropriations or funding provided by way of other legislative authority in the financial statements;
- recognition and disclosure of non-exchange revenue, including revenue derived from coercive powers, resources provided and received free of charge including grants and donations, and liabilities assumed by another entity (refer Chapter 14);
- methods adopted to determine the stage of completion of transactions involving the rendering of services;

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- the measurement of inventories, including the method(s) used to allocate costs to inventories;
- recognition of inventory expense and the treatment of supplies and consumables;
- identification, measurement and disclosure of asset impairments (refer Chapter 6);
- recognition and measurement of depreciation (refer Chapter 6);
- recognition and measurement of interest (refer Chapter 7) and the method of accounting for borrowing costs;
- recognition and measurement of employee-related expenses (refer Chapter 12);
- identification and recognition of bad and doubtful debts;
- recognition and disclosure of grants, donations and transfers made or received (refer Chapter 13);
- the treatment of gains and losses on disposal or revaluation of assets (refer Chapter 6); and
- the treatment of foreign currency gains and losses (refer Chapter 15).

8.14 The above list of accounting policies required is not necessarily complete. A complete list of policies required can be determined by working through applicable accounting standards and identifying where an accounting standard addresses recognition, measurement or disclosure of a financial element relevant to the entity. A potential list of policies is included in IPSAS 1. Another way of identifying accounting policies required is to review the accounting policies of other jurisdictions which have adopted accrual accounting – both the published statement of accounting policies, which is usually in summary form, and the more detailed accounting policy manuals.

Recognition Points for Revenues and Expenses

- 8.15 The general recognition criteria of measurability and probability underlie the recognition of all revenues and expenses. However, the application of these general principles to specific types of revenue and expenses means that an entity needs systems to identify the appropriate recognition point for such revenues and expenses. Examples of the type of information required include:
- rendering of services – reliable measurement of stage of completion, costs associated with that stage of completion and costs to complete the transaction;
 - sale of goods – identification of the point at which significant risks and rewards of ownership of the goods have passed to the purchaser and reliable measurement of costs incurred or to be incurred in relation to the transaction;
 - interest revenue – the effective yield on assets, due dates, the proportion of time elapsed during the reporting period compared to the proportion of time until the next due date;

- dividends/distributions receivable – the point at which the right to receive payment is established;
 - rental revenue – due dates and a method of calculation; a method of allocating both direct and indirect expenses associated with investment properties to specific properties; and
 - inventories sold, exchanged or distributed – a system for recognizing the cost of inventories consumed in relation to transactions; systems for billing for chargeable services.
- 8.16 Entities need to identify which types of revenues and expenses will require accruals, and develop or review systems that allow for the systematic and accurate identification of such accruals.
- 8.17 In developing systems an entity needs to consider:
- whether to record payables/creditors at the time of actual delivery or at time the invoice is received and certified. Some public sector entities may not formally invoice for goods or services supplied. In such cases the purchasing entity needs to identify the point at which it is obliged to make payment;
 - whether some receivables/debtors should be recorded in the accounting system at the end of the reporting period or on a more regular basis – the entity has the option of maintaining memorandum accounts during the period and formally acknowledging the debtor at the end of the period; and
 - whether funding from a central government body or another level of government is required to be matched against particular services, or whether it is recognized as one lump sum.
- 8.18 Entities need to develop end-of-period procedures for the identification of doubtful debts and bad debts. Doubtful debts expense is an estimate of the amount of receivables outstanding at the end of the reporting period that the entity anticipates it will not recover, but has not written-off as a bad debt.

Purchasing and Payment Systems

- 8.19 Prior to the introduction of accrual accounting, purchasing and payment systems and procedures need to be reviewed. Key requirements are that:
- the entity has good controls over the authorization of spending;
 - public money is spent for the purpose intended and in accordance with budgetary and legislative authorities;
 - payments are made on time; and
 - systems provide comprehensive, accurate and timely information.

- 8.20 Purchasing and payment systems may be centralized across the whole-of-government or decentralized to the extent that each reporting entity has the authority to determine its own arrangements. Where entities have delegated authority to determine their own systems and procedures they may decide to have one centralized system for the entity as a whole or to allow individual geographic locations or sub-units to operate their own systems. Decisions regarding the appropriate degree of centralization will be influenced by how well existing arrangements work in terms of efficiency, effective control and meeting user requirements.
- 8.21 Some of the advantages of operating well-structured, centralized purchasing and payment systems which interface to the general ledger are that:
- greater control can be exercised over the use of suppliers (the system may have a list of preferred suppliers with set items at set prices);
 - it is easier to implement policies regarding controls over certain types of spending (for example, travel and accommodation);
 - they result in fewer bank account transactions;
 - most accounting entries (for example, creditors) for goods and services purchased using the system can be automatically generated;
 - manual entries are required only for goods and services purchased outside the system;
 - employees purchasing items require less training on accruals; and
 - coding systems can be used to automatically allocate the cost of purchases to budgets. Where individuals with budget responsibilities have on-line access to their financial information they can then track actual spending against budgets during the reporting period.
- 8.22 These advantages would need to be considered against the need within the entity for flexibility in selecting and changing suppliers.

Allocation/Costing Systems

- 8.23 Where an entity is required to report revenue and expenses for particular locations, branches, programs, outputs etc, it will require systems to allocate revenues and expenses. This topic is not specifically addressed within this Study. A number of jurisdictions and entities have published documents that provide guidance on allocation issues facing public sector entities.
- 8.24 Because employee-related costs are one of the key expenses for many public sector entities, time recording is often required to support such systems. In some cases, this can involve significant cultural change. Where new time recording systems are introduced, care should be taken in trying to keep requirements simple (at least at first) so that information can be collected in a timely manner. Complex requirements can result in non-compliance, delays in processing (and preparation of financial statements) and inaccurate information.

Internal Controls

- 8.25 Examples of internal controls required to support the accruing of revenues and expenses include:
- clear identification of authorities for setting charges and fees;
 - clear identification of the authority to charge other government organizations;
 - regular reviews of charges and fees;
 - the establishment of guidelines for providing credit;
 - regular reconciliations between subsidiary and control ledgers;
 - active management of amounts owed to the entity;
 - regular review of bad debts;
 - accurate and complete records of debtors;
 - periodic reviews of costs (against charges where relevant);
 - active management of creditors to ensure payments are made in accordance with the policy on payment (for example, on or by due date);
 - consistent application of accounting policies and regular review of the application of accounting policies (for example, the review of whether costs associated with the construction of assets or creation of inventories have been appropriately capitalized or expensed);
 - establishment of policies and procedures for purchasing;
 - the establishment of tendering policies and procedures;
 - the establishment of policies for contracting out of services (if appropriate);
 - regular review of suppliers to ensure suppliers are meeting the needs of the entity and are acting in accordance with any supply agreement; and
 - the establishment of procedures to verify the receipt of goods and services against purchase orders, authorize invoices for payment and pay for goods and services.

Relevance to the Cash Basis of Accounting

- 8.26 The issues identified in this Chapter are relevant for entities intending to comply with the requirements of any future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* only to the extent that they wish to provide additional disclosure on the nature and amount of accrued revenues and expenses. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the financial statements.

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Appendix: Accounting Policies

This Appendix illustrates examples of accounting policies for a selection of revenue and expense items. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. Because of the wide variation in types of revenue and expense items which exist between various types of entities and jurisdictions, some potential policies (for example, revenue classifications) have not been illustrated.

These policies comply with relevant IPSASs such as IPSAS 9, IPSAS 11 and IPSAS 12.

However, it is possible that other policies that are consistent with these standards could also be developed – the appropriateness of a particular policy for a revenue or expense item depends on the exact conditions under which the revenue is earned or the expense is incurred. Recognition points for revenue and expense items may therefore vary between entities within a jurisdiction and between jurisdictions. In the absence of an IPSAS on impairment, this entity has chosen to base its policy directions on International Accounting Standard IAS 36, *Impairment of Assets*, with some adaptation to reflect the fact that some of its assets are not held for their ability to generate net cash inflows. Other sources of authoritative guidance on impairment may be available within particular jurisdictions. The Public Sector Committee has signaled that it intends to consider impairment of assets in its future work program.

Revenue

The definition of revenue in International Public Sector Accounting Standard IPSAS 9 *Revenue from Exchange Transactions* is to be applied.

Exchange revenue is to be recognized when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably in accordance with IPSAS 9.

Revenue received but not yet earned at the end of the reporting period is to be recognized as a liability (unearned revenue).

Revenue that has been recognized and that is subsequently written-off or waived is to be recognized as an expense.

Classification of Revenue

[The central agency will identify the categories of revenue to be used on the face of the financial statements. Each reporting entity will identify the types of revenue included within each category.]

Interest

Interest revenue is to be recognized on a time proportion basis that takes into account the effective yield on the asset. Interest earned but not received is to be accounted for as accrued revenue.

Royalties

Royalties are to be recognized when the royalty payment is due.

Dividends/Distributions

Dividends/distributions are to be recognized when the right to receive a dividend/distribution has been established.

Sale of Goods or Rendering of Services

Revenue from the sale of goods and services and the rendering of services is to be recognized in the Statement of Financial Performance as it is earned.

Revenue from partially completed services is to be recognized by reference to the stage of completion of contracts or in accordance with the underlying agreement or contract. The stage of completion is determined according to the proportion that costs incurred to date bear to the estimated total costs of completion.

Surplus or Loss on Construction Contracts

Revenue from construction contracts is to be accounted for in accordance with IPSAS 11 *Construction Contracts*.

Contract revenue is to include:

- the initial amount of revenue agreed in the contract; and
- variations in contract work, claims and incentive payments to the extent that:
 - it is probable that they will result in revenue; and
 - they are capable of being reliably measured.

Contract costs are to include:

- costs that relate directly to the specific contract;
- costs that are attributable to contract activity in general and can be allocated to the contract on a systematic and rational basis; and
- such other costs as are specifically chargeable to the customer under the terms of the contract.

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with a construction contract are to be recognized as revenue and expenses respectively, by reference to the stage of completion of the contract activity at the reporting date.

When the outcome of a construction contract cannot be estimated reliably:

- revenue is to be recognized only to the extent of contract costs incurred that it is probable will be recoverable; and

- contract costs are to be recognized as an expense in the period in which they are incurred.

When it is intended at the inception of a construction contract that contract costs are to be fully recovered from the parties to the construction contract, any expected deficit on the construction contract is to be recognized as an expense immediately.

Rent

Rent revenue is to be recognized as it is earned.

Finance Leases

Finance lease revenue is to be accounted for in accordance with International Public Sector Accounting Standard IPSAS 13 *Leases*. The recognition of finance lease revenue is to be based on a pattern reflecting a constant periodic rate of return on the lessor's net investment outstanding in respect of the finance lease.

Assets acquired by way of finance lease are to be amortized over the period of the lease. Lease payments are allocated between the principal component and the interest expense.

Expenses

The definition of expenses in IPSAS 1 is to be applied.

Expenses are to be recognized when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that is probable and can be measured reliably.

Expenses are to be recognized in the period to which they relate.

Classification of Expenses

[The central agency will identify the categories to be used on the face of the financial statements. Each reporting entity will identify the types of expense included within each category.]

Inventories

In accordance with International Public Sector Accounting Standard IPSAS 12 *Inventories*, the carrying amount of inventories sold, exchanged or distributed is to be recognized as an expense in the period in which the related revenue is recognized. If there is no related revenue, the expense is to be recognized when the goods are distributed or related service is rendered. IPSAS 12 does not apply to work in progress of services which are to be distributed for no or nominal consideration directly in return from the recipients. The entity is not expected to have any such services. However, if such services do occur, the costs of producing the service are to be expensed as they occur.

The amount of any write-down of inventories and all losses of inventories are to be recognized as an expense in the period the write-down or loss occurs.

The amount of any reversal of any write-down of inventories is to be recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs.

Inventories allocated to other asset accounts, (for example, to other forms of inventory or to self-constructed property, plant or equipment are to be accounted for in accordance with the policy on those assets).

Supplies and Consumables

Supplies and consumables (including other office costs) are to be recognized as expenses when incurred.

Bad and Doubtful Debts

At each reporting date an estimate of the amount of receivables that are unlikely to be collected is to be recognized as doubtful debts (doubtful debt expense and provision for doubtful debts).

As soon as it is probable that full or part payment of a receivable will not be received¹, the receivable is to be written-off as a bad debt. In the case of bad debts that have already been provided for by way of the provision for doubtful debts, the write-off is to be against the provision for doubtful debts. Where no provision was previously established for the doubtful debt, the write-off is to be recognized as a bad debt expense. If the debt is recovered in the future then the write-off is reversed.

Complete records of specific debts identified as bad or potentially non-collectable and approvals to write-off bad debts are to be maintained.

Operating Leases

Operating lease payments are to be accounted for in accordance with IPSAS 13. Operating lease payments are to be recognized as an expense in the operating statement on a straight-line basis over the lease term, where this is representative of the pattern of benefits to be derived from the leased property.

Depreciation

All depreciable property, plant and equipment (including revalued assets where appropriate) is to be depreciated.

The depreciation charge for each period is to be recognized as an expense unless it is included in the carrying amount of another asset.

Assets are to be depreciated in accordance with the methods and rates shown below: *[Each reporting entity will identify the methods and rates for categories of assets – these may vary between entities and jurisdictions depending upon the type of use, extent of maintenance and climatic conditions.]*

Leasehold improvements are to be depreciated either over the unexpired period of the lease or the useful lives of the improvements, whichever is the shorter.

¹ Managers should ensure that the write-off of a bad debt is in accordance with any detailed criteria or instructions governing the circumstances in which a write-off of such receivables is permissible.

Borrowing costs

Borrowing costs include: [Each reporting entity will list relevant types of borrowing costs, for example, interest on bank overdrafts and borrowings].

Borrowing costs meeting the criteria for capitalization as part of the cost of a qualifying asset are to be capitalized in accordance with International Public Sector Accounting Standard IPSAS 5 *Borrowing Costs*.

All other borrowing costs are to be recognized as an expense in the reporting period in which they are incurred.

Impairment

An impairment loss is to be recognized as an expense for assets carried at cost, and as a revaluation decrease for assets carried at revalued amounts to the extent of its revaluation reserve surplus.

The following factors may be used as possible indicators of impairment¹.

Where an indicator of impairment exists, an impairment test is to be applied:

- a change in the extent to which an asset is used;
- a change in the manner in which the asset is used;
- significant technological development;
- physical damage;
- a decline in, or cessation of, the demand or need for services provided by the asset;
- a decision to halt the construction of the asset before it is complete or in a usable condition;
- a change in the law, government policy or environment that limits the extent to which the asset can be used; or
- a significant decline in the observable market value of the asset.

Where an asset is held for its ability to generate net cash inflows, impairment is to be measured in accordance with International Accounting Standard IAS 36, *Impairment of Assets*. Impairment is to be measured by reference to the higher of net selling price and value-in-use (present value of future cash flows).

Where an asset is not held for its ability to generate net cash inflows, the observable market value of the asset is to be used in measuring any impairment loss.

¹ The *Invitation to Comment, Impairment of Assets* (IFAC, June 2000) included these factors as possible indicators of impairment and measurements of impairment losses. The PSC has not yet issued an IPSAS which deals with these matters.

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Where an asset does not have an observable market value and the asset continues to have utility for the entity, its depreciated replacement cost is to be used in measuring any impairment loss. Where an asset does not have an observable market value and the asset no longer has utility for the entity, or its ability to utilize the asset has been significantly restricted, a disposal value (net selling price) should be used.

PART IV – SPECIFIC TOPICS

Part IV of this Study discusses implementation issues arising from the recognition of certain assets, liabilities, revenues and expenses that are not covered in Part III. These topics have been dealt with separately in order to allow the reader to focus on the issues associated with these topics in more depth than would have occurred in Part III.

The Chapters focusing on specific asset topics are:

- Chapter 9 *Cash*; and
- Chapter 10 *Intangible Assets*.

Chapter 11 *Financial Instruments* deals with issues in financial reporting of financial assets and liabilities.

The Chapters focusing on specific liability topics are:

- Chapter 12 *Employee-Related Liabilities*; and
- Chapter 13 *Liabilities Arising From Social Policy Obligations*.

The issues discussed in these two Chapters also relate to the recognition of the associated expenses.

Chapter 14 *Non-Exchange Revenue* focuses on the major source of revenue for many public sector entities.

Chapter 15 *Foreign Currency* explains the implications of adopting International Public Sector Accounting Standard IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* to account for foreign currency gains and losses.

The Public Sector Committee (PSC) intends to revise this Study periodically to include explanations of the requirements of recently issued International Public Sector Accounting Standards. This revision process will not be continuous and at any point in time IPSASs additional to those included herein may be on issue. Consequently, readers will need to monitor IPSASs as they are issued on the IFAC website (www.ifac.org). As part of the revision process the PSC may develop further Chapters for inclusion in this Part or amend these Chapters. Readers are invited to provide suggestions for specific topics, along with examples of implementation strategies or issues that have arisen in their jurisdictions.

