

Exposure Draft 81
Proposed Update to Conceptual Framework
“Conceptual Framework update: Chapter 3, Qualitative characteristics and Chapter 5, Elements in Financial Statements”
REQUEST FOR COMMENTS

Task force IRSPM PSAAG, CIGAR Network, EGPA PSG XII

May 18th, 2022

The stated objective of ED 81 is to update Chapter 3, *Qualitative characteristics*, and Chapter 5, *Elements in Financial Statements*, of the Conceptual Framework, in light of the IPSASB’s experience in applying the Framework to the development and maintenance of IPSAS, as well as of developments in international thinking about conceptual issues since the Framework was approved in 2014.

The comments and responses prepared by the Task Force IRSPM PSAAG, CIGAR Network, and EGPA PSG XII are presented below. The IRSPM PSAAG, the CIGAR Network, and EGPA PSG XII are three research networks that focus on Public Sector Accounting. The Task Force is made up of 17 researchers from these networks. The views expressed in this document represent those of the members of the Task Force and not of the whole research community represented by the networks nor of the Institutions/Universities with which the researchers are affiliated.

CORE ASSUMPTIONS

We are of the opinion that, in general, public-sector entities require public sector specific principles and standards that properly accommodate public sector specificities. As such, when public sector transactions resemble those taking place in the private sector, then principles and standards may be kept as aligned as possible. However, for public sector specific transactions, we are in favour of standards that are not adapted artificially from private sector accounting, and we think there is a need to seek options that best fit the public sector. This core thesis underpins our proposals and recommendations herein.

We welcome the opportunity to comment on ED 81 and we wish to congratulate the IPSASB for producing it.

Specific Matter for Comment 1: Prudence

In paragraphs 3.14A and 3.14B, the IPSASB has provided guidance on the role of prudence in supporting neutrality, in the context of qualitative characteristics of faithful representation. Paragraphs BC3.17A-BC3.17E explain the reasons for this guidance. Do you agree with this approach?

If not, why not? How would you modify these paragraphs?

In the public-sector context, prudence is a relevant concept. Accordingly, we agree with the need to provide guidance on the role of prudence and with the inclusion of prudence in the IPSASB's Conceptual Framework.

However, we are concerned about the proposal to espouse “cautious prudence” over “asymmetric prudence”, as in the IASB's Conceptual Framework (BC 3.17A).

“Cautious prudence” is defined as “the exercise of caution when making judgements under conditions of uncertainty”. It is considered a supporting principle of neutrality, so much so that “the exercise of prudence means that assets and revenue are not overstated, and liabilities and expense are not understated. **Equally** [boldface added], the exercise of prudence does not allow for the understatement of assets or revenue or the overstatement of liabilities or expense” (para. 3.14A). Consistently, prudence is not retained to be a qualitative characteristic in its own right (BC 3.17C). “Asymmetric prudence”, which has frequently been considered the essence of prudence¹, is consequently dismissed (“The exercise of prudence does not imply a need for asymmetry”, para. 3.14B).

At the same time, para. 3.14B allows for “particular standards [to] contain asymmetric requirements”. Under the proposed approach, these asymmetries would not rest on a conceptual basis and would represent ad hoc exceptions to the principles stated in the Conceptual Framework. Importantly, these asymmetries are not rare: many asymmetric prudence manifestations have been observed in existing IFRS (Barker and McGeachin, 2015²) which also apply to IPSAS (Lorson and Haustein, 2019³). Therefore, we would suggest that the IPSASB should further reflect on situations where asymmetric prudence could support faithful representation and should provide these situations with a conceptual basis in the Conceptual Framework. Should this be the case, (asymmetric) prudence would no longer be encompassed by neutrality. Accordingly, it could be helpful to consider prudence as a distinct qualitative characteristic, *de facto* introducing a trade-off between neutrality and prudence which would also allow for more flexibility.