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CHAPTER 9: CASH

Key Points

- The adoption of International Public Sector Accounting Standards (IPSASs), particularly International Public Sector Accounting Standard IPSAS 2 *Cash Flow Statements*, means that an entity would have to report on both cash and cash equivalents in its Cash Flow Statement.
- This Chapter discusses the requirements of IPSAS 2, in particular the definition and recognition of cash, the information requirements for completion of a Cash Flow Statement, and the determination of control of cash.
- Existing administrative arrangements which involve the use of special types of bank accounts such as deposit accounts, trust accounts, advance accounts and imprest accounts, would need to be reviewed to determine whether the balances in these accounts are controlled by the entity.

Introduction

- 9.1 Most governments and government entities will already have good records of most of their cash payments, cash receipts and cash balances. Because most cash balances are readily identifiable, cash may be regarded as an “easy” asset to account for. However, there are still a number of issues that need to be considered when planning a transition to accrual accounting and the adoption of IPSASs. Some of these issues are explained below.
- IPSAS 2 requires a Cash Flow Statement to include both cash and cash equivalents. Some cash equivalents may not have previously been reported as part of opening and closing cash balances.
 - The *Glossary of Defined Terms IPSAS 1 to IPSAS 12* (IFAC, June 2001) states that assets are “resources controlled by an entity.” As cash is an asset, all cash reported as part of the entity’s opening and closing cash balances should meet this test. This raises two issues:
 - are all cash balances currently reported by the entity controlled by it or are some of those balances trust or other funds which are administered rather than controlled; and
 - are there any cash balances controlled by the entity which are not currently included in the entity’s reported cash balances?
 - International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities*, paragraph 39, notes that “in preparing consolidated financial statements, the financial statements of the controlling entity and its controlled entities are combined on a line-by-line basis by adding together like items of assets, liabilities, net assets/equity, revenue and expenses.” Entities required to produce consolidated financial statements will therefore need to identify any inter-entity cash flows and cash balances.
 - Cash is included within the definition of a financial asset in International Public Sector Accounting Standard IPSAS 15 *Financial Instruments: Disclosure and Presentation*, and is therefore subject to the disclosure requirements in that Standard.

- Some items currently recognized as cash balances may not meet the definition of cash in IPSAS 2. For example, entities using a modified form of the cash basis may have been accustomed to recognize certain receivables and payables as cash balances. Such items do not meet the definition of cash under the accrual basis.

9.2 Unless the context suggests otherwise, references to “cash” in this Chapter should be read as including “cash equivalents”.

Definitions

9.3 The definition of cash used in IPSASs includes “cash on hand and demand deposits” (*Glossary of Defined Terms IPSAS 1 to IPSAS 12*, IFAC, June 2001). Cash on hand includes:

- bank account balances (both domestic and foreign);
- cash awaiting banking;
- petty cash/imprest floats; and
- cash in transit.

9.4 Cash held in bank account balances may refer to specific accounts in a named bank. However, where a reporting entity has a number of controlled entities and operates a centralized cash management system, the bank accounts of controlled entities may be real or notional. The term “notional bank accounts” refers to a system where there is one central bank account, but the cash flows of each entity are separately identified and each entity knows its notional cash balances. The entity operating the central bank account becomes, in effect, a banker for the other entities.

9.5 The cash on hand of a government department may include its ledger balance of funds “drawn down” from the government and available for use. It would consist only of the amount actually drawn down or otherwise available for immediate use – not the total annual amount appropriated or authorized.

9.6 Cash equivalents are “short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value” (*Glossary of Defined Terms IPSAS 1 to IPSAS 12*, IFAC, June 2001). Cash equivalents therefore include:

- short-term deposits;
- deposits at call; and
- other highly liquid investments that are readily convertible to cash on hand at the entity’s option.

9.7 Cash equivalents are items that are immediately available or repayable on demand. They differ from debtors/accounts receivable in that although debtors/accounts receivable are payable to the entity, they are not payable on demand.

Recognition

- 9.8 In common with the recognition of other assets, cash and cash equivalents are recognized when they are measurable and probable. There are generally no difficulties in establishing the measurability and probability of cash and cash equivalents.

Information Requirements

- 9.9 IPSAS 2 requires that an entity:
- report consolidated cash flows and cash balances;
 - separately disclose cash and cash equivalents;
 - include an explanation, in the accounting policies, of the items which make up cash and cash equivalents; and
 - disclose any cash balances not available for use by the entity.
- 9.10 An entity complying with IPSAS 2 would need to:
- identify all bank accounts and other forms of cash or cash equivalents;
 - identify any cash balances with restricted use;
 - establish who has control (the ability to use cash for their own purposes) of the cash within each bank account; and
 - establish a system for collecting cash flow and cash balance information from all entities within the reporting entity.
- 9.11 The implications of complying with IPSAS 6 have been previously considered in Chapter 5 *Reporting Entity Issues*.
- 9.12 Some of the issues that can arise in identifying the cash and cash equivalent balances of an entity are discussed in the following sections.

Control of Cash

- 9.13 Only those cash balances controlled by the entity meet the definition of cash for that entity. The concept of control is applied to determine whether receipts collected and payments made by the entity are in fact controlled by the entity and therefore represent cash. Frameworks for governing the collection of receipts and making of payments will vary between jurisdictions but the following discussion may be useful in this exercise.
- 9.14 Two possible scenarios (illustrated using receipts only) are described below.
- Receipts that are controlled by the entity are generally considered to be either revenue or a receivable of the entity. They are available to be used by the entity and the bank account in which they are held represents cash of the entity.

- Receipts that are not controlled by the entity are not cash of the individual entity collecting the funds for example, a government department collecting taxes on behalf of the government, which it is not entitled to spend, or receipts collected on behalf of another government controlled entity in an agency or administering capacity.
- 9.15 The above two scenarios illustrate two relatively clear instances where cash is controlled or not controlled. However, in the latter scenario arrangements and controls over such funds may vary. In some cases the amounts will be required to be held in a separate bank account and may clearly belong to the other entity. In other cases the funds may be intermingled with the funds of the collecting entity, and available for use by the reporting entity with the amounts collected being remitted at regular intervals. If the reporting entity controls the funds, the funds form part of its cash balances, but a liability to the other party may also exist.
- 9.16 IPSAS 2 allows cash flows to be reported on a net basis when the cash receipts collected and payments made on behalf of customers, taxpayers or beneficiaries reflect the activities of the other parties rather than those of the entity.
- 9.17 Money held in trust is discussed separately below.

Deposit Accounts/Holding Accounts

- 9.18 An entity preparing for transition to the accrual basis may have a range of special accounts that it has used as a means of separately identifying funds of a specific nature or purpose that are not available for its general use. These accounts need to be reviewed to see if they should form part of the reported cash balances of the entity.
- 9.19 Examples of the types of cash that may be held in such accounts include:
- bonds or deposits, for example, tenancy bonds or Customs bonds; and
 - funds held for a specific purpose.
- Each of these examples is discussed further below.

Bonds or Deposits

- 9.20 A Government may require people entering the country with disposable consumer goods (that would be subject to duty if sold within the country) to pay a refundable bond or deposit. If the goods are subsequently taken out of the country, the Government would refund the deposit. If the goods are not taken out of the country within a specified time, the Government may take the bond or deposit in lieu of customs duty. The issue here is at what point the bond or deposit is controlled by, and should therefore be recognized as cash of, the individual entity responsible for collection of customs duty and/or the government as a whole. Identification of this point will depend on the circumstances in each case. Prior to the point at which such amounts are controlled, they may be more appropriately accounted for as trust money.

Funds Held For A Specific Purpose

9.21 Funds held for a specific purpose may have come from a higher level of government or private individuals or organizations. The main issue is whether such funds were a grant, donation or other form of revenue that is now controlled by the entity or whether the funds are still controlled by the “donor”. If the funds are controlled by the entity, they should be treated as part of the entity’s cash balances. In the case of funds subject to restrictions and conditions, separate note disclosure of the amount of the restricted cash balance may be appropriate, and in some cases a liability may exist. If the funds are still controlled by the donor then they belong to the donor.

Trust Accounts

9.22 Under the accrual basis, cash that is held in trust for another party is not controlled by the entity and therefore does not meet the definition of an asset of the entity. An example of cash held in trust is the cash held by a government entity on behalf of prisoners detained by the government.

9.23 As part of the identification of cash balances controlled by the entity it will be necessary to:

- review all trust accounts that are believed to hold trust money to determine who controls the cash in the accounts; and
- review all bank accounts controlled by the entity to identify whether such accounts include any cash that should be accounted for as trust money.

9.24 Because the controls over trust accounts may be different from those over other centralized bank accounts, entities using the cash basis sometimes use trust accounts for other purposes. For example, some jurisdictions using the cash basis have treated trust accounts as a mechanism to allow government-owned trading activities to operate and spend trading receipts without requiring an appropriation. Others have used trust accounts as a means of separating funds tagged for a specific purpose and to allow the funds to be spent over a period of time without requiring a separate annual appropriation each year. In neither case is the cash in the bank account held in trust for another individual or organization.

9.25 As part of the identification of cash balances controlled by the entity it will be necessary to:

- review all trust accounts that are believed to hold trust money to determine who controls the funds; and
- review all bank accounts controlled by the entity to ensure that such accounts do not include any trust money.

9.26 As part of the transition to accrual accounting many entities find it appropriate to review the treatment of trust money. This may include creating a legislative definition of trust money, and establishing who has authority to manage trust money, the banking arrangements for trust money and the type of reporting that is required for trust money. For example, the definition of trust money may be limited to situations where there is a trustee/beneficiary

relationship. In addition to reviewing the management of trust money, entities will also need to consider whether they manage any assets or liabilities on a trust basis and the most appropriate form of control and reporting with respect to those assets and liabilities.

Advance Accounts

- 9.27 Some jurisdictions may operate advance accounts whereby amounts paid from the bank account are deemed not to be cash payments because they are immediately repayable. Advance accounts may be used to forward money to individual controlled entities or individual employees for specified purposes, for example, staff travel. Advance accounts may operate as a separate bank account or a separate ledger. When an entity adopts the accrual basis, such arrangements may need to be reviewed. Under the accrual basis, any cash payment needs to be recognized as a reduction in the cash balance. The entity then needs to decide if the reduction in the cash balance represents an expense or a receivable/loan.
- 9.28 The review of advance account arrangements may result in the collection of amounts currently outstanding, the write-off of amounts unlikely to be recovered, or the formal recognition of amounts receivable.

Imprest Accounts

- 9.29 Where a government or other controlling entity using the cash basis has a centralized bank account and operates a system of cash appropriations, it may take some time for requests for payment to be authorized and processed through the system by the central processing entity. Individual entities can find this type of system restrictive and so may be granted limited access to cash, subject to retrospective approval of the spending. Such access to cash is often granted by way of imprest accounts or suspense accounts. These operate in a similar way to a petty cash float. They have a limited balance available for certain purposes and all items must be retrospectively approved before any further funds are advanced to the account.
- 9.30 Cash balances held in imprest accounts form part of the cash of the consolidated reporting entity and would therefore be included in any consolidated financial statements. Where the individual entity with access to the imprest account also prepares financial statements, it needs to decide if the cash in the imprest account meets the definition of an asset – that is, does it control the cash? If the answer is “yes”, then the cash in the imprest account would be reported as part of its cash balances. If the answer is “no”, then the imprest account would be accounted for by the entity that has control.
- 9.31 The need for imprest accounts disappears if individual entities have access to their own bank accounts (either real or nominal) and are able to write their own checks or otherwise make their own payments. However, most entities retain the use of a petty cash system for inconsequential cash spending.

Foreign Currency Bank Accounts

- 9.32 Under the cash basis, entities with funds in foreign currency bank accounts will generally have reported these balances as part of their cash balances at year-end. Under the accrual basis, differences between opening and closing balances due to the movement in rates are separately disclosed within the Cash Flow Statement. The method of translating foreign currency bank accounts under the accrual basis of accounting is set out in International Public Sector Accounting Standard IPSAS 4 *The Effects of Changes in Foreign Exchange Rates*.

Stamps and Postal Orders

- 9.33 Where an entity other than the entity responsible for the production of such items, holds material balances of items that are readily convertible to cash such as stamps and postal orders, these may be classified as cash equivalents. However, where an entity is responsible for the production of stamps, these would be recognized as inventory at cost.

Unissued Currency

- 9.34 Where an entity is responsible for the production of currency, unissued currency (notes and coins for circulation) should be recognized as inventory at cost and not cash.

Non-Cash Transactions

- 9.35 Non-cash transactions are excluded from the Cash Flow Statement. However, IPSAS 2 states that such transactions should be disclosed elsewhere in the financial statements. Where a transaction has both a cash and non-cash component, knowledge of both aspects of the transaction may be relevant for users. An example of a combined transaction is where assets are exchanged with only the net difference in the agreed price being paid in cash. The two elements of the transaction should therefore be cross-referenced in the accounting system or an additional memorandum account of such transactions should be maintained. The notes to the Cash Flow Statement can be used to disclose details of such transactions.

Relevance to the Cash Basis of Accounting

- 9.36 Many of the issues identified in this Chapter are relevant for entities intending to comply with the requirements of any future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*. The IPSAS based on IPSAS ED 9 is yet to be released. The identification of the reporting entity and the consolidation of the reporting entity's cash flows are likely to be the largest issues.
- 9.37 An additional issue raised in Exposure Draft IPSAS ED 9 is whether an entity should recognize in its primary financial statement the cash flows in respect of cash payments made on its behalf, even where these transactions do not flow through the entity's bank account. This situation could occur under the terms of a grant or loan agreement where a multi-lateral

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development agency makes payments directly to contractors on behalf of the entity. The IPSAS based on IPSAS ED 9 is yet to be released.

References

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Appendix: Accounting Policies

This Appendix illustrates an example of accounting policies for cash that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. (At the time of writing, the IPSASs do not include specific requirements dealing with the disclosure of third party settlements.)

Cash and Cash Flows

Cash is to include all cash balances on hand which are controlled by the reporting entity. This will include amounts awaiting banking, petty cash imprest floats and cash in transit. Cash will also include demand deposits of the reporting entity which are held with banks or other financial institutions including foreign currency accounts of the entity. Cash equivalents will comprise all short-term highly liquid investments that are readily convertible to cash within a maximum period of three months, and are subject to an insignificant risk of changes in value.

Where a government agency controls other entities, a consolidated financial report prepared in respect of the economic entity comprising the agency and its controlled entities is to include all the cash and cash equivalents controlled by the entities within the economic entity. Inter-entity cash flows and cash balances are to be eliminated on consolidation.

Disclosures

A cash flow statement is to be prepared in accordance with International Public Sector Accounting Standard IPSAS 2 *Cash Flow Statements*. Cash flows are to be reported on a gross basis except where reporting on a net basis is allowed by IPSAS 2. When, in accordance with IPSAS 2, certain types of cash flows are reported on a net basis, the notes to the financial statements are to acknowledge that this has occurred.

Trust Accounts and Third Party Settlements

Cash which is collected and/or held on behalf of another party and is deposited in a trust account which is not available for use of the reporting entity is not to be included in amounts reported as cash or cash flows of the reporting entity. The total amount held in trust for other parties may be reported in the notes to the financial statements by major class.

Cash payments may be made by third parties such as multilateral development banks or donors directly to the entity's creditors. Where the entity does not receive cash or cash equivalents from the multilateral development bank or donor entity, or gain control of a bank account or similar facility established for its benefit by the multilateral development bank or donor, the payments are not to be included as a cash flow of the entity. However, these amounts are to be disclosed separately in notes to the financial statements by major class of lender or donor and/or major class of activity.

CHAPTER 10: INTANGIBLE ASSETS

Key Points

- There is currently no International Public Sector Accounting Standard (IPSAS) on intangible assets. In the absence of an IPSAS, International Accounting Standard IAS 38, Intangible Assets may be used as a starting point to illustrate implementation issues associated with intangible assets. This Chapter summarizes the requirements of IAS 38 in relation to the recognition, measurement and amortization of intangible assets. Other sources of authoritative guidance are included in the References section at the end of this Chapter.
- This Chapter defines intangible assets and provides examples of intangible assets that may be held by governments and public sector entities. It outlines some of the implementation issues associated with identifying intangible assets and developing accounting policies for intangible assets.
- Much of the discussion in Chapter 6 Assets, particularly the discussion on identification, recognition, measurement and depreciation of property, plant and equipment, is also applicable to intangible assets.
- Where entities have intangible assets which do not meet the criteria for recognition, they may wish to consider providing additional disclosures of such assets.

Introduction

- 10.1 There is currently no IPSAS on intangible assets. International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* deals with one component of intangible assets: the identification and recognition of goodwill on acquisition of another entity. In the absence of an IPSAS, IAS 38 may be used to illustrate implementation issues associated with intangible assets. IAS 38 was developed by the International Accounting Standards Committee (IASC). The use of IAS 38 as an illustrative accounting standard in this Chapter does not represent the considered position of the PSC in relation to the applicability of the requirements in IAS 38 to the public sector. Readers should also be aware that, at the time of writing, the current work program of the IASB includes projects that have the potential to amend certain of the requirements of IAS 38. Other authoritative pronouncements on intangible assets from a range of jurisdictions are listed in the References section at the end of this Chapter.

Characteristics and Examples

- 10.2 In broad terms, intangible assets represent recognizable rights to future economic benefits and service potential. IAS 38, paragraph 7, defines intangible assets as “identifiable non-monetary assets without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes”. Under the IAS 38 approach, intangible assets must therefore meet both the general definition of an asset (as discussed in Chapter 6) and the additional requirements of the definition. In keeping with other non-

current assets, an intangible asset must have a useful life greater than one year. A portion of its value is amortized over time as an expense.

10.3 Intangible assets may be purchased or internally generated, separately identifiable or non-identifiable. Identifiable intangible assets can be sold or acquired separately from other assets, for example patents, databases and concessions. Identifiable intangible assets may be referred to as having a marketable value. Non-identifiable intangible assets cannot be sold separately, for example, goodwill, human resources, good labor relations and the power to tax.

10.4 Intangible assets include:

- goodwill;
- patents;
- copyrights;
- brand names;
- subscription lists;
- trade secrets/intellectual property;
- trademarks;
- franchises;
- computer software;
- concessions;
- operating rights or rights of use, such as rights/licenses to extract mineral ore, access rights, rights to operate a radio spectrum; and
- capitalized research and development costs.

10.5 The incidence of intangible assets is potentially much broader in the public sector than in the private sector due to the wide scope of the powers of government to create and delegate powers and rights. A description of the ways in which a government unit may create certain intangible assets (for example, “intangible fixed assets” and “intangible nonproduced assets”) is found in the International Monetary Fund (IMF) *Manual on Government Finance Statistics* Chapter 7 (IMF, December 2001). Examples of intangible assets held by public sector entities include:

- rights under licensing agreements for films, videos, plays, and manuscripts, in entities such as broadcasting, tourism, arts and culture;
- patents and copyrights held by government entities in fields such as tourism, research, education, health, agriculture, archives;
- databases and database management software created and maintained by government entities, such as those containing information on the demographic statistics of the

- population, land ownership, private sector entity ownership and registers of securities and charges;
- airport landing rights;
 - licenses to operate radio or television stations;
 - import/export licenses;
 - fishing quotas;
 - right to control the extraction of mineral resources;
 - agreements with other entities which give that other entity a right to provide utilities; and
 - rights to issue rights, licenses and quotas.

10.6 Some assets, such as computer software, may have both tangible and intangible elements. In some jurisdictions accounting standards provide for the recognition of internally generated software as a tangible fixed asset, recognizing that the software represents expenditure that is of continuing use to the entity and which supports the generation of future economic benefits. The tangibility of software derives from the fact that it is an integral part of the hardware to which it attaches. Judgment may be required to assess which element is more significant.

International Accounting Standard IAS 38

10.7 This section provides a brief summary of the requirements of IAS 38. IAS 38:

- applies only to certain types of intangible assets. For example, mineral rights are excluded from the scope of the standard;
- permits the recognition of an identifiable intangible asset only when it is probable that the future economic benefits that are attributable to the asset will flow to the entity and the cost of the asset can be measured reliably;
- limits the recognition of internally generated intangible assets. Expenditure on the research phase of generation is to be recognized as an expense. Expenditure on the development phase of generation is to be recognized as an asset when, and only when, the entity meets certain criteria indicating some certainty that the potential benefits associated with the expenditure will be realized;
- requires that identifiable intangible assets be initially measured at cost and subsequently carried at cost or revalued;
- requires the amortization (the systematic allocation of an intangible asset's service potential, excluding any residual value, over the estimated useful life of the asset) of intangible assets. IAS 38 includes a rebuttable presumption that the useful life of an intangible asset will not exceed 20 years;
- requires the regular review of intangible assets for impairment; and
- does not permit the recognition of non-identifiable intangible assets.

- 10.8 IAS 38 does not allow the recognition of internally generated goodwill. However, International Accounting Standard IAS 22, Business Combinations requires purchased goodwill to be recognized. The Public Sector Committee (PSC) has not developed an IPSAS based on IAS 22.

Identification of Intangible Assets

- 10.9 Regardless of which particular accounting standard is adopted, an entity intending to recognize intangible assets will need to compile a list of all potential intangible assets and apply the definition and recognition criteria for intangible assets to each item on the list. Potential intangible assets include a government's rights or agreements with other parties. Although some of these rights and agreements will not be recognized because they do not meet the recognition criteria for assets generally or intangible assets specifically, it is worth including them in the initial scoping exercise. An entity would then apply the criteria for recognition from the relevant accounting standard to determine whether it should recognize the intangible assets identified during the scoping exercise. If this stage of the process is carefully documented, the information collected and conclusions reached can provide useful evidence to support reported balances during an external audit.
- 10.10 Where it becomes apparent that the application of an accounting standard with regard to an intangible asset or group of intangible assets is going to take some time to resolve, an entity may choose to defer recognition of those intangible assets for a set period.
- 10.11 The main steps required in order to account for intangible assets on an accrual basis are:
- identify authoritative guidance and develop accounting policies based on that guidance;
 - identify all potential intangible assets;
 - apply accounting policies to potential intangible assets to determine which intangible assets should be recognized (and whether it would be appropriate to defer recognition of certain intangible assets pending further work);
 - measure intangible assets; and
 - ensure systems are in place to record ongoing transactions and provide for the regular review of impairment.

Development of Accounting Policies for Identifiable Intangible Assets

- 10.12 Accounting policies for identifiable intangible assets need to address:
- initial recognition;
 - recognition of subsequent expenditure;
 - initial measurement;
 - measurement subsequent to initial recognition;
 - amortization;

- impairment; and
- sale or disposal.

10.13 In addition, accounting policies on accounting for goodwill are required. In common with policies on other categories of assets, an entity may also need policies on donated or subsidized assets. Some of the issues facing entities recognizing intangible assets are discussed in more detail below.

Measurement of Identifiable Intangible Assets

- 10.14 IAS 38 requires that identifiable intangible assets be initially measured at cost. In order to satisfy the criterion of measurability, this generally means that intangible assets need to be supported by an appropriate costing system or purchase price. An entity will therefore need to review the adequacy of costing systems and records for identifiable intangible assets.
- 10.15 The availability of cost data will depend upon the type of accounting records previously maintained. Options for measurement in the case of first-time recognition of assets have been discussed in Chapter 6. These options include the re-creation of cost data and the use of fair values as at the date of initial recognition.

Impairment

- 10.16 In order to be in a position to conduct a regular review of recognized intangible assets to determine whether such assets are impaired or should be tested for impairment, an entity will need to regularly collect data on the measures used to apply impairment tests in that jurisdiction.
- 10.17 The accounting policies for impairment, the methods to be used to collect the required data, and responsibility for conducting the impairment review should be established at the same time as the policies for the recognition of intangible assets.

Accounting for Goodwill on Adoption of Accrual Accounting if International Accounting Standard IAS 38 is to be Applied

- 10.18 Tasks associated with accounting for goodwill at the time of first adoption of accrual accounting if it is decided that IAS 38 is to be applied by a public sector entity include:
- identification of situations where the acquisition of an interest in another entity could have involved the payment of goodwill;
 - determining whether the fair values of assets and liabilities acquired at that time can be reliably determined (in the absence of information on fair values at the time of acquisition, goodwill cannot be retrospectively identified);
 - calculating goodwill as at the time of acquisition;
 - calculating the accumulated amortization for goodwill; and

- recognizing goodwill in the separate controlling entity ledger (some jurisdictions require the preparation of separate controlling entity financial statements. However, even in the absence of a requirement for such statements to be prepared, an internal ledger must be created as part of the consolidation process).

Disclosure of Information about Intangible Assets Not Recognized in Financial Statements

- 10.19 Many accounting standards permit the recognition of identifiable intangible assets only and prohibit (or constrain) the recognition of internally generated intangible assets. There is often very little information about intangibles in financial reports. The Financial Accounting Standards Board (FASB) in the United States of America, which develops accounting standards for the private sector, has initiated a proposed project (FASB, August 2001) to consider the possibility of expanding the disclosure of information about intangible assets not recognized in the financial statements.

Relevance to the Cash Basis of Accounting

- 10.20 The issues identified in this Chapter are relevant for entities intending to comply with the requirements of any future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* if they wish to provide additional disclosure on the nature and amount of intangible assets. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the primary financial statement.

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Appendix: Accounting Policies

This Appendix illustrates an example of accounting policies for intangible assets that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. In the absence of an IPSAS on this topic, the illustrative policy is based largely upon IAS 38. The policy illustrated requires intangible assets to be measured initially at cost, with subsequent revaluations to fair value where fair values are available. The policy adopted by a particular entity will be influenced by relevant authoritative pronouncements in that jurisdiction.

Recognition of Intangible Assets

Intangible assets are to be recognized when it is probable that the future economic benefits that are attributable to the intangible asset will flow to the entity and the cost of the asset can be measured reliably.

Where the cost of an acquired intangible asset is not available at the time of first recognition, the asset is to be recognized at its fair value as at the date it is first recognized as an asset in the financial statements. This value will be determined by reference to an active market, or in the absence of an active market, by a professional valuer.

Research and Development

Expenditure on the research phase is to be recognized as an expense.

Expenditure on the development phase is to be recognized as an asset when, and only when, the expenditure meets the criteria in International Accounting Standard IAS 38, *Intangible Assets* regarding the likelihood of potential benefits being realized.

Internally Generated Intangible Assets

The cost of an internally generated intangible asset is to include all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use.

Overheads are to be included in the cost of the asset but only to the extent that they are necessary to generate the asset and can be allocated to the asset on a reasonable and consistent basis.

Internally generated goodwill, logos, magazine mastheads, publishing titles, client lists and items similar in substance are not to be recognized as intangible assets.

Subsequent Periods

In subsequent periods, intangible assets are to be recognized at cost¹, less any accumulated amortization and any accumulated impairment losses.

¹ Although this entity has chosen to recognize intangible assets at cost, some entities may choose to revalue intangible assets.

For entities adopting regular revaluations:

Intangible assets are to be regularly revalued to fair value, where fair value is determined by reference to an active market. Where there is no active or liquid market for an asset it is to be recognized at the latest fair value obtained with reference to an active market, less any accumulated amortization and any accumulated impairment loss since that date.

Amortization policies are to be reviewed annually.

Additional Disclosure

Information on intangible assets not recognized is to be disclosed in the notes to the financial statements in accordance with the policy on assets not recognized.¹

¹ The proposals in FASB, August 2001 may be of assistance in considering the nature of these disclosures.

CHAPTER 11: FINANCIAL INSTRUMENTS

Key Points

- International Public Sector Accounting Standard IPSAS 15 *Financial Instruments: Disclosure and Presentation* contains requirements regarding the disclosure and presentation of financial instruments.
- In the absence of an International Public Sector Accounting Standard (IPSAS) on the recognition and measurement of financial instruments, this Chapter uses International Accounting Standard IAS 39, *Financial Instruments: Recognition and Measurement* to outline the types of requirements for the measurement of financial assets and financial liabilities. Certain limited aspects of IAS 39 are currently subject to review by the International Accounting Standards Board.
- This Chapter illustrates a list of tasks and issues to assist entities in planning for the identification, disclosure, presentation, recognition and measurement of financial instruments.
- There are a number of current international developments regarding the recognition and measurement of financial instruments which may have an impact on the reporting of financial instruments.

Introduction

- 11.1 This Chapter outlines the requirements in IPSAS 15 and explains the steps that an entity choosing to comply with IPSAS 15 would need to work through. The Chapter also outlines current developments regarding the recognition and measurement of financial instruments. Readers will need to consider the potential implications of these developments when developing criteria for recognition of financial instruments and selecting the basis of measurement for various classes of financial instruments.
- 11.2 As noted in Chapter 7, in common with the International Accounting Standards (IASs) on which they are based, IPSASs do not specifically address issues associated with Islamic financial services that do not fit with the notions in IPSAS 15. For example, while IPSAS 15 may apply to a range of contracts or components of contracts that arise within Islamic law, its requirements regarding disclosure of interest will not be relevant. The Accounting and Auditing Organization for Islamic Financial Institutions prepares accounting standards for Islamic financial institutions. These standards are regarded as complementing IASs in areas where IASs are insufficient to meet the Islamic Law requirements to which Islamic financial institutions adhere in their business transactions.

Definitions

- 11.3 IPSAS 15, paragraph 9, defines financial instruments as “any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.” IPSAS 15 states that commodity-based contracts that give either party the right to settle in cash or some other financial instrument should be accounted for as if they were financial

instruments. The exception is where the entity entered into the commodity contract because it required the commodities for its operations.

11.4 Financial assets as defined in IPSAS 15 include:

- cash;
- contractual rights to receive cash or another financial asset from another entity;
- contractual rights to exchange financial instruments with another entity under conditions that are potentially favorable; and
- equity instruments of another entity.

11.5 Financial assets therefore include cash, revenues receivable, loans and advances, investments, derivatives and prepayments. Under a historical cost accounting model, foreign exchange assets are commonly carried at closing rates and short- and long-term loans are carried at face value. However, as discussed below, standard setters are currently considering proposals that all financial assets be carried at fair value.

11.6 Financial liabilities are contractual obligations:

- to deliver cash or another financial asset to another entity; or
- to exchange financial instruments with another entity under conditions that are potentially unfavorable.

Disclosure and Presentation

11.7 IPSAS 15 disclosure requirements relate to a wide range of financial instruments – not just those that have met the criteria for recognition in the financial statements. The implications of these requirements are outlined in the implementation section below.

Recognition and Measurement

11.8 There is currently no IPSAS dealing with the measurement of financial assets and liabilities. In the absence of an IPSAS dealing with this issue, IAS 39 has been used to outline the types of requirements that may be found in standards dealing with the measurement of financial assets and liabilities. The use of IAS 39 as an illustrative standard does not convey the considered position of the PSC in relation to the measurement of financial assets and liabilities. IAS 39 requirements include:

- all financial assets and liabilities, including derivatives, are to be recognized;
- financial instruments are to be initially measured at cost (including transaction costs);
- normal purchases and sales of financial assets are to be recognized at either trade or settlement date;
- most financial assets are to be subsequently re-measured at fair value – exclusions include loans and receivables originated by the entity and not held for trading, other

fixed interest maturity investments with fixed or determinable payments, and financial assets whose value cannot be reliably measured;

- most financial liabilities should subsequently be measured at initially recorded cost less principal repayments and amortization; and
- where derivatives and liabilities are held for trading they should be re-measured at fair value.

11.9 The measurement approach adopted in IAS 39 is currently subject to review. Proposals for a more comprehensive standard include the views of the International Accounting Standards Committee (IASC) Joint Working Group (JWG), which have been published in the *Draft Standard and Basis for Conclusions – Accounting for Financial Instruments and Similar Items* (Financial Instruments Joint Working Group, December 2000)¹. The *Draft Standard* proposed replacement of most of IAS 39 and International Accounting Standard IAS 32, *Financial Instruments: Disclosure and Presentation*. The proposals in the *Draft Standard* include:

- measurement of virtually all financial instruments at fair value;
- recognition of virtually all gains and losses resulting from changes in fair value in the Statement of Financial Performance in the periods in which they arise;
- the prohibition of special accounting for financial instruments used in hedging relationships;
- adoption of a components approach for accounting for transfers of financial assets; and
- some expansion of disclosures about financial instruments, financial risk positions and Statement of Financial Performance effects.

While the current review of IAS 39 encompasses certain of the proposals of the draft standard, further work on the draft standard is not currently on the short-term timetable of the IASB.

11.10 Although these proposals could have a significant impact on the reported balances of some entities, entities complying with IPSAS 15 would already have information on fair values for disclosure purposes.

11.11 Discussion of issues associated with the measurement of certain financial assets and liabilities at fair values, including the estimation of fair value when little or no market

¹ The JWG was formed in 1997 for the sole purpose of developing a coherent framework for reporting financial instruments at fair value. That framework was to be based on the principles discussed in the March 1997 Discussion Paper, *Accounting for Financial Assets and Financial Liabilities*, issued by the IASB and the Canadian Institute of Chartered Accountants, as further developed or amended as a result of the deliberations of the JWG. The JWG consists of nominees of accounting standard setters or other professional organizations in Australia, Canada, France, Germany, Japan, New Zealand, the Nordic Federation, the United Kingdom, and the United States, as well as the IASB. The positions taken in the Draft Standard reflect the views of a majority of the members of the JWG. They do not necessarily represent the view of the organizations that nominated the members of the JWG. Updates on developments in this area can be monitored at <http://www.iasb.org.uk>.

evidence is available, is found in *Preliminary Views on Major Issues Related to Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value* (FASB 1999). The recommendations in the *JWG Draft Standard* for fair value measurement are broadly similar to those in the *Preliminary Views*, though some details differ. A discussion of some differences is found in the *JWG Draft Standard*.

Implementation Issues

- 11.12 The following list of tasks and issues will assist entities in planning for the identification, disclosure, presentation, recognition and measurement of financial instruments. Completion of these steps should enable an entity to meet the requirements in IPSAS 15. When developing criteria for recognition of financial instruments and determining the basis of measurement for each class of financial instrument, entities are encouraged to review the latest international and national developments in this area, and consider the impact of these developments on their future reporting requirements.