On a more general level, we would invite the Board to think further about the consequences of cautious prudence in the public-sector context. Certain basic principles, such as inter-generational equity, will be affected by prudence through its influence on the measurement of net assets. The IPSASB highlights that all “misstatements can lead to the overstatement or understatement of

¹ Wagenhofer, A. (2015, October 13). *The Never Ending Story of Prudence and IFRS*. IFAC. <https://www.ifac.org/knowledge-gateway/supporting-international-standards/discussion/never-ending-story-prudence-and-ifrs> (accessed: March 7, 2022).

² Barker, R., and McGeachin, A. (2015), An Analysis of Concepts and Evidence on the Question of Whether IFRS should be conservative. *Abacus*, 51: 169–207.

³ Lorson, P. and Haustein, E. (2019), Debate: On the role of prudence in public sector accounting, *Public Money & Management*, 39(6): 389-390.

revenue or expense in future reporting periods” (para 3.14A), thus possibly undermining the faithful representation of intergenerational equity. Indeed, in principle, cautious prudence would better contribute to the robustness of net assets measurement. However, the period in which prudence-induced revenues and expenses are recorded might not be the period in which the relevant risks originate – e.g., when an expense is initially classified as possible and only in later periods is it reclassified as probable (Lorson and Haustein, 2019). Moreover, strong incentives exist also in the public sector to overstate financial position and performance and to shift costs and deficits to future generations, especially for entities that are struggling to achieve break-even and when financial statements are used as instruments to enforce financial sustainability measures⁴. From this perspective, asymmetric prudence (as defined for example in German standards⁵) could better serve the pursuit of intergenerational equity and could be usefully retained as a distinct qualitative characteristic – as is currently the case both in the proposed EPSAS conceptual framework⁶ and in German standards⁷.

⁴ See Hodges R. (2018). "How might harmonization influence the future prevalence of public sector creative accounting?" *Tékhné* 16(1): 3-14 and, more generally, the recent literature on earnings management in the public sector.

⁵ Bundesministerium der Justiz. Dok. 2021/0955989. Standards für die Staatliche doppelte Buchführung (23. November 2021), SsD I.1.4 (Adoption of the basic principles of bookkeeping and accounting under commercial law; translated by the authors), p. 16. The SsD apply to federal and state governments that voluntarily prepare accrual-based financial statements. The explanation of these principles is not applicable, but also applies to governments at the third level (municipalities and counties), which as well prepare accrual-based financial statements, because their accounting principles were likewise derived from the applicable law of the private sectors and these principles (including the asymmetric prudence principle) are unchangeable.

⁶ EPSAS WG 18/07. *European Public Sector Accounting Standards – Conceptual Framework – Reflection paper – for discussion*, Luxembourg, 25 April 2018, p. 6.

⁷ Bundesministerium der Justiz. Dok. 2021/0955989. Standards für die Staatliche doppelte Buchführung (23. November 2021), p. 17.

Specific Matter for Comment 2: Obscuring information as a factor relevant to materiality judgements

In discussing materiality in paragraph 3.32 the IPSASB has added obscuring information to misstating or omitting information as factors relevant to materiality judgements. The reasons for this addition are in paragraphs BC3.32A and BC3.32B.

Do you agree with the addition of obscuring information to factors relevant to materiality judgements? If not, why not?

Yes, we agree.

However, we have three specific concerns regarding the proposed paragraphs 3.32 and 3.32A:

- Para. 3.32 states that, “where an entity judges that a material item is not separately displayed on the face of a financial statement (or displayed sufficiently prominently), an entity **considers** [boldface added] disclosure”. We feel that the verb “consider” may be too weak. If a material item is not properly displayed on the face of a financial statement, the entity should **provide** disclosure.
- The motivations for not providing a uniform materiality threshold (nor “a uniform characteristic or a uniform set of characteristics”) seem peculiar and not entirely convincing. Para 3.32A currently states that such threshold or characteristics cannot be specified because “GPFs may encompass qualitative and quantitative information about service delivery achievements during the reporting period, and expectations about service delivery and financial outcomes in the future”. Conversely, no mention is made to more established motivations: for example, that “assessing whether an omission or misstatement could influence decisions of users, and so be material, requires consideration of the characteristics of those users” (IPSAS 3, para. 8) and is thus entity-specific; that materiality judgements are also affected by qualitative considerations so that an item cannot be considered as immaterial only because it is lower than a predetermined quantitative threshold; or that individually immaterial items may cumulatively become material.
- In the public sector, the absence of a uniform materiality threshold (or a uniform characteristic or set of characteristics) poses significant practical challenges. For this reason, further application guidance on the definition of materiality and its practical applications would be particularly helpful.

Moreover, we would suggest that the text should provide at least some illustrative examples of obscuring information, such as: provision of excessive immaterial information which ends up hiding material information (which is currently the only example being explicitly provided, see para BC 3.32B); material information being scattered throughout the financial statements or disclosed using vague or unclear language; items being inappropriately aggregated or disaggregated (possibly cross-referencing the criteria set out in para. 5.26D).

Specific Matter for Comment 3: Right-Based Approach to Resource

Paragraphs 5.7A-5.7G reflect a rights-based approach to the description of resources in the context of an asset. The reasons for this approach are in paragraphs BC5.3A-BC5.3F.

Do you agree with this proposed change?

If not, why not?

We agree with the proposed change to the definition of assets: “An asset is a resource presently controlled by the entity as a result of past events” (para 5.6).

However, we have several concerns regarding the proposed shift to a rights-based approach.

To start with, we wonder whether a limited scope project such as ED 81 is the appropriate way of introducing significant changes to the definition of assets, which is a key building block of IPSAS. In our view, limited scope projects are more suitable for the first part of the declared purpose of this ED, namely incorporating the IPSASB’s experience in applying the Conceptual Framework to the development and maintenance of IPSAS.

More importantly, a rights-based approach is conceptually very challenging. It also has significant implications for the unit of account. Its application, moreover, has been shown to be problematic even in the private sector⁸.

The conceptual challenges are well exemplified by the ED itself. For example:

- The need for para. 5.7E, which states: “In principle, each of an entity’s rights is a separate asset. However, for accounting purposes, related rights are often treated as a single unit of account that is a single asset [...]. For example, legal ownership of a physical object may give rise to several rights, including a right to ...”. Indeed, it is peculiar that the proposed rights-based approach ends up requiring a specific clarification with respect not to some marginal and exceptional case, but to the most common type of assets, i.e., physical objects on which the entity has legal ownership. It is also interesting that the ED, in the example, focuses on physical objects, which raises the question of whether the conceptual issues may be even more intricate with respect to intangibles.
- The apparent inconsistency emerging from paragraphs 5.6A, 5.7E, and 5.7F, whereby [boldfacing added]: (i) “A resource is **a right**” (para. 5.6A) and “**each** of an entity’s rights is a separate asset” (para. 5.7E), but (ii) with reference to “the set of rights arising from legal ownership of a physical object”, “the resource is **the set of rights**” (para. 5.7F).
- The need to further explore the significance of “**having control of a right**”. This construct emerges, for example, by the combination of paragraphs 5.11 (“an entity must have control of a resource”) and 5.6A (“a resource is a right”).

⁸ See for example Biondi Y. et al. (2011), “A Perspective on the Joint IASB/FASB Exposure Draft on Accounting for Leases”, *Accounting Horizons*, 25(4): 861–871; Biondi Y. et al. (2014), “‘Old Hens Make the Best Soup’: Accounting for the Earnings Process and the IASB/FASB Attempts to Reform Revenue Recognition Accounting Standards”, *Accounting in Europe*, 2014, 11(1): 13-33.

- The need to introduce a specific paragraph (5.7C) regarding “services – for example employee services and services-in-kind – [which] are received and immediately consumed”. Indeed, the purpose of this paragraph is not clear and should be better explained in the BC.