Identification

- Identify all potential financial instruments in all controlled reporting entities. This includes checking for financial instruments that do not meet the criteria for recognition (for example, gold bullion is regarded as a commodity rather than a financial instrument).
- Identify all derivatives contracts – examples of common derivative contracts are provided in *IAS 39 Implementation Guidance – Questions and Answers* (IASB, January 2001).
- Record details of where existing information on financial instruments is held.
- Allocate responsibility for the maintenance of information on such financial instruments and financial reporting of various categories of assets and liabilities.
- Identify all categories of revenue, expense, assets and liabilities associated with financial instruments that are relevant for the reporting entities and the classifications that will be used in the chart of accounts and the financial statements.
- Identify existing accounting policies and update these as new accounting policies are developed.
- Review/develop and implement administrative procedures for the issuance, collection and safe custody of financial instruments, including:
 - individual identification of instruments;
 - the establishment of a register of instruments and their status;
 - retention of a copy of all instruments on issue;
 - appropriate cancellation procedures; and
 - safe custody arrangements for instrument stationery.

- Review/develop systems for providing details of significant terms and conditions of financial instruments.

Disclosure and Presentation

- Classify all financial instruments in accordance with the required categories, for example, trading/non-trading. Identify how the entity will demonstrate its intention to hold certain loans and receivables to maturity.
- Classify all financial instruments issued by the entity as liabilities or net assets/equity.
- Identify all financial instruments held as specific hedges rather than as hedges against an overall position.
- Check whether all shares meet the definition of equity instruments. If not, ensure that dividends relating to these shares are classified as expenses.
- Check whether any financial assets and liabilities meet the criteria for set-off.
- Identify the extent to which financial risks, including price risk (currency risk, interest rate risk, and market risk), credit risk, liquidity risk and cash flow risk, are relevant for the reporting entity.
- Develop and document financial risk management objectives and policies, including hedging policies (such objectives and policies may already be in existence for certain categories of financial instruments such as borrowings and government securities).
- Develop methods of monitoring and reporting on financial risks, including information on maturity dates, effective interest rates and maximum credit risk exposure.
- Decide where disclosures on financial instruments will occur. Options include the face of the financial statements (for recognized financial instruments only), the notes to the financial statements, and supplementary schedules or statements.
- Develop the format for disclosures and identify how this information can be obtained each reporting period and who has responsibility for the provision of this information for external reporting.
- Prepare pro forma disclosures – examples are illustrated in an Appendix to IPSAS 15.

Recognition and Measurement

- Develop/review criteria for recognition and derecognition.
- Develop/review the basis of measurement for each class of financial asset and financial liability:
 - where historic cost or modified historic cost is used, identify the method used for initial and subsequent measurement, including the treatment of premiums and discounts on issue, indexed instruments, doubtful debts and impairment;
 - where fair value is used, identify determination of carrying amounts, for example, quoted market prices and discounted cash flows;

Transition to the Accrual Basis of Accounting

- where discounted cash flows are used to obtain fair value, identify the appropriate discount rate; and
- identify any significant assumptions required for measurement.
- Develop/review policies for financial instruments used to hedge anticipated transactions.
- Develop/review basis on which revenue and expense arising from the financial assets and liabilities will be recognized.
- Develop policies for certain types of transactions involving financial instruments (refer to IPSAS 15).
- Apply recognition criteria.
- Identify the relevant opening balance for all recognized financial instruments.
- Identify fair value for all financial assets and liabilities or identify where this is not practicable. Note that fair values are required for disclosure purposes even where another measurement base is used.
- Develop/review systems for obtaining fair values at reporting dates.

Relevance to the Cash and Other Bases of Accounting

- 11.13 The issues identified in this Chapter are relevant for entities intending to comply with the requirements of any future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*. Entities using the cash basis of accounting will have recognized most of their cash assets (refer Chapter 9 *Cash* for additional discussion of issues associated with the recognition of cash under the accrual basis). It is also likely that entities using the cash basis of accounting will maintain additional records of some investments and formal debt. However, they are unlikely to have comprehensive records of all financial assets and liabilities.
- 11.14 Entities using a modified version of the accrual basis are likely to have information on a much wider range of financial assets and liabilities. However, existing records and systems still need to be assessed against the disclosure and recognition requirements of the accounting standards adopted under accrual accounting.

References

Financial Accounting Standards Board (FASB), No. 204-B, *Financial Accounting Series Preliminary Views on Major Issues Related to Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value*, <http://www.fasb.org>, December 1999.

Financial Instruments Joint Working Group, *Draft Standard and Basis for Conclusions – Financial Instruments and Similar Items*, <http://www.iasb.org.uk/>, June 2001.

International Accounting Standards Board (IASB), IAS 39, *Financial Instruments: Recognition and Measurement*, January 2001.

International Accounting Standards Board (IASB), IAS 39, *Implementation Guidance – Questions and Answers*, <http://www.iasb.org.uk/>, January 2001.

International Federation of Accountants (IFAC), IPSAS 15 *Financial Instruments: Disclosure and Presentation*, December 2001.

International Federation of Accountants (IFAC), IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting*, <http://www.ifac.org>, May 2000.

Appendix: Accounting Policies

This Appendix illustrates the internal accounting policies used to identify, disclose, recognize and measure a selection of financial instruments. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The disclosure and presentation policies are based on the assumption that the entity will adopt IPSAS 15. The recognition and measurement policies illustrated in IPSAS 15, Appendix 2 will not necessarily be those chosen by other entities, as the recognition and measurement of financial instruments varies across jurisdictions.

Chapter 9 *Cash* and Chapter 7 *Liabilities* also contain useful discussion of accounting policy issues relating to financial instruments.

Financial Instruments

The entity will comply with the financial instrument disclosures required by International Public Sector Accounting Standard IPSAS 15 *Financial Instruments: Disclosure and Presentation*. It will make appropriate disclosures in line with the examples shown in Appendices 2 and 3 of IPSAS 15.

Receivables and advances

Receivables and advances are recorded at the amounts expected to be ultimately collected in cash.

Investments

Marketable securities held for trading purposes

Marketable securities held for trading purposes are recorded at fair value.

Equity investments

Equity investments (other than those forming part of the reporting entity) are recorded at the lower of cost and fair value.

Other investments and marketable securities held for investment purposes

Other investments, including marketable securities held for investment purposes, are recorded at the lower of cost and fair value.

Investments held for hedging purposes are recorded on the same basis as the item being hedged.

Creditors and payables

Creditors and payables are recognized for amounts to be paid in the future for goods or services received.

Borrowings

In the Statement of Financial Position, borrowings (including currency swaps) are recorded at nominal value adjusted for the unamortized portion of the premium or discount on issue.

Derivative Financial Instruments

A number of financial instruments are used to assist in meeting debt management objectives with respect to currency and interest-rate exposures in the Government's net foreign debt portfolio. The range of instruments currently being used includes currency and interest-rate swaps, foreign-exchange contracts and futures contracts. Interest-rate swaps are also used in the domestic debt portfolio.

CHAPTER 12: EMPLOYEE-RELATED LIABILITIES

Key Points

- At the time of writing, there is no International Public Sector Accounting Standard (IPSAS) dealing with the recognition, measurement or disclosure of employee-related expenses and liabilities. In the absence of an IPSAS, entities will need to develop accounting policies based on appropriate authoritative guidance. International Accounting Standard IAS 19 *Employee Benefits* is one source of guidance on these matters.
- Certain policy decisions, such as the devolution or non-devolution of authority for personnel functions and the extent to which personnel functions are centralized can have a major impact on the design of information systems. Such decisions would ideally be made at an early stage of the reform process.

Introduction

- 12.1 Employee expenses¹ are employees' entitlements as a result of rendering their services to an employer. Employee-related liabilities include liabilities associated with the following employee-related expenses:
- salaries and wages (including overtime and allowances);
 - annual leave;
 - sick leave;
 - long service leave;
 - pension and superannuation entitlements (referred to as pensions throughout this Chapter);
 - redundancy payments;
 - other post-employment benefits; and
 - other employee entitlements, for example free or subsidized health care.
- 12.2 Most salaries and wages earned during a reporting period are paid during that period and therefore only a small liability exists at the end of the period. However, in the case of other employee entitlements, particularly pension entitlements, end-of-period liabilities can be significant. This Chapter deals with issues associated with the recognition of such liabilities. It does not address issues associated with pensions provided to citizens as opposed to government employees. Issues associated with the recognition of such pension schemes are discussed in Chapter 13.

¹ In some circumstances employee-related costs are not expensed, for example, where employee-related costs form part of the costs of a self-constructed asset.

Review of Existing Systems and Structures

- 12.3 All entities, regardless of the basis of accounting used, will have established systems (manual or computer-based) for calculating and processing wage and salary payments and maintaining records on employee entitlements to benefits such as paid leave. There are two main issues when assessing the extent to which these systems will be able to provide the information required for the preparation of accrual-based financial statements:
- whether existing systems hold information in a form that is readily accessible to those responsible for the preparation of the financial statements; and
 - whether the required information is accessible at the level of the individual reporting entity and if not, the nature of system changes that will be required.

Accessibility

- 12.4 Existing systems may accurately record details of each individual employee's remuneration and entitlements such as annual leave earned and taken. However, if this information is available only by consulting each individual's personnel records at the end of each reporting period (for example, monthly or quarterly) the task of aggregating the liability could be onerous or impossible.

The Reporting Entity and the Degree of Centralization

- 12.5 Many governments have centralized personnel or human resource departments or entities, which have responsibility for a wide range of personnel functions including recruitment, training, promotion, establishment of terms and conditions, administration of disciplinary processes, personnel records and wage and salary systems. The introduction of accrual accounting may be accompanied by changes to centralized personnel functions such as the devolution of some of these functions. Such devolution is not a consequence of adopting accrual accounting.
- 12.6 The definition of the reporting entity has an impact on the level of aggregation required. If individual government entities are reporting entities and centralized systems are maintained, then it is necessary to either:
- ensure that personnel systems can record employee expenses and accrued liabilities for each individual reporting entity. This may involve the use of internal allocations or actual payments by individual entities to reimburse the central entity; or
 - decide that individual entities will not be required to account for certain employee expenses and liabilities. This latter option is not consistent with accrual accounting to the extent that the financial statements should include all expenses, including the cost of goods and services provided free of charge. However, for practical reasons some jurisdictions may choose not to allocate certain costs to individual entities. The non-allocation of some costs and accrued liabilities may in some circumstances be justified on the grounds that they are the responsibility of the government as a whole rather than its individual entities.

- 12.7 As the devolution or non-devolution of authority for personnel functions can have a major impact on the design of systems, such policy decisions would ideally be made at an early stage of the reform process.

Implementation

- 12.8 The following list sets out some of the steps required for the recognition of employee-related liabilities. Where entities have been using a modified version of the cash or accrual basis for budgeting or financial reporting, some or most of the information referred to in these steps may already be readily available:
- Develop accounting policies.
 - Determine appropriate classifications, including current and non-current.
 - Identify all potential employee-related expenses and liabilities.
 - Document the background to each entitlement, including the underlying authority, entitlement criteria, when entitlement occurs, payment dates, existing information on the likely amount of the associated liability, and contact details for people responsible for administering the entitlements.
 - Distinguish between benefits that lead to an absolute entitlement and those taken on the basis of need, as the recognition point for the two will differ.
 - Estimate the likely range for the amount of each liability at the end of each reporting period to assess the materiality of the liabilities.
 - Identify possible ways in which liabilities could be determined at the end of each reporting period and the information required in order to calculate relevant amounts (for example, system changes, actuarial valuations, estimation).
 - Develop recommendations on proposed methods of obtaining information including system changes.

Accounting Policies

- 12.9 At the time of writing, there is no IPSAS dealing with the recognition of liabilities arising from employee-related expenses. Exposure Draft International Public Sector Accounting Standard IPSAS ED 21 *Provisions, Contingent Liabilities and Contingent Assets* excludes provisions arising from employee benefits. International Accounting Standard IAS 19, *Employee Benefits* is one source of guidance on the recognition of employee-related expenses, including pension costs. The Public Sector Committee (PSC) has not yet considered the application of this standard to public sector entities, but has indicated its intention to develop an IPSAS on employee benefits. Examples of other authoritative pronouncements are included in the References to this Chapter. Despite the fact that Exposure Draft IPSAS ED 21 does not apply to employee entitlements, the guidance in Exposure Draft IPSAS ED 21 may be useful where the accounting standard being applied by an entity does not contain guidance on a specific employee entitlement, or where the entity is uncertain whether an obligation meets the definition of an employee entitlement.

Accrued Salaries and Wages

- 12.10 Monthly financial statements are often prepared for internal reporting purposes. Salaries and wages are commonly paid weekly, fortnightly, four weekly or monthly. They may be paid in arrears, in advance, or a mixture of both. Accrued salaries and wages are determined by multiplying the average daily salary and wage bill by the number of days between the last salary and wage payment and the end of the reporting period (less any days that were paid in advance). Entities need to decide whether the “days” used in this calculation are calendar days or working days.
- 12.11 Accruals for allowances that are regular in amount may be calculated in the same way as for salaries and wages. Where payment dates differ or the amounts fluctuate markedly between periods, a separate accrual may be required for some types of payment. Adjustments may need to be made for large one-off or unusual payments that should not form part of the average daily salary and wage bill.
- 12.12 Although some entities in the public sector may have a wide range of allowances that form part of an employee’s remuneration, the calculation of salary and wage accruals should be performed in the same manner as in the private sector. The reference manuals for accounting systems generally contain guidance on options within the system for such accruals.
- 12.13 In terms of implementation, the main issues are to identify payment dates, the extent to which payments are in arrears or advance, which salary and wage components should be included in the average daily salary bill and the definition of “days”. In addition, an entity needs to decide whether it will perform these accruals for the entity as a whole, or whether it will allocate these accruals to individual sub-units within the entity.
- 12.14 Performance pay is usually classified as salaries and wages, although it may be paid only once or twice a year.

Annual Leave

- 12.15 Entities should be able to obtain details of opening and closing annual leave entitlements from their payroll system (changes to payroll systems to ensure that this information is available on a regular and timely basis is the major implementation issue for recognition of this liability).
- 12.16 An entity may have a policy limiting the number of days’ leave that may be carried forward. In such cases, the accrual for the annual leave liability may be calculated for the full amount of annual leave owing, even where some individuals have accumulated leave in excess of the permitted amount, with reductions in accordance with the policy being performed as a separate exercise.
- 12.17 Accrued annual leave is usually taken within the following period and there is therefore no need to discount the amount.

- 12.18 In practice, annual leave that employees take during a period is often classified as salary expense rather than as annual leave expense.

Long Service Leave

- 12.19 Some jurisdictions provide extended or additional leave entitlements in recognition of periods of long service by employees. These entitlements usually vest after a specified period of service. A liability for long service leave (and other long service benefits such as overseas trips) should be accrued based upon an estimate of the number of employees likely to qualify for the leave, the amount of the entitlement and the estimated date of entitlement.
- 12.20 In order to assess the likely amount of the liability, the entity will need to research such matters as:
- the number of employees qualifying for the leave in recent years and any factors which are likely to lead to a higher or lower uptake rate in the future (for example, projected attrition rates);
 - their average rate of pay and projected pay of future recipients, taking account of pay increases due to promotion and inflation; and
 - the likely cost of the long service leave to be paid to existing employees in future years and the present value of those amounts.
- 12.21 It may be argued that, technically the liability should be recognized from the first year of service. However, because of employee turnover, recognizing the liability only for those employees who have been employed for a certain time and are therefore more likely to qualify for the leave may provide a reasonable estimate. The approach adopted by an entity will depend upon the amount of work involved and the impact on the financial statements of calculating the liability for all employees from their first year of service or from some other date, such as from five or ten years from their date of employment. The latter approach results in the first five or ten years' obligation for an employee being recorded as an expense in one period. Where there are low numbers of employees qualifying for long service leave or the value of the benefit is minimal, there may be no material impact on the financial statements of recognizing the expense as the entitlement falls due. Actuarial estimates may be helpful in assessing the most appropriate time at which to begin recording long service leave.
- 12.22 Where similar conditions of service apply across a range of government entities, guidance on the appropriate time of recognition should be provided to all entities to ensure a consistent approach.
- 12.23 The long service leave expense is the change in the provision for long service leave entitlements between the beginning and end of the reporting period, plus any payments made during the period. Where long service leave payments are paid as normal salary amounts it is helpful if the personnel system also highlights the amount relating to long service leave. If payments during a period are not material, the change in the provision during the period may provide a reasonable estimate of the expense. However, to justify this approach an entity

would need to provide evidence showing how it had estimated leave payments during the period.

Sick Leave

- 12.24 Employees may be allowed to accumulate sick leave up to a specified number of days. However, the entitlement to sick leave is generally available only in times of sickness and is therefore non-vesting. Where employees, on average, take fewer sick leaves than their entitlement, there is no need to recognize a liability. The entity needs to research (and document) the amount of sick leave taken by various groups of employees to support the approach taken.

Pensions

- 12.25 Defined benefit plans are retirement benefit plans under which pensions are determined by reference to a formula based on employees' remuneration and length of service. Defined contribution plans are retirement benefit plans under which the employer and employee make specified contributions to the plan during a set period. Defined benefit plans may be fully funded (plan assets are sufficient to offset plan liabilities), partially funded (plan assets partially offset plan liabilities), or are funded on a pay-as-you-go basis. On a pay-as-you-go basis, the employee may make a regular contribution to the scheme, but the government contributes only the amount required to pay the amounts currently owing to retired employees. Where plan assets are less than plan liabilities, the net amount is often referred to as the unfunded component.
- 12.26 In order to meet the requirements of reliable measurement, the amount of the unfunded liability is usually estimated by actuaries. Although the detailed calculations are performed by actuaries, the entity still needs to work through the following steps to ensure that all potential liabilities are accounted for:
- Identify all government pension plans/payments (including ex gratia payments to employees in lieu of pension payments).
 - Document the contributors and recipients for each plan.
 - Classify pensions to employees as either costs which should be allocated to individual reporting entities or costs which should be reported at the whole-of-government level (for example, ongoing obligations to previous government employees may be treated by some governments as a whole-of-government expense).
 - Determine whether there is a legal obligation (supported by legislation or contract) to make payments. In the case of payments where there is no clear legal obligation, establish whether there is a constructive obligation.
 - Determine whether schemes are defined benefit plans or defined contribution plans in terms of IAS 19.
 - Determine whether schemes are fully funded, partially funded, or are funded on a pay-as-you-go basis. Fully funded schemes are those where annual contributions to the scheme

cover the annual expense. The unfunded component of schemes occurs when annual payments are not sufficient to cover the annual expense. Where schemes are not fully funded, including on a pay-as-you-go basis, regular actuarial valuations are required to provide evidence of the amount of the unfunded liability.

- Research and assess the likelihood of the government changing employees' pension entitlements. This will impact upon the probability of future payments being made and the calculation of the pension liability.
- Clarify institutional arrangements for the recognition of the liability. Each individual reporting entity should recognize total employee-related expenses. However, if a central entity has assumed responsibility for the liability then an individual entity does not need to recognize the liability. Instead it would recognize both an expense and a corresponding revenue to acknowledge that another entity has assumed one of its obligations. Where responsibility for pension liability is assumed at a central level, the central entity will need to devise a method of allocating the aggregate pension expense to individual entities. Such allocations may be based on actuarial assessments where these are available. In the absence of such assessments, pro rating the total pension expense by entity personnel expense/total government personnel expense may give an approximation.
- Select an appropriate discount rate for calculating the present value of liabilities.

Other Employee Benefits

- 12.27 Employee expenses do not include amounts paid or owed to employees as reimbursement for work-related expenses paid for by the employee. Such expenses could include amounts paid for travel and accommodation while performing duties as an employee.
- 12.28 The classification of other benefits provided to employees is subject to judgment. For example, the provision of rental accommodation to employees free of charge may be shown as employee expenses or as accommodation expenses. Classification is of importance when complying with requirements concerning the disclosure of employee remuneration. Entities can assist users of financial statements by providing a clear description of the accounting policy for the determination of remuneration, including reference to relevant disclosure standards.

Relevance to the Cash Basis of Accounting

- 12.29 The issues identified in this Chapter are relevant for entities intending to comply with the requirements of any future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* if they wish to provide additional disclosure on the nature and amount of employee-related liabilities. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the primary financial statement.

References

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Chapter 12: Employee-Related Liabilities

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Appendix: Accounting Policies

This Appendix illustrates the internal accounting policies for the recognition of employee expenses and associated employee-related liabilities. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. There is no IPSAS on this topic. In the absence of an IPSAS, entities will need to develop accounting policies based on appropriate authoritative guidance. Generally accepted accounting practice with regard to employee-related liabilities varies between countries. For example, in some jurisdictions it is not common practice to recognize a liability for accrued leave.

General

The full cost of employees' services is to be recognized as an expense when the expense is incurred. Amounts incurred but not paid are to be accrued. Liabilities assumed by another entity are to be recognized as an expense of one entity and a revenue of the other.

Salaries and Wages

A liability for salaries and wages incurred but not paid is to be accrued at the end of the reporting period.

Annual Leave

Annual leave due but not taken is to be recognized as a liability. It is to be calculated on the basis of leave owing to each employee (including any time in lieu), and is to be based on the individual employee's expected salary at the time the leave is likely to be taken. For example, if the leave is expected to be taken within the following period, the employee's expected salary during that period would be used.

Accrued annual leave that must be taken within the following year is to be classified as a current liability. Accrued annual leave that may be taken after the following year is to be classified as a non-current liability. The provision for annual leave is not discounted.

Long Service Leave

Provisions for long service leave entitlements are to be initially recognized once an employee has completed five years' service¹ and subsequently recognized each year following that time.

Long service leave liabilities are to be measured as the present value of estimated leave service entitlements. In measuring the present value of long service leave entitlement liabilities, the average interest rate attaching, as at the reporting date, to borrowings of the entity is to be used to discount estimated future cash outflows.

Provisions for long service leave are to be classified as current or non-current as appropriate.

¹ The number of years' service required by an entity before it begins to account for long service leave will vary depending upon the entitlement criteria for the leave and the relationship between various lengths of service and the proportion of employees qualifying for the leave.

Other long service benefits are to be recognized at the point that the employee becomes entitled to them.¹

Sick Leave/Compassionate Leave

No liability or expense is to be recognized in relation to sick leave and compassionate leave until the time of absence.²

Pensions

Defined Benefit Plans

The liability (the unfunded component) arising in respect of the following defined benefit plans is to be accounted for in accordance with International Accounting Standard IAS 19, *Employee Benefits*³.

- [*The reporting entity is to list the pension plans.*]

The amount recognized as a defined benefit liability is to be the net of the following amounts:

- the present value of the defined benefit obligation as at the end of the reporting period (after taking account of any payments against the liability during the period);
- plus any actuarial gains (less any actuarial losses) to the extent that they are recognized in accordance with IAS 19 (this refers to fluctuations which exceed the limits set out in IAS 19);
- less any past service cost not yet recognized as an expense; and
- less the fair value at the end of the reporting period of plan assets out of which the obligations are to be settled directly.

The liability is to be assessed annually by [*reporting entity to insert details of specified actuary*]. It is to be calculated based on the latest actuarial assessment [*reporting entity to specify frequency with which assessment occurs*] or more recent data if this is available.

Defined Contribution Plans

The contribution due to a defined contribution plan in exchange for service provided by employees during the year is to be recognized as an expense in accordance with IAS 19.

A liability for contributions payable to a defined contribution plan is to be recognized only if the contribution paid during the period is less than the contribution required.

¹ This policy assumes that the impact of recognizing such other long service benefits in this way is immaterial.

² This policy assumes that sick leave is non-vesting and that employees on average take sick leave equal to or less than the entitlements that accrue in the reporting period.

³ Readers should note the use of IAS 19 in these illustrations does not imply that the PSC has reviewed the applicability of this IAS to the public sector.

Severance/Termination Benefits

A liability for severance/termination payments is to be recognized if there is a present obligation on the employer at the reporting date. There is an obligation to be met where there is an award or agreement that provides for payments to be made under specified conditions and these conditions are satisfied.

CHAPTER 13: LIABILITIES ARISING FROM SOCIAL POLICY OBLIGATIONS

Key Points

- This Chapter addresses issues associated with the accounting treatment of liabilities or potential liabilities arising from certain social policy obligations of governments. Examples of circumstances in which a government may have a social policy obligation include:
 - future obligations arising from social benefits such as state retirement benefits and unemployment benefits;
 - moral or equitable obligations to provide relief to victims of natural disasters;
 - obligations under accident compensation schemes;
 - the announcement of a new program or spending initiative; and
 - future obligations under current policies.
- At the time of writing, there is no International Public Sector Accounting Standard (IPSAS) dealing with the recognition, measurement or disclosure of liabilities arising from social benefits provided by an entity for which it receives no or nominal consideration directly in return from the recipients of those benefits. In the absence of an IPSAS, entities will need to develop accounting policies based on appropriate authoritative guidance. The PSC has recently established a Steering Committee to assist in the development of guidance on this issue.
- This Chapter outlines approaches adopted by some governments to the recognition of various obligations arising from these social benefits. The types of social benefits provided, eligibility criteria, timing of eligibility and likelihood of future obligations vary between jurisdictions.
- This Chapter suggests that entities first identify all potential social policy obligations, and then attempt to find solutions to the accounting issues associated with those obligations by grouping them into categories with similar characteristics.

Introduction

- 13.1 This Chapter addresses issues associated with the identification and recognition of liabilities arising from the social policy obligations of governments for which the government receives no or nominal consideration directly in return from the recipients of those benefits. Social policy obligations arising from exchange transactions will be dealt with by the IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 21 *Provisions, Contingent Liabilities and Contingent Assets* (refer Chapter 7). In addition, this Chapter does not address issues associated with employee-related liabilities (refer Chapter 12).
- 13.2 Social policy obligations are the current and future financial obligations of a government to provide goods, services and transfers to citizens under its existing social policies. Social policies encompass a government's policies in relation to the direct provision or funding of

services such as health, education, housing and social protection. The provision of services or various forms of social protection through transfers may be targeted (for example, recipients may be restricted to families and children, the elderly, the ill, the widowed, the unemployed or those on low incomes). Alternatively they may be available to all citizens. Governments at all levels may provide financial assistance to individuals and groups in the community to access services to meet their particular needs, or to supplement their income.

- 13.3 Social policy obligations may be funded entirely by the government, or partially by the government and partially by way of contribution from the recipients. In such cases, the government's portion of the cost may be funded by way of tied taxes or general taxes. Both government contributions and individual contributions may be made over a period of years (often to a separate scheme or plan) or at the time of provision. In some jurisdictions social benefits may be provided in the form of an exchange transaction whereby recipients pay a government agency an amount approximately equal to the benefit received.
- 13.4 Governments are generally involved in a much wider range of activities than individual private sector entities, and face more issues in relation to the identification and measurement of liabilities. Accounting standard setters developing standards for the private sector generally do not consider the full range of issues that arise in the public sector. Governments which have adopted, or are adopting, accrual accounting have been forced to address these issues. Some of the approaches taken within various jurisdictions are discussed further below.
- 13.5 At the time of writing there is no IPSAS dealing specifically with the accounting treatment of liabilities arising from social policy obligations. In addition, Exposure Draft IPSAS ED 21 excludes from the scope of the Standard provisions and contingent liabilities that arise from social benefits which the entity provides to the community and for which no or nominal consideration is expected directly in return from the recipients of those benefits.

Possible Approaches

- 13.6 This section outlines approaches adopted by some governments to the recognition of various obligations arising from social benefits. The types of social benefits provided, eligibility criteria, timing of eligibility and likelihood of future obligations vary between jurisdictions. The approaches should not be seen as mutually exclusive, but as examples of approaches that may be appropriate given the nature of a particular social benefit.

Example 1

A government accrues unpaid amounts due to service providers in relation to free and subsidized medical care already provided by government-owned institutions at the end of the reporting period. Although it does not recognize the future costs of such medical care policies in the financial statements themselves, it provides additional disclosures.

Example 2

A government recognizes its obligation to third party recipients to deliver goods, services or transfers once the intended third party recipient has met certain eligibility criteria as established in the contract or legislation. For example, in the case of welfare payments the government does not recognize a liability until it acknowledges an obligation to the recipient for the welfare payment. This happens when the government receives an application for a welfare payment and the application meets the eligibility criteria in legislation or regulations.

Example 3

A government has no legal obligation to make welfare payments. This government recognizes welfare payments as a liability and an expense when they are due to be paid, regardless of when payment actually occurs. If such liabilities have not been paid by the end of the reporting period, the liability is recognized in the Statement of Financial Position. The obligation recognized includes any recipients who have been entered into the system for that payment period.

Example 4

A government operates a workers' injury compensation plan. It recognizes the future costs of past claims and the future costs of new claims in respect of which the injuries have occurred but claims have yet to be notified.

Example 5

Government entities use grants to reimburse external providers for payments made to entitled citizens in accordance with government policy. The government entities recognize an obligation to the external providers at the point at which the external providers make the payments to citizens. This is considered to be the "past event" which triggers the "present obligation".

Implementation Issues

- 13.7 The first step is to identify all potential obligations that could lead to the recognition of a liability or provision and where the accounting treatment has not already been determined using specific authoritative accounting standards or generally accepted accounting practice. Examples of obligations that may fall into this category include:
- personal benefits;
 - disaster relief;
 - transfers/grants;
 - donations; and
 - subsidized student loans.
- 13.8 Whether these obligations are social policy obligations for a particular jurisdiction depends upon the legislative framework within which the government in that jurisdiction operates. (IPSAS ED 21 notes the difficulties of identifying provisions and contingent liabilities

relating to social policy obligations and provides some guidance on doing so.) The aim of this initial scoping exercise is to identify those liabilities where the entity has not yet identified a specific accounting standard or accounting treatment as being applicable and to then identify an appropriate accounting standard or accounting treatment.

13.9 In identifying an appropriate accounting standard or accounting treatment an entity may find the following approach helpful.

- Is the obligation covered by an IPSAS or other authoritative accounting standard? For example, is the obligation a form of employee benefit which could be accounted for using the principles in an authoritative accounting standard on employee benefits? If yes, apply the principles in that authoritative accounting standard.
- Can the obligation be accounted for in a manner similar to the obligations associated with other exchange transactions? For example, some obligations which are at first classified as social policy obligations because they are related to grants made by a government, rather than consideration provided by the beneficiaries, may in fact have an element of exchange. Where there is an element of exchange, the entity could review the terms and conditions of the grant and re-establish the grant as an exchange transaction. As part of this process the government and public sector entities making the grants to individuals and entities would clarify what they expect in return for the grant, the point at which they expect this return, when the good or service is deemed to be delivered and when payment of the grant is due. This would then provide an appropriate point for the government to recognize the expense and any accrued liability. This approach is used in jurisdictions that adopt a purchaser-provider model. In such jurisdictions, all transactions by a government with entities or individuals are classified as the purchase of goods or services (outputs) or transfers (where the government receives no direct benefit in return). The fact that a jurisdiction has not formally adopted a purchaser-provider model would not preclude a government from exploring this approach. Social policy obligations arising from exchange transactions will be dealt with by the IPSAS based on IPSAS ED 21.

13.10 The remaining social policy obligations may be sub-classified as those that are reasonably certain as to timing and amount or those that are uncertain as to timing or amount. Those that are reasonably certain as to timing and amount may be recognized in the same way as other liabilities (for example, the timing and amount of pensions for aged citizens may be known with sufficient certainty to justify a period-end accrual). In relation to those that are uncertain as to timing or amount, the entity needs to decide whether it would be appropriate to recognize a provision or disclose a contingent liability. Although Exposure Draft IPSAS ED 21 excludes from its scope those obligations and contingent liabilities arising from social benefits provided by an entity for which it receives no or nominal consideration directly in return from the recipients of those benefits, the guidance in this ED may nonetheless be useful in recognizing and measuring such provisions or disclosing such contingent liabilities.

13.11 Once an entity decides that a social policy obligation meets the conditions for recognition, it then needs to collect information on the amount of likely future cash flows and determine the

method of calculation. For example, the entity will need to select an appropriate discount rate and determine the appropriate treatment of risk (for example, risk-free discount rates or risk-free cash flows and risk-adjusted discount rates or risk-adjusted cash flows).

- 13.12 Where an entity decides that a social policy obligation does not meet the conditions for recognition or for disclosure as a contingent liability, it then needs to consider whether it wishes to provide some form of supplemental disclosure.

Background Information/Entitlement Criteria

- 13.13 For each type of potential obligation it is helpful to record details of:
- the relevant legislation, agreements or examples of such payments;
 - entitlement criteria where applicable;
 - approval systems for applications and methods of notification;
 - payment mechanisms;
 - information available on current payments and the extent to which these relate to past or future obligations;
 - actuarial estimates of future obligations; and
 - current accounting treatment and disclosures.
- 13.14 This information can then be used to justify the classification of obligations into similar groups and the subsequent accounting treatment chosen. The information forms part of the audit trail.

Obligating Event

- 13.15 Determination of the obligating event can be a difficult issue for some obligations. Obligations may be legal or constructive. Legal obligations can be evidenced by legislative requirements and legally enforceable contracts. Constructive obligations are defined in IPSAS ED 21, paragraph 18 as follows:

A constructive obligation is 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.*

- 13.16 In the absence of a legal obligation, an entity needs to determine whether there is sufficient evidence to indicate the existence of a constructive obligation.
- 13.17 For example, when a disaster has occurred, if a government has a policy of providing disaster relief assistance, its past practice, and public communication of its intention to provide such assistance for particular types of disasters, may be sufficient to provide evidence of a constructive obligation.