The implications for the unit of account do not seem to have been fully explored, even if ED 81 does add a Section on Unit of Account. Indeed, the motivations for this proposed addition, as presented in BC 5.36A-BC 5.36C, do not make explicit reference to the proposed shift to a rights-based approach.

As for practical applications, an emerging issue highlighted by the literature (see footnote 8) is that a rights-based approach may pave the way to structuring opportunities by unbundling sets of rights and obligations embedded in underlying transactions.

In our view, therefore, the conceptual and practical benefits of espousing a rights-based approach in the public sector should be more extensively investigated, presented, and exemplified. The short motivations currently provided in BC 5.3B to 5.3D, conversely, seemingly place an almost exclusive emphasis on alignment with the IASB’s Conceptual Framework, as does the stated objective to amend the Conceptual Framework “in light of [...] developments in international thinking about conceptual issues”.

In the meantime, we still believe that defining an asset as a resource should mean that an asset is a storage of services⁹, not “a right to either service potential or the capability to generate economic benefits, or a right to both” (para. 5.6A)¹⁰. The concept of rights should rather be used to assess whether and how the entity presently controls this storage of services. We would thus suggest the following specifications:

- A resource is a storage of services which can provide a useful contribution to the achievement of the entity’s objectives.
- The entity must have control over these resources, which happens when the entity has rights over them.
- Rights take several forms, as well exemplified by the case of leasing as opposed to legal ownership (see BC 5.10).

⁹ Sprague, C. (1907), *The Philosophy of Accounts*, Ronald Press.

¹⁰ Accordingly, conceptually, it does not make sense to distinguish the object (for instance a building) and the services embodied in it; Kam, V. (1990), *Accounting Theory*, John Wiley and Sons, p. 103. Therefore, in this perspective, we agree with the last sentence of para. 5.7F., which highlights that “describing the set of rights as the physical object will often provide a faithful representation of those rights in the most concise and understandable way”.

Specific Matter for Comment 4: Definition of a Liability

The revised definition of a liability is in paragraph 5.14:

A present obligation of the entity to transfer resources as a result of past events.

The reasons for the revised definition are in paragraphs BC 5.18A-BC 5.18H

Do you agree with the revised definition?

If do you not agree with the revised definition, what definition do you support and why?

We agree with the proposed change to the general definition of a liability.

At the same time, we would like to emphasise, once again, that the explicit reference to non-legally binding obligations in a public-sector context is particularly problematic and may have potentially undesirable implications. On the one hand, we appreciate the examples that paragraphs 5.15F and 5.17B-D provide in order to clarify if and to what extent a present obligation may arise from a political promise, the announcement of a policy, economic coercion and so on. On the other hand, however:

- As pointed out in our comment to ED71, we would underline that, in several administrative regimes, the legal form is indisputable, so that it would be difficult, if not outright forbidden, to identify a non-legally binding obligation.
- In fact, even promises which are embodied in existing legislation and have so far been fulfilled (including promises of retirement and social benefits) may be subject to changes by law and by fiat in the future.
- The reference to non-legally binding obligations, if not carefully delimited, may pave the way to an undesirable extension in the recognition of liabilities, including promises of retirement and social benefits, as well as other general-purpose guarantees provided by the government. This extension, in turn, would undermine the meaningfulness of net assets as reported in the balance sheet.
- Critically, ED 81 does not seem to narrow the existing gap between the Conceptual Framework and IPSAS 42. According to para. 5.15F, “non-legally binding obligations that give rise to liabilities have the following attributes: (i) the entity has indicated to other parties by any published pattern of past practice, published policies, or a sufficiently specific current statement that it will accept certain responsibilities; (ii) as a result of such an indication, the entity has created a valid expectation on the part of those are the parties that it will discharge those responsibilities; and (iii) the entity has little or no realistic alternative to avoid settling the obligation arising from those responsibilities”. These attributes seemingly provide the basis for a much more extensive recognition of liabilities than IPSAS 42 currently allows for. This inconsistency is confirmed by the publication, in the BC to IPSAS 42, of a detailed alternate view (BC74–BC93) which also makes explicit reference to non-legally binding obligations (BC86).