Transition to the Accrual Basis of Accounting

- 13.18 In the case of discretionary items such as donations, there is generally no legal obligation prior to the transfer of cash, assets or loan forgiveness. Where there is a legally enforceable obligation prior to the transfer of cash then a liability would exist at the time the obligation becomes enforceable (for example, on the signing of an agreement).
- 13.19 The timing of entitlement in relation to benefits determines whether there is a liability for end-of-period accruals. For example, where entitlement does not occur until the date of payment, governments do not generally recognize a liability in relation to the benefit, apart from the amount due and payable at the reporting date.
- 13.20 The entity may need to develop policies for each benefit, specifying both the eligibility criteria and the policy to be followed in determining whether those eligibility criteria have been met. For example, are individuals seeking medical assistance from a government regarded as having met eligibility criteria when:
- they develop a condition and meet the criteria although they have not notified anyone that they intend to seek assistance from the government;
 - they have completed an application seeking assistance;
 - they have been assessed by a health care provider (employed by a non-government entity) who has recommended that their application be approved;
 - the government entity responsible for approving assistance has received the application and has approved it;
 - their name and details have been entered into the system for payment; or
 - the payment is due?
- 13.21 For some benefits there is no single obligating event creating a future liability. Rather, the individual or organization must meet the entitlement criteria at regular intervals.
- 13.22 The point selected for recognition of the expense (and hence any related liability) is not solely dependent upon the existence of an obligating event. The obligation must also be able to be reliably measured. Reliable measurement depends on the nature of the information available.

Future Cash Flows

- 13.23 The identification of future cash flows associated with an obligation may require some research and estimation. For example, an entity may need to collect data on the conditions under which payments would be required, the number of instances of such payments being made in the past and the projected number of instances of such payments being required in the future. Actuarial estimates of the likelihood of certain events occurring may be required. In the case of period-end accruals however, an entity may know exactly how much it owes to another government entity or an individual for services delivered or to be delivered.

Classification

- 13.24 For those obligations that are recognized, an entity needs to develop a policy on the classification of various types of changes that will be recognized as expenses. For example, the unwinding of the discount rate would be classified as interest expense.

Disclosure of Accounting Policies

- 13.25 An entity should develop, document and disclose the accounting policies used for various obligations, including the point basis on which the provisions have been recognized and the measurement basis adopted.

Ongoing Review and Procedures

- 13.26 In order to ensure that the information provided each period is accurate, an entity will need to review all provisions regularly. Adjustments may be made to reflect the current best estimate or to reflect material changes in the assumptions underlying the calculations of the cash flows. An entity will therefore need to allocate responsibility for such reviews, provide guidance on issues to be considered in such reviews and the level of documentation required, and carry out regular checks to ensure that such reviews are occurring in accordance with these guidelines.
- 13.27 Only expenditures that relate to the purpose for which a provision was originally created may be offset against that provision. Generally, an entity establishes authorization procedures to ensure that any increases in provisions or use of provisions are approved by appropriate personnel. This may be done by specifying the individuals or positions with authority to create and/or amend provisions, and restricting access within the accounting system to those individuals.

Relevance to the Cash Basis of Accounting

- 13.28 The issues identified in this Chapter are relevant for entities intending to comply with the requirements of any future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* if they wish to provide additional disclosure on the nature and amount of liabilities arising from certain social policy obligations. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the primary financial statement.

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Appendix: Accounting Policies

This Appendix illustrates the internal accounting policies for the recognition of certain social policy obligations that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. At the time of writing, there is no International Public Sector Accounting Standard (IPSAS) dealing with the recognition, measurement or disclosure of liabilities arising from social benefits provided by an entity for which it receives no or nominal consideration directly in return from the recipients of those benefits. In the absence of an IPSAS, entities will need to develop accounting policies based on appropriate authoritative guidance.

Generally accepted accounting practice with regard to such obligations can vary between countries and is determined by the nature of the arrangements underlying specific social policy obligations. These arrangements also vary significantly between jurisdictions. The following policies assume that a government provides a range of social benefits which impose financial obligations on the whole-of-government and individual public sector entities.

Individual social benefits

A liability for benefits is to be recognized in respect of benefits payable based on the estimated number of beneficiaries entitled to benefits at year end where claims either have been made or are expected to be made and which remain unpaid at the end of the year. The calculation of expected claims is to be based on population numbers and estimated drawing rates, having regard to the record of historical patterns of drawings. Outstanding claims likely to be settled within six months of the reporting date need not be discounted.

Each entity is to disclose an explanation of the policy adopted in relation to each main category of benefit, including the recognition criteria adopted and factors taken into account in estimating the number of beneficiaries and measuring the expected amount of claims (including the discount rate applied in any present value calculation).

Grants and subsidies

Where grants and subsidies are discretionary until payment occurs, an expense is to be recognized when the payment is made. Where services are required to be performed by the grantee to establish eligibility for such grants or subsidies, the expense and any associated liability are to be recognized when the services have been performed.

Where specified criteria are required to be fulfilled in order for entitlement to occur, an expense and any associated liability is to be recognized when those criteria have been satisfied and the government has received notice that this has occurred.

Workers' Injury Compensation Scheme – Outstanding Claims

An estimate of the future costs of all outstanding claims arising from past events and for which the entity has a present obligation is to be recognized as a provision. Outstanding claims are to include all claims, regardless of whether they have been reported, as at balance date. The estimate is to be based on an assessment by an independent actuary. The total cost of new claims is therefore to be recognized in the year that claims occur.

CHAPTER 14: NON-EXCHANGE REVENUE

Key Points

- There is currently no International Public Sector Accounting Standard (IPSAS) dealing with the definition and recognition of non-exchange revenue. Sources of guidance include Financial Accounting Standards Board (1999) and GASB (1998 and 2000). The PSC has recently established a Steering Committee to assist in developing guidance on this issue.
- International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements* requires certain disclosures relating to non-exchange revenue.
- Issues associated with accounting for non-exchange revenues include classification, determining recognition points, and determining the appropriate treatment of conditions attached to grants.

Introduction

- 14.1 This Chapter outlines issues arising from the recognition of certain non-exchange revenue (also referred to as non-reciprocal revenue¹) on an accrual basis.
- 14.2 There is currently no IPSAS dealing with the definition and recognition of non-exchange revenue. Other sources of guidance include a G4+1² Special Report, *Accounting by Recipients for Non-Reciprocal Transfers, Excluding Contributions by Owners: Their Definition, Recognition and Measurement* (Westwood and Mackenzie, 1999) which considered the appropriate treatments for non-reciprocal transfers, and Governmental Accounting Standards Board (GASB) Statements 33 and 36 dealing with the recognition of non-exchange transactions on a modified accrual basis (GASB 1998 and 2000). International Accounting Standard IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* deals with the recognition of government grants and assistance by enterprises. It does not focus on the types of non-exchange revenues that may be received by the government itself.
- 14.3 International Public Sector Accounting Standard IPSAS 9 *Revenue from Exchange Transactions* deals only with revenue arising from exchange transactions. In paragraph 5 it states that:

An exchange transaction is one in which the entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of goods, services or use of assets) to the other party in exchange. Examples of exchange transactions include:

- (a) the purchase or sale of goods or services; or*
- (b) the lease of property, plant and equipment; at market rates.*

¹ The term “non-exchange” is generally used throughout this Chapter. However, where another publication is quoted which uses the term “non-reciprocal” that term is used.

² The G4+1 is an international group of standard setters. The standard-setting bodies associated with this Special Report were: Australian Accounting Standards Board, Canadian Accounting Standards Board, International Accounting Standards Board, New Zealand Financial Reporting Standards Board, United Kingdom Accounting Standards Board, and United States Financial Accounting Standards Board.

- 14.4 By contrast, non-exchange revenue is derived from transactions where the entity receives assets or services, or has liabilities extinguished but does not give approximately equal value to the other party in exchange. Examples of non-exchange revenue include:
- taxes (direct and indirect);
 - grants from national governments, other levels of government, and international agencies;
 - fines, penalties and forfeits;
 - fees and charges (some fees and charges may be exchange revenue); and
 - gifts and donations.
- 14.5 Classification of revenue as exchange or non-exchange is usually clear, but in some cases it can be difficult. In some transactions, particularly user fees and charges, there is an exchange of value – the question is whether the exchange is of approximately equal value. In classifying revenue as exchange or non-exchange, consideration should be given to the substance, rather than the form of the transaction (IPSAS 9).
- 14.6 IPSAS 1 requires some specific disclosure of non-exchange revenue and encourages other disclosures as follows:
- The Statement of Financial Position must include, as separate line items on the face of the statement, recoverables from non-exchange transactions, and taxes and transfers receivable from exchange transactions.
 - Total revenue must be sub-classified, either on the face of the Statement of Financial Performance or in the notes to the statement of financial performance, in a manner appropriate to the entity's operations. The illustrative financial statements in the Appendix to IPSAS 1 include revenue from exchange transactions as a separate line item.
 - Commentary on the disclosure of accounting policies states that public sector entities would be expected to disclose an accounting policy for recognition of taxes, donations and other forms of non-exchange revenue.
 - Commentary on disclosure of receivables states that additional disclosure will be made of categories of receivables, including amounts receivable from user charges, taxes and other non-exchange revenues.

Development of Accounting Policies

- 14.7 The main accounting policy issues associated with non-exchange revenues are:
- classification of revenues, including classifications to be used on the face of the financial statements, in the notes to the financial statements and in the chart of accounts;
 - determining the point at which the criteria for recognition of revenue are satisfied for various categories of non-exchange revenues such as taxes and transfers; and

- identifying whether conditions attached to grants meet the definition and criteria for recognition of a liability.

Classification

- 14.8 Useful sources of information or considerations in establishing a system of revenue classifications include the:
- existing revenue classification system used under the current basis of accounting;
 - disclosures required by authoritative accounting standards including IPSASs and national accounting standards being applied by the entity (for example, GASB Statement No. 33 uses the categories of derived tax revenues, imposed non-exchange revenues, government-mandated non-exchange transactions and voluntary transactions);
 - existence of any restrictions or conditions on the revenue and related assets;
 - classifications required by any external agency, for example the reporting requirements of the European Union; and
 - classifications required for statistical reporting.
- 14.9 Where an entity has been using a basis other than the accrual basis, it will need to ensure that non-cash revenues such as non-cash grants or donations are included in the classification system.
- 14.10 Because IPSAS 1 requires the separate disclosure of some information on exchange and non-exchange revenues, each class of revenue item should be classified as exchange or non-exchange.
- 14.11 Some non-exchange revenues will be subject to stipulations as to use. GASB Statement No. 33 distinguishes between time requirements and purpose restrictions. The G4+1 Special Report distinguishes between restrictions and conditions. It explains that a restriction imposed by the transferor limits or directs the use of contributed assets and that a condition establishes a right of return of the transferred resource that is exercisable by the transferor if a specified uncertain future event occurs.
- 14.12 Individuals responsible for external financial reporting and those responsible for statistical reporting should be involved in the development of classifications. Although a statistical reporting system (for example, the Government Finance Statistics (GFS)) may not explicitly require the separate disclosure of exchange and non-exchange revenues, most of the revenue classifications are likely to be either exchange or non-exchange. Some fees and grants may include elements of both exchange and non-exchange revenues.
- 14.13 Another aspect of classification is determining whether non-exchange revenues are to be reported as revenues of an individual entity or as revenues of the government as a whole. Revenues collected by an entity on behalf of the government as a whole or on behalf of another entity and which cannot be retained by the entity, will be accounted for by the collecting entity in accordance with the policies for such receipts.

Revenue from Appropriations and Other Budgetary Authorities

- 14.14 Appropriations or other forms of budgetary authorities represent an authorization by the legislature to expend funds. Each reporting entity needs to determine whether the funds received by way of appropriation or authority meet the definition of revenue, and if so, whether such revenue is exchange or non-exchange (exchange revenue is discussed in Chapter 8). The legislative and administrative arrangements surrounding appropriations vary considerably from one jurisdiction to another. Where appropriations restrict the use of funds to a particular purpose, the entity receiving the funds must consider the appropriate point of recognition.

Recognition

- 14.15 Although there is no specific IPSAS dealing with the recognition of non-exchange revenues, application of the definitions of assets and revenues and the general recognition criteria of measurability of the amount of revenue and probability of the economic benefits/service potential flowing to the entity provides a useful working framework for the analysis of issues relating to their identification and recognition.
- 14.16 The G4+1 Special Report considers the issue of when an entity obtains control of an asset (and by implication when it should recognize the associated revenue). This publication argues that non-exchange transfers should be recognized by recipients as revenue at the following points:
- where the non-exchange transfer involves a transfer of an asset, at the earlier of when the recipient has an enforceable right to receive a future delivery of a promised asset without conditions attached or has received delivery of the asset; or
 - where the non-exchange transfer involves a reduction in a liability, when the transferor waives its right to receive a future payment.
- 14.17 In some cases, there may be a range of possible recognition points with measurability and probability being different at each point. For example, in the case of income tax, the following are potential recognition points:
- when the taxpayer earns the taxable income;
 - at the end of the income year;
 - when the tax returns are filed;
 - when tax is assessed;
 - when a tax liability is recognized by the taxpayer; or
 - when payment is received.
- 14.18 For each revenue item, an entity needs to identify the possible recognition points and identify, given existing or planned collection mechanisms and information systems, the point at which the entity obtains control over the asset and the revenue is both measurable and probable. This task could be performed in the following way:

- Obtain a complete list of relevant revenue items (for example, exclude those that are to be accounted for as exchange transactions in accordance with IPSAS 9).
- Document the nature of the item, the circumstances in which it arises, the periods for which the revenue is due, the payment dates and any evidence on the amount of revenue due that is actually collected (this information may already be available).
- Identify and talk to individuals with responsibility for developing existing recognition points and operating existing systems. Information sought should include how the revenue is collected and the extent to which the entity has information (or can generate information) on the likely amount of revenue due and to be collected. Relevant individuals could include those who are responsible for drafting relevant legislation and regulations, preparing financial reports and operating collection systems.
- Draft both general and detailed proposed recognition points for each revenue item. The detailed policy could include reference to any particular document or procedure. For example, the presentation of a signed declaration to a Customs Officer, or the release of goods for home consumption could be the point of recognition.
- Identify any changes that would be required in order to move the recognition point closer to the point at which the revenue is “earned” or “due”. Existing administrative processes may not provide the information necessary for accrual at the point the underlying event or transaction occurs. For material revenue items, it may be appropriate to consider whether administrative and system changes could be implemented in the near future.
- In relation to promises to give, an entity needs to document the nature of existing donations and grants, identify those which are enforceable and identify material items that may require disclosure. On an ongoing basis, the entity will need to ensure that it has a system for recording and monitoring promises to give.

14.19 Because the nature of taxes and other non-exchange revenues and the procedures and systems used to collect and record revenues vary greatly between jurisdictions, it is possible that the initial points of recognition will also vary. In considering alternative recognition points for items, it is helpful to:

- investigate whether it is possible to reliably estimate revenues at an earlier recognition point; and
- calculate the amount of revenue that would be recognized using different recognition points and see if there is any material difference.

Transfers

14.20 In order to determine the appropriate recognition point for government transfers received by an entity, it is necessary to document:

- the process for authorization of the transfer by the donor/transferor;
- any eligibility criteria;

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- the way in which the donor/transferor confirms that criteria have been met;
- the likelihood of eligibility criteria not being met;
- in the event of eligibility criteria not being met, the likelihood of funds having to be returned to the transferor; and
- the point at which a reasonable estimate of the amount can be made.

- 14.21 In order to ensure that restrictions or conditions relating to cash transfers or donated assets are not breached, it would be prudent for an entity to record outstanding restrictions and conditions attached to all material non-exchange transfers. These restrictions or conditions may or may not be disclosed in the external financial statements. International Public Sector Accounting Standard IPSAS 2 *Cash Flow Statements* encourages entities to disclose the amount and nature of restricted cash balances. Similarly, New Zealand and Australian standards require entities to disclose in the notes to the financial statements where part or all of cash balances are restricted or are otherwise not available for general use.
- 14.22 There is some debate over the point at which an entity should recognize as revenue transfers subject to conditions. One view is that externally restricted inflows should be recognized as revenues only once the resources have been used for the purpose or purposes specified, or when the related expenses are recognized. Until that point, the unspent portion of the transfer would be recorded as deferred revenue.
- 14.23 The alternative view is that revenue recognition should be related to when the entity obtains control over the contributed assets. Under this view, a liability for repayment of a transfer would be recognized only when an entity fails to meet the specific conditions attaching to a contribution, and the amount of the contribution is required to be repaid. Discussion of these issues can be found in the G4+1 Special Report.
- 14.24 Regardless of which approach is adopted by the entity, it is necessary to disclose details of the accounting policy adopted, maintain details of conditions, and implement systems to monitor whether a liability exists.
- 14.25 Restrictions not accompanied by conditions do not require the recognition of a liability.

Tax Revenue

- 14.26 In some jurisdictions, tax revenues may be recognized at the time when tax payments are due and payable according to legislation or when an assessment is issued by the relevant taxation authority. An alternative approach is to recognize tax revenue based upon the tax liabilities that will arise (in any period) with respect to the transactions and balances occurring during that reporting period, even where an assessment has not yet occurred. Under this method, current year revenue is also affected by variations between prior year estimates and the associated actual transactions during the current year. The first approach generally provides more certainty in the recording of revenue and less possibility of material misstatement.

Relevance to the Cash Basis of Accounting

- 14.27 The discussion of classification of revenues as exchange or non-exchange is relevant for entities developing cash-based accounting policies. The discussion on recognition of non-exchange revenues is relevant for entities intending to comply with the requirements of any forthcoming IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* if they wish to provide additional disclosure on the nature and amount of receivables and restrictions or conditions associated with such revenues. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the primary financial statement.

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<http://www.aasb.com.au> for purchase details, 1999.

Appendix: Accounting Policies

This Appendix illustrates the accounting policies for the recognition of non-exchange revenue. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The policies are not based on any IPSASs¹.

Taxation Revenue

- Personal income tax on salaries and wages and interest, which is deducted at source, is to be recognized when the individual earns the income subject to the source deductions.
- Corporate tax is to be recognized as installments are received and as assessments of final tax due are made.
- Taxes on international travel are to be recognized on the date of departure of the vessel or aircraft.
- Land tax is to be recognized at the time the assessment is issued.

Other Forms of Non-Exchange Revenue

- Customs and excise duties are to be recognized when goods subject to these taxes are distributed for consumption.
- Stamp duty is to be recognized when the duty is received by the collecting entity.
- Fines are to be recognized at the point the fine is imposed.
- Business and professional licenses are to be recognized at the time of initial application and upon renewal.

¹ The policies for the recognition of non-exchange revenue may vary considerably between jurisdictions and levels of government. This is because the characteristics of non-exchange revenue, such as manner of assessment, assessment dates, payment dates, payment systems, availability of information at various points and the likelihood of payment, vary widely between types of revenue and between jurisdictions. Recognition policies are heavily reliant on the accuracy and reliability of information prior to the receipt of revenue.

CHAPTER 15: FOREIGN CURRENCY

Key Points

- International Public Sector Accounting Standard IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* contains guidance on accounting for foreign currency transactions and foreign operations.
- In order to apply IPSAS 4, entities will need to ensure they have systems for identifying the transactions and balances referred to in IPSAS 4 and have classified foreign operations as either foreign operations that are integral to the operations of the reporting entity or as foreign entities.
- The adoption of accrual accounting is often associated with an increased emphasis on the management of foreign exchange risk. This may involve the development of policies regarding exposures to individual currencies and financial institutions, and the types of instruments to be used to manage those exposures.

Introduction

- 15.1 A foreign exchange gain or loss occurs when there are transactions payable or receivable in foreign currency and exchange rates change between the time of recognition of the transaction and the time of payment. Such gains or losses may be realized or unrealized at the end of the reporting period. Gains or losses may also occur due to changes in the rates used to translate the balances associated with foreign operations.
- 15.2 As noted in the International Monetary Fund (IMF) and World Bank's *Guidelines for Public Debt Management* (IMF and World Bank, 2001), excessive unhedged foreign exchange exposures are a common pitfall in public debt management. Excessive amounts of foreign currency denominated debt and foreign exchange indexed debt can leave governments vulnerable to volatile and possibly increasing debt service costs if their exchange rates depreciate, and the risk of default if they cannot roll over their debts.
- 15.3 Many governments will also have significant foreign exchange risk exposures arising from government entities' purchases and sales. The adoption of accrual accounting provides a government with a timely opportunity to review its management of foreign exchange exposures, both in relation to debt and the operations of its entities. Options include the establishment of specific thresholds beyond which cover will be taken, or remaining uninsured at the whole-of-government level (sometimes referred to as self-insuring). Foreign currency management of risks associated with the operations of individual entities can occur at an entity level or as a centralized function.

Development and Implementation of Accounting Policies

- 15.4 IPSAS 4:
- deals with accounting for foreign currency transactions and foreign operations;

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- sets out the requirements for determining which exchange rate to use for the recognition of certain transactions and balances; and
- explains how to recognize the financial effect of changes in exchange rates in the financial statements.

15.5 Entities intending to comply with IPSAS 4 will need to:

- identify transactions (purchases, sales, grants, loans and advances, borrowings) which are commonly required to be settled in foreign currency;
- identify the magnitude of such transactions during the reporting period and the potential foreign exchange gains and losses associated with those transactions;
- identify balances held in foreign currencies (for example, investments, trading activities, borrowings, loans and advances, overseas properties);
- identify all foreign operations and classify them as either integral operations or foreign entities;
- identify the extent to which some exchange differences should be classified as borrowing costs and whether borrowing costs are capitalized in accordance with the allowed alternative treatment in International Public Sector Accounting Standard IPSAS 5 *Borrowing Costs*;
- develop accounting policies to cover actual and likely transactions and balances (draft policies are shown in the Appendix); and
- where accrual budgeting is adopted, establish policies for the recognition of foreign currency gains and losses in budgets.

Foreign Currency Risk Management

15.6 Although management of foreign currency risk is not strictly an accounting issue, the adoption of accrual accounting often provides the impetus for improved risk management. In particular, the adoption of accrual accounting is likely to improve an entity's ability to accurately identify a wider range of foreign currency exposures. An entity wishing to review its management of foreign currency exposures would need to address the following issues:

- Decide whether foreign currency exposures will be managed at a central level or by individual entities.
- Develop a policy on the operation of foreign currency bank accounts, including the establishment of thresholds for government-wide exposure to particular banks and currencies.
- Develop policies (government-wide and individual entity policies as appropriate) for managing foreign currency exposures and for maintaining foreign exchange reserves. For example, governments are likely to adopt a risk-averse approach and to attempt to minimize foreign exchange costs.

- Develop tendering and expenditure approval processes which involve a proper assessment of foreign exchange risk and are consistent with policies on the treatment of foreign exchange risk.

Complying With Policies

- 15.7 For an entity to ensure that it operates in compliance with its accounting policies and risk management policies, it needs to carry out a series of regular checks to ensure that:
- the policy, operating procedures and guidelines are in place and communicated to all staff;
 - the policy, operating procedures and guidelines are complied with, for example, by regular monitoring of various types of exposure thresholds;
 - staff responsible for managing foreign exchange exposure have the appropriate skills and experience;
 - all foreign currency bank accounts comply with any policy on the operation of foreign currency bank accounts;
 - the correct rate (as required by the accounting policies) is applied to each foreign exchange transaction;
 - foreign exchange rate coverage (in accordance with policies) is obtained where transactions exceed exposure thresholds; and
 - the entity meets reporting requirements in a timely manner and that the information in such reports is correct.

Relevance to the Cash Basis of Accounting

- 15.8 This Chapter is relevant for entities intending to comply with the requirements of any future IPSAS based on Exposure Draft International Public Sector Accounting Standard IPSAS ED 9 *Financial Reporting Under the Cash Basis of Accounting* if they wish to provide additional disclosure on the nature and amount of outstanding foreign currency exposures. Although an entity may provide additional disclosures within the financial statements or as supplementary information, such amounts cannot be included in the amounts shown on the face of the primary financial statement. Management of foreign currency exposures can occur in a cash-based environment, but requires significant additional systems and is often restricted to management of foreign currency exposures associated with government borrowing.

References

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<http://www.ifac.org>, May 2000.

Appendix: Accounting Policies

This Appendix illustrates the accounting policies to be adopted to account for foreign currency transactions and balances. These policies are examples of policies that may be developed by a central entity for internal application by all individual entities forming part of a whole-of-government reporting entity. The policies are based upon the requirements in IPSAS 4, where such requirements exist. (The government and its entities, whether domestic or foreign, do not operate in hyperinflationary economies.)

Foreign Currency Transactions

Foreign currency transactions are to be measured and recorded in (*the domestic currency of the reporting entity*) using the exchange rate in effect at the date of the transaction.

Where short-term transactions are covered by a forward exchange contract, the forward rates specified in those contracts are to be used to translate the transactions into (*the domestic currency of the reporting entity*). Gains or losses on foreign currency forward contracts are to be separately disclosed.¹

Foreign Currency Balances

At the end of the reporting period the following exchange rates are to be used to translate foreign currency balances:

- foreign currency monetary items are to be reported in (*the domestic currency of the reporting entity*) using the closing rate;
- non-monetary items which are carried in terms of historical cost denominated in a foreign currency are to be reported in (*the domestic currency of the reporting entity*) using the exchange rate at the date of the transaction; and
- non-monetary items which are carried at fair value denominated in a foreign currency are to be reported using the exchange rates that existed when the fair values were determined.

Foreign currency monetary items include borrowings denominated in foreign currency and amounts owed for overseas purchases where the account is to be settled in another currency.

Foreign Currency Gains and Losses

Exchange differences (apart from the two exceptions listed below) arising on the settlement of monetary items, or on reporting monetary items at rates different from those at which they were initially recorded or reported, are to be recognised as revenue or expenses in the period in which they arise.

¹ This is not covered in IPSAS 4. IPSAS 4 is silent on treatment of forward exchange contracts.

The two exceptions are:

- exchange differences arising on a monetary item that, in substance, forms part of an entity's net investment in a foreign entity; and
- exchange differences arising on a foreign currency liability accounted for as a hedge of an entity's net investment in a foreign entity.

These two forms of exchange differences are to be taken directly to the Statement of Financial Position and classified as equity/net assets until the disposal of the net investment, at which time they should be recognised as revenue or expenses.

Translation of Foreign Operations

The foreign currency transactions and balances of integral foreign operations are to be accounted for in the same way as those of the reporting entity.

The foreign currency transactions and balances of foreign entities are to be translated as follows:

- monetary and non-monetary assets and liabilities are to be translated at the closing rate;
- revenue and expense items are to be translated at exchange rates at the dates of the transactions; and
- all resulting exchange differences are to be classified as net assets/equity until the disposal of the net investment.

POSTSCRIPT

The material included in this Public Sector Committee (PSC) Study is based on current International Public Sector Accounting Standards (IPSASs) and other relevant accounting pronouncements and guidance. This Study does not provide comprehensive coverage of all the issues on which readers may be seeking advice nor does it provide authoritative guidance on the issues not addressed in the IPSASs currently on release. The Study has been published in the interests of providing timely assistance to support the adoption of accrual accounting.

Further editions of this Study will be prepared periodically to provide relevant and up-to-date assistance to readers. With this in mind, readers are invited to propose suggestions or provide material for inclusion in future editions.

At the time of issue of this Study there are 17 accrual-based IPSASs on issue, with three further exposure drafts currently being considered by the PSC or issued for comment (refer to Appendix 1). The PSC has also published a *Glossary of Defined Terms (IPSAS 1–IPSAS 12)* (refer to Appendix 2) to be read in conjunction with published IPSASs. This Glossary will be updated periodically as further IPSASs are approved and published.

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APPENDIX 1

SUMMARY OF PSC STANDARDS PROGRAM DOCUMENTS

BACKGROUND PAPER

IFAC PSC Study 11 *Governmental Financial Reporting: Accounting Issues and Practices* aims to assist governments in the preparation of their financial reports and contains a detailed description of the common bases of accounting used by governments: cash accounting (including modified cash accounting) and accrual accounting (including modified accrual accounting). The Study also provides examples of actual financial statements prepared under each basis.

INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS (IPSASs)

IPSAS 1 *Presentation of Financial Statements* sets out the overall considerations for the presentation of financial statements, guidance for the structure of those statements and minimum requirements for their content under the accrual basis of accounting.

IPSAS 2 *Cash Flow Statements* requires the provision of information about the changes in cash and cash equivalents during the period from operating, investing and financing activities.

IPSAS 3 *Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies* specifies the accounting treatment for changes in accounting estimates, changes in accounting policies and the correction of fundamental errors; defines extraordinary items; and requires the separate disclosure of certain items in the financial statements.

IPSAS 4 *The Effect of Changes in Foreign Exchange Rates* deals with accounting for foreign currency transactions and foreign operations. IPSAS 4 sets out the requirements for determining which exchange rate to use for the recognition of certain transactions and balances and how to recognize in the financial statements the financial effect of changes in exchange rates.

IPSAS 5 *Borrowing Costs* prescribes the accounting treatment for borrowing costs and requires either the immediate expensing of borrowing costs or, as an allowed alternative treatment, the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* requires all controlling entities to prepare consolidated financial statements which consolidate all controlled entities on a line-by-line basis. The Standard also contains a detailed discussion of the concept of control as it applies in the public sector and guidance on determining whether control exists for financial reporting purposes.

IPSAS 7 *Accounting for Investments in Associates* requires all investments in associates to be accounted for in the consolidated financial statements using the equity method of accounting; except

when the investment is acquired and held exclusively with a view to its disposal in the near future, in which case the cost method is required.

IPSAS 8 *Financial Reporting of Interests in Joint Ventures* requires proportionate consolidation to be adopted as the benchmark treatment for accounting for such joint ventures entered into by public sector entities. However, IPSAS 8 also permits – as an allowed alternative – joint ventures to be accounted for using the equity method of accounting.

IPSAS 9 *Revenue from Exchange Transactions* establishes the conditions for the recognition of revenue arising from exchange transactions, requires such revenue to be measured at the fair value of the consideration received or receivable and includes disclosure requirements.

IPSAS 10 *Financial Reporting in Hyperinflationary Economies* describes the characteristics of a hyperinflationary economy and requires financial statements of entities which operate in such economies to be restated.

IPSAS 11 *Construction Contracts* defines construction contracts, establishes requirements for the recognition of revenues and expenses arising from such contracts and identifies certain disclosure requirements.

IPSAS 12 *Inventories* defines inventories, establishes measurement requirements for inventories (including those inventories which are held for distribution at no or nominal charge) under the historical cost system, and includes disclosure requirements.

Glossary of Defined Terms (IPSAS 1–IPSAS 12) identifies the terms defined in IPSASs on issue at 30 June 2001.

IPSAS 13 *Leases* establishes requirements for the accounting treatment of operating and finance leasing transactions by lessees and lessors.

IPSAS 14 *Events After the Reporting Date* establishes requirements for the treatment of certain events that occur after the reporting date, and distinguishes between adjustable and non-adjustable events.

IPSAS 15 *Financial Instruments: Disclosure and Presentation* establishes requirements for the presentation of on-balance-sheet financial instruments and identifies the information that should be disclosed about both on-balance-sheet (recognized) and off-balance-sheet (unrecognized) financial instruments.

IPSAS 16 *Investment Property* establishes the accounting treatment, and related disclosures, for investment property. It provides for application of either a fair value or in historical cost model.

IPSAS 17 *Property, Plant and Equipment* establishes the accounting treatment for property, plant and equipment, including the basis and timing of their initial recognition, and the determination of their ongoing carrying amounts and related depreciation. It does not require or prohibit the recognition of heritage assets.

EXPOSURE DRAFTS/INVITATION TO COMMENT – COMMENT PERIOD EXPIRED – UNDER CONSIDERATION BY PSC

ED 9 *Financial Reporting Under the Cash Basis of Accounting* proposes requirements for the preparation and presentation of the Cash Flow Statement and supporting accounting policy notes under the cash basis of accounting. It includes requirements relating to the identification of the reporting entity and the structure and the minimum content of the Cash Flow Statement. ***The comment period closed November 30, 2000.***

ITC *Impairment of Assets* – The PSC has published an Invitation to Comment (ITC) on *Impairment of Assets* to seek comments on the appropriate accounting treatment for the impairment of assets. It reflects the tentative position of the PSC that an impairment test should be applied to all assets but that the cash flow test required by International Accounting Standard IAS 36 *Impairment of Assets* is not appropriate for assets held by public sector entities for the delivery of goods and services rather than the generation of positive cash flows for the entity. ***The comment period closed January 30, 2001.***

ED 17 *Segment Reporting* proposes requirements for the disclosure of financial statement information about distinguishable activities of reporting entities. ***The comment period closed May 31, 2001.***

ED 20 *Related Party Disclosures* proposes requirements for the disclosure of transactions with parties that are related to the reporting entity, including Government Ministers, senior management, and their relatives. ***The comment period closed 30 November 2001.***

ED 21 *Provisions, Contingent Liabilities and Contingent Assets* proposes requirements for the recognition of provisions, and the disclosure of contingent liabilities and contingent assets. ***The comment period closed 30 November 2001.***

ED 22 *Definition of a Segment: Amendment to the Definition Proposed in ED 17 Segment Reporting* proposes an amendment to the definition of a segment included in ED 17 *Segment Reporting*. The change in definition may require some public sector entities to construct segments specifically for external reporting purposes. ***Comment deadline February 28, 2002.***

APPENDIX 2

IPSAS GLOSSARY OF DEFINED TERMS

This Glossary contains all terms defined in International Public Sector Accounting Standards (IPSASs) on issue at 30 June 2002. At this date, 17 IPSASs were on issue. A list of these IPSASs is located on the inside back cover of the Glossary.

Where multiple definitions of the same term exist, this Glossary indicates all IPSASs in which the term appears and the definition that applies to that particular IPSAS.

Definitions

References to IPSASs are by Standard number and paragraph number. For example, “1.6” refers users to International Public Sector Accounting Standard IPSAS 1 *Presentation of Financial Statements*, paragraph 6. References set out in brackets indicate a minor variation in wording.