In addition to our concerns regarding non-legally binding obligations, we would like to highlight two further issues of a more formal nature.

The first issue relates to the conditions for the existence of a present obligation as listed in paragraph 5.17A. Condition (a), in particular, requires that “the entity has already obtained service potential or economic benefits or taken an action”. The reference to “taking an action” presumably refers to non-exchange transactions. In the public sector, however, obligations from non-exchange transactions often arise not because the entity has taken an action, but because a higher tier of government has done so (e.g., by passing a law that requires the entity to make payments to certain classes of beneficiaries). The wording of paragraph 5.17A could be modified to better capture this case.

The second issue relates to the presence of some inconsistencies in terminology between ED 81 and EDs 70-71-72. At this stage, these inconsistencies are inevitable. However, they will need to be resolved before final approval.

Specific Matter for Comment 5: Guidance on the Transfer of Resources

The IPSASB has included guidance on the transfer of resources in paragraphs 5.16A-5.16F of the section on Liabilities. The reasons for including this guidance are in paragraphs BC5.19A-BC5.19D

Do you agree with guidance?

If not, how would you modify it?

Yes, we agree, subject to the concerns expressed in our response to SMC 4.

Specific Matter for Comment 6: Revised Structure of Guidance on Liabilities

In addition to including guidance on the transfer of resources, the IPSASB has restructured the guidance on liabilities so that it aligns better with the revised definition of a liability. This guidance is in paragraphs 5.14A-5.17D. Paragraph BC5.18H explains the reasons for this restructuring.

Do you agree with this restructuring?

If not, how would you modify it?

Yes, we agree, subject to the concerns expressed in our response to SMC 4.

Specific Matter for Comment 7: Unit of Account

The IPSASB has added a section on Unit of Account in paragraphs 5.26A-5.26J. The reasons for proposing this section are in paragraphs BC5.36A-BC5.36C

Do you agree with the addition of a section on Unit of Account and its content?

If not, how would you modify it and why?

In general, we agree that the selection of a unit of account has to be based on relevance and faithful representation, as well as on other qualitative characteristics (see BC5.36C) and cost-benefit constraints (see para 5.26E).

The definition of the unit of account is based on the definitions of assets and liabilities and then on “rights” and “obligations”. Therefore, please see our comments on SMC 3 regarding both the rights-based approach *per se* and the need to further explore its implications for the unit of account.

Specific Matter for Comment 8: Accounting Principles for Binding Arrangements that are Equally Unperformed

The IPSASB took the view that guidance on accounting principles for binding arrangements that are equally unperformed should be included in the Conceptual Framework, but that a separate section on accounting principles for such binding arrangements are unnecessary. These principles are included in paragraphs 5.26G-5.26H of the section on Unit of Account. The explanation is at paragraphs BC5-36D-BC5.36F.

Do you agree that:

- (a) Guidance on principles for binding arrangements that are equally unperformed is necessary; and if so
- (b) Such guidance should be included in the Unit of Account section, rather than in a separate section?

If you do not agree, please give your reasons.

In general, we are always in favour of providing guidance to support preparers and users. Therefore, we agree with the provision of guidance on principles for bindings arrangements that are equally unperformed.

However, we think it would be better to provide such guidance in a separate section. This is also because, with respect to equally unperformed arrangements, the ED provides guidance that exceeds narrow unit-of-account considerations by stipulating that the entity may have an asset or a liability depending on whether the “terms of the exchange are currently favourable [or] unfavourable” (para. 5.26G).

To the extent that this is consistent with the nature and style of a Conceptual Framework, further exemplifications would also be helpful.

Date: May 18th, 2022

Signed on behalf of the persons listed below:

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