Term	Definition	Location
accounting policies	The specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.	1.6, 3.6, 5.5, 6.8, 7.6
accrual basis	A basis of accounting under which transactions and other events are recognized when they occur (and not only when cash or its equivalent is received or paid). Therefore, the transactions and events are recorded in the accounting records and recognized in the financial statements of the periods to which they relate. The elements recognized under accrual accounting are assets, liabilities, net assets/equity, revenue and expenses.	1.6, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5, (2.8)
assets	Resources controlled by an entity as a result of past events and from which future economic benefits or service potential ¹ are expected to flow to the entity.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5
associate	An entity in which the investor has significant influence and which is neither a controlled entity nor a joint venture of the investor.	1.6, 2.8, 4.9, 6.8, 7.6, 8.5
borrowing costs	Interest and other expenses incurred by an entity in connection with the borrowing of funds.	1.6, 3.6, 5.5

¹ *Commentary:* Assets provide a means for entities to achieve their objectives. Assets that are used to deliver goods and services in accordance with an entity’s objectives but which do not directly generate net cash inflows are often described as embodying “service potential”. Assets that are used to generate net cash inflows are often described as embodying “future economic benefits”. To encompass all the purposes to which assets may be put, this series of Standards uses the term “future economic benefits or service potential” to describe the essential characteristic of assets.

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Term	Definition	Location
carrying amount	The amount at which an asset is recognized in the statement of financial position.	16.6
carrying amount of an asset	The amount at which an asset is recognized in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses thereon.	10.7
carrying amount of a liability	The amount at which a liability is recognized in the statement of financial position.	10.7
cash	Comprises cash on hand and demand deposits.	1.6, 2.8, 4.9, 5.5, 6.8, 8.5, 10.7
cash equivalents	Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.	1.6, 2.8, 3.6, 4.9
cash flows	Inflows and outflows of cash and cash equivalents.	1.6, 2.8, 3.6, 4.9, 8.5
class of property, plant and equipment	A grouping of assets of a similar nature or function in an entity's operations, that is shown as a single item for the purpose of disclosure in the financial statements.	17.12
closing rate	The spot exchange rate at the reporting date.	4.9
consolidated financial statements	The financial statements of an economic entity presented as those of a single entity.	1.6, 4.9, 6.8, 7.6, 8.5
construction contract	A contract, or a similar binding arrangement, specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.	11.4
contingent rent	Is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).	13.7
contractor	An entity that performs construction work pursuant to a construction contract.	11.4

Appendix 2

Term	Definition	Location
contributions from owners	<p>Future economic benefits or service potential that has been contributed to the entity by parties external to the entity, other than those that result in liabilities of the entity, that establish a financial interest in the net assets/equity of the entity, which:</p> <p>(a) conveys entitlement both to distributions of future economic benefits or service potential by the entity during its life, such distributions being at the discretion of the owners or their representatives, and to distributions of any excess of assets over liabilities in the event of the entity being wound up; and/or</p> <p>(b) can be sold, exchanged, transferred or redeemed.</p>	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5
control	The power to govern the financial and operating policies of another entity so as to benefit from its activities.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5
controlled entity	An entity that is under the control of another entity (known as the controlling entity).	1.6, 2.8, 4.9, 5.5, 6.8, 8.5, (7.6)
controlling entity	An entity that has one or more controlled entities.	1.6, 2.8, 4.9, 5.5, 6.8, 7.6, 8.5
cost	The amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.	16.6, 17.12
cost method	A method of accounting whereby the investment is recorded at cost. The statement of financial performance reflects revenue from the investment only to the extent that the investor receives distributions from accumulated net surpluses of the investee arising subsequent to the date of acquisition.	2.8, 7.6
cost plus or cost based contract	A construction contract in which the contractor is reimbursed for allowable or otherwise defined costs and, in the case of a commercially-based contract, an additional percentage of these costs or a fixed fee, if any.	11.4
current replacement cost	The cost the entity would incur to acquire the asset on the reporting date.	12.6
depreciable amount	The cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.	17.12
depreciation	The systematic allocation of the depreciable amount of an asset over its useful life.	17.12

Term	Definition	Location
discontinued operation	Results from the sale or abandonment of an operation that represents a separate, major line of business of an entity and of which the assets, net surplus or deficit and activities can be distinguished physically, operationally and for financial reporting purposes.	3.6
distribution to owners	Future economic benefits or service potential distributed by the entity to all or some of its owners, either as a return on investment or as a return of investment.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5
economic entity ¹	A group of entities comprising a controlling entity and one or more controlled entities.	1.6, 2.8, 4.9, 5.5, 6.8, 7.6, 8.5
economic life	Is either: (a) the period over which an asset is expected to yield economic benefits or service potential to one or more users; or (b) the number of production or similar units expected to be obtained from the asset by one or more users.	13.7
equity instrument	Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.	15.9
equity method	A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets/equity of the investee. The statement of financial performance reflects the investor's share of the results of operations of the investee. A method of accounting and reporting whereby an interest in a jointly controlled entity is initially recorded at cost and adjusted thereafter for the post-acquisition change in the venturer's share of net assets/equity of the jointly controlled entity. The statement of financial performance reflects the venturer's share of the results of operations of the jointly controlled entity.	1.6, 2.8, 4.9, 6.8, 7.6 8.5

¹ *Commentary:* The term "economic entity" is used in this series of Standards to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities. Other terms sometimes used to refer to an economic entity include "administrative entity", "financial entity" (*IPSAS 4: "financial reporting entity"*), "consolidated entity" and "group". An economic entity may include entities with both social policy and commercial objectives. For example, a government housing department may be an economic entity which includes entities that provide housing for a nominal charge, as well as entities that provide accommodation on a commercial basis.

Term	Definition	Location
events after the reporting date	Those events, both favorable and unfavorable, that occur between the reporting date and the date when the financial statements are authorized for issue. Two types of events can be identified: (a) those that provide evidence of conditions that existed at the reporting date (<u>adjusting events after the reporting date</u>); and (b) those that are indicative of conditions that arose after the reporting date (<u>non-adjusting events after the reporting date</u>).	14.4
exchange difference	The difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.	1.6, 4.9, 5.5
exchange rate	The ratio for exchange of two currencies.	2.8, 4.9, 5.5
expenses	Decreases in economic benefits or service potential during the reporting period in the form of outflows or consumption of assets or incurrences of liabilities that result in decreases in net assets/equity, other than those relating to distributions to owners.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5
extraordinary items	Revenue or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the entity, are not expected to recur frequently or regularly and are outside the control or influence of the entity.	1.6, 2.8, 3.6, 4.9
fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.	1.6, 4.9, 7.6, 9.11, 15.9, 16.6, 17.12
finance lease	A lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.	13.7
financial asset	Any asset that is: (a) cash; (b) a contractual right to receive cash or another financial asset from another entity; (c) a contractual right to exchange financial instruments with another entity under conditions that are potentially favorable; or (d) an equity instrument of another entity.	1.6, 15.9

Transition to the Accrual Basis of Accounting

Term	Definition	Location
financial instrument	Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Commodity-based contracts that give either party the right to settle in cash or some other financial instrument should be accounted for as if they were financial instruments, with the exception of commodity contracts that (a) were entered into and continue to meet the entity's expected purchase, sale, or usage requirements, (b) were designated for that purpose at their inception, and (c) are expected to be settled by delivery.	15.9
financial liability	Any liability that is a contractual obligation: (a) to deliver cash or another financial asset to another entity; or (b) to exchange financial instruments with another entity under conditions that are potentially unfavorable. An entity may have a contractual obligation that it can settle either by payment of financial assets or by payment in the form of its own equity securities. In such a case, if the number of equity securities required to settle the obligation varies with changes in their fair value so that the total fair value of the equity securities paid always equals the amount of the contractual obligation, the holder of the obligation is not exposed to gain or loss from fluctuations in the price of its equity securities. Such an obligation should be accounted for as a financial liability of the entity.	15.9
financing activities	Activities that result in changes in the size and composition of the contributed capital and borrowings of the entity.	2.8, 3.6, 4.9
fixed price contract	A construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.	11.4
foreign currency	A currency other than the reporting currency of an entity.	1.6, 2.8, 4.9, 5.5
foreign entity	A foreign operation, the activities of which are not an integral part of those of the reporting entity.	3.6, 4.9
foreign operation	A controlled entity, associate, joint venture or branch of the reporting entity, the activities of which are based or conducted in a country other than the country of the reporting entity.	1.6, 3.6, 4.9

Term	Definition	Location
fundamental errors	Errors discovered in the current period that are of such significance that the financial statements of one or more prior periods can no longer be considered to have been reliable at the date of their issue.	1.6, 3.6
Government Business Enterprise ¹	An entity that has all the following characteristics: <ul style="list-style-type: none"> (a) is an entity with the power to contract in its own name; (b) has been assigned the financial and operational authority to carry on a business; (c) sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery; (d) is not reliant on continuing government funding to be a going concern (other than purchases of outputs at arm's length); and (e) is controlled by a public sector entity. 	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5
gross investment in the lease	The aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.	13.7
guaranteed residual value	is: <ul style="list-style-type: none"> (a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and (b) in the case of the lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee. 	13.7
inception of the lease	The earlier of the date of the lease agreement or of a commitment by the parties to the principal provisions of the lease.	13.7

¹ *Commentary:* Government Business Enterprises (GBEs) include both trading enterprises, such as utilities, and financial enterprises, such as financial institutions. GBEs are, in substance, no different from entities conducting similar activities in the private sector. GBEs generally operate to make a profit, although some may have limited community service obligations under which they are required to provide some individuals and organizations in the community with goods and services at either no charge or a significantly reduced charge. International Public Sector Accounting Standard IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* provides guidance on determining whether control exists for financial reporting purposes, and should be referred to in determining whether a GBE is controlled by another public sector entity.

Transition to the Accrual Basis of Accounting

Term	Definition	Location
insurance contract	A contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and interruption of operations.	15.9
interest rate implicit in the lease	The discount rate that, at the inception of the lease, causes the aggregate present value of: (a) the minimum lease payments; and (b) the unguaranteed residual value to be equal to the fair value of the leased asset.	13.7
inventories	Assets: (a) in the form of materials or supplies to be consumed in the production process; (b) in the form of materials or supplies to be consumed or distributed in the rendering of services; (c) held for sale or distribution in the ordinary course of operations; or (d) in the process of production for sale or distribution.	12.6
investing activities	The acquisition and disposal of long-term assets and other investments not included in cash equivalents.	2.8, 4.9
investment property	property (land or a building – or part of a building – or both) held to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of operations.	16.6
investor	In a joint venture is a party to a joint venture and does not have joint control over that joint venture.	2.8, 6.8, 7.6, 8.5
joint control	The agreed sharing of control over an activity by a binding arrangement.	6.8, 8.5
joint venture	A binding arrangement whereby two or more parties are committed to undertake an activity which is subject to joint control.	1.6, 2.8, 4.9, 6.8, 7.6, 8.5
lease	An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.	13.7

Appendix 2

Term	Definition	Location
lease term	The non-cancelable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.	13.7
lessee's incremental borrowing rate of interest	The rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.	13.7
liabilities	Present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits or service potential.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5
market value	The amount obtainable from the sale, or payable on the acquisition, of a financial instrument in an active market.	15.9
materiality	Information is material if its omission or misstatement could influence the decisions or assessments of users made on the basis of the financial statements. Materiality depends on the nature or size of the item or error judged in the particular circumstances of omission or misstatement.	1.6

Transition to the Accrual Basis of Accounting

Term	Definition	Location
minimum lease payments	<p>The payments over the lease term that the lessee is, or can be, required to make, excluding contingent rent, costs for services and, where appropriate, taxes to be paid by and reimbursed to the lessor, together with:</p> <p>(a) in the case of the lessee, any amounts guaranteed by the lessee or by a party related to the lessee; or</p> <p>(b) in the case of the lessor, any residual value guaranteed to the lessor by either:</p> <p>(i) the lessee;</p> <p>(ii) a party related to the lessee; or</p> <p>(iii) an independent third party financially capable of meeting this guarantee.</p> <p>However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, so that at the inception of the lease, the option is reasonably certain to be exercised, the minimum lease payments comprise the minimum payments payable over the lease term and the payment required to exercise this purchase option.</p>	13.7
minority interest	That part of the net surplus (deficit) and of net assets/equity of a controlled entity attributable to interests which are not owned, directly or indirectly through controlled entities, by the controlling entity.	1.6, 2.8, 4.9, 6.8
monetary items	Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.	4.9, 10.7
monetary (financial assets and financial liabilities – also referred to as monetary financial instruments)	Financial assets and financial liabilities to be received or paid in fixed or determinable amounts of money.	15.9
net assets/equity ¹	The residual interest in the assets of the entity after deducting all its liabilities.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5

¹ *Commentary:* “Net assets/equity” is the term used in this series of Standards to refer to the residual measure in the statement of financial position (assets less liabilities). Net assets/equity may be positive or negative. Other terms may be used in place of net assets/equity, provided that their meaning is clear.

Appendix 2

Term	Definition	Location
net investment in a foreign entity	The reporting entity's share in the net assets/equity of that entity.	4.9
net investment in the lease	The gross investment in the lease less unearned finance revenue.	13.7
net realizable value	The estimated selling price in the ordinary course of operations less the estimated costs of completion and the estimated costs necessary to make the sale, exchange or distribution.	12.6
net surplus/deficit	Comprises the following components: (a) surplus or deficit from ordinary activities; and (b) extraordinary items.	1.6, 2.8, 3.6, 4.9, 6.8, 7.6
non-cancelable lease	a lease that is cancelable only: (a) upon the occurrence of some remote contingency; (b) with the permission of the lessor; (c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or (d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.	13.7
non-monetary items	Items that are not monetary items.	10.7
operating activities	The activities of the entity that are not investing or financing activities.	2.8, 3.6, 4.9
operating lease	A lease other than a finance lease.	13.7
ordinary activities	Any activities which are undertaken by an entity as part of its service delivery or trading activities. Ordinary activities include such related activities in which the entity engages in furtherance of, incidental to, or arising from these activities.	1.6, 3.6, 4.9
owner-occupied property	Property held (by the owner or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.	16.6

Transition to the Accrual Basis of Accounting

Term	Definition	Location
property, plant and equipment	tangible assets that: (a) are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one reporting period.	17.12
proportionate consolidation	A method of accounting and reporting whereby a venturer's share of each of the assets, liabilities, revenue and expenses of a jointly controlled entity is combined on a line-by-line basis with similar items in the venturer's financial statements or reported as separate line items in the venturer's financial statements.	2.8, 4.9, 8.5
qualifying asset	An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.	1.6, 5.5
reporting currency	The currency used in presenting the financial statements.	1.6, 2.8, 4.9
reporting date	The date of the last day of the reporting period to which the financial statements relate.	1.6, 2.8, 4.9, 6.8, 7.6, 14.4
residual value	The net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.	17.12
revenue	The gross inflow of economic benefits or service potential during the reporting period when those inflows result in an increase in net assets/equity, other than increases relating to contributions from owners.	1.6, 2.8, 3.6, 4.9, 5.5, 6.8, 7.6, 8.5, 9.11
significant influence	The power to participate in the financial and operating policy decisions of the investee, but is not control over those policies. The power to participate in the financial and operating policy decisions of an activity but is not control or joint control over those policies.	6.8, 7.6 8.5
surplus/deficit from ordinary activities	The residual amount that remains after expenses arising from ordinary activities have been deducted from revenue arising from ordinary activities.	1.6, 2.8, 3.6, 4.9

Appendix 2

Term	Definition	Location
unearned finance revenue	The difference between: (a) the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor; and (b) the present value of (a) above, at the interest rate implicit in the lease.	13.7
unguaranteed residual value	That portion of the residual value of the leased asset, the realization of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.	13.7
useful life	The estimated remaining period, from the beginning of the lease term, without limitation by the lease term, over which the economic benefits or service potential embodied in the asset are expected to be consumed by the entity.	13.7
	Either:	17.12
	(a) the period of time over which an asset is expected to be used by the entity; or	
	(b) the number of production or similar units expected to be obtained from the asset by the entity.	
venturer	A party to a joint venture and has joint control over that joint venture.	8.5

IPSASs on Issue at January 2002

International Public Sector Accounting Standards on issue at 31 January 2002 are:

- IPSAS 1 *Presentation of Financial Statements* (May 2000)
- IPSAS 2 *Cash Flow Statements* (May 2000)
- IPSAS 3 *Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policies* (May 2000)
- IPSAS 4 *The Effects of Changes in Foreign Exchange Rates* (May 2000)
- IPSAS 5 *Borrowing Costs* (May 2000)
- IPSAS 6 *Consolidated Financial Statements and Accounting for Controlled Entities* (May 2000)
- IPSAS 7 *Accounting for Investments in Associates* (May 2000)
- IPSAS 8 *Financial Reporting of Interests in Joint Ventures* (May 2000)
- IPSAS 9 *Revenue from Exchange Transactions* (June 2001)
- IPSAS 10 *Financial Reporting in Hyperinflationary Economies* (June 2001)
- IPSAS 11 *Construction Contracts* (June 2001)
- IPSAS 12 *Inventories* (June 2001)
- IPSAS 13 *Leases* (December 2001)
- IPSAS 14 *Events After the Reporting Date* (December 2001)
- IPSAS 15 *Financial Instruments: Disclosure and Presentation* (December 2001)
- IPSAS 16 *Investment Property* (December 2001)
- IPSAS 17 *Property, Plant and Equipment* (December 2001)